

TITLE PAGE

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ABSTRACT

The OECD made certain recommendations in its 2014 discussion draft, “Neutralising the Effects of Hybrid Mismatch Arrangements”, comprising recommendations on domestic law and double tax convention measures. This dissertation assesses the potential implication of these recommendations for South Africa’s tax laws and double tax conventions as these relate to cross border financing arrangements between two taxpayers using hybrid instruments or hybrid entities. These hybrid entities and mismatches and which give rise to mismatch outcomes either through a deduction arising in either jurisdictions or a deduction arising in one jurisdiction without an inclusion in income in the other jurisdiction. This assessment is made to understand how these recommendations could impact on South Africa’s tax laws and double tax conventions.

This impact is assessed by determining the publically expressed sentiment of the South African government towards the OECD’s base erosion and profit shifting proposals and thereafter by assessing how the above noted recommendations may interact with the Income Tax Act and South Africa’s double tax conventions to address mismatches within the scope of this dissertation. This interactions is assessed by:

- reviewing the treatment of cross border hybrid instrument and hybrid entity arrangements in the Income Tax Act,
- the withholding tax measures in the Income Tax Act,
- the treatment of these arrangements in double tax conventions concluded by South Africa, and
- the interaction of the recommendations in the above OECD report with the Income Tax Act and double tax conventions concluded by South Africa.

Conclusions are then drawn from this analysis.

The review of publically expressed sentiments of the South African government evidenced support for the OECD’s base erosion and profit shifting proposals but also a sensitivity to South Africa’s tax sovereignty. The review of the treatment in the Income Tax Act of the arrangements within the scope of this dissertation found that at times the Income Tax Act

potentially did not resolve the mismatches of concern and that withholding tax may not have the potential to comprehensively preserve the tax base against these arrangements, particularly taking into account the influence of double tax conventions. The review of the recommendations in the above OECD report found that these recommendations could assist existing domestic tax law measures in addressing the mismatch outcomes of concern, albeit not necessarily comprehensively and potentially at the cost of added complexity. It was also found that the double tax convention recommendations appeared to have limited impact to clarifying and confirming the existing treatment of arrangements involving hybrid entities.

These findings are significant as they indicate a support for the OECD's recommendations by the South African government and that the recommendations could assist in addressing the mismatch outcomes addressed in this dissertation.

ABBREVIATIONS

| | |
|---------------------------|---|
| BEPS | Base erosion and profit shifting |
| BEPS Action Plan | OECD. 2013. Action Plan on Base Erosion and Profit Shifting. |
| BEPS Declaration | OECD. 2013. Declaration on Base Erosion and Profit Shifting: Adopted on 29 May 2013. |
| BEPS 2013 Report | OECD. 2013. Addressing Base Erosion and Profit Shifting. |
| CFC | Controlled foreign company |
| Companies Act | Companies Act 71 of 2008, as updated to Government Gazette 36485 dated 31 May, 2013. |
| DTI | Department of Trade and Industry |
| Domestic Discussion Draft | OECD. 2014. Public Discussion Draft – BEPS Action 2: Neutralise The Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws) 19 March 2014 – 2 May 2014. |
| DT | Dividends Tax as provided for in Part VIII of the Income Tax Act 58 of 1962 |
| DTC | Double Tax Convention |
| G20 | Group of Twenty |
| G20 Leaders Declaration | The Group of Twenty. 2013. The G20 Leader’s Declaration: September, 2013. St. Petersburg Summit. |
| GAAR | General anti-avoidance rules |
| Government | The South African Government |
| Hybrid Report | OECD.2014. Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project. |
| OECD Model | OECD. 2014. Model Convention With Respect To Taxes on Income and on Capital as it read on 15 July 2014 |
| OECD | Organisation for Economic Co-operation and Development |
| OEEC | Organisation for European Economic Co-Operation |
| Recommendations | The draft domestic law and tax treaty recommendations set out in the Hybrid Report to address mismatch outcomes from hybrid instruments and entities |
| REIT | Real Estate Investment Trust |
| Republic | Republic of South Africa |

| | |
|--------------------------------|--|
| SARS | South African Revenue Service |
| the Act | Income Tax Act No. 58 of 1962, updated to Government Gazette 38406 dated 20 January, 2015. |
| the Commentary | OECD. 2014. The Commentaries on the Model Tax Convention on Income and on Capital: Condensed Version 2014 |
| the G20 | The Group of Twenty |
| the Partnership Report | OECD. 1999. The application of the OECD Model Tax Convention to partnerships. |
| the Thin Capitalisation Report | OECD. 1986. Thin Capitalisation. |
| Treaty Discussion Draft | OECD. 2014. Public Discussion Draft – BEPS Action 2: Neutralise The Effects of Hybrid Mismatch Arrangements (Treaty Issues) 19 March 2014 – 2 May 2014 |
| VCLT | Vienna Convention on the Law of Treaties, 23 May 1969 |
| WHT | Withholding Tax |
| WHTI | Withholding Tax on Interest as provided for in Part IVB of the Act |

All section references in this dissertation are to those of the Act unless otherwise stated. All Article references are to those of the OECD Model unless otherwise stated.

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1. INTRODUCTION

1.1 Background

In 2013 the OECD issued a report, the BEPS 2013 Report, in which it stated that BEPS presented “a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike” (OECD, 2013b:5). This report characterised BEPS as “planning aimed at shifting profits in ways that erode the taxable base to locations where they are subject to a more favourable tax treatment” (OECD, 2013b:13). Certain areas were identified as being key contributors to BEPS and it was proposed that action plans be formulated to address these areas (OECD, 2013b:10). The stated objective of these plans was to “ensure that profits are taxed where economic activities generating the profits are performed and where value is created” (OECD, 2014d:3).

One area identified as a contributor to BEPS was cross border arbitrage using hybrid mismatch arrangements.

The OECD defined a hybrid mismatch arrangement as being:

“an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement” (OECD, 2014d:29)

Elements highlighted as contributing to these mismatches were the deduction in one jurisdiction without an inclusion in income in another jurisdiction (referred to as a D/NI outcome) and deductions in two jurisdictions without matching inclusions in income (referred as a DD outcome) (OECD, 2014d:14).

The OECD formulated the BEPS Action Plan which included a plan to neutralise the effects of hybrid mismatch arrangements, including changes to the OECD Model and domestic tax laws (see Annexure A).

The OECD tasked Working Party No. 11 on Aggressive Tax Planning to develop the domestic law measures and Working Party No. 1 on Tax Conventions and Related Questions to work on the OECD Model aspects. These working parties issued two public discussion documents in March 2014, being the Domestic Discussion Draft and the Treaty Discussion Draft, and a final report in September 2014, being the Hybrid Report. The Hybrid Report sets out the Recommendations.

1.2 Topic of dissertation

This dissertation assesses the potential impact of the Recommendations on South Africa's tax laws and tax treaties as these relate to selected cross border financing arrangements between two taxpayers using hybrid instruments or hybrid entities and which give rise to a DD or D/NI mismatch outcome.

1.3 Approach to assessing potential impact and concluding thereon

This potential impact will be assessed firstly through determining the sentiment of the Government through publicly available documents towards the OECD's BEPS proposals and thereafter by assessing how the Recommendations may interact with the Act and South Africa's DTCs in addressing DD and D/DNI mismatch outcomes. .

The interaction between the Recommendations, the Act and DTCs will be assessed firstly by reviewing the treatment of selected cross border hybrid instrument and hybrid entity arrangements in the Act and whether or not these provisions demonstrate a potential to not effectively address cross border DD and D/NI mismatch outcomes, then by reviewing WHT measures in the Act with a view to assessing whether or not these have the apparent potential to preserve the tax base against cross border hybrid arrangements, then by reviewing the treatment of these arrangements in DTCs concluded by South Africa so as to

assess how these may influence the outcomes of measures in the Act to address hybrid mismatch arrangements and to preserve the tax base and lastly by reviewing how the Recommendations may interact with the Act and the DTCs in addressing DD and D/NI mismatch outcomes that may otherwise arise and in preserving domestic .

1.4 Scope limitations to topic

Foreign tax treatment

As this dissertation assesses the impact on South African tax laws and DTCs, it is outside the scope of the dissertation to analyse how foreign tax laws treat hybrid arrangements, and accordingly assumptions on this treatment will be made as is necessary.

Hybrid mismatches out of scope

This dissertation has a focus on DD and D/NI mismatches and therefore mismatches arising from dual resident entities and multiple foreign tax credits are outside the scope of this dissertation. In addition an analysis of the role of trusts in mismatch arrangements is excluded.

Specialised arrangements and situations

This dissertation assess hybrid financing arrangements in general. Therefore the impact on special situations such as long-term insurers, short-term insurer's collective investment schemes, REITs and persons subject to section 24JB are outside the scope of this dissertation.

Transfer pricing

The impact of transfer pricing provisions of the Act and the Associated Enterprise article of a DTC on hybrid arrangements are outside the scope of this dissertation.

GAAR and CFC provisions

It is acknowledged that the GAAR and CFC provisions of the Act could potentially assist in neutralising hybrid mismatch arrangements but are excluded from the scope of this dissertation in light of the uncertainty of the impact of these provision in DTC situations.

Other BEPS Actions Plans

The impact of recommendations arising from other plans in the BEPS Actions Plan are outside the scope of this dissertation, as is the interaction between these various recommendations.

DTC analysed

South Africa has 73 DTCs in force (SARS, 2014). It is beyond the scope of this dissertation to assess the impact applying each individual DTC but instead conclusions will be drawn with reference to the OECD Model. This is on the basis that all but 7¹ of South Africa's DTCs came into force after 1994, only 3 before 1963², that South Africa's DTCs concluded after 1994 have mostly followed the OECD Model (Brincker, 2010) and that a review of the history of the OECD Model (OECD, 2012b) confirms that subsequent to 1977 there have not been significant changes to the OECD Model terms relevant to this dissertation. These terms are "person" in Article 3(1), "resident of a Contracting State" in Article 4(1), "dividend" in Article 10(3), "interest" in Article 11(3) and "beneficial owner" in Articles 10(2) and 11(2). The impact of Articles 23A, 23B and 24 are outside the scope of this dissertation and are therefore not considered.

A review of a sample of DTCs concluded by South Africa³ show that these terms were applied in line with the OECD Model, albeit with some variations. These terms are set out

¹ Being the DTCs with Israel, Germany, Grenada, Malawi, Sierra Leone, Zambia and Zimbabwe.

² Being the DTCs with Grenada, Sierra Leone and Zambia

³ Being the DTCs concluded with those countries listed by the DTI as being a top 5 export partner or a top 5 import partner (DTI, 2014). In addition the DTCs concluded with France, Italy, Ireland, Luxembourg, Mauritius, Netherlands and the United Kingdom were also reviewed.

in Annexures B and C, highlighting significant variations to the OECD Model. These variations are discussed further in the part of the dissertation dealing with these terms, when is relevant.

1.5 Interpretation of DTC terms

Article 3(2) provides that a term which are not defined in the OECD Model shall bear its domestic law meaning unless “the context otherwise indicates”.

The Supreme Court in *Commissioner for the South African Revenue Service v Tradehold Ltd* [2012] ZASCA 61 at para. 23 held that the meaning of a DTC term “must be given a meaning that is congruent with the language of the DTA having regard to its object and purpose”.

The VCLT includes norms for interpreting treaties including a general rule that “a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose” (VCLT: Article 31(1)). The VCLT reflects customary international law for interpreting treaties and therefore has application.⁴ It has also been applied by the Constitutional Court in *Glenister v President of the Republic of South Africa and Others* 2011 (3) SA 347 (CC) at para. 187 in interpreting a treaty.

