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**Does the proposed Dividends Tax overcome the international tax flaws that Secondary Tax on Companies may have, namely exclusion from the scope of some Double Tax Agreements and violation of the anti-discrimination provisions embodied in the OECD Model Tax Convention?**

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## ABSTRACT

STC and the new dividends tax and its exemptions therefrom could be in contravention of the non-discrimination provisions of Article 24(5) of the OECD MTC. This question has not been decided in a South African court. This dissertation proposes the resolution to this question. The outcome of this research may be particularly relevant in the context of the proposed new dividends tax and value extraction tax (“VET”) and the exemptions therefrom, which are, again, based on residency.

The interpretational rules applicable to tax treaties and fiscal legislation in South Africa are applied to the analysis of STC; the new dividends tax; and the relevant DTA articles. The OECD Model provides the core commentary considering that most South African DTAs are based on this model. A comprehensive analysis of the arguments for and against the contention that the STC provision violates Article 24(5) of the OECD MTC is provided in this dissertation.

In any South African litigation, it would appear that the application of the non-discrimination provision should prevail over the conflicting residence requirement of s 64B(5)(f), with the result that South African companies should be entitled to claim the relief afforded by s 64B(5)(f) on the dividends they declared to other companies in the same group, even if the latter are not resident in South Africa, provided that they are resident in a country with whom South Africa had a DTA which includes a prohibition of discrimination along the lines of Article 24(5). However, it is submitted that after taking into consideration recently decided foreign tax cases, this cannot be the case.

In the South African context, the type of discrimination covered by Article 24(5) is solely the discrimination against a subsidiary in South Africa on the grounds that its capital is wholly or partly owned or controlled in a foreign country. For the reasons given in the *Boake Allen* House of Lords [United Kingdom] decision, there exists persuasive influence that the provisions of s 64B(5)(f) did not discriminate against the South African subsidiaries of foreign companies on that ground. The contention that the exemption provided for in s 64B(5)(f) violated the non-discrimination provisions embodied in South African DTAs would therefore probably not be sustained in a South African court. It is submitted that the real

ground for the different treatment is whether the recipient is liable to pay STC, and not the residence of the owner. Therefore it is submitted that this type of discrimination is not that which is prohibited by the non-discrimination provision.

Paragraph 5 of Article 24 of the OECD MTC is aimed at ensuring that all resident companies are treated equally regardless of who owns or controls their capital and does not seek to ensure that distributions to residents and non-residents are treated in the same way. Accordingly, it is submitted that the proposed dividends tax would not violate the anti-discrimination provisions embodied in the OECD model tax convention.

Accordingly, it is submitted that no resolutions are required.

University of Cape Town

## TABLE OF CONTENTS

<b>ABSTRACT</b> .....	<b>ii</b>
<b>TABLE OF CONTENTS</b> .....	<b>iv</b>
<b>ABBREVIATIONS AND GLOSSARY</b> .....	<b>vi</b>
<b>CHAPTER 1</b> .....	<b>1</b>
<b>INTRODUCTION</b> .....	<b>1</b>
1.1 <i>Discrimination on the basis of tax residency</i> .....	1
1.2 <i>Background</i> .....	2
1.3 <i>Purpose and value of the research</i> .....	5
1.4 <i>Research problem</i> .....	5
1.5 <i>Limitations of scope to the dissertation</i> .....	6
1.6 <i>Structure of the dissertation</i> .....	6
<b>CHAPTER 2</b> .....	<b>8</b>
<b>NON-DISCRIMINATION AND INTERPRETATION METHODOLOGY</b> .....	<b>8</b>
2.1 <i>Introduction</i> .....	8
2.2 <i>The approach to interpreting a treaty</i> .....	8
2.3 <i>Non-discrimination</i> .....	10
2.3.1 <i>Nationality based non-discrimination</i> .....	11
2.3.2 <i>Residency based non-discrimination</i> .....	13
2.4 <i>Restriction on the scope of the articles</i> .....	15
2.5 <i>Conclusion</i> .....	16
<b>CHAPTER 3</b> .....	<b>18</b>
<b>DOES STC VIOLATE THE NON-DISCRIMINATION PROVISIONS?</b> .....	<b>18</b>
3.1 <i>Introduction</i> .....	18
3.2 <i>Background to STC</i> .....	18
3.3 <i>The discriminatory scenario</i> .....	20
3.4 <i>Arguments against the application of the non-discrimination article:</i> .....	21
3.4.1 <i>The application of the non-discrimination article could have an anomalous effect</i> .....	22
3.4.2 <i>The non-discrimination article simply required that, for the exemption to apply, the shareholder to which the dividend accrued was a resident</i> .....	24
3.5 <i>Arguments for the contention that STC violated the non-discrimination provisions embodied in South African DTAs</i> .....	25
3.5.1 <i>Validity of the non-discrimination provision on South Africa under International law</i> .....	25
3.5.2 <i>Application of the non-discrimination provision to domestic tax law</i> .....	27

3.5.3 The exemption contravenes Article 24(5) in that it differentiates between companies resident in South Africa and discriminates against South African companies whose capital is wholly or partly owned offshore .....	28
3.5.4 The appropriate comparator - a “similar enterprise” .....	29
3.5.5 Argument for inclusion of STC in the scope of DTA’s non-discrimination clauses .....	34
3.5.6 Further support for the application of Article 24(5) in favour of South African companies on the ground that their shareholders are resident in the foreign State and not in South Africa.....	35
3.6 <i>Foreign influence on whether the contention that STC violated the non-discrimination provisions embodied in South African Double Tax Treaties</i> .....	36
3.7 <i>Conclusion</i> .....	42
<b>CHAPTER 4.....</b>	<b>44</b>
<b>DIVIDENDS TAX.....</b>	<b>44</b>
4.1 <i>Introduction</i> .....	44
4.2 <i>Exclusion from the scope of some DTAs and violation of other DTA principles?</i> .....	44
4.3 <i>Violation of the non-discrimination provisions embodied in the OECD model tax convention?</i> .....	46
4.3.1 Dividend exemptions .....	46
4.3.2 Exemptions to the VET.....	47
4.3.3 Violation of the anti-discrimination provisions embodied in the OECD model tax convention? .....	47
4.4 <i>Conclusion</i> .....	48
<b>CHAPTER 5.....</b>	<b>49</b>
<b>CONCLUSION .....</b>	<b>49</b>
<b>BIBLIOGRAPHY .....</b>	<b>54</b>

## **ABBREVIATIONS AND GLOSSARY**

CSARS	Commissioner for the South African Revenue Service
DTA / treaty	Double Tax Agreement / Double Tax Convention
DTC	Double Tax Convention
EU	European Union
ITA	Income Tax Act 58 of 1962 (as amended)
OECD	Organisation for Economic Co-operation and Development
OECD Model	OECD Model Tax Convention on Income and on Capital
OECD MTC Commentary	Commentary on the OECD Model Tax Convention on Income and on Capital
SARS	South African Revenue Service
State	Country or Contracting State in a bilateral DTA
The source State	The State (country) of Source
The residence State	The State (country) of Residence
STC	Secondary Tax on Companies
UN Model	United Nations Model Double Taxation Convention between Developed and Developing Countries
USA Model	USA Model Income Tax Convention
VCLT	Vienna Convention on the Law of Treaties

# CHAPTER 1

## INTRODUCTION

### *1.1 Discrimination on the basis of tax residency*

No decided cases exist in the South African jurisdiction on the issue of discrimination on the basis of tax residency. There is accordingly a likelihood that our legal system will yet have to determine a contention similar to the one that arose in the House of Lords (United Kingdom) concerning Advanced Corporation Tax.<sup>1</sup> The South African context of such a decision is the STC exemptions based on residency, or the new dividends tax and the exemptions therefrom based on residency. This issue is of particular relevance as certain multinational companies have sought to argue that South African subsidiary companies could declare dividends to non-resident group holding companies without paying STC. The contention is that STC, in the above instances, contravenes the non-discrimination provisions embodied in South Africa's Double Tax Agreements with other nations (DTA's).

Since its re-introduction into the world economy and political arena in 1994, South Africa has entered into a significant number of DTAs and it now has an extensive DTA network. As at April 2010, 66 DTAs were in force with governments around the world. Almost all DTAs entered into by South Africa prior to 1994 contained a non-discrimination (ND) article. The ND articles, in most instances, replicate that of the OECD MTC.

“During 2004 the issue arose under South African domestic law regarding whether the fact that dividends declared to South African resident companies (and not dividends declared to non-resident companies) were exempt from secondary tax on companies under s 64B(5)(f) of the Income Tax Act, [...]”<sup>2</sup> was valid.

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<sup>1</sup> *Boake Allen Limited and others (Appellants) v. Her Majesty's Revenue and Customs (Respondents)*. 2007. Session 2006-07 UK: House of Lords.

<sup>2</sup> *International Tax, A South African Perspective 2008*, 4<sup>th</sup> Edition, Lynette Olivier, Michael Honiball p. 375.

The kind of differentiation prohibited by a sub-paragraph of the ND article<sup>3</sup> of the OECD MTC is the imposition of “any taxation or any requirement connected therewith” on some South African residents which is “other or more burdensome” than that imposed on others. Section 64B(5)(f), as originally enacted, provided that when a company declared a dividend in favour of another company in the same group of companies, the dividend was exempt from STC but only if the recipient of the dividend was resident in South Africa.<sup>4</sup> In other words, section 64B(5)(f) required that some South African companies paid STC on their dividends declared to holding companies, but exempted others from such tax.

As part of the annual amendments to the South African Income Tax Act in 2004, s 64B(5)(f) was amended in 2004, to remove the reference to residents and make the exemption subject to it being subject to STC in the hands of the recipient. The amendment was effective from 26 August 2004. The purpose of the amendment was to eliminate any possibility of the kind of differentiation described above, from occurring. However, on the assumption that s 64B(5)(f), as originally enacted, did amount to discrimination on the basis of residency, “it is doubtful whether the amendment succeeded in its purpose. Although the wording of the article no longer distinguishes between residents and non-residents, in substance the exemption is not available to non-residents”.<sup>5</sup>

## **1.2 Background**

In addition to normal tax, companies are also liable for a tax known as Secondary Tax on Companies (STC) under section 64B of the ITA 58 of 1962, which is a tax on dividends declared by South African companies. STC is currently levied at the rate of 10% on the amount by which the dividend declared exceeds the sum of any dividends (with certain exceptions) which had accrued to the company in the dividend cycle.

In effect, a company that acts as a conduit of a dividend stream which it receives and passes on, is not liable for STC. The purpose of this rule is to avoid the cascading effect if the STC was levied every time a dividend stream passed through an intermediate company on its way from its source to its ultimate recipients, the ultimate shareholders. The rule avoids this

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<sup>3</sup> *OECD MTC*, Article 24(5)

<sup>4</sup> S. 64B(5)(f)(iii) as originally enacted. Since 2004 the requirement of residence has been replaced by a requirement that the recipient company must itself be potentially liable to STC.

<sup>5</sup> *International Tax, A South African Perspective 2008*, 4<sup>th</sup> Edition, Lynette Olivier, Michael Honiball p. 377.

cascading effect by levying STC on the dividend stream only when it leaves the STC net i.e. when it is declared to the ultimate shareholders (or when it leaves the Republic).

There are exceptions to this rule in that certain dividend receipts do not qualify for set-off against dividends declared. The major exception being that dividends from non-SA resident companies do not count as dividends which had accrued to the company for this purpose (see section 64B(3)(b) (now 64B(3A)(d)) of the ITA)). It appears that the reason for this treatment is that such dividends would not have been subject to STC in the hands of the company declaring the dividend. However, for the purposes of this dissertation, the exceptions to this rule are not important.

The relief afforded to group companies is significant for two reasons. The first is that it defers liability for STC for so long as the dividend stream winds its way through the various tiers within the group and becomes payable only when the dividend stream leaves the group. This has an obvious cash-flow benefit. The second is that, if the dividend flow remains within the group and never leaves it, no STC is payable on it at all. This happens if the ultimate recipient of the dividend stream within the group (the holding company) does not declare a dividend. In such cases, the relief afforded to subsidiary group companies by subsection (5)(f) is to exempt them from STC altogether.

However, a dividend declared by one group company to another company within the same group was exempt under subsection (5)(f) only if the recipient was resident in South Africa. The reason for this requirement was to promote the policy of retaining investment in the South African economy. If a South African group company declared a dividend to another group company offshore, the dividend did not qualify for exemption. It meant the moment the dividend stream went offshore, the South African company that declared the dividend to its foreign shareholder had to pay STC.