Accordingly the principles as set out above in Article 3(2) and the VCLT as well as by the Supreme Court shall be applied when interpreting a meaning of a DTC term.

⁴ Section 232 of the Constitution provides that customary international law is law in South Africa unless inconsistent with the Constitution or an Act of Parliament. The Court of Appeal of England and Wales (Civil Division) held in *Ben Nevis (Holdings) Limited (1) and Metlika (Trading) Limited (2) v. Commissioners for HM Revenue and Customs* [2013] EWCA Civ 578 that the “rules of interpretation set out in Articles 31 and 32 of the Vienna Convention are rules of customary international law and therefore binding on all States regardless of whether or not they are parties to that Convention”.

2. SENTIMENT OF THE GOVERNMENT

2.1 Publically expressed sentiments reflecting the Government's position

The Government has publically endorsed the BEPS Action Plan by way of signing the BEPS Declaration and G20 Leaders' Declaration (OECD, 2013:2; The G20, 2013).

Included in the BEPS Declaration was support for developing a comprehensive action plan to address “asymmetries in domestic and international tax rules [...] resulting in “double non-taxation” or very low effective taxation” and agreement that national authorities needed to cooperate to develop solutions.

This public support was reinforced in the G20 Leaders' Declaration, in which it was declared:

“In order to minimize BEPS, we call on member countries to examine how our own domestic laws contribute to BEPS and to ensure that international and our own tax rules do not allow or encourage multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions. We acknowledge that effective taxation of mobile income is one of the key challenges. We look forward to regular reporting on the development of proposals and recommendations to tackle the 15 issues identified in the Action Plan and commit to take the necessary individual and collective action with the paradigm of sovereignty taken into consideration ” (The G20, 2013:12).

Although this declaration is that of the G20 and not of the Government, it would, with due regard to tax sovereignty, politically commit Government by virtue of its membership of G20.

Thus Government has publically expressed support for the OECD's position on BEPS and its proposed actions and redress measures.

2.2 BEPS influenced measures

Government support for BEPS has been evidenced in a practical way through the introduction of interest deduction limitation rules⁵ and hybrid debt rules⁶ with the BEPS 2013 Report being cited as impetus for this introduction (National Treasury & SARS, 2013a). Further evidence is found in the Minister of Finance mandating the Davis Tax Committee to include BEPS in its review of South Africa's corporate tax system (The Davis Committee, 2013).

In the 2015 National Budget Review, the Minister of Finance announced the introduction of certain measures⁷ noting the influence of the BEPS 2013 Report (National Treasury, 2015:49).

2.3 National interest

In setting the terms of reference for the Davis Tax Committee, the Minister of Finance stated that: "Social objectives, building a cohesive and inclusive society can be met partially through a progressive tax system and by raising revenue in order to redistribute resources" (The Davis Tax Committee: 2013). This was set as an objective for South Africa's tax system.

An underlying purpose of the Recommendations is to address erosion of tax bases and thus prima facie should support the Government objective of using the South African tax system to advance social objectives.

It is acknowledged that the Davis Tax Committee issued a first interim report on the Hybrid Report, expressing the view that South Africa "had been proactive and was ahead of the curve" with regard to hybrid mismatch arrangements (Davis Tax Committee, 2014:66). However, this dissertation has focused on other sources for information recognising that the Davis Tax Committee report is an interim report and subject to possible change.

⁵ Section 23M

⁶ Sections 8F and 8FA

⁷ These measures related to transfer pricing documentation and reporting, CFC rules and the digital economy.

2.4 Conclusion on the sentiment of Government

It is clear from the public statements and actions of Government that it is sensitive to BEPS and supports the OECD actions in addressing BEPS and thus the Recommendations, albeit with due regard to tax sovereignty.

In this light the question arises as to whether or not the Act and DTCs concluded by South Africa neutralise DD and D/NI outcomes from cross border arrangement using hybrid financial instruments or hybrid entities and to the extent there are shortcomings whether or not the Recommendations would neutralise this arbitrage when this is not the case in a way that may be acceptable to Government.

These questions will be addressed below.

3. THE CHARACTERISATION AND TREATMENT OF HYBRID ARRANGEMENTS IN THE ACT

3.1 Introduction

The mismatch outcomes in hybrid transactions has been described in the case of a hybrid financial instrument as arising from differences in the characterisation of the financing arrangement (OECD, 2014b:19), and in the case of a hybrid entity payment as arising from differences in the treatment of transparency of the entity (OECD, 2014b:44).

This part of the dissertation provides an overview of the treatment of debt and equity arrangements in the Act and the fiscal transparency of relevant entities in terms of the Act, taking into account measures in the Act to address mismatch outcomes, with a view to assessing whether or not these provisions exhibit a potential to not effectively address DD or D/NI outcomes in selected cross border financing arrangements using hybrid instruments or hybrid entities. The interaction of these provisions with applicable WHT provisions and DTCs concluded by South Africa is assessed thereafter.

3.2 Taxation of debt and equity instruments – general treatment

Introduction

In general and subject to specified exceptions, interest income is taxable,⁸ interest expenditure is deductible (subject to the expenditure being incurred in the carrying of a trade and in the production of income),⁹ dividend income is exempt in whole or part¹⁰ and a dividend distribution is not deductible.¹¹ A return of capital which is of a revenue nature is

⁸ In terms of section 24J(3) where interest is receivable in terms of an instrument which is subject to section 24J(3) (being an “income instrument” as defined in section 24J(1)) and for other instances on the basis that the interest is “gross income” as defined in section 1.

⁹ In terms of section 24J(2) where the interest is payable in terms of an “instrument” as defined in section 24J(1) and for other instances in terms of section 11(a).

¹⁰ Refer section 10(1)(k)(i) for the exemption of a “dividend” as defined in section 1 and section for the exemption a “foreign dividend” as defined in section 1 of the Act.

¹¹ This is on the basis that it is not an amount of expenditure incurred in the production of income and thus does not meet the requirements of the general deduction provision, namely section 11(a).

taxed in full¹² while those of a capital nature form part of the capital gains computation for purposes of determining the amount, if any, to be included in taxable income,¹³ but with certain capital gains being disregarded.¹⁴

Therefore the characterisation of an amount as interest, dividend or a return of capital has an important bearing on the tax outcome of a financing arrangement.

Interest

The Act defines interest in section 24J.¹⁵ While this definition does not apply for purposes of the Act,¹⁶ the breadth of application of this section gives this definition wide application in the Act.

Section 24J, except in limited instances,¹⁷ deems a qualifying amount to be “an amount of interest” which has been “incurred” or “accrued”, as the case may be, and is to be deducted from “income”¹⁸ or included in “gross income”¹⁹, as the case may be.²⁰ This deemed amount though includes interest as ordinarily understood.²¹

The meaning of interest as it applied before the introduction of section 24J was considered by our courts in *Commissioner for Inland Revenue v Lever Brothers & Unilever Ltd* 1946

¹² Definition of “gross income” in section 1 (where shares are held as trading stock).

¹³ Part XI of the 8th Schedule to the Act read with section 26A.

¹⁴ Para 64B(4) of the 8th Schedule to Act disregards a qualifying “foreign return of capital” as defined in section 1.

¹⁵ Section 24J(1).

¹⁶ Refer to preamble to section 24J(1).

¹⁷ This limited instance would arise when an “instrument” is held by persons other than a “company” and which has a term of one year or less or is not subject to a discount, premium or “deferred interest”.

¹⁸ Refer definition in section 1.

¹⁹ Refer definition in section 1.

²⁰ Refer sections 24J(2) and (3).

²¹ Para. (c) of the definition of “instrument” in section 24J(1) includes “any interest-bearing arrangement or debt”, while para (a) of the definition of “interest” in section 24J(1) includes the “gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement”. This internal reference to interest makes financial arrangements which bear interest as ordinarily understood an “instrument” for purposes of section 24J. This is important as the amounts which are deemed to be interest for section 24J purposes are the “accrual amounts” in respect of that “instrument”. An “accrual amount” is defined in section 24J(1) but is essentially the income in respect of that instrument as calculated on a yield to maturity basis.

AD 441 and in *Cactus Investments (Pty) Ltd v Commissioner for Inland Revenue* [1999] 1 All SA 345 (A).

In *Lever Brothers*, a supply of credit was considered and it was held that the interest payable on a supply of credit was consideration for the supply of credit (*Commissioner for Inland Revenue v Lever Brothers & Unilever Ltd* 1946 AD 441, 14 SATC 1 at 10). The *Cactus* case dealt with a loan of money and it was held that the lender became entitled to receive interest at a stipulated future date as soon as the funds were made available to the borrower (*Cactus Investments (Pty) Ltd v Commissioner for Inland Revenue* [1999] 1 All SA 345 (A) at 44). In so holding the court held that common law principles applied unless the agreement indicated otherwise. The court considered that the interest for the loan was the amount stipulated in the agreement as being payable in return for the continued availability of the loan (Brincker, 2011:Ch. V.2).

Notable from these decisions is that common law principles and the nature of the underlying agreement is relevant. That is to say the legal substance of the financing arrangement appears to be decisive in determining whether an amount is interest in common law. Accordingly, where a financing arrangement is in the form of debt then the consideration (in the case of a supply of credit) or stipulated return (in the case of loan) will be treated as interest for purposes of the Act.

Section 24J does however extend the ambit of interest beyond the amounts which are interest in law by deeming certain amounts to also fall within the ambit of the provision. This is done by way of including certain specified amounts in the section 24J definition of “interest” and certain specified arrangements in the section 24J definition of “instrument”. Certain of these inclusions are relevant to hybrid instrument arrangements and are discussed in part 3.3 of this dissertation.

Dividend

The Act defines the term “dividend” to broadly be an amount which is “transferred or applied” by a resident company for “the benefit or on behalf of” any person “in respect of

any share” in that company to be a dividend except to the extent that the distribution reduces the companies “contributed tax capital”,²² constitutes shares in that company or constitutes a qualifying repurchase of its shares.²³ This transfer or application must therefore be by way of a distribution by the company or repurchase of its shares.

The term “distribution” is not defined in the Act but is defined in the Companies Act. This definition includes a “transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of one or more holders of any shares, or to the holder of a beneficial interest in any such shares, of that company or of another company within the same group of companies [...]”.²⁴

A “share” is defined in relation to a company to mean “any unit into which the proprietary interest in that company is divided”.²⁵ A “share” for Companies Act purposes holds the same meaning.²⁶

Taking the above into account an amount should comprise a “distribution” for purposes of the Act where it comprises a transfer of company money or property to a holder of a “share” or a holder of a “beneficial interest” in the share in circumstances where the transfer is in respect of that “share.

The aforementioned indicates that the legal substance of the instrument is important to the characterisation of the income flowing therefrom as a dividend.

The Act provides for distributions by non-resident companies by way of separate definitions of a “foreign dividend” and a “foreign return of capital”.

²² “Contributed Tax Capital” is defined in section 1 but is broadly the tax equivalent of a company’s share capital account.

²³ Refer to definition of “dividend” in section 1.

²⁴ Refer definition of “distribution” in section 1 of the Companies Act.

²⁵ Section 1.

²⁶ Refer definition of “share” in section 1 of the Companies Act.