Although the policy of the residence requirement was sound, it did impact adversely on South African companies whose holding companies were based offshore. If a South African company declared a dividend to its South African holding company, STC was not payable by the subsidiary (if the group exemption election was made) and was only payable by the holding company if and when it in turn declared a dividend to a shareholder outside the group. On the other hand, if a South African company declared a dividend to its offshore

holding company, the South African company was immediately liable for STC, whatever the fate of the dividend in the hands of its offshore holding company. This was the supposed disadvantage (or “more burdensome taxation”) of which some multinational groups complained on the basis that it contravened the prohibition against discrimination in the DTAs between South Africa and the countries in which their holding companies were resident.

“The South African authorities denied that the exemption amounts to discrimination towards non-residents (see Trevor Manual (Minister of Finance) Press Announcement Pretoria 26 August 2004) [...]

The Minister’s position was presumably based on the fact that as non South African resident companies would never be liable to pay STC, if their subsidiaries enjoyed an STC exemption it would place international groups in a better position than solely South African resident groups. In addition, it may be argued that if the aim of the treaty (which is to relieve double taxation) is taken into account, s 64B(5)(f) cannot amount to discrimination.”<sup>[6]</sup>

“One of the counter arguments was that, for the specific purposes of Article 24(5) of the OECD MTC, the tax position of the recipient of the dividend is irrelevant, it is solely the taxation of the comparative subsidiary that is at issue. On that basis the discrimination as envisaged in Article 24(5) does exist. In addition, while non-South African resident parent companies may not pay STC per se, this does not mean that international groups are necessarily in a better position than South African groups. The dividends may still be liable to tax in the hands of the parent companies and/or their shareholders in their home jurisdictions (which may contrast with the South African position where the dividends would be exempt). On this interpretation, Article 24(5) merely amounts to a division of taxing rights between Contracting States”.<sup>7</sup>

According to the OECD MTC commentary which accompanies the model articles, the non-discrimination provision prohibits a contracting State from providing less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other contracting State. It further points out that the discrimination which is targeted relates to the taxation only of the enterprise and not of the persons owning or controlling its capital. The object is to ensure equal treatment for taxpayers residing in the same State. To quote the relevant paragraph from the 2010 OECD MTC commentary:

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<sup>6</sup> *International Tax, A South African Perspective 2008*, 4<sup>th</sup> Edition, Lynette Olivier, Michael Honiball p. 375.

<sup>7</sup> *Ibid* at p. 376

“This paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital.”<sup>8</sup>

### ***1.3 Purpose and value of the research***

This dissertation seeks to resolve the question whether the residence requirement for exemption under section 64B(5)(f) contravened the prohibition of discrimination in Article 24(5) of the OECD Model Convention with respect to Taxes on Income and on Capital (“OECD MTC”). The implications of such contravention (if any) and its proposed cure must then also be considered. The outcome of this research may be particularly relevant in the context of the proposed new dividends tax and value extraction tax (“VET”) and the exemptions therefrom, which are, again, based on residency.

### ***1.4 Research problem***

STC and the new dividends tax and its exemptions therefrom could be in contravention of the non-discrimination provisions of Article 24(5) of the OECD MTC as well as violate other provisions of the OECD MTC. This question has not been decided in a South African court. This dissertation proposes the resolution to these questions.

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<sup>8</sup> *OECD MTC Commentary*, 22 July 2010, Commentary on Article 24(5), at p. 350, Para. 76

### ***1.5 Limitations of scope to the dissertation***

This dissertation will examine the South African income tax exemption provisions of STC as well as the new dividends tax and certain aspects of the DTA non-discrimination provisions. Nationality based non-discrimination is limited to the context created by cases decided in South Africa. International cases (United Kingdom) on discrimination in a tax context are relied upon to the extent that the taxes considered are similar to STC, such as the Advanced Corporations Tax which was considered to be in contravention of Article 24(5) of the OECD MTC or its equivalent. Despite the plethora of EU case law on non-discrimination in recent years, these judgments are only binding on EU States. Such case law has therefore been excluded from the scope of this dissertation. This dissertation does not examine the domestic tax law of any other countries or any other taxes.

### ***1.6 Structure of the dissertation***

Chapter 2 provides an approach to the interpretation of tax treaties and the methodology for the analysis of the DTA articles. Attention is then drawn to relevant provisions in Article 24 of the OECD. A brief discussion of case law in South Africa where non-discrimination based on nationality has been in issue is provided, in order to gain any valuable insight from those cases which may be relevant in the interpretation of the residency based non-discrimination article. A brief analysis of Article 24(5) is provided next to illustrate why this particular provision is the one which certain multinationals may wish to rely upon in the context of STC and dividends tax. A more detailed analysis of this article appears in chapter 3. The scope of these non-discrimination provisions is then addressed in order to assess whether or not they will apply to all SA taxes.

Chapter 3 considers whether or not STC violates the non-discrimination provisions embodied in South African Double Tax Treaties (“DTAs”). A background to STC is provided including a more detailed reference to the provision which may violate the non-discrimination provisions within the South African DTAs. Arguments for and against a possible contention that the STC provision contravenes the non-discrimination Article 24(5) of the OECD MTC are provided. International judicial experience is considered before concluding remarks are

made on these arguments. The chapter concludes with a submission as to whether or not the STC exemption considered, contravenes the non-discrimination article.

Chapter 4 scrutinises the new dividends tax and its exemptions against the background of STC which the new tax replaces, for any possible violations of DTA principals including a possible contravention of the non-discrimination provisions embodied in the OECD MTC.

Chapter 5 summaries and concludes the dissertation.

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## CHAPTER 2

### NON-DISCRIMINATION AND INTERPRETATION METHODOLOGY

#### *2.1 Introduction*

In order to answer the research question as to whether or not the STC and dividends tax exemptions contravene the non-discrimination article, it is first essential to obtain an understanding of the article by applying an interpretational methodology. This chapter serves to achieve that purpose.

This chapter provides a definition of non-discrimination in a tax context and then highlights the purpose of the various non-discrimination provisions in Article 24 of the OECD MTC. In this context the chapter goes on to analyse paragraph 1 of Article 24. In the absence of decided cases in the South African jurisdiction on the issue of discrimination on the basis of tax residency, it is considered prudent and insightful to include in the discussion a brief analysis of instances of case law that have arisen in South Africa where non-discrimination based on nationality has been in issue. Article 24(5) is considered in the context of why this particular paragraph of the non-discrimination provisions is relevant to the issues facing certain multinational companies. Further analysis of Article 24(5) is provided in chapter 3.

#### *2.2 The approach to interpreting a treaty*

The approach to the interpretation of tax treaties as set out below provides the methodology for the analysis of DTA articles as discussed in this dissertation.

In *IRC v Commerzbank*,<sup>9</sup> Mummery J summarised the approach to treaty interpretation laid down by the House of Lords in *Fothergill v Monarch Airlines Ltd* [1981] AC 251 in the following way:

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<sup>9</sup> [1990] STC 285, 297-8

“(1) It is necessary to look first for a clear meaning of the words used in the relevant article of the convention, bearing in mind that 'consideration of the purpose of an enactment is always a legitimate part of the process of interpretation': per Lord Wilberforce (at 272) and Lord Scarman (at 294). A strictly literal approach to interpretation is not appropriate in construing legislation which gives effect to or incorporates an international treaty: per Lord Fraser (at 285) and Lord Scarman (at 290). A literal interpretation may be obviously inconsistent with the purposes of the particular article or of the treaty as a whole. If the provisions of a particular article are ambiguous, it may be possible to resolve that ambiguity by giving a purposive construction to the convention looking at it as a whole by reference to its language as set out in the relevant United Kingdom legislative instrument: per Lord Diplock (at 279).

(3) Among those principles is the general principle of international law, now embodied in article 31(1) of the Vienna Convention on the Law of Treaties, that 'a treaty should be interpreted in good faith and 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'. A similar principle is expressed in slightly different terms in McNair's *The Law of Treaties* (1961) p 365, where it is stated that the task of applying or construing or interpreting a treaty is 'the duty of giving effect to the expressed intention of the parties, that is, their intention as expressed in the words used by them in the light of the surrounding circumstances'. It is also stated in that work (p 366) that references to the primary necessity of giving effect to 'the plain terms' of a treaty or construing words according to their 'general and ordinary meaning' or their 'natural signification' are to be a starting point or prima facie guide and 'cannot be allowed to obstruct the essential quest in the application of treaties, namely the search for the real intention of the contracting parties in using the language employed by them'.

(4) If the adoption of this approach to the article leaves the meaning of the relevant provision unclear or ambiguous or leads to a result which is manifestly absurd or unreasonable recourse may be had to 'supplementary means of interpretation' including travaux préparatoires: per Lord Diplock (at 282) referring to article 32 of the Vienna Convention, which came into force after the conclusion of this double taxation convention, but codified an already existing principle of public international law. See also Lord Fraser (at 287) and Lord Scarman (at 294).

(5) Subsequent commentaries on a convention or treaty have persuasive value only, depending on the cogency of their reasoning. Similarly, decisions of foreign courts on the interpretation of a convention or treaty text depend for their authority on the reputation and status of the court in question: per Lord Diplock (at 283–284) and per Lord Scarman (at 295).”<sup>10</sup>

The following approach to the interpretation of tax treaties is therefore to be applied in this dissertation. First, an understanding or clear meaning of the words used through analysis of

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<sup>10</sup> *IRC v Commerzbank* [1990] STC 285, 297-8

definitions and commentaries will be provided. If the provisions of an article are ambiguous it may be possible to resolve that ambiguity using the purposive approach. A treaty should be interpreted in good faith giving effect to the intention of the parties in the light of the surrounding circumstances. Subsequent commentaries on the treaties have persuasive value only. Decisions of foreign courts on the interpretation of a treaty depend for their authority on the reputation and status of the court in question.

### **2.3 Non-discrimination**

“In a taxation context, discrimination can be regarded as an unfavourable treatment of a taxpayer in comparison with another taxpayer or category of taxpayers in respect of the same taxable item(s) and in the same circumstances.”<sup>11</sup>

The following passages from the OECD MTC Commentary highlights that the various provisions of Article 24 use different language to achieve the same result:

“The various provisions of Article 24 prevent differences in tax treatment that are solely based on certain specific grounds (e.g. nationality, in the case of paragraph 1). Thus, for these paragraphs to apply, other relevant aspects must be the same. The various provisions of Article 24 use different wording to achieve that result (e.g. "in the same circumstances" in paragraphs 1 and 2; "carrying on the same activities" in paragraph 3; "similar enterprises" in paragraph 5). Also, whilst the Article seeks to eliminate distinctions that are solely based on certain grounds, it is not intended to provide foreign nationals, non-residents, enterprises of other States or domestic enterprises owned or controlled by non-residents with a tax treatment that is better than that of nationals, residents or domestic enterprises owned or controlled by residents...”<sup>12</sup>

Based on the definition of discrimination provided above and the OECD MTC Commentary, it is submitted that discrimination is different tax treatment between similar taxpayers in comparable circumstances that is solely based on certain specific grounds (e.g. nationality, in the case of paragraph 1 or residency, in the case of paragraph 5 of Article 24). The term “other similar enterprises” is analysed in detail in chapter 3.

In the absence of any decided cases in the South African jurisdiction on the issue of discrimination on the basis of tax residency, discrimination based on nationality primarily in

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<sup>11</sup> Kevin Holmes, *International Tax Policy and Double Tax Treaties*, IBFD, 2007, p. 400.

<sup>12</sup> *OECD MTC Commentary*, Commentary on Article 24(1), at p. 333, Para. 5

the context of non-residents shareholders tax (“NRST”) on dividends where the provision discriminated between nationals of South Africa and nationals of the other State, is now considered.

### ***2.3.1 Nationality based non-discrimination***

Paragraph 1 of Article 24 of the OECD MC states the general principle “...that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances”.<sup>13</sup>

“Nationals of a Contracting State shall not be subjected in any other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which Nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States”.<sup>14</sup>

Article 24 of the OECD MTC also applies to persons who are not residents of one or both of the Contracting States, notwithstanding the provisions of Article 1 of the OECD MTC. This highlights the fact that the terms “national” and “resident” are different concepts.

“The term “national”... means any individual possessing the nationality... of a Contracting State; and any legal person or association deriving its status from the laws in force in a Contracting State”.<sup>15</sup>

Discrimination does not apply if the tax is uniformly applicable to resident and non-resident corporations. The issue of non-discrimination on the basis of nationality has been considered by the South African judiciary<sup>16</sup> in the context of non-residents shareholders tax (“NRST”) on dividends. In these cases, foreign companies receiving dividends from a South African company were subject to NRST, unlike a South African company in the same position.

In ITC 1544<sup>17</sup> “it was held that the provision in the Income Tax Act imposing NRST on companies which were not South African resident companies was invalid and that it contravened the DTA entered into between South Africa and the Netherlands. The provision

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<sup>13</sup> *OECD MTC Commentary*, Commentary on Article 24(1), at p. 333, Para. 5

<sup>14</sup> *OECD MTC*, Article 24(1)

<sup>15</sup> *OECD MTC*, Article 3(1)(g)

<sup>16</sup> *ITC 1544, BAT v. COT*, 57 SATC 271

<sup>17</sup> 54 SATC 456

was found to discriminate between nationals of South Africa and nationals of the Netherlands. This was prohibited by the specific DTA, which required that nationals of one State should not be subjected in the other Contracting State to any taxation which was other or more burdensome than the taxation to which nationals of that other State in the same circumstances, in particular with respect to residence, were or might be subject[ed]. In consequence, the relevant provisions of the Income Tax Act were amended to avoid such discrimination in future by imposing NRST on all companies whose effective management was outside South Africa. It was further held that:<sup>18</sup>

“the effect of section 108(2) of the Income Tax Act is to grant statutory relief in certain circumstances where the South African Act imposes a tax, where the provisions of a double tax convention grants immunity or exemption from such tax to persons governed by the Convention. Tax is not payable to the extent to which an immunity or exemption from tax is granted in terms of a binding double tax Convention which has been proclaimed and thus has statutory effect”.

Since the sole criterion for the imposition of the NRST was the nationality of the company receiving the dividends, it was held to be discriminatory. NRST was subsequently abolished.

On the other hand, in another case<sup>19</sup> described below where legislation imposed a dividend withholding tax on the basis of a shareholder company’s place of effective management it was held that this did not amount to discrimination on the basis of nationality.

In *Cohen Brothers Furniture*<sup>20</sup> the Court had to decide whether a withholding tax imposed under the Ciskeian Income Tax Act 44 of 1984 (“the Ciskei Act”) imposed on companies which had their effective management outside the Ciskei violated the non-discrimination clause in the Ciskei treaty. The taxpayer company was incorporated in South Africa and had its place of effective management in South Africa. It owned all the shares of a company incorporated in the Republic of Ciskei.<sup>21</sup>

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<sup>18</sup> Kruger, L. 2008. *Branch Reporter - South Africa. IFA. Page 531*

<sup>19</sup> *Cohen Brothers Furniture (Pty) Ltd; Allied Re-insurance Co (Pty) Ltd v. The Minister of Finance and the Commissioner for Inland Revenue* 1998 (2) SA 1128 (SCA).

<sup>20</sup> *Cohen Brothers Furniture (Pty) Ltd; Allied Re-insurance Co (Pty) Ltd v. The Minister of Finance and the Commissioner for Inland Revenue* 1998 (2) SA 1128 (SCA).

<sup>21</sup> The Republic of Ciskei was created as an independent homeland from the territory of South Africa pursuant to the “apartheid” political system (abolished in 1990). The existence of these homelands as separate and distinct countries was, however, never recognised under international law, and consequently only South Africa respected the “sanctity” of double tax treaties concluded by these “countries”.

“The dispute was resolved by the South African Supreme Court of Appeal (“SCA”), as the Republic of Ciskei no longer existed at the time of the litigation. The issues were whether the unamended Ciskeian legislation imposing dividend withholding tax discriminated solely on grounds of nationality; and if it did, whether any withholding tax erroneously paid could be retained to offset a liability for dividend withholding tax that may be due in respect of amended legislation imposing dividend withholding tax.

The SCA held that the amended Ciskeian legislation that imposed dividend withholding tax on the basis of a shareholder company’s place of effective management did not amount to discrimination on the basis of nationality. Consequently, the amended Ciskeian legislation that imposed dividend withholding tax was not in contravention of the treaty’s non-discrimination provisions”.<sup>22</sup>

While the OECD MTC Commentary states that “the different language used in the various non-discrimination provisions is designed to achieve the same result” the provisions do differ in some material respects. The cases decided in the South African courts (discussed above) were limited to instances where Article 24(1) and nationality based non-discrimination applied. The issue of residency based non-discrimination, however, has not been brought before the South African judiciary. Some guidance concerning the general principals of the non-discrimination provisions may be drawn from the South African cases discussed above. However, specific guidance concerning residency based discrimination (as pertains to STC and potentially the new dividends tax) must be sought from international experience. Those decided international cases considered relevant are discussed in later chapters. For example, the conclusion in the *NEC [UK]* case discussed in chapter 3, is consistent with the reasoning and conclusion of the Special Court in *ITC 1544*.<sup>23</sup> The interpretational methodology is now applied to Article 24(5) to the extent of obtaining a clear understanding of the words and phrases used in the residency based non-discrimination provision.

### **2.3.2 Residency based non-discrimination**

Whereas Article 24(1) addresses nationality based non-discrimination, Article 24(5) covers residency based non-discrimination. Article 24(5) has been considered in various local debates concerning STC. In addition, non-discrimination cases abroad have considered this article. Some of these international cases are analysed in chapters 3 and 4, as far as is

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<sup>22</sup> *Cohen Brothers Furniture (Pty) Ltd; Allied Re-insurance Co (Pty) Ltd v. The Minister of Finance and the Commissioner for Inland Revenue* 1998 (2) SA 1128 (SCA), Editors note.

<sup>23</sup> 54 SATC 456

relevant to the scope of this dissertation. However, in order to gain an initial understanding of Article 24(5), an analysis of the relevant definitions<sup>24</sup> and commentary<sup>25</sup> is considered. The purpose is to obtain a clear meaning of the words used. Article 24(5) deals specifically with the situation where there is an:

“enterprise of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, [...]”

The differences between Article 24(5) of the OECD MTC and Article 24(1) include the following: the word “Enterprise” supersedes “National” and there is a reference to residency (“residents”). Further, there is a reference to “ownership and control of capital by residents of the other State”.

The term “enterprise of a Contracting State” is defined as meaning “an enterprise carried on by a resident of a Contracting State”<sup>26</sup> and the term “enterprise” is defined as applying to the “carrying on of any business”.<sup>27</sup> It is submitted that it is the company that is taxed in respect of the enterprise and it would be arguable that this definition would extend to the company carrying on business in the country in question - South Africa. It follows that this provision may be applicable to business enterprises (subsidiaries) with non-resident holding companies, carrying on business in South Africa, in other words, South African multinationals.

In such a case an enterprise “...shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected”.<sup>28</sup> This final part of the provision is very similar to that of Article 24(1).

The research question is whether or not the STC and dividends tax exemptions contravene the non-discrimination principles of Article 24(5) of the OECD MTC. Based on the analysis of Article 24(5) thus far, it does appear that to deprive a South African subsidiary of the exemption from paying STC because its holding company is not resident in South Africa, but to grant such exemption to another South African subsidiary, because its holding company is resident in South Africa, would appear to be discrimination contrary to the prohibition in

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<sup>24</sup> *OECD MTC*

<sup>25</sup> *OECD MTC Commentary*

<sup>26</sup> *OECD MTC*, Article 3(1)(d)

<sup>27</sup> *OECD MTC*, Article 3(1)(c)

<sup>28</sup> *OECD MTC*, Article 24(5)

Article 24(5). The OECD MTC Commentary which accompanies the model articles, states that the provision prohibits a Contracting State from giving less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. It would be arguable that the discrimination which is targeted relates to the taxation only of the enterprise and not of the persons owning or controlling its capital, the object being to ensure equal treatment for taxpayers residing in the same State. However, as mentioned previously, specific guidance concerning residency based discrimination (as pertains to STC and potentially the new dividends tax) must be sought from international experience. This is particularly relevant in considering, for example, the meaning of the words “other similar enterprises”.<sup>29</sup> In other words “what is the correct comparator”? An analysis to this and other issues is provided in chapter 3.

The next section considers whether or not the provisions of the non-discrimination articles based on those contained in the OECD MTC cover all taxes or only those specifically covered in the DTA.

#### ***2.4 Restriction on the scope of the articles***

Almost all non-OECD members have reserved their right to restrict the scope of the articles to the taxes covered by the DTA in the context of the Model Convention, but South Africa has not. In a South African context, therefore, paragraphs (1) and (5) of Article 24 should be interpreted as prohibiting discrimination under all taxes, and not only those specifically covered by the DTA. “The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description”.<sup>30</sup> STC was only introduced from 1992 and is a relatively new tax. Many of the relevant DTA’s do not specifically cover STC as part of the scope of the DTA. However, it is submitted that they should be construed to cover STC as being a substantially similar tax to South African taxes enumerated in the treaty. Refer to 3.5.5 where support for this submission is provided in more detail.

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<sup>29</sup> *OECD MTC*, Article 24(5)

<sup>30</sup> *OECD MTC*, Article 24(6)

## ***2.5 Conclusion***

An approach to the interpretation of tax treaties provides the methodology for the analysis of DTA articles. The methodology adopted is to first look for a clear meaning of the words used and if the provisions of an article are ambiguous it may be possible to resolve that ambiguity using the purposive approach. A treaty should be interpreted in good faith giving effect to the intention of the parties in the light of the surrounding circumstances. Subsequent commentaries on the treaties have persuasive value only. Decisions of foreign courts on the interpretation of a treaty depend for their authority on the reputation and status of the court in question. For the purposes of this dissertation, relevant cases decided in UK courts, particularly those decided in the House of Lords [UK], have persuasive influence on the interpretation of a DTA.

Discrimination in a tax context may be described as different tax treatment between taxpayers in comparable circumstances that is solely based on certain specific grounds. The non-discrimination provisions of the OECD MTC seek to prohibit this kind of discrimination.

The OECD MTC Commentary highlights that the various provisions of Article 24 use different language to achieve the same result. An example of discrimination based on nationality (which is a different tax concept to residency) was described in a South African case involving NRST where it was held that the sole criterion for its imposition of the tax was the nationality of the company receiving the dividends and thus it was held to be discriminatory. On the other hand, where legislation imposed a dividend withholding tax on the basis of a shareholder company's place of effective management it was held that this did not amount to discrimination solely on the basis of nationality. It is submitted that this demonstrates the importance of a clear understanding of the language used in the articles and that a treaty should be interpreted in good faith giving effect to the intention of the parties in the light of the surrounding circumstances. This reinforces the interpretational methodology adopted in this dissertation which provides the methodology for analysis of Article 24(5).

In the context of STC and its exemptions based on residency, certain multinationals sought to argue that to deprive a South African subsidiary of the exemption from paying STC because its holding company is not resident in South Africa, but to grant such exemption to another South African subsidiary, because its holding company is resident in South Africa, would

appear discrimination contrary to the prohibition in Article 24(5) of the OECD MTC. It is submitted that Article 24(5) relates to the taxation of the company that is taxed in respect of the enterprise and it would be arguable that this definition would extend to the company carrying on business in the country in question. This provision may be applicable to business enterprises (subsidiaries) with non-resident holding companies, carrying on business in South Africa. Many of the DTA's do not specifically cover STC as part of the scope of the DTA. However it is submitted that they should be construed to cover STC as being a substantially similar tax to South African taxes enumerated in the treaty.

Specific guidance concerning residency based discrimination (as pertains to STC and potentially the new dividends tax) must be sought from international experience. A more detailed analysis of these issues is considered in chapters 3 and 4.

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## **CHAPTER 3**

### **DOES STC VIOLATE THE NON-DISCRIMINATION PROVISIONS?**

#### ***3.1 Introduction***

This chapter considers whether or not STC violates the non-discrimination provisions embodied in South African Double Tax Treaties (“DTAs”). A background to STC is provided at the start including more detailed reference to the provision which may violate the non-discrimination provisions within the South African DTAs. To illustrate the application of the STC provision and to demonstrate the “discrimination” that results, a scenario is provided in which a group structure involving a South African subsidiary with a non-resident holding company (a resident of the United Kingdom for tax purposes) is compared to a similar group structure but replacing the non-resident holding company with that of a resident holding company.

A comprehensive analysis of the arguments that the STC provision contravenes Article 24(5) of the OECD MTC is provided. The arguments against the contention that the STC group exemption contravenes the non-discrimination article of the South African DTAs are then considered. After taking into consideration international judicial experience (considered in 3.6), concluding remarks are provided on these arguments

The chapter concludes with a submission as to whether or not the STC exemption considered contravenes the non-discrimination article.

#### ***3.2 Background to STC***

In terms of 64B(2) of the ITA; “There shall be levied and paid [...] a tax to be known as secondary tax on companies, which is calculated at the rate of 10 per cent of the net amount...of any dividend declared on or after 14 March 1996 by any company which is a resident”.

S64B(5), as it was then, provided for exemptions from STC and sub-section (f) thereof provided as follows:

“(5) There shall be exempt from the secondary tax on companies

[...]