Foreign dividend

The definition of “foreign dividend” broadly includes any amount that is “paid or payable by a foreign company in respect of a share in that foreign company”.²⁷

Thus a payment by a non-resident company in respect of an instrument which provides for a proprietary interest in that company should be “foreign dividend” for purposes of the Act. Therefore the legal substance of the instrument is also important to the characterisation of the income flowing therefrom as a “foreign dividend”.

Return of capital

The Act defines the term “return of capital” to broadly comprise a transfer as contemplated in the “dividend” definition which however reduces the “contributed tax capital” of the company in question.²⁸

Foreign return of capital

The Act defines the term “foreign return of capital” to broadly comprise a payment that is treated as a distribution or similar payment (other than an amount that constitutes a foreign dividend) by that foreign company” in terms of certain specified laws of its place of effective management.²⁹

Conclusion

The legal substance of the instrument is important to the characterisation of the income arising therefrom as a dividend, foreign dividend, return of capital, foreign return of capital or an amount of interest. This suggests that absent legislative intervention, the Act may not effectively address D/NI or DD outcomes in cross border arrangements involving hybrid instruments where the instrument is taxed in the other state on a basis other than its legal

²⁷ Refer section 1 of the Act for the definition.

²⁸ Definition of “return of capital” in section 1.

²⁹ Definition of “foreign return of capital” in Section 1.

substance or where the other state simply does not tax the income arising from the instrument.

South Africa has introduced measures targeted at hybrid instruments. These are discussed below.

3.3 Taxation of debt and equity instruments – hybrid instrument related anti-avoidance measures

Introduction

The Act includes certain measures targeted at hybrid instrument arrangements. These are discussed below in broad outline, as is the apparent potential of these measures to not effectively address DD and D/NI mismatch outcomes.

The WHT and DTC implications arising from the below provisions are discussed later in this dissertation.

Hybrid debt instruments and hybrid debt

Sections 8F and 8FA broadly target payments by companies under arrangements which in legal substance are interest bearing debt or give rise to interest but which contain certain features considered to be hallmarks of an equity arrangement (National Treasury, 2013:28).

These provisions deem the interest on qualifying arrangements to be a non-deductible “dividend *in specie*” which is declared and paid by the company which incurred the interest to the person who accrued the interest.³⁰ The intention of National Treasury is that these amounts be treated as a dividend by both parties to the transaction (National Treasury & SARS, 2013a:3).

³⁰ Sections 8F(2) and 8FA(2).

In a transaction involving a qualifying payment from a resident company to a non-resident person, these provisions would deny a deduction that would otherwise have been available³¹ and thus neutralise qualifying D/NI mismatch arrangements.

Essential to the application of these provisions is that either the instrument is a “hybrid debt instrument” as defined³² or the interest amount is “hybrid interest” as defined.³³ Rule sets determine the ambit of these definitions and it is questioned whether a rule set can reflect all the conditions that might be applied in a similar set of provisions in other states. This leads to the apparent possibility of financing provided by a non-resident in the form a debt falling outside of sections 8F and 8FA but within a hybrid re-characterisation provision in the other state, resulting in a D/NI mismatch.

Further, sections 8F and 8FA apply to qualifying payments made by a “company” as defined in section 1 and would therefore include payments by non-resident companies.³⁴ Thus, in a transaction involving a qualifying payment from a non-resident company to a resident, these provisions could result in an amount that would otherwise have been taxable as an amount of interest now being treated as an exempt dividend *in specie*. This would be on the basis that in deeming the payment to be a dividend *in specie*, these provisions have the effect of also treating these receipts (as for qualifying payments by resident companies) as falling within the ambit of section 10(1)(k) and thus being exempt from tax.

For this outcome not to arise, it is submitted that sections 8F and 8FA would have to be read as deeming such payments to be a “foreign dividend” for purposes of section 10B or as not being applicable to payments by foreign companies.

³¹ Sections 8F(2) and 8FA(2).

³² Section 8F(1).

³³ Section 8FA(1).

³⁴ Paragraph (b) of the definition of company in section 1 includes “any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law”

However the use of the term “dividend *in specie*” in section 64F, the separate definitions of the terms “dividend” and “foreign dividend”³⁵ and the definition of the term “company” would not support this reading.

Accordingly, absent legislative amendment to sections 8F and 8FA to make it clear that these provisions do not apply to payments by non-resident companies, a court may need to rely on the anti-avoidance context of these provisions to apply these provisions in way that does not have an avoidance outcome.³⁶ It is submitted that this outcome in a court is not guaranteed and therefore at best there appears to be uncertainty on the application of these provisions in the context of a payment by a non-resident to which the provisions prima-facie apply.

As these provisions are not linked to the treatment of the arrangement in the foreign state it would appear to be possible for such qualifying transactions to arise in circumstances where the other state continues to tax according to the legal substance of the arrangement and thus giving rise to a D/NI mismatch outcome.

Thus sections 8F and 8FA, while having the potential to neutralise D/NI mismatch outcomes in respect of certain hybrid debt financing arrangements, do not appear to certainly apply to all cross border hybrid debt financing arrangements and thus effectively address all hybrid debt D/NI mismatches.

Hybrid equity instruments and third party backed shares

Sections 8E and 8EA of the Act target interest bearing arrangements which are equity arrangements in legal substance (National Treasury, 2003: Clause 19) and (National Treasury, 2012:22) apply to “dividends” and “foreign dividends” received or accrued by

³⁵ Sections 64F and 64FA reference a “dividend” comprising a distribution *in specie* as being a “dividend *in specie*”. This indicates an intention on the part of National Treasury that in deeming a qualifying payment to be a “dividend *in specie*” that the payment was deemed to be a “dividend” comprising a distribution in specie. Since a “foreign dividend” is a separately defined term it would not be such a “dividend *in specie*”.

³⁶ Our courts have held that the context and apparent purpose of a term must also be taken into account when determining its statutory meaning (*Commissioner for the South African Revenue Service v Bosch* 2015 (2) SA 174 (SCA) at para 9).

any person in respect of a qualifying share.³⁷ These provisions treat qualifying dividends or foreign dividends that would otherwise have been exempt or partially exempt from normal tax as being income for purposes of the Act and thus subject to normal tax in full.³⁸

In the case of a qualifying payment by a non-resident to a resident, these provisions may result in the resident being taxed on amounts that would otherwise be exempt or partly exempt amounts³⁹ and thus would, in these cases, neutralise any D/NI mismatch.

It may be that this section does not cover all instances where a “foreign dividend” would otherwise be deductible but then the dividend would no longer enjoy a full exemption in terms of section 10B of the Act. Refer to the discussion below on the provision addressing deductible foreign dividends.

In the case of a qualifying payment by a resident to a non-resident, the payment would remain a dividend and thus not deductible. In addition the non-resident is deemed to be in receipt of income that is not exempt from normal tax.⁴⁰

Thus these provisions when seen in conjunction with the proviso to section 10B(2) of the Act should neutralise D/NI outcomes from legal substance equity hybrid arrangements.

Repurchase/sale and leaseback arrangements

As noted above section 24J expands the ambit of amounts deemed to be interest for purposes of that section by way of expanding its definition of “interest” and “instrument” to include certain specified situations. These instances include net payments and receipts under

³⁷ Section 8E(2) read with the definition of “hybrid equity instrument” in section 8E(1) and section 8EA(2) read with the definition of “third-party backed share” in section 8EA(1).

³⁸ Section 8E(2) and 8EA(2).

³⁹ A dividend paid by a foreign company which qualifies as a “foreign dividend” as defined in section 1 would be exempt in part or in full in terms of section 10B. This section partly exempts “foreign dividends” from normal tax except for those which meet the participation threshold. These latter “foreign dividends” are instead subject to a full exemption from normal tax. By deeming the dividend to be an amount of income this exemption is neutralized with the result that the amount is subject to normal tax.

⁴⁰ Section 10(1)(k), which exempts dividends from normal tax, and the source rules of section 9 (this is relevant as a non-resident is, under general principles, only subject to tax on amounts from a South African source) should not vary this outcome as sections 8E and 8EA deem these amounts be “income” thereby making these provisions redundant.

certain defined sale and leaseback arrangements⁴¹ and certain repurchase and resale agreements.⁴²

In this way qualifying arrangements which legally give rise to sale and leaseback payments or sale and repurchase payments are treated as financing arrangements deemed to give rise to interest amounts for tax purposes. The interest amount in these instances is the net payment or receipt.⁴³

Where a resident provides financing to a non-resident by way of the above noted arrangements, these provisions result in the net proceeds from the arrangement being taxed in the hands of the resident as an amount of interest income instead of as a gain from a resale or sale and leaseback arrangement.⁴⁴

On the other hand where a resident is a recipient of such financing, these provisions may result in a tax benefit that would otherwise not have been available.⁴⁵

Consider, for example, an arrangement involving the sale of shares by a South African resident to a non-resident on the basis that these shares will be repurchased by the resident at an agreed future date and agreed price in excess of the sale price. The resident receives a principal amount on the sale leg, which would otherwise be taxable as revenue or capital proceeds, and incurs expenditure on the repurchase leg. The expenditure may only be available as a future deduction when the asset is eventually sold.

⁴¹ Para (c) of the definition of “interest” in section 24J(1).

⁴² Para (e) of the definition of “interest” in section 24J(1).

⁴³ Definition of “accrual amount” in section 24J(1) read with the definition of “yield to maturity” therein.

⁴⁴ These gains in any event may have been taxable in full on the basis that they form part of profit making scheme (*Commissioner of Inland Revenue v Pick ‘n Pay Employee Share Purchase Trust* 1992 (4) SA (39)). However, section 24J results in the gain being taxed over the term of arrangement and thus potentially averts a long term deferral of tax. The outcome contemplated in this dissertation though assumes that the net returns on the arrangement are determined either with reference to a rate of interest or the “time value of money” and thus is not “hybrid interest” as contemplated by para. (a) of the definition of “hybrid interest” in section 8FA(1). If this were to be the case then the interest amount as calculated by section 24J would be deemed to a non-deductible “dividend *in specie*”.

⁴⁵ This outcome assumes that the net returns on the arrangement are determined either with reference to a rate of interest or the “time value of money” and thus is not “hybrid interest” as contemplated by para. (a) of the definition of “hybrid interest” in section 8FA(1). If this were to be the case then the interest amount as calculated by section 24J would be deemed to a non-deductible “dividend *in specie*” which had been declared and paid to the non-resident.

However, section 24J includes within the ambit of an “instrument” a “repurchase agreement”⁴⁶. This is relevant as the payments and receipts on the arrangement will then be subject to the deemed interest calculation of section 24J.⁴⁷

The arrangement in this example would fall within the ambit of a “repurchase agreement” as there has been a disposal of an asset on the basis that this asset will be resold to the resident at an agreed future date.⁴⁸

This means that section 24J(2) would deem the resident to have incurred, subject to the amount being incurred in the production of income, a deductible amount of interest equal to the difference between the sale price and the repurchase price.⁴⁹

On the other hand the financier would similarly be deemed in terms of section 24J(3) to have accrued an amount as interest income which must be included in gross income, also over the term of arrangement on the above noted yield to maturity basis.⁵⁰

This deemed inclusion in gross income would at first seem to match the deduction obtained by the resident and thus resolve the potential D/NI mismatch. However, this amount could be exempt in terms of section 10(1)(h). This section exempts “any amount of interest which is received or accrues by or to any person that is not a resident” and as section 24J(3) deems

⁴⁶ Definition of “instrument” in section 24J(1)

⁴⁷ Section 24J(2) deems “accrual amounts” in respect of an “instrument” issued by the person to be amounts of interest incurred by the person. An “accrual amount” is defined in section 24J(1) with the result that difference between the sale price and repurchase price will be deemed to be an “accrual amount” over the term of the arrangement on the basis of the “yield to maturity” calculation set out in section 24J(1).