- (f) any dividend declared by a company which accrues to a shareholder (as defined in Part III) of that company if –
  - (i) that shareholder is a company forming part of the same group of companies as the company declaring the dividend;
  - (ii) to the extent that the dividend is derived out of profits earned by that company during any period when that company formed part of the same group of companies as the shareholder to whom the dividend accrued;
  - (iii) the shareholder is a resident; and
  - (iv) [deleted]
  - (v) the company declaring the dividend elects the exemption under this paragraph to apply by submitting this election –
    - (aa) no later than the last day on which the secondary tax on companies would otherwise be due but for this paragraph (or no later than any other subsequent date prescribed by the Commissioner); and
    - (bb) in such a form as the Commissioner may prescribe.

Provided that for the purposes of this paragraph, where that shareholder was formed solely by one or more companies within that group of companies, that shareholder must be deemed to have been in existence and to have been the controlling company in relation to that company declaring the dividend from the date on which the controlling company in relation to that shareholder was formed”.

The deletion of (iv) created a situation that but for the requirement of residence of the parent, the subsidiary would be entitled to elect to be exempt from STC. It was common cause that the tax was payable and the exemption did not apply where the shareholder company receiving the dividend from the South African company was non-resident. However, the contention was raised by some taxpayers, that in certain circumstances, even where the recipient shareholder was a non-resident, the exemption from STC should still apply.

These taxpayers were relying on a provision appearing in Article 24(5) in the OECD Model Tax Convention, and which has been included in some of the South African DTAs. The application of the non-discrimination article is illustrated in a discriminatory scenario involving a group structure with a South African subsidiary and a non-resident holding company. Arguments for and against the application of the non-discrimination article in the context of the scenario are then considered.

### ***3.3 The discriminatory scenario***

In order to illustrate the application of the STC provision and to demonstrate the “discrimination” that results, the following scenario is provided in which a group structure involving a South African subsidiary with a non-resident holding company (a resident of the United Kingdom for tax purposes) is compared to a similar group structure where the non-resident holding company is replaced with that of a resident holding company.

In this scenario, the group includes a South African company that is a wholly owned subsidiary (SASub2) of a company incorporated in the Netherlands, but effectively managed in and controlled in the UK (UKP). This would make UKP tax resident of the UK for the purposes of the DTA between the Republic of South Africa and the United Kingdom of Great Britain and Northern Ireland (“SA-UK DTA”). SASub2 is tax resident in SA and has been the subsidiary of its parent, UKP, for many years.

The comparator is a South African holding company (“SAH”) with a wholly owned South African subsidiary (“SASub1”). Both SAH and SASub1 are tax resident in South Africa. SAH has been the parent of SASub 1 for many years.

SASub1 and SASub2 pay dividends to SAH and UKP respectively out of profits earned during the period that the latter were controlling companies in relation to their respective subsidiaries.

The effect of the pre-2004 version of s64B(5)(f) was that, provided SASub1 elected the group relief exemption within the prescribed time limit, any dividend declared by it to SAH was exempt from STC as all the conditions of the exemption would have been met. SASub2, on the other hand, was not able to claim the benefit of the election and pay a dividend to UKP free of STC inasmuch as UKP was not a South African resident. Despite SASub2, like SASub1, being a South African resident subsidiary wishing to pay a dividend to a parent company in the same group, SASub2 was precluded from claiming the benefit because its parent, UKP, was not a South African resident.

Assuming UKP was a resident of the United Kingdom for tax purposes, UKP would also be resident in the United Kingdom under the terms of the SA-UK DTA. Section 64B(5)(f) had

the effect of precluding SASub2 from claiming the benefit of the exemption and paying the dividend free of STC, because its parent, UKP, was not a South African resident. The question is whether or not this was discrimination against SASub2 (and indirectly UKP) contrary to Article 23(4) of the SA-UK DTA, being equivalent to Article 24(5) of the OECD MTC.

It is submitted that SASub2 is an enterprise as envisaged in Article 23(4), being a company whose capital is wholly owned by a company which is a resident of the United Kingdom for the purposes of the treaty. It may therefore not be subjected in South Africa to any taxation, or requirement connected therewith, which is more onerous than the requirements which applied to similar South African companies.

Article 23(6) further provides that “The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description”. The SA-UK DTA therefore applies irrespective of STC’s inclusion in the scope of the distributive DTA articles.

The taxpayer would submit that Article 23(4) of the UK-SA DTA prohibits the discrimination experienced by SASub2 in bearing a more onerous tax liability as it is not entitled to apply the exemption afforded to a similar company (SASub1) with a South African holding company. The resultant discrimination is exclusively caused by the ownership by a UK resident (being UKP) of the capital in SASub2. The arguments against the application of the non-discrimination article are considered in 3.4 below. The arguments in favour of such treatment being considered discriminatory are discussed in 3.5. A conclusion as to the validity of these arguments is provided at 3.7 and a more detailed conclusion is provided in chapter 5.

### ***3.4 Arguments against the application of the non-discrimination article:***

Although different meanings may be attached to the concept of “double taxation”, it is well established that the concept means the taxation of the same income twice in the hands of the same person. It does not mean that the same amount is taxed twice in the hands of different people who received it on different grounds and in different capacities.<sup>31</sup> The intention is not to provide multinational groups with a more favourable STC dispensation than domestic groups. This would be the case if these multinationals were exempted from STC altogether.

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<sup>31</sup> *Silke on South African Income Tax*, Chapter 25 Interpretation, § 25.3 Double taxation

This would effectively amount to the opposite (anomalous) effect of what the non-discrimination provisions seek to achieve.

### ***3.4.1 The application of the non-discrimination article could have an anomalous effect***

Should the non-discrimination provision override s 64B(5)(f), the effect may be anomalous and may lead to absurd results. South African companies with non-resident shareholders would enjoy an undue tax benefit (being that although SASub2 would be exempt from paying STC as would SASub 1, UKP (unlike SAH) is not subject to STC when it declares a dividend hence rather than delaying the payment of STC, it is avoided altogether) which would confer on them an unfair advantage. The South African courts are reluctant to place an interpretation on a statute that would lead to an absurd and anomalous result.<sup>32</sup>

“Applying the literal meaning to words may be departed from if the ordinary grammatical language gives rise to a glaring absurdity, and the court is justified in departing from the ordinary effect of the words to the extent necessary to remove the absurdity and to give effect to the true intention of the legislature”.<sup>33</sup>

Before a court of law is entitled to depart from the literal language of a statute or “modify” or “cut down” or “vary” the actual language of a statute it must be shown:

“that the case falls within the rule of *Rex v. Venter*, 1907 T.S. 915, which has again and again been approved and followed by this court. That rule is that, where the language of a statute is unambiguous, and its meaning is clear, the court may only depart from such meaning ‘if it leads to absurdity so glaring that it could never have been contemplated by the Legislature, or if it leads to a result contrary to the intention of Parliament as shown by the context or by such other considerations as the court is justified in taking into account’. (I quote from the judgment of INNES, C.J., in *Rex v. Venter*.)”<sup>34</sup>

“The general rule is that where the wording of such legislation is found by a court to be ambiguous, the court will follow an interpretation favourable to the taxpayer and against the *fiscus*, i.e. the Commissioner. This rule is called the *contra fiscum* rule of interpretation”.<sup>35</sup> However, the emphasis is that there must be some ambiguity in the words used in a statute if

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<sup>32</sup> *R v Bennet & Co* 1941 TPD 200

<sup>33</sup> *Silke on South African Income Tax*, Chapter 25 Interpretation, § 25.3 Double taxation

<sup>34</sup> *Savage v Commissioner for Inland Revenue* [1951] 4 All SA 249 (A), Page 253

<sup>35</sup> M T Steyn, *Interpretation of Fiscal Legislation*, 2009

there is to be any departure from the ordinary meaning of those words. Hence it is submitted that the argument against the application of the non-discrimination article is that the taxpayer would have failed to show some ambiguity in the words used.

It is submitted that should the non-discrimination provision override s 64B(5)(f), the effect would be anomalous and may lead to absurd results. South African companies with non-resident shareholders would enjoy an undue tax advantage. Rather than delaying the payment of STC, it would be avoided altogether. On the other hand, South African companies with resident shareholders can only delay the inevitable payment of STC for so long as the holding company does not declare a dividend.

As explained by the Minister of Finance in the press release of 26 August 2004: “it is not and has never been Government’s intention in enacting s 64B(5)(f) of the Act to provide multinational groups with a more favourable STC dispensation than domestic groups. The clear rationale of the election afforded by s 64B(5)(f) is a deferment of STC within a group of companies only where STC is ultimately payable”. The Minister included an announcement of an intention to introduce an amendment to the ITA, to ensure that companies which declare dividends to non-residents would not enjoy the exemption from STC in terms of section 64B(5)(f)). This amendment to section 64B was to be effected by clause 45 of the Revenue Laws Amendment Bill, 2004, and clearly confirms the rationale of SARS.

It is submitted that even if the differentiation was discrimination as contemplated in Article 24(5), the primary purpose of a DTA is the avoidance of double taxation. The provisions of the DTA cannot accordingly be used to put South African tax residents with a non-resident holding company at an advantage to other similar South African companies with South African shareholders. If the STC exemption is held to be discriminatory, the effect would be exactly the opposite. The non-resident group with South African subsidiaries would never have to pay STC on the profits of the South African subsidiaries, which would place it at an advantage to a South African tax resident group of companies.

One of the subsidiary purposes of a DTA is to promote free trade between countries and the non-discrimination provision is merely there to support this purpose and to ensure that a non-resident has an equal footing for tax purposes when competing with residents of a country in the domestic economy. The STC provision does not create this discriminatory result which

the non-discrimination provisions guard against. The non-resident parent company may, like the resident parent company, defer STC for as long as the funds are used in the business operations in South Africa. The STC exemption therefore does not tax the subsidiary of the non-resident in a manner “other or more burdensome” than the residents’ subsidiary.

***3.4.2 The non-discrimination article simply required that, for the exemption to apply, the shareholder to which the dividend accrued was a resident***

In the argument against the application of the non-discrimination provision it would also be submitted that the exemption in terms of s 64B(5)(f) applies where the dividend is paid to a “resident”, which is defined in section 1 of the Income Tax Act to mean, in the case of a company, a person “which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic”. The exemption would not apply where the dividend was not paid to a resident, as so defined.

It is further submitted that the non-discrimination article prohibits discrimination on the basis that the capital of the relevant taxpayer is wholly or partly owned or controlled by a resident of the other contracting State. The original wording of s 64B(5)(f)(iii) of the Income Tax Act did not discriminate between a company which was wholly or partly owned or controlled by a resident of the other contracting state and one which was not so owned or controlled. It simply required that, for the exemption to apply, the shareholder, as defined in the Income Tax Act, to which the dividend accrued was a resident, as defined in the Income Tax Act.

Accordingly, it is submitted that the discrimination against which the Article was directed was not the discrimination contemplated in section 64B(5)(f)(iii) of the Income Tax Act. The discrimination that arose through the normal operation of section 64B(5)(f) was that in order to claim exemption from tax, it was necessary for the parent receiving the dividend to be “resident” in the same State (South Africa) as the company paying the dividend.

### ***3.5 Arguments for the contention that STC violated the non-discrimination provisions embodied in South African DTAs***

#### ***3.5.1 Validity of the non-discrimination provision on South Africa under International law***

The prohibition of discrimination in terms of Article 24(5) occurs in a series of bilateral treaties between South Africa and other states. The rules that govern such treaties under s 231 of the Constitution distinguish between their effect at an international level and at a domestic level.

In terms of ss 231(2) and (3) of the Constitution, an international agreement becomes binding on South Africa under international law only after it has been approved by resolution in both Houses of Parliament, unless it is of a technical, administrative or executive nature or an agreement which does not require ratification or accession. DTAs are ordinarily approved in this way and thereby become binding on South Africa under International law. This means that a non-discrimination provision in a double tax treaty entered into by the national executive and approved by Parliament is binding in South Africa under International law.

The national executive has the power under s 231(1) of the Constitution to “negotiate and sign all agreements”. They do in other words have the power to enter into a double tax treaty which incorporates a non-discrimination provision. They have this power in terms of s 231(1) of the Constitution, even if the treaty goes wider than that authorised by s 108(1) of the ITA.

The difficulty, however, is that in terms of s 231(4) of the Constitution, such a treaty is only incorporated into South African domestic law if and when “it is enacted into law by national legislation”.<sup>36</sup> The South African companies denied the exemption under s 64B(5)(f) in contravention of the prohibition of discrimination in Article 24(5), will only be able to invoke the non-discrimination article under South African law if the treaty on which reliance is placed has been enacted into law by national legislation. DTAs are normally so enacted into law by proclamation in terms of s 108(2) of the ITA. But this section only provides for

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<sup>36</sup> Subject to an exception not applicable in this case, in the case of self-executing provisions of an international agreement.

DTAs of the kind contemplated in s 108(1) to be enacted into law in this way. "...Once a treaty is accepted by parliament" as contemplated in s 231 of the Constitution "and is published in the Government Gazette, it forms part of the domestic law under s 108(2). The non-discrimination article therefore forms part of South African domestic law".<sup>37</sup> This means that, if and to the extent that a DTA goes beyond the parameters of s 108(1), it may not be validly enacted into law by proclamation under s 108(2). The conclusion that a non-discrimination article in a DTA goes beyond the parameters of s 108(1), accordingly means that the non-discrimination provision is not validly incorporated into South African domestic law by proclamation of the treaty under s 108(2).

The conclusion that a non-discrimination provision in a DTA approved by Parliament is valid and binding on South Africa under international law, but does not form part of our domestic law, would have the implications as discussed below.

SA courts would not enforce the non-discrimination provision because it would not form part of SA domestic law. They would uphold domestic law such as s 64B(5)(f) of the Income Tax Act, even if it were held that it conflicted with the non-discrimination provision.

This would result in South Africa being in contravention of international law if it permitted discrimination by way of s 64B(5)(f) in a manner prohibited by the non-discrimination provision binding on it under international law.

While the victims of the discrimination would not have a remedy under our domestic law, they may have one under international law. This depends on the terms of the treaty on which they rely. For example, Article 24 of South Africa's DTA with the UK allows a UK resident who complains of discrimination under s 64B(5)(f) of the ITA in violation of the non-discrimination provision in article 23(4) of the treaty, to take his case to the UK authorities - who are then required to take it up with the South African authorities with a view to resolution of the complaint by mutual agreement between the two governments.

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<sup>37</sup> *International Tax, A South African Perspective 2008*, 4th Edition, Lynette Olivier, Michael Honiball p. 376.

### ***3.5.2 Application of the non-discrimination provision to domestic tax law***

Once a DTA is enacted into domestic law, there would be a conflict between the two statutory provisions. The STC provision (section 64B(5)(f) of the ITA) would be in conflict with the non-discrimination article (the equivalent Article 24(5) in the relevant DTA). The question is which of them would prevail over the other? To answer the question, the conflict between the two provisions has to be resolved in the same way as statutory conflicts are normally resolved.<sup>38</sup>

It is submitted that the prohibition of discrimination in this case would prevail over the residence requirement of s 64B(5)(f). The latter section is a general provision designed to afford relief to companies that declare dividends to other companies within the same group. If the prohibition of discrimination were to prevail over the residence requirement, the effect would be merely to extend the relief afforded to group companies to those who declare dividends to foreign shareholders as well. The very purpose of the prohibition against discrimination is to ensure that benefits of this kind afforded to companies with South African shareholders, are extended to foreign shareholders as well. If the residence requirement in s 64B(5)(f) were to prevail instead, the very purpose of the prohibition of discrimination would be negated.

The resolution of the conflict between the residence requirement of s 64B(5)(f) and the prohibition of discrimination in the DTAs as aforesaid would accord with the approach to such conflicts prescribed by s 233 of the Constitution. It says that when the courts interpret any legislation, they “must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law”. That would mean that the conflicting provisions would have to be interpreted in a manner that would be consistent with the obligations undertaken by South Africa under the bilateral treaties under international law. This would mean that the prohibition of discrimination under Article 24(5) should prevail. If the residence requirement of s 64B(5)(f) prevailed instead, it would mean that South Africa would be in contravention of Article 24(5) at international law. It is that outcome which s 233 seeks to avoid.

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<sup>38</sup> *ITC 1544 54 SATC 456 at 460*

### ***3.5.3 The exemption contravenes Article 24(5) in that it differentiates between companies resident in South Africa and discriminates against South African companies whose capital is wholly or partly owned offshore***

South Africa is not a member of the OECD and therefore the recommendations of the OECD Council do not hold any force. However, many of the South African DTAs include provisions identical or substantially identical to Article 24(5) of the OECD MTC. This article (as it would apply to South Africa under a particular DTA) provides as follows:

“Enterprises of Contracting State [South Africa], the capital of which is wholly or partly controlled, directly or indirectly, by one or more residents of the other Contracting State [UK], shall not be subjected in the first mentioned State [South Africa] to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first mentioned State [South Africa] are or may be subjected”.

The prohibition is directed at impermissible discrimination between different classes of resident enterprises. Section 64B(5)(f) appears to differentiate between companies resident in South Africa (as demonstrated by the scenario in 3.3 above). It does so by granting an STC exemption to some of them, but not to others.

The kind of differentiation prohibited by Article 24(5) is the imposition of “any taxation or any requirement connected therewith” on some South African nationals which is “other or more burdensome” than that imposed on others. Section 64B(5)(f) requires that some South African companies pay STC on their dividends but exempts others from it. It is submitted that this requirement is clearly “taxation or any requirement connected therewith” which was “other or more burdensome” than that imposed on the South African companies whose dividends qualify for exemption.

To determine whether or not the differentiation imposed by s 64B(5)(f) violates article 24(5), it is submitted that the article only prohibits differentiation of the kind described if it is discrimination between:

- 1) South African companies “the capital of which is wholly or partly controlled, directly or indirectly, by one or more residents of the other Contracting State” on the one hand, and
- 2) “other similar” South African companies, on the other.

It is accordingly submitted that the lines along which s 64B(5)(f) differentiates between different classes of South African companies, coincides with this prohibited line of differentiation in some respects. Article 24(5) prohibits discrimination against South African companies whose capital is wholly or partly owned or controlled offshore. It is submitted that this is what 64B(5)(f) does. Although it does not specify ownership or control of capital, it discriminates against South African companies whose shareholders are resident offshore. In other words, it discriminates against South African companies whose capital is wholly or partly owned offshore. To that extent s 64B(5)(f) does precisely what Article 24(5) prohibits.

#### ***3.5.4 The appropriate comparator - a “similar enterprise”***

In line with the scenario presented in 3.3 above and considering that the article in the South African DTA with the United Kingdom equivalent to Article 24(5) of the OECD MTC mirrors that of the OECD MTC, the “appropriate comparator” is sought using this specific DTA as an illustration.

The effect of s 64B(5)(f) is *inter alia* to deny South African group companies whose shareholders are resident in the UK, the exemption from STC granted to South African group companies whose shareholders are resident in South Africa. It is submitted that the question whether it contravened the prohibition in South Africa’s treaty with the UK, of discrimination against South African companies whose capital was held by UK residents, depends on whether those companies should be compared:

- 1) with other South African companies whose shareholders were resident in South Africa, or
- 2) with other South African companies whose shareholders were also resident offshore, but in countries other than the UK.

Where South African companies whose holding company is resident in the UK are compared with South African companies whose holding company is resident in South Africa, it is submitted that s 64B(5)(f) contravenes the non-discrimination article because it denies the STC exemption to the former, which it gave to the latter.

Where, on the other hand, South African companies whose holding company is resident in the UK are compared with South African companies whose holding company is resident offshore, but in countries other than the UK, there is no discrimination and no contravention of the non-discrimination article because none of them qualified for the STC exemption under s 64B(5)(f). Article 24(5) requires that to determine whether s 64B(5)(f) discriminates against South African companies whose holding companies are resident in the UK, they must be compared with other “similar” South African companies. The question is whether or not this means other South African companies whose holding companies are resident in South Africa or South African companies whose holding companies are also resident offshore, but in countries other than the UK.

It is submitted that the appropriate comparator is other South African companies whose shareholders are resident in South Africa, for the reason that the primary purpose of the prohibition in Article 24(5) is to ensure that the South African enterprises owned by residents of the foreign state party are not treated less favourably than South African enterprises owned by South African residents. In the context of South Africa’s treaty with the UK, its purpose is to ensure that South Africa treats South African companies owned by UK residents no less favourably than South African companies owned by South African residents. The purpose of Article 24(5) is not merely to ensure that South Africa afforded the interests of UK residents the same treatment as that afforded to the interests of other foreign residents. The appropriate comparison is between the treatment that South Africa afforded to the interests of UK residents and the treatment that it afforded to the interests of its own residents.

It is therefore submitted that the correct comparator is other South African companies whose shareholders are resident in South Africa. Using such a comparator, s 64B(5)(f) clearly violates the prohibition because it treats South African companies whose shareholders are resident in the UK less favourably than South African companies whose shareholders are resident in South Africa.

This conclusion and the reasoning on which the above submission is based has cogent support in the opinion of the Chancery Division of the High Court of England in the NEC case.<sup>39</sup> Although the facts of the case were not identical, the issues were substantially the

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<sup>39</sup> *NEC Semi-Conductors Ltd and Others v The Commissioner of Inland Revenue*, [2003] EWHC2813 (CH)

same. The case concerned whether a provision similar to s 64B(5)(f) would have contravened the prohibition on discrimination contained in a DTA identical to the one in Article 24(5). Park J concluded that the answer to the question depended on the identification of the appropriate comparator with which the treatment of a UK subsidiary of a foreign parent had to be compared.<sup>40</sup> He also concluded<sup>41</sup> that the appropriate comparator was a UK subsidiary of a UK parent because “it is obvious from the whole scheme and purpose of the non-discrimination article that that is what the particular sub-article is getting at”.<sup>42</sup>

“The increase in claims by South African taxpayers on the basis of the above counter argument is attributable to the decision of the Chancery Division of the High Court of England in the *NEC...*” case.<sup>43</sup>

The *NEC* case concerned the validity of a provision of United Kingdom law, which permitted a United Kingdom resident subsidiary company paying dividends to its UK parent company, to make a group income election, thereby avoiding liability for Advance Corporation Tax (“ACT”). The provision did not, however, allow a United Kingdom resident subsidiary company with a foreign resident parent company the same treatment. The issue arose in the context of double taxation agreements between the United Kingdom and the foreign countries concerned (Japan and the United States) which contained non-discrimination provisions which were based on the OECD model non-discrimination article.

For the purposes of its decision, the English Court had to construe the non-discrimination provisions in the relevant tax treaties. The Claimant’s contention was that denying the United Kingdom subsidiaries of the foreign parent companies the ability to make group income elections so as to be able to pay dividends without ACT, was in conflict with the non-discrimination provisions. In paragraphs 21 to 33 of the opinion, the Court upheld the Claimant’s argument. In doing so it considered three issues:

First, the meaning of the term “**other similar enterprises**” of the United Kingdom;

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<sup>40</sup> In para 27

<sup>41</sup> In paras 27 to 30

<sup>42</sup> Para 29

<sup>43</sup> *International Tax, A South African Perspective 2008*, 4<sup>th</sup> Edition, Lynette Olivier, Michael Honiball p. 376.

Secondly, whether the position created under the United Kingdom statute precluding a group company election and non-payment of ACT fell within the ambit of the phrase “**taxation or any requirements connected therewith**”; and

Thirdly, whether, if it did, it was “**other or more burdensome**” than the taxation and connected requirements to which “**other similar enterprises**” of the United Kingdom were or might be subject.

As to the first issue, the court rejected the interpretation that “**other similar enterprises**” were United Kingdom subsidiaries of other parent companies resident in the other contracting (foreign) State, holding that this could never be the intention. It also rejected as a viable interpretation that “**other similar enterprises**” were United Kingdom subsidiaries of other parent companies resident in third States, being neither the United Kingdom nor the foreign State, as well as the proposition that there were no “**other similar enterprises**”. The Court found that the correct interpretation was that “**other similar enterprises**” were United Kingdom subsidiaries of United Kingdom resident companies.

The Court accordingly concluded that the comparator “**similar enterprise**” postulated by the non-discrimination provision in question was a United Kingdom subsidiary company owned by a United Kingdom parent.

The South African context is a South African subsidiary controlled by a parent company resident in the other Contracting State (e.g. the United Kingdom) which pays a dividend to its parent. In that context the “other similar enterprise of [South Africa]” means other South African subsidiaries controlled by the parent companies resident, not in the other Contracting State, but in the same Contracting State (i.e. South Africa) which pays dividends to their parents.

As to the second issue, the Court held that the treatment under the United Kingdom statutory provisions of a United Kingdom subsidiary which paid dividends to its non-resident parent company, requiring it to pay ACT and depriving it of the right to make a group income election with its parent to obviate the ACT liability was “taxation”, in that the result was that ACT had to be paid. Alternatively, such treatment could be regarded as a requirement connected with taxation inasmuch as, in order to make a group election, the United Kingdom subsidiary needed to have a United Kingdom parent company – a requirement with which it could not comply.

As to the third issue, the Court held that the taxation or connected requirement to which the United Kingdom subsidiaries of the foreign parent companies were subjected was clearly **“other or more burdensome”** than the taxation and connected requirements to which the hypothetical United Kingdom comparator would have been subjected.