⁴⁸ A “repurchase agreement” is defined in section 24J(1) to mean “the obtaining of money (which money shall for the purposes of this section be deemed to have been so obtained by way of a loan) through the disposal of an asset by any person to any other person subject to an agreement in terms of which such person undertakes to acquire from such other person at a future date the asset so disposed of or any other asset issued by the issuer of, and which has been so issued subject to the same conditions regarding term, interest rate and price as, the asset so disposed of”

⁴⁹ Section 24(J)(2) read with definition of “accrual amount” in section 24J(1)

⁵⁰ This deemed inclusion in gross income would negate the need to test whether the non-resident had accrued income from a South African source and thus an amount of gross income. Amounts which have been received by or accrued to non-residents are, in terms of paragraph (i) of the definition of “gross income” in section 1, only “gross income” if the amount is from a source within South Africa.

the holder, for purposes of the Act, to have accrued an amount of interest, this interest would on this interpretation of section 10(1)(h) exempt this interest.

The question arises as to whether this interpretation is counter to the intended purpose and context of the exemption.

National Treasury stated in 2010 that historically this exemption was intended to attract foreign debt capital to South Africa but that the “blanket income tax exemption” previously granted was now considered inappropriate and that going forward the provision would play a narrower role and be balanced by a WHT on interest paid to non-residents (National Treasury, 2010:69).

It is noted that notwithstanding this review National Treasury has not made an exemption under section 10(1)(h) specifically subject to WHT being levied on the amount in question. This suggests that National Treasury could intend section 10(1)(h) to continue to exempt interest which had accrued to non-residents⁵¹ and to instead rely on the WHT provisions to operate effectively to balance this exemption.

It is possible however that there could be a mismatch between the interest that is subject to a section 10(1)(h) exemption and the interest that is subject to WHT. This is because section 10(1)(h) applies to amounts which have accrued to the non-resident (and thus potentially exempt section 24J(3) amounts) while WHT applies to interest “paid” to the non-resident in circumstances where the WHT provision does not define interest.⁵² This could mean that the interest in question could be exempt but not be subject to WHT. For a further discussion on this refer part 4.2 of this dissertation.

This mismatch could lead a court to conclude that the broader context of the provisions, namely the anti-avoidance role of section 24J and the legislators intention to balance a section 10(1)(h) exemption with WHT, requires that section 10(1)(h) be interpreted independently of section 24J(3) and in way which maximises consistency with Part IVB of

⁵¹ Except for instances where interest was effectively connected to a permanent establishment located in South Africa or accrued to a natural person physically present in South Africa for the qualifying period

⁵² Refer to sections 50A and 50B.

the Act. However, the court could also conclude that the exemption should be allowed on the basis of the interplay between sections 24J(3) and 10(1)(h) and that rather the WHT provisions should be interpreted in a way that is consistent with this exemption. This being the case a D/NI mismatch would apply which remains to be balanced by WHT collections. In any event, it is at a minimum unclear how a court would resolve the above apparent mismatches between these provisions suggesting that a legislative amendment to clarify the application of section 10(1)(h) in such situations would be appropriate.

Accordingly in the case where a resident is the financier, the provisions would appear to neutralise a D/NI outcome but to potentially not effectively address the mismatch where a resident is the recipient of financing.

Deductible foreign dividends

“Foreign dividends” are exempt in full if the recipient has a qualifying holding in the non-resident company paying the dividend.⁵³ This full exemption though does not apply if the company declaring the dividend is entitled to deduct the dividend for tax purposes in the country in which the company has its place of effective management,⁵⁴ with the result that the dividend is taxed.⁵⁵

In addition if the payment is not treated as a dividend or similar payment⁵⁶ for tax purposes in the country in which it has its place of effective management⁵⁷ then the receipt will not

⁵³ Section 10B(2)(a)

⁵⁴ Proviso to section 10B(2).

⁵⁵ Section 10B(3) provides for a partial exemption which results in companies paying normal tax equal to 15% of the dividend and other persons having a marginal tax rate of 40% also paying normal tax equal to 15% of the dividend.

⁵⁶ It is submitted that reference to “treatment” in the definition of “foreign dividend” is a reference to the characterization of the amount and is not a reference to the deduction allowed in respect of the amount in question under the relevant foreign tax act. The support for this is the proviso to section 10B(2) disallowing a full exemption for “foreign dividends” allowed to be deducted in the country of place of effective management. This proviso would be redundant if the alternative interpretation to the term “treatment” was applied.

⁵⁷ Definition of “foreign dividend” in section 1. Where the country of place of effective management does not have any income tax laws, then this definition merely requires that it be treated as a dividend or similar payment under the laws of the country of formation or establishment.

qualify as a “foreign dividend”.⁵⁸ It will also not qualify as a “dividend”⁵⁹ resulting in the receipt being taxed in full.⁶⁰

These provisions link the domestic treatment of a foreign dividend with its treatment in the foreign jurisdiction and for this reason together would appear to have the potential to neutralise D/NI outcomes involving outbound legal substance equity financing arrangements.

Deductible foreign return of capital

The definition of “foreign return of capital” excludes distributions that would otherwise qualify but which are deductible for tax purposes in the country of its place of effective management. It seems that this exclusion was intended to result in such distributions being taxable in full and thereby neutralising a D/NI mismatch.⁶¹

Conclusion on anti-avoidance measure

In general the provisions targeted at hybrid instruments would appear to be most effective in neutralising D/NI mismatches when the domestic treatment is linked to the foreign treatment. These characteristics are not found in sections 8F and 8FA and the hybrid provisions in section 24J, resulting in these provisions having an apparent potential to not effectively address D/NI outcomes from cross border hybrid instrument arrangements. It is also questioned whether sections 8F and 8FA are not susceptible to being bypassed by way of considered structuring of arrangements.

⁵⁸ Refer definition of the term in section 1.

⁵⁹ Refer definition of the term in section 1.

⁶⁰ The receipt would be “gross income” as defined in section 1 but would not fall within the ambit of exempt income.

⁶¹ Presumably this is on the basis that the distribution would then be taxable in full on the basis that it would neither be exempt in terms of section 10B of the Act nor subject to the capital gains tax participation exemption of para. 64B(4) of the 8th Schedule of the Act.

Accordingly, it appears that the Act has an apparent potential to not effectively address D/NI mismatches in cross border hybrid instrument arrangements in certain instances.

3.4 Taxation of entities in South African tax law – general treatment

Cross border entity mismatches arise from an entity being treated as taxable in one jurisdiction and as transparent in the other jurisdiction. This raises the question as to how entities are taxed in South Africa.

Normal tax is levied on a “person” and a “company”,⁶² with the result that a⁶³ “company”⁶⁴ would be treated as separately taxable entities in South Africa.

A partnership is treated in law as a mere grouping or association of individuals without any legal personality separate from its members (Henning, 2006:para. 252 & 279). Thus a partnership is not a legal persona and thus would not, ordinarily, be taxed separately from its members.⁶⁵

The question then arises as to what measures are in place in the Act to align the above scoping of taxable entities with the taxation of entities in foreign jurisdictions. This is addressed in part 3.5 of this dissertation.

⁶² Section 5(1).

⁶³ As confirmed in *Trustees Of The Phillip Frame Will Trust v Commissioner For Inland Revenue* 1991 (2) SA 340(W) 53 SATC 166 at 170

⁶⁴ Refer definition of “company” in section 1.

⁶⁵ This fiscal transparency is confirmed in section 24H which treats the individual members of a partnership as having accrued or received their share of the partnership income on the date that the income is received or accrued in common by the partners

3.5 Taxation of entities in South African tax law – hybrid entity related anti avoidance measures

The question of the alignment of the taxation of entities with their taxation under foreign tax laws is particularly relevant to partnerships, which have been cited as playing a role in hybrid mismatch arrangements.⁶⁶

A mismatch exposure would arise in South Africa where a partnership is treated as fiscally opaque in a foreign jurisdiction.

The definition of “company” includes any “association [...] incorporated under the law of any country other than the Republic”.⁶⁷ Accordingly a partnership which is incorporated under a foreign law should be a “company” as defined and thus be taxed as a separate person for purposes of the Act.⁶⁸

This reference to “incorporation” could be read as limiting the applicable foreign law to incorporation that is regulated by statute. However, incorporation in South Africa can occur in common law⁶⁹ although this requires “an assertion of its independent existence in the association’s constitution” (Williams, 2012: para. 64). This suggests that an association which is recognised under a foreign law as having a separate legal personality from its members may on one view be a “company” (and taxed separately from its members) and this will be the case regardless of whether this recognition occurs under a specific statute or common law.

⁶⁶ Partnership Report, para. 6.5 of the Commentary on Article 1, Hybrid Report (para. 10), para. 10 of the Domestic Discussion Draft (para.10) and the Treaty Discussion Draft (para. 10).

⁶⁷ Para (b) of the definition of “company” section 1.

⁶⁸ This conclusion is supported by a ruling issued by SARS (Binding Private Ruling: BPR 061) which ruled that a foreign incorporated partnership is a “company” for purposes of the Act. The ruling dealt with a partnership which was incorporated under a foreign partnership Act with the result that the incorporated partnership was treated as a body corporate with separate legal status and the partner’s liability being limited to their contributions to the partnership.

⁶⁹ In *Morrison v Standard Building Society* 1932 AD 229 Wessel J.A. held that “an association of individuals does not always require the special sanction of the State in order to enable it to hold property and to sue in its corporate name”.

That this is the case is reinforced by the fact that para (b) of the definition also includes “any body corporate formed or established under such law”. The law referred to in this part of the definition is “the law of any country other than the Republic”.

While the above would cater for those foreign partnerships which have a separate juristic personality under a foreign law and thus align domestic and foreign jurisdiction treatment it would not cater for situations where partnerships are not separate juristic persons but are nonetheless separately taxed. An example can be found in India which taxes certain partnerships (being those which have an instrument setting out the profit sharing arrangement between the partners) (Gupta, 2015b:s1) notwithstanding that partnerships have no separate legal existence (Gupta, 2015a:s2).

Accordingly, while paragraph (b) of the definition of “company” would appear to align the domestic treatment of fiscally opaque foreign partnerships with that of the foreign jurisdiction it does not appear to do so comprehensively.

Fiscally transparent foreign companies

As indicated above a “company” is defined to include associations, corporations or companies incorporated under a foreign law and body corporates formed or established under such law. However, the definition of “company” excludes “foreign partnerships” from its ambit,⁷⁰ essentially with the result that body corporates which are treated as fiscally transparent for purposes of a foreign tax law may also, depending on the particular facts and circumstances, be taxed on a transparent basis in South Africa like a partnership.⁷¹

This provision, by virtue of linking the South African treatment with the foreign treatment would appear to neutralise DD or D/NI outcomes that would otherwise arise from body corporates that are taxed in a foreign jurisdiction on a transparent basis.

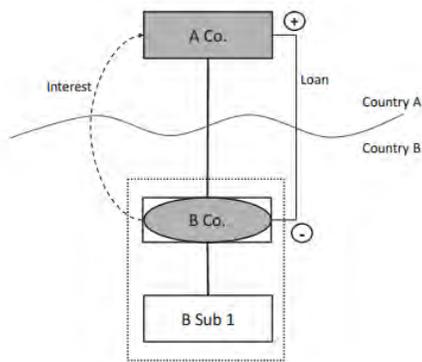
An example of a possible D/NI mismatch scenario involving a partnership, though, may be found in the Hybrid Report (OECD 2014d:42). Following this example, a South African

⁷⁰ Refer to the definition of “company” in section 1.