It was accordingly the Court’s finding that the relevant statutory rules (insofar as their impact on the payment of dividends by the claimant United Kingdom subsidiaries was concerned) were contrary to the non-discrimination provisions of the relevant tax treaties. In fact, however, the claims did not succeed because the Court found that the non-discrimination provisions relied on by the claimants had not been incorporated into United Kingdom domestic law, having regard to the peculiar requirements of the United Kingdom tax statute in that regard. In consequence of that finding, the claims for restitution for infringement of the non-discrimination provisions in the tax treaties, failed. Refer to the discussion at 3.5.1 concerning s 108.

Accordingly, it is submitted that the NEC case provides cogent support for the conclusion that the provisions of s 64B(5)(f) contravene the prohibition on discrimination contained in Article 24(5). This section created a situation which was virtually indistinguishable from that which confronted the Court in the NEC case. The English Court’s clear analysis and interpretation of the identical non-discrimination provisions and their application to the facts, is directly relevant to the South African scenario. Decisions of foreign courts on the interpretation of a treaty depend for their authority on the reputation and status of the court in question (refer chapter 2). Further analysis of identical non-discrimination provisions and their application is considered in a House of Lords decision (UK) in 3.6 below. It is submitted that South African Courts would place reliance on this decision.

### ***3.5.5 Argument for inclusion of STC in the scope of DTA's non-discrimination clauses***

Many of the relevant DTA's do not specifically cover STC as part of the scope of the DTA. However, it is submitted that they should be construed to cover STC as being a substantially similar tax to South African taxes enumerated in the treaty.

Unlike the SA-UK DTA which came into effect on 17 December 2002 and specifically included STC in South Africa as a tax to which the treaty applied, the SA-Netherlands DTA made no specific mention of STC as a tax covered by the treaty. This was no doubt due to the fact that the treaty dated back to 1971 and STC was only introduced from 1992.

Nevertheless, there were clear indications in the SA-Netherlands DTA that it was intended to apply to subsequently imposed taxes similar to those which were in existence when the treaty was concluded. Thus, Article 2(1) stated that the treaty applied to taxes on income imposed on behalf of each of the States, irrespective of the manner in which they were levied. Article 2(2) provided that the taxes on income included all taxes imposed on total income, or on elements of income. Article 2(3) specified particular taxes to which the treaty applied and, in the case of South Africa, included the undistributed profits tax which was in existence at the time. Article 2(4) provided further that the treaty applied

“...to any identical or substantially similar taxes which are subsequently imposed in addition, or in place of, the existing taxes. The competent authorities of the States shall notify to each other any substantial changes which have been made in their respective taxation laws”.

Therefore, where the group holding company was situated in the Netherlands, the taxpayer could contend that STC would be a tax, subsequently imposed, which would be covered by the provisions of the SA-Netherlands DTA. That, in 2009 a new treaty with the Netherlands became effective, which does mention STC adds to this argument.

Other DTA's, including the SA-UK DTA, included Article 2(3)(a)(ii) which applied to STC and the provisions of the treaty were all incorporated in the Act pursuant to the provisions of s 108(2). This was in contrast to the position in the United Kingdom where the Court found, in the NEC case, that the relevant Article had not become part of the United Kingdom domestic law in terms of the relevant requirements of the statute there.

### ***3.5.6 Further support for the application of Article 24(5) in favour of South African companies on the ground that their shareholders are resident in the foreign State and not in South Africa.***

The conclusion in the *NEC* case is consistent with the reasoning and conclusion of the Special Court in *ITC 1544*<sup>44</sup> and that of the High Court of Zimbabwe in the *BAT* case,<sup>45</sup> although the provisions in issue in those cases are not identical to those currently under consideration.

Klaus Vogel's commentary on the prohibition of discrimination in Article 24(5) of the Model Convention reads as follows:

“The prohibition prohibits tax discrimination of an enterprise on the ground of its capital being owned or controlled by residents of the other Contracting State”.

“What is forbidden is only other or discriminatory taxation which attaches to capital ownership by non-resident shareholders or partners. The provision does not protect enterprises in which non-residents participate, against discrimination generally, when there is no connection between the discrimination and the ownership by foreigners”.

“The enterprise must not, on account of some or all of its capital being held by non-residents, be subjected to taxation other or more burdensome than the taxation of a similar enterprise of the taxing State. A comparison should be made with an enterprise, the shareholders or partners of which are exclusively residents”.<sup>46</sup>

In other words the comparison should be made with domestic enterprises operating in the same legal form as the enterprise concerned.

The discrimination in s 64B(5)(f) does “attach to capital ownership by non-resident shareholders”. It discriminates against South African companies whose shareholders are non-residents and does so on that very ground. It exempts a South African company from STC if its shareholders to whom it declares a dividend are resident in South Africa, but denies the exemption if the shareholders to whom the dividend is declared are non-resident.

On the other hand, arguments against the application of the non-discrimination provision as mentioned above submit that s 64B(5)(f) does not contravene the prohibition in Article 24(5)

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<sup>44</sup> 54 SATC 456

<sup>45</sup> *BAT v Commissioner of Taxes* 57 SATC 271

<sup>46</sup> Vogel, 1997 art 24 par 166

because it does not discriminate on the basis prohibited by Article 24(5). It does not discriminate between a company which is wholly or partly owned or controlled by a resident of the other Contracting State and the one which is not so owned or controlled, but instead discriminates between a company paying a dividend to a shareholder which is “resident”, as defined in the Income Tax Act and a company paying a dividend to a shareholder which is not a “resident” as defined.

The next section explores United Kingdom (House of Lords) cases where they are relevant to the discussion.

### ***3.6 Foreign influence on whether the contention that STC violated the non-discrimination provisions embodied in South African Double Tax Treaties***

As mentioned above, the discrimination in s 64B(5)(f) was identical in nature to that in s 247 of the UK Taxes Act, which was found to be discrimination in the NEC case. NEC Corporation was one of the appellants in the House of Lords decision known as *Boake Allen Limited v Revenue and Customs Commissioners*.<sup>47</sup> This section considers the influence of this House of Lords decision in the South African context.

In any South African litigation, the SA taxpayers’ contentions would have been similar to the argument raised by the claimants, and rejected by the House of Lords, in *Boake Allen’s* case. The case concerned the UK advance corporation tax (“ACT”) system and, in particular, the provisions in that system for making group income elections (“GIE”).

ACT had many similarities to STC. A UK resident company which paid a dividend was liable to account for ACT which was computed as a percentage of the dividend. As with STC, the company only had to pay ACT on the excess of the dividends paid over dividends received from other UK companies (known as franked investment income). However, one major difference was that ACT was conceptually an advance payment of mainstream corporation tax and was, therefore, able to be set off against the company’s liability to corporation tax on its profits.

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<sup>47</sup> [2007] UKHL 25; [2007] 1 WLR 1386

The system for making group income elections also had certain similarities (and certain differences) to the exemption in s 64B(5)(f). It applied to dividends paid to a parent with more than a 50% shareholding, which had to be a UK resident. The company making the payment and the recipient had to jointly elect for this treatment to apply. In *Hoescht/Metallgesellschaft v IRC*,<sup>48</sup> the European Court of Justice held that the requirement that the parent company be resident in the UK contravened the EC Treaty provisions on freedom of establishment (Article 43). Parent companies established outside the EC could not rely upon Article 43 and so had to claim under the article in the relevant DTA or under Article 56 of the EC Treaty. However the House of Lords rejected this latter claim on the basis of the application of the “standstill” provision in Article 57 EC (see paragraph 24 of the speech of Lord Hoffmann).

As regards the non-discrimination article (which was in identical form to Article 23(4) of the Convention), the House of Lords held that the GIE provisions did not discriminate against a UK company on the grounds that its capital was “wholly or partly owned or controlled, directly or indirectly” by residents of the US or Japan. It was held that the true reason that an election could not be made, and that consequently dividends could not be paid free of ACT, was that the parent was not liable for ACT on dividends which it paid. This happened to be because it was not resident in the UK, but residency was not the ground for the discrimination. As the GIE was a joint decision by two companies as to which of them would be liable to ACT, it was not a concept that could be meaningfully applied where one of the companies was not liable for ACT at all. Lord Hoffmann’s speech was follows:

“16. The question, as it seems to me, is whether section 247 discriminates against a UK company *on the ground that* its capital is “wholly or partly owned or controlled, directly or indirectly” by residents of the US, or Japan, or some other foreign state. In relation to Article 24(1) of the OECD model convention, which prohibits discrimination between residents on grounds of nationality, the commentary says that the “underlying question” is whether two residents are being treated differently “solely by reason of having a different nationality”. It does not repeat this observation in relation to Article 24(5), but the principle must be the same. Does section 247 discriminate on the grounds that the capital of the subsidiary is controlled by a non-resident company?

17. In my opinion it plainly does not. For example, if a US parent were to interpose a UK resident holding company between itself and its UK-resident subsidiary, the control would remain in the US but

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<sup>48</sup> (Joined cases C-397 and 410/98) [2001] Ch 620

there would be no objection to an election by the UK subsidiary and its immediate, UK-resident parent. On the other hand, an individual US shareholder and the company he controls in the UK could not elect, but the reason is not because the company is subject to US control. An individual UK shareholder and his company could not elect either, for the same reason that a non-resident company cannot elect. It is because an individual is not liable to corporation tax. An election is a joint decision by two entities paying and receiving dividends that one rather than the other will be liable for ACT. This is not a concept which can meaningfully be applied when one of the entities is not liable for ACT at all”.<sup>49</sup>

The House of Lords further held that it was not possible to decouple the positions of the parent and subsidiary as the judge and the Court of Appeal had sought to do. If a GIE was available where the dividend was paid to a non-UK resident company, it would not be receiving the relief which was available to a wholly UK resident group. It would not be an election as to who was to be liable for ACT, but as to whether the group should pay ACT at all.

This reasoning applies, *mutatis mutandis*, to STC and the exemption in s 65B(5)(f). It is true that the House of Lords emphasised the point, which had been central to the earlier case of *Pirelli Cable Holdings NV v IRC*,<sup>50</sup> that the GIE was a joint election by the parent and subsidiary. The point was luminously made by Lord Nicholls of Birkenhead, in a speech with which the rest of their Lordships agreed:

“A group income election is a group election. A group income election cannot be made by a subsidiary alone. It is an election made jointly by the subsidiary paying the dividend and the parent receiving the dividend. By making such an election both companies seek the fiscal consequences of making the election. One consequence is that by making the election the subsidiary will obtain the advantage of not paying ACT in respect of the relevant dividend. Another consequence is that the subsidiary will obtain this advantage at the cost of depriving the parent of a tax credit in respect of the dividend. These two fiscal consequences are inextricably linked. You cannot have one without the other. That is why the election has to be made jointly. The advantage to the paying subsidiary comes at a price to the recipient parent”.<sup>51</sup>

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<sup>49</sup> paragraphs 16 and 17 of the speech of Lord Hoffmann, *Boake Allen Limited v Revenue and Customs Commissioners*, [2007] UKHL 25; [2007] 1 WLR 1386

<sup>50</sup> [2006] 1 WLR 400

<sup>51</sup> *Pirelli Cable Holdings NV v IRC* [2006] 1 WLR 400, Para 19

However, the more important point in *Boake Allen* was that the purpose of the GIE provisions was to allow the group to decide at what level ACT was paid. It was not to allow ACT to be avoided altogether. This was the reason that the recipient had to be a UK resident before there could be a GIE. In essence, the recipient itself had to be liable, in principle, for ACT. In any South African case, it is submitted that the argument against the application of the non-discrimination article would be that STC was exactly the same in this regard. The purpose of s 64B(5)(f) was to allow a group to decide which company within it paid STC and to allow profits to be transferred within the group, free of STC, provided that STC was paid wherever those profits were paid as dividends outside the group. It was not the purpose of the section to allow a group to decide whether STC was paid at all.

“19. In my respectful opinion, it is not possible to decouple the positions of parent and subsidiary as the judge and the Court of Appeal sought to do. To allow an election by a group with a US-resident parent would not be to give a relief available to a group with a UK-resident parent. It would be something different in kind. It would not be an election as to who would be liable for ACT but as to whether the group should pay it at all”.<sup>52</sup>

Central to the decision in *Boake Allen* was not that the election was made jointly, but that the system of the election was there to determine which of the two companies would be liable for ACT. I submit that the system of election for STC served a precisely equivalent purpose.

In a recent decision in the First-Tier (Tax) Tribunal in the United Kingdom Lord Hoffmann's approach was summarised as follows:<sup>53</sup>

“(1) The alleged discrimination was the inability of the taxpayer (the UK subsidiary) to make a group income election under s 247 TA 1988:

"(1) Where a company ('the receiving company') receives dividends from another company ('the paying company'), both being bodies resident in the United Kingdom, and the paying company is—(a) a 51 per cent subsidiary of the other...then...the receiving company and the paying company may jointly elect that this subsection shall apply to the dividends received from the paying company by the receiving company ('the election dividends')

(2) So long as the election under subsection (1) above is in force the election dividends shall be excluded from sections 14(1) and 231....."

<sup>52</sup> Paragraph 19 of the speech of Lord Hoffmann, *Boake Allen Limited v Revenue and Customs Commissioners*, [2007] UKHL 25; [2007] 1 WLR 1386

<sup>53</sup> *TC/2009/12324*, United Kingdom, 1 April 2010, First-Tier (Tax) Tribunal

(2) If the parent had been UK resident the two companies could have made a group income election.

(3) The reason why the two companies could not make a group income election was because the recipient of the dividend was not liable to pay ACT, as shown by the tabulation of Lord Hoffmann's examples, not because the recipient was a US resident rather than a UK resident.

Type of ownership	Residence of recipient of dividend	Group income of election possible	Whether recipient liable to pay ACT on payment of a dividend
Direct, company (the situation in the case)	US	No	No
Direct, company	UK	Yes	Yes
Indirect, non-resident company (as to the dividend between the UK sub-subsidiary and subsidiary)	UK	Yes	Yes
Direct, individual	UK	No	No
Direct, individual	US	No	No

15. The table shows the exact concurrence between liability to pay ACT and the ability to make a group income election, which is different from the residence of the recipient. Therefore it clearly shows that the ground for the difference in treatment was the recipient's liability to pay ACT. Therefore the alleged discrimination was not prevented by the Treaty provision.

16. We believe that there is a further situation, which is particularly relevant as it concerns a corporate shareholder, that supports the argument, where the owner of the shares is an incorporated charity resident in the UK:

Direct, incorporated charity	UK	No	No
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Section 247(5) provided that an election may not be made where the receiving company is entitled by virtue of an exemption to claim the tax credit on the dividend.

17. The significance of the examples is therefore to show that the real ground of the difference in treatment was the liability of the recipient to pay ACT, and the residence of the owner in the situation under appeal was not the real ground. The examples of the individual owner (and also the charity) demonstrate that the liability to pay ACT is not equivalent to the residence of the owner, although it would be if only company recipients were considered (as was pointed out by Brian Cleave in "*Boake Allen Limited and others v HMRC—group income elections and non-discrimination*" [2007] BTR 604 at 606). Having decided that the real ground for the

difference in treatment was not the residence of the owner that is the end of the matter. There was no need to go back to the facts of the case.”<sup>54</sup>

As already mentioned, the situation in *Boake Allen*, as was emphasised by Lord Hoffmann at [19] above, was that it was not possible to “decouple the positions of parent and subsidiary”.<sup>55</sup> What distinguished the appeal in this case<sup>56</sup> was that it involved a group relief claim and surrender made by the two (UK) subsidiaries. The parent company (US) was not involved. In *Boake Allen* the tax treatment of the parent was material because the legislation required a joint election by the parent and subsidiary. In *TC/2009/12324*<sup>57</sup> the position was different. The tax treatment of the parent was irrelevant to group relief between the two UK subsidiaries. The only relevant consideration was the residence of the owner of the two subsidiaries. If the holding company had been UK resident the appellant could have made a group relief claim.

“The question was whether the inability of the appellant to make a group relief claim was the US residence of the holding company, or something else. We repeat the same examples in the table:

Type of ownership	Residence of holding company	Group relief claim possible
Direct, company (the situation in this appeal)	US	No
Direct, company	UK	Yes
Indirect, non-resident company (as to group relief between the subsidiaries of the UK intermediate holding company)	UK (the intermediate holding company)	Yes
Direct, individual	UK	No
Direct, individual	US	No
Direct, incorporated charity	UK	Yes

The appeal court held that:

“19. The important point is that there is no possible equivalent right hand column which unifies all the examples as there was in *Boake Allen*. What is the consequence? [...] The purpose of Lord

<sup>54</sup> *TC/2009/12324*, United Kingdom, 1 April 2010, First-Tier (Tax) Tribunal, paras 14 - 17

<sup>55</sup> *Boake Allen Limited v Revenue and Customs Commissioners*, [2007] UKHL 25; [2007] 1 WLR 1386, para. 19.

<sup>56</sup> *TC/2009/12324*

<sup>57</sup> *TC/2009/12324*, United Kingdom, 1 April 2010, First-Tier (Tax) Tribunal

Hoffmann's examples was to show that there was a ground other than ownership for the difference in treatment, and here there is not. The examples serve a positive purpose of analysing whether there is a different ground from the apparent one of residence; they cannot be used for a negative purpose of showing that on the facts of the particular case the difference in treatment is not on the ground of residence. On the facts of this appeal the difference in treatment is because the direct holding company is US rather than UK resident. No other ground for the difference in treatment can be shown. That is therefore discrimination prevented by the plain wording of the Treaty provision.

20. [...] The correct comparison with indirect ownership is that the group relief treatment of the two subsidiaries of the UK intermediate holding company is the same whatever the residence of the ultimate holding company, which means that there is no discrimination on the ground of indirect ownership. Similarly, the fact that an individual cannot be the holding "company" of a group for this purpose, whatever his residence, is irrelevant to whether there is discrimination on the ground of ownership when there is a holding company; it merely shows that there is no discrimination where the owner is an individual."<sup>58</sup>

The court reached the unanimous conclusion that the "Treaty prohibits the denial of group relief where there is a US (as opposed to a UK) holding company and rely on the fact that courts at the highest level in at least three other countries have reached the same conclusion on identical (or near so) treaty provisions in relation to similar reliefs in their respective jurisdictions. We regard it as important that courts give consistent interpretations of treaty provisions contained in the OECD Model that are widely used in tax treaties".<sup>59</sup>

### **3.7 Conclusion**

Arguments for and against the application of the non-discrimination article were provided in the context of a scenario involving a South African subsidiary with a non-resident holding company. The conclusion drawn from these arguments is that in any South African litigation, it would appear that the application of the non-discrimination provision should prevail over the conflicting residence requirement of s 64B(5)(f), with the result that South African companies should be entitled to claim the relief afforded by s 64B(5)(f) on the dividends they declared to other companies in the same group, even if the latter are not resident in South Africa, provided that they are resident in a country with whom South Africa had a DTA which includes a prohibition of discrimination along the lines of Article 24(5). However, it is

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<sup>58</sup> *TC/2009/12324*, Para. 18 - 20

<sup>59</sup> *TC/2009/12324*, at Para. 21

submitted that after taking into consideration recently decided foreign tax cases, this cannot be the case.

An analysis of relevant United Kingdom case law was provided. The NEC case<sup>60</sup> provides cogent support for the conclusion that the provisions of s 64B(5)(f) contravene the prohibition on discrimination contained in Article 24(5) on the ground that their shareholders are resident in the foreign State and not in South Africa. The English Court's clear analysis and interpretation of the identical non-discrimination provisions and their application to the facts, is directly relevant to the South African scenario. However, further analysis of identical non-discrimination provisions and their application was considered in a House of Lords [UK] decision and it is submitted that South African Courts would place reliance on this decision.

In the South African context, the type of discrimination covered by Article 24(5) is solely the discrimination against a subsidiary in South Africa on the grounds that its capital is wholly or partly owned or controlled in a foreign country. For the reasons given in the *Boake Allen* decision, there exists persuasive influence that the provisions of s 64B(5)(f) did not discriminate against the South African subsidiaries of foreign companies on that ground. The contention that the exemption provided for in s 64B(5)(f) violated the non-discrimination provisions embodied in South African DTAs would therefore probably not be sustained in a South African court. It is submitted that the real ground for the different treatment is whether the recipient is liable to pay STC, and not the residence of the owner. Therefore it is submitted that this type of discrimination is not that which is prohibited by the Treaty provision.

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<sup>60</sup> *NEC Semi-Conductors Ltd and Others v The Commissioner of Inland Revenue*, [2003] EWHC2813 (CH)

## CHAPTER 4

### DIVIDENDS TAX

#### *4.1 Introduction*

In this chapter the question whether the proposed Dividends Tax overcomes international tax flaws, namely exclusion from the scope of some DTAs and violation of the anti-discrimination provisions embodied in the OECD MTC, is addressed. Against the background of STC, which the new tax replaces and in the context of the previous discussion in chapter 3, where it was considered whether STC contravened the scope and any other principals embodied in DTAs, the new dividends tax, and its exclusion provisions, is scrutinised for any possible violations.

#### *4.2 Exclusion from the scope of some DTAs and violation of other DTA principles?*

As discussed above in chapter 3 arguments were made for inclusion of STC in the scope of DTA's as well as undistributed profits tax and "identical or substantially similar taxes which are subsequently imposed". However, it was clear from the *Volkswagen* case<sup>61</sup> that STC violated other principals embodied in DTAs. STC was not a taxation of dividends but rather a tax imposed on the company declaring the dividends and accordingly STC was outside the ambit of Article 7 of the DTA between South Africa and Germany, which would otherwise have effectively limited the rate of STC payable on dividends declared by the taxpayer to its holding company. The DTA between South Africa and Germany, which aimed to avoid double taxation between the two countries, had been concluded on 25 January 1973 and at that time the provisions relating to the STC did not exist.

The differences between STC and a withholding tax negated the submission in the *Volkswagen* case<sup>62</sup> that STC was substantially similar to a withholding tax, such as the previously imposed non-resident shareholder's tax. It was held that STC was a tax on the company declaring a dividend, and not a tax on the recipient of the dividend and, consequently, Article 7 of the DTA did not apply to STC.

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<sup>61</sup> *Volkswagen of South Africa (Pty) Ltd v C: SARS 70 SATC 195*

<sup>62</sup> *Volkswagen of South Africa (Pty) Ltd v C: SARS 70 SATC 195*

Further, Article 7(2)(a) of the DTA referred to a recipient of dividends and not to a company declaring the dividend and the benefits conferred by the said article were to be enjoyed by the recipients of the dividends, and not the company declaring the dividends.

STC is to be replaced with a 'dividend tax' and value extraction tax (VET), effective from a date to be determined by the Minister of Finance by notice in the Gazette. The dividend tax is a withholding tax on dividends. The VET is not a new concept as it essentially replaces the deemed dividend anti-avoidance rules found in the STC legislation, of which the debit shareholders loan is the most common.

There are four types of transactions that are affected by VET:

- financial assistance, which is in essence any loan or advance granted by the company to a connected person at an interest rate below a deemed market related interest charge;
- the release or waiver of any loan obligation owing by a connected person to the company;
- the settlement of any debt by the company where the debt is owed by a connected party to a third party;
- A company ceases to be a South African tax resident.

Sufficient time has been provided for the renegotiation of various DTAs, which previously provided for a withholding tax rate of zero where dividends were paid to non-residents. National Treasury (falling within the Government Department of Finance) has indicated that government will accept a lower rate of 5% under such agreements where the non-resident shareholder has a reasonably substantial shareholding. Many of these treaties have now been renegotiated. It is submitted that this withholding tax will fall within the ambit of many of the existing DTAs, particularly as at the time the older treaties were negotiated, South Africa had a form of withholding tax on dividends.<sup>63</sup>

Further support for this view is to be found in Article 2(4) of many of the DTAs, which extends the scope of the DTA to non-resident shareholders' tax and also 'to any identical or substantially similar taxes which are subsequently imposed in addition to or in place of the

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<sup>63</sup> This tax was known as the Non-resident Shareholders Tax (NRST) and was repealed by Act 21 of 1995.

existing taxes'. The dividends tax is a withholding tax on dividends and thus a substantially similar tax to which many of the existing South African DTAs would apply.

A further advantage of the new dividend tax is that international investors are more familiar with a dividend tax at the shareholder level and often enjoy double tax treaty limitations on a dividend tax at this level. It is envisaged that the withholding tax will be a final withholding tax and that companies paying dividends will have to determine whether a reduced withholding tax rate applies as a result of the application of a double tax treaty.<sup>64</sup>

The next section considers whether the new dividends tax and its exclusions would contravene the non-discrimination provisions embodied in the OECD model tax convention.

### ***4.3 Violation of the non-discrimination provisions embodied in the OECD model tax convention?***

Before considering this question, it is necessary to consider the types of exemptions that are included in the new provisions that could be in violation of the DTAs.