⁷¹ Refer definition of “foreign partnership” in section 1.

resident partner makes an interest bearing loan to a foreign partnership of which he is a partner. The partnership is interposed between a foreign operating subsidiary and is treated as a separate entity by the other state. The other state operates a group taxation regime, with the result that the interest is deducted by the operating subsidiary.

This arrangement is illustrated in the Hybrid Report as follows:



As noted in part 3.4 of this dissertation, partnerships are fiscally transparent under South African law unless deemed otherwise. In the instance if the foreign partnership is not regulated by statute in a foreign country then it may not be a company as defined in the Act and thus remain fiscally transparent in South Africa.⁷² In this case the loan and interest thereon would be treated as notional and thus disregarded to the extent of A Co's share in the partnership.⁷³

Accordingly, South Africa's tax laws may not resolve a D/Ni outcome in this case.

Conclusion – hybrid entity alignment

The Act does include provisions which seek to align the domestic treatment of partnerships and companies with that of the relevant foreign jurisdiction. However, notwithstanding

⁷² Refer paragraph (b) of the definition of “company” in section 1.

⁷³ *Anglo American Corporation of SA Ltd v Commissioner of Taxes* 1975 (1) SA 973 (RAD). This case concerned the tax deduction by a branch of Anglo American in the then Rhodesia of a “foreign exchange loss” in respect of an amount owed to its head office in South Africa. The court held that this internal loan had to be disregarded as “an individual taxpayer ... cannot make agreements with himself which will affect his tax liability”.

these it would appear that there could still be instances where foreign partnerships are separately taxed in a foreign jurisdiction but remain to be taxed locally on a transparent basis.

In this light it would seem that the Act may not resolve DD or D/NI outcomes in all cross border hybrid entity arrangements in.

3.6 Conclusion on treatment in the Act of cross border financing arrangements using hybrid instruments or hybrid entities

The legal substance of a financing instrument has an important role in the characterisation of income from those instruments and the treatment thereof in the Act. Accordingly, absent specific provisions to the contrary, the Act would appear to have the potential to not effectively address all D/NI outcomes from cross border financing arrangements involving hybrid instruments.

The Act though includes certain provisions targeted at hybrid instruments. However, these provisions do not appear to neutralise all cross border D/NI mismatch situations, particularly sections 8F, 8FA and 24J...

As regards entities, it appears that the related anti-avoidance provisions may not effectively address all D/NI or DD mismatch situations.

It would therefore appear that the Recommendations could have a role to play by addressing those situations where the Act does not neutralise D/NI or DD outcomes. However, before reviewing how the Recommendations might assist, the WHT measures taken to protect South Africa's tax base against hybrid arrangements and the impact of DTCs on these outcomes is first assessed.

4. WHT MEASURES IN THE ACT TO PROTECT THE SOUTH AFRICAN TAX BASE AGAINST CROSS BORDER HYBRID ARRANGEMENTS IN THE ABSENCE OF TREATY PROVISIONS

4.1 Introduction

The Act includes a number of WHT measures, including DT of 15% and WHTI of 15%.

Broadly, WHTI applies to South African source interest⁷⁴ paid by any person to a non-residents⁷⁵ while DT applies to dividends paid by a resident company to a qualifying “beneficial owner” of that dividend, including a non-resident.⁷⁶ The dividend paid to the non-resident is subject to a withholding requirement in respect of this DT.⁷⁷

National Treasury has stated that a role of WHT is to prevent base erosion (National Treasury, 2013:75). This part of the dissertation assesses whether or not these taxes have the apparent potential to preserve the tax base against cross border hybrid arrangements.

The DTC impact on WHT is discussed part 5 of this dissertation and therefore the comments and conclusions in this part of the dissertation are those that apply absent any DTC effects.

4.2 WHT – general application

At first sight, WHTI appears to preserve the tax base as it applies to payments that will likely have resulted in a local tax deduction for the payer⁷⁸ in circumstances where the recipient’s receipt is exempt from tax.⁷⁹ The tax base preservation role of DT is not as clear

⁷⁴ Interest will be from a South African source if the interest falls within the ambit of section 9(2)(b).

⁷⁵ Section 50B.

⁷⁶ Section 64E read with the definition of “dividend” in section 1.

⁷⁷ Section 64G.

⁷⁸ In terms of section 9(1)(b), subject to some exceptions interest as defined in section 24J broadly has a South African source where that interest is incurred by a resident or arises from funds which are utilized or applied in South Africa

⁷⁹ Subject to some exceptions, section 10(1)(h) exempts interest received or accrued by a non-resident from normal tax.

as it applies to payments which are not ordinarily deductible for normal tax purposes, though it may assist in a hybrid financing context as WHT is collected regardless of the legal substance of the financing.

Although WHTI applies to amounts which are subject to a tax deduction it may not cover all interest deductions. This is because Part IVB of the Act levies WHTI on qualifying South African source interest paid to a non-resident but does so without defining the term interest. This could lead to a conclusion that WHTI applies only to interest in common law and not the extended section 24J interest.⁸⁰ Further, as discussed in part 3.3 above, that section 24J interest which falls outside of WHTI could be exempt from normal tax.⁸¹ As discussed in part 3.3, it may be that a court would decide that the context and purpose of Part IVB require that interest exempted in terms of section 10(1)(h) would be interest for purposes of Part IVB. However, it is not certain that a court would do so.

For this reason, it is submitted that absent DTC effects, WHT may not wholly preserve the tax base.

4.3 WHT – application in a hybrid instrument context

General

⁸⁰ Section 50A, which contains the definitions applicable to Part IVB of the Act, does not include a definition of interest. Further section 24J does not apply to determine the meaning of this term for WHTI purposes. This is on the basis that section 24J(2) deems the amount to which it applies to have been “incurred” while the WHTI provision applies to amounts which have been paid or have become due and payable (section 50B). Our courts have held that incurred does not mean paid (Watermeyer AJP held in *Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue* 1936 CPD 241, 8 SATC 13 at 15 that ““actually incurred” cannot mean “actually paid””). This is further supported by the now repealed Part IA of the Act, in which interest was defined to include section 24J and 8E amounts. This suggests that the legislature intended a new WHTI meaning when introducing Part IVB of the Act, being a common law meaning. That this is the case is supported by National Treasury’s and SARS report back to the Standing Committee on Finance on the draft Taxation Laws Amendments Bill, 2013 and Tax Administration Laws Amendment Bill, 2013 on 11 September 2013 in which it was noted that interest for these purposes was intended to hold its common law meaning (National Treasury & SARS, 2013b:26).

⁸¹ Section 10(1)(h) read with section 24J(3). The latter provision applies for purposes of the whole Act and deems the amount to have been accrued as interest. The former provision applies to interest received or accrued by non-residents.

This part of the dissertation assesses the effectiveness of WHT on the hybrid instrument rules. However, as WHT would only be relevant to outbound payments this part of the dissertation will limit this analysis to the impact on outbound payments.

As was noted in part 3 of this dissertation, measures which are relevant to outbound payments include those targeting hybrid debt and hybrid interest arrangements,⁸² hybrid equity arrangements⁸³ and hybrid capital payments.⁸⁴

In the event that the hybrid debt and hybrid interest measures apply, the related outbound payment would be re-characterised as a non-deductible dividend *in specie* thereby protecting the normal tax base. In the event that the hybrid equity measures apply, the related outbound payment would in terms of domestic tax law remain a non-deductible dividend. This means that WHT is not required in these instances to preserve the tax base.

Where the hybrid capital payment measures apply, the related outbound payment would reduce normal tax collections, meaning that WHT would have a role in preserving the tax base.

However, the WHT outcomes in these instances are not consistent with the above. These are discussed below.

Sections 8F and 8FA

Sections 8F and 8FA deem qualifying interest amounts that may otherwise have been deductible to be a non-deductible “dividend *in specie*” which is declared and paid by the paying company.⁸⁵ The result is that WHT remains applicable but instead now by way of DT.⁸⁶ This is notwithstanding that the arrangement no longer gives rise to a local tax deduction.

⁸² Sections 8F and 8FA.

⁸³ Section 8E and 8EA.

⁸⁴ Refer to section 24J.

⁸⁵ Sections 8F(2) and 8FA(2).

⁸⁶ This is on the basis that it is now deemed to be a dividend *in specie* and is thus a dividend for DT purposes and further that it is not subject to DT exemption of section 64F(1) by reason of this exemption not extending to *in specie* dividends.

Sections 8E and 8EA

Sections 8E and 8EA deem a qualifying “dividend” or “foreign dividend” to be an amount of income to the person who received or accrued the dividend.

While DT would no longer be applicable⁸⁷ these amounts will now be subject to normal tax on the basis of deemed to be an amount of “income”, with the result that WHT is not required in this instance to preserve the tax base.⁸⁸

Section 24J

While section 24J may re-characterise certain payments to be interest payments, this re-characterisation may not increase WHTI collections if these amounts are not interest at common law. Accordingly the net hybrid capital payments subject to section 24J may not lead to further WHTI collection. Further, this shortfall may not be compensated by additional normal tax collections.⁸⁹

Conclusion

In the event of the hybrid instrument rules applying to outbound payments, WHT would no longer appear to have an apparent direct role in preserving the tax base except where the section 24J hybrid rules operate. However, in light of the possible lack of WHT in the instance where the section 24J hybrid rules apply, when seen from a broader perspective the DT applied in respect of section 8F/8FA payments may continue to have a role in preserving the tax base against cross border hybrid instrument arrangements, although

⁸⁷ Section 64F(1)(l) of the Act exempts from DT any amount that comprises income. A section 8E/8EA dividend will not be exempt income in terms of section 10(1)(k) as “income” is defined in section 1 to be “gross income” less amounts exempt from normal tax. Accordingly, by deeming a dividend to be an amount of income the exemptions of section 10 of the Act are bypassed as is the source requirement of the “gross income” definition in section 1.

⁸⁸ This is on the basis that practically this tax could be collected in all applicable instances.

⁸⁹ The full amount deemed to be interest in terms of section 24J could be exempt income for the non-resident in terms of section 10(1)(h).

whether it can compensate in full remains an open question. In addition, the application of normal tax to section 8E/8EA amounts would also assist in preserving the tax base.

4.4 WHT – application in a partnership context

Introduction

In a partnership context, relevant to WHT’s role in preserving the tax base against financing arrangements through these hybrid entities is whether interest payments to such non-resident entities are subject to WHTI. This is relevant as these payments may be deductible for local tax purposes⁹⁰ but be exempt from normal tax.⁹¹ The application of DT in a hybrid entity context is also considered on the basis that it may complement WHTI.

The “beneficial owner” of a dividend is liable for DT,⁹² unless the dividend consists of a distribution *in specie*, in which case the company declaring the dividend is liable.⁹³ WHTI applies to South African source interest “paid to or for the benefit of any foreign person”.

Subject to a certain exception,⁹⁴ the term “beneficial owner” is defined for DT purposes to mean “the person entitled to the benefit of the dividend attaching to a share”.⁹⁵

Therefore, what is relevant for DT purposes is whether the partnership or the partner is entitled to the benefit of the dividend and for WHTI purposes whether the interest is paid for the benefit of the partnership or the partner.

⁹⁰ Assuming that the requirements of section 11(a) read with section 23 are complied with.

⁹¹ Section 10(1)(h).