#### ***4.3.1 Dividend exemptions***

A dividend distributed may be exempt from the dividends tax depending on the nature or classification of the 'beneficial owner', who is defined as the person entitled to the benefit of the dividend attaching to the share.<sup>65</sup>

A dividend will be exempt if the beneficial owner is a company which is a resident. The objective behind this exemption is to avoid the tax being levied more than once on the same amount when the company in receipt of the dividend on-distributes it to its shareholders. This exemption applies irrespective of the resident company's shareholding in the company declaring the dividend.<sup>66</sup>

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<sup>64</sup> SARS Media Release – *Explanatory Note: STC Reforms*, February 21st 2007.

<sup>65</sup> s 64D

<sup>66</sup> Income Tax, *Silke on South African Income Tax*, Chapter 9 Dividends, § 9.54 Dividends tax — exemptions

### ***4.3.2 Exemptions to the VET***

There are a number of exemptions to the VET with one of the most significant being where the value extraction is effected in favour of a South African tax resident company. The next section considers whether the exemption provisions would violate the anti-discrimination provisions embodied in the OECD model tax convention.

### ***4.3.3 Violation of the anti-discrimination provisions embodied in the OECD model tax convention?***

The exemption to the VET and dividends tax exemption would not apply to non-resident companies. It is submitted that these exemptions would not violate Article 24(5). Consider an example where a State levies tax on resident companies that makes distributions to their shareholders regardless of whether or not they are residents or non-residents, but which, in order to avoid a multiple application of that tax, would not apply it to distributions made to related resident companies that are themselves subject to the tax upon their own distributions. In that case, it is not because the capital of the resident company is owned or controlled by a non-resident that it is treated differently; it is because it makes distributions to companies that, under the provisions of the treaty, cannot be subjected to the same tax when they re-distribute the dividends received from the resident company.

“...Also, because paragraph 5 is aimed at ensuring that all resident companies are treated equally regardless of who owns or controls their capital and does not seek to ensure that distributions to residents and non-residents are treated in the same way ... it follows that withholding tax obligations that are imposed on a resident company with respect to dividends paid to non-resident shareholders but not with respect to dividends paid to resident shareholders cannot be considered to violate paragraph 5. In that case, the different treatment is not dependent on the fact that the capital of the company is owned or controlled by non-residents but, rather, on the fact that dividends paid to non-residents are taxed differently. A similar example would be that of a State that levies a tax on resident companies that make distributions to their shareholders regardless of whether or not they are residents or non-residents, but which, in order to avoid a multiple application of that tax, would not apply it to distributions made to related resident companies that are themselves subject to the tax upon their own distributions. The fact that the latter exemption would not apply to distributions to non-resident companies should not be considered to violate paragraph 5. In that case, it is not because the capital of the resident company is owned or controlled by non-residents that it is treated differently; it is because it makes distributions to companies that, under the provisions of the treaty, cannot be subjected to the same tax when they re-distribute the dividends received from that resident company. In this example, all resident companies are treated the same way regardless of who owns or controls their capital and the different treatment is

restricted to cases where distributions are made in circumstances where the distribution tax could be avoided.”<sup>67</sup>

#### **4.4 Conclusion**

In conclusion it is submitted that the proposed new dividends tax will not be excluded from the scope of most South African DTAs. Furthermore, the dividend tax is a withholding tax on dividends, unlike STC and will therefore not violate other principals embodied in DTAs like the one that effectively limits the rate payable on dividends declared by the taxpayer to its holding company.

The issue taxpayers had with STC was that the requirement of s 64B(5)(f)(iii), was in conflict with Article 24(5). As with STC as originally enacted, a dividend will be exempt from withholdings tax if the beneficial owner is a company which is a resident. Similarly, there are a number of exemptions to the VET, with one of the most significant being where the value extraction is effected in favour of a South African tax resident company. The fact that the exemptions would not apply to non-resident companies should not be considered to violate Article 24(5), as the rationale for this is the same as in relation to s 64B(5)(f)(iii). Paragraph 5 of Article 24 of the OECD MTC is aimed at ensuring that all resident companies are treated equally regardless of who owns or controls their capital and does not seek to ensure that distributions to residents and non-residents are treated in the same way. Accordingly, it is submitted that the proposed dividends tax would not violate the anti-discrimination provisions embodied in the OECD model tax convention.

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<sup>67</sup> *TC/2009/12324*. 2010. United Kingdom: First-Tier (Tax) Tribunal.

## CHAPTER 5

### CONCLUSION

This dissertation seeks to resolve the question whether the residence requirement for exemption under se 64B(5)(f) contravened the prohibition of discrimination in Article 24(5) of the OECD Model Convention with respect to Taxes on Income and on Capital (“OECD MTC”). The outcome of this research may be particularly relevant in the context of the proposed new dividends tax and value extraction tax (“VET”) and the exemptions therefrom, which are, again, based on residency.

An approach to the interpretation of tax treaties provides the methodology for the analysis of DTA articles. The methodology adopted is to first look for a clear meaning of the words used and if the provisions of an article are ambiguous it may be possible to resolve that ambiguity using the purposive approach. A treaty should be interpreted in good faith giving effect to the intention of the parties in the light of the surrounding circumstances. Subsequent commentaries on the treaties have persuasive value only. Decisions of foreign courts on the interpretation of a treaty depend for their authority on the reputation and status of the court in question. Relevant cases decided in UK courts, particularly those decided in the House of Lords [UK] have persuasive influence on the interpretation of a treaty.

Discrimination in a tax context is the different tax treatment between similar taxpayers in comparable circumstances that is solely based on certain specific grounds. The non-discrimination provisions of the OECD MTC seek to prohibit this kind of discrimination, using different language to achieve the same result. A discussion of case law in South Africa where non-discrimination based on nationality has been in issue demonstrated that in these cases the non-discrimination provisions “prevent differences in tax treatment that are solely based on certain specific grounds (e.g. nationality, in the case of paragraph 1)”.<sup>68</sup> In the context of STC and its exemptions based on residency, certain multinationals sought to argue that to deprive a South African subsidiary of the exemption from paying STC because its holding company is not resident in South Africa, but to grant such exemption to another South African subsidiary, because its holding company is resident in South Africa, would

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<sup>68</sup> *OECD MTC Commentary*

appear to be discrimination contrary to the prohibition in Article 24(5)<sup>69</sup>. This article may be applicable to business enterprises (subsidiaries) with non-resident holding companies, carrying on business in South Africa, in other words, South African multinationals. However, in the absence of decided cases in the South African jurisdiction on the issue of discrimination based on tax residency, specific guidance (as pertains to STC and potentially the new dividends tax) must be sought from international experience.

Many of the DTA's do not specifically cover STC as part of the scope of the DTA. However it is submitted that they should be construed to cover STC as being a substantially similar tax to South African taxes enumerated in the treaty.

Chapter 3 considered whether or not STC violates the non-discrimination provisions embodied in South African Double Tax Treaties. Arguments against the application of the non-discrimination article are summarised as follows:

The primary purpose of a DTA is the avoidance of double taxation. The provisions of the DTA cannot accordingly be used to put South African tax residents with a non-resident holding company at an advantage to other similar South African companies with South African shareholders. It is submitted that should the non-discrimination provision override s 64B(5)(f), the effect would be anomalous and may lead to absurd results. South African companies with non-resident shareholders would enjoy an undue tax advantage. Rather than delaying the payment of STC, it would be avoided altogether whereas South African companies with resident shareholders can only delay the inevitable payment of STC for so long as the holding company does not declare a dividend.

One of the subsidiary purposes of a DTA is to promote free trade between countries and the non-discrimination provision is merely there to support this purpose and to ensure that a non-resident has an equal footing for tax purposes when competing with residents of a country in the domestic economy. The STC provision does not create this discriminatory result which the non-discrimination provisions guard against. The non-resident parent company may, like the resident parent company, defer STC for as long as the funds are used in the business operations in South Africa. The STC exemption therefore does not tax the subsidiary of the non-resident in a manner "other or more burdensome" than the residents' subsidiary.

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<sup>69</sup> *OECD MTC*

The original wording of s 64B(5)(f)(iii) of the Income Tax Act simply required that, for the exemption to apply, the shareholder, as defined in the Income Tax Act, to which the dividend accrued was a resident, as defined in the Income Tax Act. The argument against the application of the non-discrimination provision was that the discrimination against which the article was directed was not the discrimination contemplated in s 64B(5)(f)(iii) of the Income Tax Act. The discrimination that arose through the normal operation of section 64B(5)(f) was that in order to claim exemption from tax, it was necessary for the parent receiving the dividend to be “resident” in the same State (South Africa) as the company paying the dividend.

Arguments for the contention that STC violated the non-discrimination provisions embodied in South African DTAs were provided. Although s 64B(5)(f) did not specify ownership or control of capital, it discriminated against South African companies whose shareholders were resident offshore. In other words, it discriminated against South African companies whose capital was wholly or partly owned offshore.

Arguments for and against the application of the non-discriminations provision to domestic law were provided. A conclusion that a non-discrimination provision in a DTA approved by Parliament is valid and binding on South Africa under international law, but does not form part of our domestic law, would have the following implications:

SA courts would not enforce the non-discrimination provision because it would not form part of SA domestic law. They would uphold domestic law such as s 64B(5)(f) of the Income Tax Act, even if it were held that it conflicted with the non-discrimination provision.

This would result in South Africa being in contravention of international law if it permitted discrimination by way of s 64B(5)(f) in a manner prohibited by the non-discrimination provision binding on it under international law.

While the victims of the discrimination would not have a remedy under our domestic law, they may have one under international law.

Conflicting provisions would have to be interpreted in a manner that would be consistent with the obligations undertaken by South Africa under the bilateral DTAs under international law.

This would mean that the prohibition of discrimination under Article 24(5) should prevail over s 64B(5)(f). If the residence requirement of s 64B(5)(f) prevailed instead, it would mean that South Africa would be in contravention of Article 24(5) at international law. It is that outcome which s 233 of the Constitution seeks to avoid.

An analysis of relevant United Kingdom case law was provided. The NEC case<sup>70</sup> provides cogent support for the conclusion that the provisions of s 64B(5)(f) contravene the prohibition on discrimination contained in Article 24(5) on the ground that their shareholders are resident in the foreign State and not in South Africa. The English Court's clear analysis and interpretation of the identical non-discrimination provisions and their application to the facts, is directly relevant to the South African scenario. However, further analysis of identical non-discrimination provisions and their application was considered in a House of Lords [UK] decision and it is submitted that South African Courts would place reliance on this decision.

The important point in *Boake Allen*<sup>71</sup>, for the purposes of this dissertation, was that the purpose of the GIE provisions was to allow the group to decide at what level ACT was paid. It was not to allow ACT to be avoided altogether. This was the reason that the recipient had to be a UK resident before there could be a GIE. In essence, the recipient itself had to be liable, in principle, for ACT. In any South African case, the argument would be that STC was exactly the same in this regard. The purpose of s 64B(5)(f) was to allow a group to decide which company within it paid STC and to allow profits to be transferred within the group, free of STC, provided that STC was paid wherever those profits were paid as dividends outside the group. It was not the purpose of the section to allow a group to decide whether STC was paid at all.

Chapter 3 concluded that in the South African context, the type of discrimination covered by Article 24(5) is solely the discrimination against a subsidiary in South Africa on the grounds that its capital is wholly or partly owned or controlled in the UK. For the reasons given in the *Boake Allen* decision, there exists persuasive influence that the provisions of s 64B(5)(f) did not discriminate against the South African subsidiaries of foreign companies on that ground.

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<sup>70</sup> *NEC Semi-Conductors Ltd and Others v The Commissioner of Inland Revenue*, [2003] EWHC2813 (CH)

<sup>71</sup> *Boake Allen Limited v Revenue and Customs Commissioners*, [2007] UKHL 25; [2007] 1 WLR 1386

The arguments that the exemption provided for in s 64B(5)(f) violated the non-discrimination provisions embodied in South African DTAs would therefore probably not be sustained in a South African court. It was submitted that the real ground for the different treatment is whether the recipient is liable to pay STC, and not the residence of the owner. Therefore it was submitted that this type of discrimination is not that which is prohibited by the DTA article.

Chapter 4 scrutinised the new dividends tax and its exemptions against the background of STC which the new tax replaces, for any possible violations of DTAs principals including a possible contravention of the anti-discrimination provisions embodied in the OECD MTC.

This chapter concluded that the proposed new dividends tax will not be excluded from the scope of most South African DTAs. Furthermore, the dividend tax is a withholding tax on dividends, unlike STC and will therefore not violate other principals embodied in DTAs including those that effectively limit the rate payable on dividends declared by the taxpayer to its holding company. The proposed dividends tax and exemptions therefrom would not violate the anti-discrimination provisions embodied in the OECD model tax convention. Paragraph 5 of Article 24 of the OECD MTC is aimed at ensuring that all resident companies are treated equally regardless of who owns or controls their capital and does not seek to ensure that distributions to residents and non-residents are treated in the same way.

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