⁹² Although subject to a withholding obligation in terms of section 64G.

⁹³ Section 64EA.

⁹⁴ Section 64EB.

⁹⁵ Section 64D.

*Hybrid foreign partnership*⁹⁶

In terms of the Act, a fiscally transparent partnership would not be treated as a “person” for purposes of the Act and therefore would not be liable for either WHTI or DT as it could not be the “person” benefiting from an interest or a dividend payment.

In terms of our common law an essential condition for the formation of a partnership is that the business of the partnership is carried on for the joint benefit of all partners (*Joubert v Tarry* 1915 TPD 277). Applying this principle means that the partners would have the beneficial interest in the dividend or interest payment. Accordingly the partners and not the partnership would be liable for WHTI and DT.

This result aligns with the normal tax treatment of interest and dividends in that these amounts would be treated as accruing to the partners and not the partnership. Accordingly, WHTI’s role in preserving the tax base against cross border hybrid financing arrangements involving hybrid partnerships should be maintained and DT should continue to complement this role.

Conclusion

Absent DTC considerations, the fact that cross border financing is arranged through a hybrid foreign partnership should not compromise the potential of WHT to preserve the tax base against cross border hybrid financing arrangements.

4.5 WHT – conclusion on role in protecting the tax base against hybrid arrangements

In general WHT does have an apparent potential to preserve the tax base against cross border hybrid financing arrangements. However, WHT may not be a complete solution, for a variety of reasons, suggesting that National Treasury may not be able to rely on WHT to

⁹⁶ That is to say a foreign partnership which is fiscally transparent in South Africa but fiscally opaque in the foreign country. Where the partnership is a “foreign partnership” as defined in section 1, the partnership would be fiscally transparent in South Africa. This would then be in line with the other state, with the result that there should not be mismatch outcomes in the taxation of income flowing through the partnership. A similar outcome would arise for partnerships incorporated in terms of a foreign law and thus are separately taxed in South Africa and the other State. This is on the basis that this partnership would then be separately taxed in South Africa and thus be in line with its taxation in the other state.

compensate in full for mismatch outcomes from cross border hybrid financing arrangements.

However, as WHT is raised on payments to non-residents, a complete understanding of the role of WHT such situations requires an understanding of how a DTC may affect WHT collections. This is addressed below.

5. DTC TREATMENT OF CROSS BORDER FINANCING ARRANGEMENTS INVOLVING HYBRID INSTRUMENTS OR HYBRID ENTITIES

5.1 Introduction

Although the role of a DTC may include the prevention of fiscal avoidance⁹⁷ this does not permit a DTC to deny a deduction or an exemption that would otherwise be available under domestic law.⁹⁸ This means that a DTC could not be used to neutralise a DD or D/NI outcome in this way. However, a DTC may influence an outcome from a cross border hybrid arrangement through the relief afforded from taxation in the source state. Specifically in the case of South Africa, this means the relief afforded from WHT and in the case of a section 8E/8EA amount the relief afforded from normal tax.

A DTC could influence South Africa's WHT collections through providing relief against source taxation of dividends and interest in general and also through characterising interest and dividends in a way which varies from domestic law characterisation. This latter aspect is relevant as Article 11 of the DTCs concluded by South Africa generally grant more beneficial relief than Article 10 (refer Annexure D). Article 10 and 11 apply respectively to interest and dividend as defined in the DTC.⁹⁹ In addition, it may be that income from a financing arrangement is instead subject to one of Articles 7 (the business profits article), 13 (the capital gains article) or 21 (the other income article). These articles would apply to provide full relief from source taxation, assuming that the resident does not have a permanent establishment in South Africa.

⁹⁷ Para 16 of the Introduction to the Commentary notes that the OECD Model also deals with "tax evasion".

⁹⁸ Para 2 of the Introduction to the Commentary confirms that the main purpose of the OECD Model is to resolve "the most common problems that arise in the field of international juridical double taxation". This ambit and priority is reinforced in para 17 of the Introduction to the Commentary where it is stated in explaining the broad structure of the OECD Model that the "main part is made up of Chapters III to V, which settles to what extent each of the two Contracting States may tax income and capital and how international juridical taxation is to be reinforced". The Associated Enterprise Article (Article 9) though does allow in qualifying circumstances for the certain profits to be added to the profits of enterprise of a state and taxed.

⁹⁹ It may be that is the resident of the other Contracting State carried on a financing business that Article 7 would instead apply, but for purposes of this dissertation this assumed not to be the case.

These aspects will be assessed below with reference to the OECD Model and with a view to assessing whether or not a DTC supports the efforts of National Treasury to protect the tax base using WHT.

5.2 DTC – general

Articles 10 and 11 of the OECD Model specify a maximum rate at which qualifying dividends and interest may be taxed in the source state (and thus levied with WHT or normal tax).

Annexure D reflects the maximum rates at which interest and dividends paid to a beneficial owner who is resident in the other Contracting State may be taxed in South Africa for those DTCs selected as a sample for this dissertation. This sample indicates that DTCs in general do reduce the amount of WHT that can be applied by South Africa, particularly in the case of dividends arising from significant share ownerships and interest amounts. Thus in general the DTCs reduce WHT's potential to preserve the tax base against cross border hybrid arrangements, but this would only mainly be of significance for treaties with jurisdictions that pose of risk of profit shifting.

5.3 DTC and hybrid instruments – characterisation of interest and dividends

The OECD Model contains definitions of the terms “dividend” and “interest”, which apply respectively for purposes of Articles 10 and 11 of the OECD Model. The question arises as to which Article applies to a particular financing arrangement.

Treaty characterisation - Interest

The term “interest” as applied in the OECD Model does not include any reference to domestic law and thus applies autonomously of such law. This is supported in the Commentary on Article 11 (para. 2.1) in which it is noted that the definition is exhaustive and is free of a reference to domestic law so that, amongst other reasons, “conventions would be unaffected by future changes in any country’s domestic law”.

The Commentary on Article 11 in paragraph 1 notes that interest as contemplated by Article 11 is “generally taken to mean remuneration on money lent, being remuneration coming within the category of ‘income from movable capital’”. Interest in common law should comprise “remuneration on money lent”, with the result that the interest on which WHTI is levied should also be interest for OECD Model purposes.

Given that the OECD Model meaning is independent of domestic law characterisation, common law interest amounts which are re-characterised as a “dividend *in specie*” in terms of section 8F or 8FA of the Act would remain interest for Article 11 purposes. However, sections 8F and 8FA take into account interest as defined in section 24J and thus potentially give rise to DT on amounts that would not be interest in common law. The question therefore arises as to whether these further section 24J amounts would also be interest for purposes of Article 11.

Further clarity on the ambit of interest for OECD Model purposes is provided in the Commentary on Article 11 where it is stated in paragraph 20 that interest is broad enough to include a premium on a bond or debenture but is not so broad so as to include “a profit or loss, not representing accrued interest or original issue discount or premium, which a holder of a security such as a bond or debenture realises by the sale thereof to another person or by the repayment of the principal of a security that he has acquired from a previous holder for an amount that is different from the amount received by the issuer of the security”.

This suggests that finance charges, premiums and discounts as contemplated in paragraph (a) of the definition of interest in section 24J would also be interest for OECD Model purposes but that profits from sale/leaseback arrangements and sale/repurchase arrangements would not, notwithstanding that these profits give rise to interest for purposes

of section 24J.¹⁰⁰ However, these profits may instead be subject to relief under either Article 7 (as comprising a business profit) or Article 21 (as being an amount of other income).¹⁰¹

Although the above section 8F/8FA amounts may comprise interest for OECD Model purposes the question arises as to whether these are also a dividend for purposes of Article 10 given that they have been deemed to a “dividend *in specie*”. This question is relevant as the OECD Model does not contain an ordering rule in the event that both Article 10 and 11 apply, leading to the possibility that Article 10 may apply in preference in such situations.¹⁰² The potential application of the Article 10 to section 8F/FA amounts is addressed below in the discussion on the treaty characterisation of a dividend.

In summary, subject to the potential application of Article 10, Article 11 of the OECD Model should provide relief from any WHT on amounts which are interest in common law, regardless of any domestic law re-characterisation. Similarly, Article 11 relief should also apply to any DT on section 24J finance charge, premium or discount amounts while Article 7 or 21 should provide relief from any DT on profits from sale/leaseback and sale/repurchase arrangements.

This means that, subject to any application of Article 10, an OECD Model like DTC would further undermine WHT’s tax preservation role by continuing to treat section 8F/FA amounts as interest for OECD Model purposes regardless of the domestic law re-characterisation.

¹⁰⁰ The Commentary on Article 11 does note in para. 21.1 that the OECD Model term will apply “to the extent that a loan is considered to exist under a “substance over form” rule, an “abuse of rights” principle, or any similar doctrine”. It may be that the legislature taxed these profits as interest on the basis of the perceived substance of such arrangements but it is submitted that this does not mean that all such arrangements are in fact loan arrangements in substance. Accordingly, it is submitted that that Article 11 will not apply to **all** such arrangements but may possibly apply to individual arrangements which in fact are loan arrangements in substance.

¹⁰¹ Article 7(4) provides that in the event that an amount is also dealt with by another Article that the other Article shall apply in preference and Article 21’s ambit is limited in terms of Article 21(1) to amounts not dealt with by other Articles. Thus in the event that either of Article 10 or 11 apply, Articles 7 and 11 would not apply.

¹⁰² This seems to have been contemplated by the drafters of the OECD Model as the Commentary on Article 10 notes in paragraph 19 that Article 10 would take precedence in such situations.

Treaty characterisation - Dividend

Article 10(3) defines the meaning of “dividend”. Avery-Jones et al (2009:406) state that this definition comprises three limbs, being income from:

- (1) Shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares.
- (2) Other rights, not being debt-claims, participating in profits, and
- (3) “Other corporate rights” which is subjected to the same taxation treatment as income from shares by the “laws of the State” of which the company making the distribution is a resident.

The Commentary on Article 10 notes in paragraph 24 that a dividend as contemplated in Article 10 includes “distributions of profits the title to which is constituted by shares”. Accordingly a “dividend” as defined in the Act would be a dividend for purposes of Article 10. This means that a dividend which has been deemed to be “income” in terms of section 8E or 8EA of the Act would remain a dividend for OECD Model purposes and thus be subject to relief from normal tax to the extent allowed by Article 10. This is because the Article 10 dividend definition does not make reference to domestic law treatment, except in the third limb, with the result that the first and second limbs are autonomous of domestic law. Thus a distribution of profits to shareholders would be a dividend for DTC purposes under the first limb of the Article 10 definition regardless of its treatment under the Act. To the extent the “dividend” as defined in the Act comprises a return of capital the third limb of the Article 10 definition should include such distributions on the basis that they are “subjected to the same taxation treatment as income from shares by the ‘laws of [South Africa]’”.¹⁰³ An exception may arise in respect of a “dividend” as defined in the Act comprising a return of capital by way of a share buy back on the basis that this gives rise to an “alienation of property” for purposes of Article 13 of a DTC and would thus be subject to that Article instead. In addition, although less clear in the case of a section 8E/8EA dividend, it is submitted that a return of capital would also be dividend for DTC purposes on the basis that they remain a dividend in the hands of the distributing company for purposes of the Act and thus fall within the third limb of the Article 10 definition.

¹⁰³ It is possible for a return of capital to comprise a “dividend” for purposes of the Act if the return of capital is not determined to be a reduction of “contributed tax capital”. However, this return should still be a dividend for OECD Model purposes either under the first limb or the third limb of the above definition.

The third limb of the OECD Model definition does however refer to domestic law raising the question as to whether this reference brings a section 8F/FA amount within the ambit of a dividend for DTC purposes.

The Commentary on Article 10 states in paragraph 15(d) that income from a loan can be a dividend where the loan is treated as part of the capital of the company under an “internal law or practice” other than company law. This Commentary further states in paragraph 25 that “Article 10 deals not only with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company”. Additionally the Thin Capitalisation Report states in paragraph 56 that the third limb of the dividend definition has a broad meaning to “include income arising from any financial relationship which is treated as constituting a corporate right under national law” as opposed to a narrower meaning requiring a “membership of a corporate body”.

These statements suggest that a section 8F/FA amount would be a dividend under Article 10 of an OECD Model like DTC.

However, these statements were inserted into the Commentary in 1977 and 1995¹⁰⁴ whereas the reference to the domestic law treatment in limb 3 was already present in the 1963 OECD Model. This raises the question as to whether these statements in fact reflect the intended meaning of the OECD Model as originally drafted.

A review of commentaries on this issue reveals a consensus that the meaning of limb 3 is ambiguous (Avery Jones, 2009:434 and Pijl, 2011:para. 4.5) and therefore recourse to preparatory work would appear to be appropriate to determine the ambit of this third leg (Article 32 of the VCLT). Part of this preparatory work is the records of the OEEC and OECD working parties tasked with drafting this term. The OEEC work is relevant as the term adopted in the 1963 OECD Model was founded on this work (Hattingh, 2009:1).

¹⁰⁴ History of the Commentary C(10)-32 to 33 and C(10)-37 (OECD, 2012b).

Hattingh (2009:8) asserts a core “essential condition” to the term based on the OEEC’s work. This core is that there must be “on the one hand an independent legal entity [...] and on the other hand a relationship founded on a contract of association and giving right to participate in the profits” (OEEC, 1958:para.10 of Commentary).

Significant to Avery Jones et al (2009:424) in the drafting history was that the OEEC working party drafted the original version in French and that the equivalent of the phrase “other corporate rights” as used in this version is ordinarily understood to refer to a shareholder or member type of right. An additional factor considered to support the French version as reflecting the true meaning was that the English version was thought to be the work of a translator.

Further support in the drafting history is found in a report of the OECD working party tasked with the 1977 amendment to the term (OECD, 1973). The report considered deleting all reference to domestic law in the dividend definition (OECD, 1973: para. 8& 10) but would appear to have only retained this reference albeit in a modified form on the basis that wide differences in domestic laws meant that it was not possible to draft an autonomous treaty definition that accommodated all domestic concepts (OECD, 1973: para. 23).

It would therefore appear that a reference to domestic laws was retained to ensure that the OECD Model term was broad enough to accommodate all concepts of dividends as opposed to ensuring that the OECD Model term accommodated domestic law adjustments for perceived abusive situations.¹⁰⁵

The context of the phrase “other corporate rights” has also been argued to indicate a membership type right, in that all three limbs are generally required in civil law countries to accommodate both public and private enterprises (Avery Jones, 2009:419) and that the word “other” indicates corporate rights of a type of contained in limbs 1 and 2, as does the use of word “distribution” in limb 3 (Avery Jones, 2009:430).

¹⁰⁵ That this is the case is supported by the example used to illustrate the qualification challenges posed by domestic laws. In this example a partnership could elect to be taxed as either a partnership or a company. It was observed in the report that it would be inappropriate to treat the partnership distributions as a dividend for OECD Model purposes if the choice was to be taxed as a partnership (OECD, 1973: para. 12)

On balance it is submitted that the drafting history and context of the term support a meaning contrary to that suggested in the Commentary, namely that the income in question must arise from some membership type right. This meaning is supported by a body of judicial decisions on the matter¹⁰⁶ including *Volkswagen of South Africa (Pty) Ltd v. CSARS* [2008] ZAGPHC 112.¹⁰⁷

In summary it is therefore submitted that an amount of interest which has been re-characterised as a “dividend *in specie*” would not be a dividend for purposes of the OECD Model and thus would be subject to relief in terms of Article 11 (to the extent it comprises common law interest, finance charges, discounts or premiums) or otherwise to Article 7 or 21 relief.

However, this conclusion would not apply to those DTCs that follow the South Africa/USA DTC dividend definition, namely those which have a third limb referencing domestic law treatment but without requiring the amount to be income from an “other corporate right”. These DTCs should result in section 8F/FA amounts being dividends for DTC purposes and thus subject to Article 10 relief instead of another DTC Article.¹⁰⁸ South Africa’s DTC with the United States (and also that with Ireland and the United Kingdom) includes a specific rule giving preference to Article 10 in the event that Article 11 could also apply.

DTC characterisation - Conclusion

Those DTCs concluded by South Africa which include a dividend and interest definition in line with the OECD Model would treat an amount as interest or dividend based on the treaty

¹⁰⁶ See for examples cases as cited by J Hattingh (2009) being, *Hoge Raad* HR Case 29.531, 15 March 1995 and HR Case 38.461, 12 December 2003; Finish Supreme Administrative Court (*Korkein Hallinto-oikeus*), Case 14.06.1999/1600; KHO: 1999:34; French Supreme Administrative Court (*Conseil d’État*), Decision 15649 36 *Droit Fiscal* 39 (1984), 1092, Decision 28177 35 *Droit Fiscal* 23 (1983) 780 and Case 27391 36 *Droit Fiscal* 10 (1984) 402; Administrative Appeal Court of Paris, Decision 1051 42 *Droit Fiscal* (1990) 1753.

¹⁰⁷ The High Court held in *Volkswagen* (70 SATC 195 at 202) that an amount which was deemed to be a dividend in terms of section 64C of the Act was not a dividend for purposes of the South Africa/Germany DTC

¹⁰⁸ Hattingh (2009) cites certain cases as supporting this treatment, being *Framatome Connectors USA, Inc. and Subsidiaries v. Commissioner of Internal Revenue* 118 T.C. 32 and *RMM Canadian Enterprises Inc. v. Her Majesty the Queen* (1997) 97 D.T.C. 302 (T.C.C.)(2002).

meaning of the term and as such would disregard a section 24J/8E/8EA/8F/8FA re-characterisation. These meanings should result in distributions which are dividends for purposes of the Act being a dividend for DTC purposes (including section 8E/8EA amounts but excluding section 8F/8FA amounts) and common law interest and section 24J finance charges, premiums and discounts being interest amounts for DTC purposes. However, the domestic law and DTC outcomes should be the same in those DTC's which follow the USA/SA DTC dividend formulation.

5.4 DTC and partnerships – general

Article 10(2) provides that dividends paid by a company which is a “resident” of a Contracting State are subject to DTC relief where the dividend is paid to a “beneficial owner” of the dividend who is a “resident” of the other Contracting State” while Article 11(2) similarly provides that interest “arising in a Contracting State” is subject to DTC relief. A “resident” for OECD Model purposes is any “person” who is “liable to tax” in that state by reason of “domicile, residence, place of management or other criterion of a similar nature”.

These requirements raise two questions, firstly whether the interest/dividend is paid to a “person” who is “liable to tax” in the other contracting state in the required manner and secondly whether the “beneficial owner” is a resident of the other Contracting State?

An issue that arises in respect of the first question in a hybrid entity context is whether DTC relief applies only on the basis of the person claiming the relief or primarily on the basis of the income which has been taxed. Wheeler (2012: Ch. 3 para. 3.1) characterises these two approaches respectively as the subjective basis and the objective basis. This issue arises as Articles 10 and 11 appear to focus on providing relief from the income in question being double taxed yet Article 1 specifies that a DTC “shall apply to persons who are residents of one or both of the Contracting States.

These above questions are relevant from a WHT perspective as they will determine which DTC, if any, applies and thereby the extent to which WHT collections are reduced.

For example, a partnership is taxed on an amount of interest in the source state. The state of residence of partners may treat this interest to be that of a non-resident partnership and thus not taxable in that state. If the source state applied the subjective approach it would look to who had been taxed in the source state (being the partners) and whether these persons were treaty resident in the other contracting state. DTC relief would thus be granted on the basis that the partners were so resident. However, if the source state applied the objective approach it would look to whom the income had been allocated and if, in doing so, applied the laws of the other contracting state would determine that the interest had not been paid to a resident of that state and therefore was not subject to relief under DTC relief was not available under the DTC with this other contracting state.

In the above example, the subjective approach may result in the interest amount not being taxed at all, if the state in which the partnership is nominally resident treats partnerships as fiscally transparent.

5.5 Subject matter of DTC relief

Introduction

As noted above a question arises as to whether DTC relief applies to the person or to the income which has been taxed in the source state.

Commentary

The Commentary on Article 1 states in paragraph 6.3 as follows in this regard:

“the State of source should take into account [...] the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident.”

The Partnership Report illustrates the application of this principle in a royalty income example of a partnership which is fiscally transparent in the source State but is separately taxed in the other Contracting State (OECD, 1999:ex.5). In this instance the report concludes that the partnership and not the partners should be entitled to relief under the OECD Model for tax in the source State on the royalty income (OECD, 1999:para.63).

This approach is hereafter referred to as the OECD income allocation approach. This approach applies the objective basis (by looking to whether the other contracting state allocates the income in question to a resident of this state) except where the person is treated by the domestic tax laws of the source state as a resident of that state. In this instance, the source state will consider who has been subject to tax on the income in question in the source state.¹⁰⁹ That is to say the approach would then switch from the objective to a subjective approach.

South Africa has not recorded a disagreement in the Non-OECD Economies' Position in the Commentary to the OECD income allocation approach. This suggests that the Government, when negotiating DTCs which follow the OECD Model, intends these DTCs to be applied using this approach.

Commentators

Commentators exhibit a lack of consensus on this issue with Wheeler (2012: Ch.3 para.3.2.2) citing differences amongst commentators as to the correct approach.

¹⁰⁹ Para 6.1 of the Commentary on Article 1

Foreign case law

On the basis of the foreign case law cited by Wheeler (2012: Ch. 5) it would appear that no dominant trend has emerged in foreign case law with some courts applying the subjective approach¹¹⁰ and others the objective approach.¹¹¹

South African case law

The question of DTC relief in the context of a foreign partnership was considered in *Grundlingh v Commissioner for the South African Revenue Service* [2009] ZAFSHC 88. The court had to decide whether a South African resident partner of a Lesotho partnership was protected from tax in South Africa under the business profits article of the South Africa/Lesotho DTC on the basis that the partnership was “an enterprise of Lesotho”. Claasen AJ held against the taxpayer and in doing so looked to how the income of the partner had been taxed in Lesotho.¹¹² Accordingly, an approach in line with the objective approach was applied.¹¹³

As the OECD income allocation approach is based on the objective approach a question arises as to whether *Grundlingh* acts as precedent for this approach.

If the OECD approach had been strictly applied, it would have been determined that Lesotho was the source state and that accordingly the question as to enterprise to which the

¹¹⁰ *Russell v Commissioner of Taxation* [2011] FCAFC 10; *Conseil d'Etat*, 28 March 2008, Case No. 271366; *Commissioners of Inland Revenue v. P G and R M Willoughby*, Special Commissioners, London 23 March 1993, Volume 70 Reports of Tax Cases, p. 57 at para. 14.

¹¹¹ *Padmore v. Inland Revenue Commissioners* [1989] STC 493; *TD Securities (USA) LLC v. Her Majesty the Queen* 2010 TCC 186 (CanLII); *Linklaters LLP v Income Tax Officer- International Taxation Ward 1(1)(2), Mumbai, ITA No. 4896/M u m/0 3*.

¹¹² Article 3(1)(i) of the South Africa/Lesotho DTC defines a “person” to include “any other body of persons which is treated as an entity for tax purposes”. Claasen AJ specifically referred to this definition in paragraph 9 of the judgment and having done so held in paragraph 10 that the appellant’s case depended on whether the partnership was “liable to tax” in Lesotho. The Judge then reviewed the treatment of partnerships in Lesotho and South Africa and held in paragraph 10.3 that as both states treated partnerships as fiscally transparent that the individual partners and not the partnership were the entities who were liable to pay to taxes. Based on this the Judge held in paragraph 1.8 that the partnership was “not an enterprise, liable to pay tax, in Lesotho”.

¹¹³ If Claasen AJ had applied a subjective approach he would have looked to the person who was seeking immunity from tax, namely the SA resident partner, and determined that that person was an enterprise of South Africa and therefore not exempt from tax in South Africa under the business profits article.

profits belonged should be answered with reference to South Africa's tax laws. Following this it would have been determined that under the Act the enterprise was the partner and not the partnership and further that this enterprise was a resident of South Africa and thus not subject to DTC relief from South African tax. The same result but with different reasoning.

However, both approaches are similar in that, at least initially, the subject matter of the enquiry is the income in question as opposed to the person claiming the relief.

While the above noted differences do create an element of doubt, it is submitted that the similarities as regards the subject matter means that an application of the OECD approach would not be inconsistent with *Grundlingh* approach and that in this sense this case may act as precedent.

Conclusion

A review of the commentators and foreign case law does not evidence an emerging trend on the correct approach to applying a DTC. However, based on the precedent of *Grundlingh*, the objective approach would appear to apply in South Africa to determine whether DTC relief applies to WHT levied on members of a hybrid entity. Although not free of doubt this case may also act as precedent for the OECD income allocation approach, which would appear to be the approach intended by the Government when negotiating DTCs based on the OECD Model.

In summary, before taking into account the potential impact of the "beneficial owner" requirement of the OECD Model, that the impact of DTCs on WHT collections in a hybrid entity context involving partnerships is uncertain.

5.6 DTC and partnerships – beneficial owner

Introduction

As noted above Articles 10 and 11 provide relief to the extent the dividend/interest is paid to the “beneficial owner” of the dividend/interest.

From a WHT collection perspective the meaning of this term has relevance in that it determines which DTC applies.

OECD Model meaning – domestic or autonomous

The term “beneficial owner” is not defined in the OECD Model. Article 3(2) provides that a term which is not defined in the OECD Model shall have its domestic law meaning unless the context otherwise indicates.

The term is not found in our common law (Olivier, 2011:544). It is though found in section 64D but only for limited DT purposes. Further this DT term only applied with effect from 1 April 2012. For these reasons it is submitted that the term as applied in DTCs concluded by South Africa does not have a domestic meaning but rather an autonomous DTC meaning. This conclusion is supported by *Indofood International Ltd. v. JP Morgan Chase Bank N.A. London Branch* [2006] EWCA Civ 158 at para. 42 where it held that the term “is to be given an international fiscal meaning not derived from the domestic laws of contracting states”. This approach is also followed in the Commentary on Article 10 where it is stated in paragraph 12.1 that this term was not intended to “refer to any technical meaning that it could have had under the domestic law of a specific country”. The Canadian Tax Court in *Prévost Car Inc. v. Her Majesty the Queen* 2008 TCC 231 at para. 95 looked to a “domestic solution”. However, on appeal the Federal Court of Appeal in *Prévost Car Inc. v Canada* 2009 FCA 57 held that this meaning reconciled with civil law, international law and the Commentary and therefore should not undermine a conclusion that the term has a meaning independent of a domestic law (para. 8 and 14).

International meaning

The question then arises as what meaning has been attributed to the term “beneficial owner” for DTC purposes.

Prior to its 2014 update, the Commentary did not per se provide a meaning but rather some illustrative examples, being that a “beneficial owner” excludes a person who receives an amount in a “capacity of agent or nominee” and a formal owner who “has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties”.¹¹⁴ However, in 2014 the Commentary was updated to state that the persons referred to in the above illustrative examples were not the “beneficial owner” of the amounts in question as they did not have “the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person”.¹¹⁵

In *Indofood* the court considered the beneficial owner to be the person who in “commercial and practical terms” has “full privilege to directly benefit from the income” and is not merely an “administrator of the income”.¹¹⁶

In *Prévost*, the Federal Court of Appeal held that the beneficial owner is “the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received”.¹¹⁷

In *Prévost* it was noted that the Hoge Raad case of BNB 1994/217 held that the beneficial owner did not have to be the owner of the shares. This is in line with Commentary on Article 10.¹¹⁸

¹¹⁴ Para 12.1 of the 2010 Commentary on Article 10

¹¹⁵ Para 12.4 of the Commentary on Article 10.

¹¹⁶ Para 42 and 44

¹¹⁷ Para 13

¹¹⁸ Para 12.4.

Vogel (1991:457) considers the term to mean “the person who is free to decide (1) whether or not the capital or other assets should be used or made available for use by others or (2) on how the yields should be used or (3) both”.

Du Toit (2010:para. 2) considers the term to mean the person “whose ownership attributes outweigh that of any other person”.

While there is some consistency between the 2014 Commentary update and *Prévost* there nonetheless still remains a wide variance in the interpretation of the meaning of the term, including whether it is a question of law or substance.¹¹⁹ This variance indicates that the meaning of the term remains to be settled.

Application to hybrid foreign partnerships

Even if the meaning of the term “beneficial owner” was settled, the question that would still remain in hybrid entity context whether a South African court would recognise an entity which is disregarded under local law as being a “beneficial owner” of an amount of income.

Although the Commentary on Article 3 in paragraph state that the concept of a “person” in the OECD Model does accommodate a partnership, it does not automatically follow that our courts would recognise a hybrid partnership as being a “beneficial owner” for DTC purposes.

The uncertainty surrounding the DTC meaning of “beneficial owner” is exacerbated where the contracting states have different approaches to the fiscal transparency of partnerships.

¹¹⁹ The Commentary on Article 10 in para 12.4 and *Indofood* treat the meaning to be as much a question of substance as of law while the Canadian Federal Court of Appeal in *Prévost* supported the matter as being one of a question of law. This court held that the corporate veil could only be pierced if the corporation “has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else’s behalf pursuant to that person’s instructions without any right to do other than what that person instructs it” (2009 FCA 59, para 13). It is argued the Dutch Supreme Court decision in BNB 1994/217 also establishes the matter to be question of law. In 2008 TCC 231, [2008] 5 C.T.C. 2306 at para 43, Professor van Weeghel gave expert evidence on the application of the Dutch treaty and is so doing cited the case of Hoge Raad 6 April 1994, BNB 1994/217 as providing authority that a person must have the freedom to “avail of” the dividend coupon and “monies distributed” in law in order to be the beneficial owner.

Conclusion on beneficial owner

The meaning of “beneficial owner” for DTC purposes should be autonomous of domestic law. While the Commentary has recently provided a meaning to the term, the fact that this was only included in the 2014 brings into question whether it could be said to be that meaning which was intended to apply to DTCs concluded prior to this update. Foreign judicial decisions on the matter have not been consistent, resulting in uncertainty as to what the term could mean and in particular how this may apply in a hybrid entity context. This brings into doubt whether a local court would give the term a meaning that allows income to be allocated in a hybrid entity context that is in line with the OECD income allocation approach.

This uncertainty also renders the WHT role in a hybrid entity context uncertain.

5.7 DTC - conclusion

In general a DTC operates to reduce the WHT that would otherwise be collected in financing arrangements involving hybrid instruments and hybrid entities. Further, OECD Model characterisation of interest and dividends would override the section 8F/8FA characterisation, thus exposing the WHT levied thereon to the more favourable relief of Article 11.

As regards the impact of DTCs on WHT collected on financing arrangements through hybrid foreign partnerships there remains considerable uncertainty on two key elements, namely whether the person or the income is the subject matter of the relief and the meaning of “beneficial owner”.

Taking the above into account, DTCs overall appear to diminish the apparent potential of WHT to assist in neutralising cross border hybrid arrangements, thus giving more potential significance to the Recommendations.

The potential role of the Recommendations is discussed next.

6. DOMESTIC LAW RECOMMENDATIONS

Introduction

The Recommendations comprise recommendations on domestic laws and treaties. This part of the dissertation assesses the domestic law recommendations, while the treaty recommendations are considered in part 7 of this dissertation.

The domestic law recommendations broadly do not seek to re-characterise payments but rather to link the tax treatment between the relevant states to determine the tax outcomes. The Recommendations include two suggested amendments to domestic laws, rule sets for 6 hybrid scenarios or events and also definition and implementation and co-ordination rules.

Specific recommendations on domestic law amendments

The following amendments to domestic tax laws are recommended:

- i. A denial of exemption for dividends which are deducted in the payer state and also denies unilateral foreign tax credits to the extent they are related to income which is not taxed in the state of residence (OECD, 2014d:41). The Act already includes such provisions.¹²⁰
- ii. CFC measures focused on reverse hybrids and imported mismatches, denying fiscal transparency to reverse hybrids in the state of establishment in certain circumstances and imposing information reporting obligation for reverse hybrid jurisdictions in certain circumstances (OECD, 2014d:49).

Hybrid event rule sets

The hybrid entity rule sets are broadly as follows:

¹²⁰ Proviso to section 10B(2) and section 6quat(1B).

- i. A hybrid financial instrument rule, which targets D/NI outcomes arising from hybrid instrument and hybrid transfer mismatches (OECD, 2014d:37).
- ii. A disregarded hybrid payments rule, which targets D/NI outcomes arising from payments which are disregarded in the payee state but recognised in the payer state (OECD, 2014d:44).
- iii. A reverse hybrid rule, which targets D/NI outcomes arising from payments to an entity which is recognised in the investor state but is disregarded in the state in which it is established (OECD, 2014d:47).
- iv. A deductible hybrid payments rule, which targets DD outcomes from payments made to an entity which is transparent to the payee state but is recognised in the subsidiary state (OECD, 2014d:53).
- v. A dual resident payer rule. This falls outside the scope of this dissertation and is therefore not considered (OECD, 2014d:56).
- vi. An imported mismatch rule, which targets an indirect D/NI outcomes from arrangements which shift a mismatch outcome to a third state. This rule is outside the scope of this dissertation as only recommendations which impact on two states are assessed (OECD, 2014d:61).

Design principles

The principles applied to the design of the rules are set out in the Recommendations. Nine principles are so set out, including notably that the rules be comprehensive, apply automatically, neutralise the mismatch rather than reverse the tax benefit, be workable and keep compliance costs to a minimum (OECD, 2014d:64).

Structure of rule sets

Subject to some variations, the rules for the 6 hybrid events comprise: a definition of the hybrid event, a response rule which sets out the primary adjustment, a defensive rule to be applied in the other state if the primary response is not applied or if the other state does not have a hybrid mismatch rule, a rule on the extent to which an adjustment can be made and a

scoping rule setting out the relationship that needs to be present for the transaction to fall within scope.

Variations are found in the reverse hybrid rule, which does not include a defensive rule (OECD, 2014d:47), and in the hybrid instrument rule, which includes rules on the treatment of timing differences and the application of the primary rule to regulated investment vehicles (OECD, 2014d:37). A further variation is found in the hybrid entity related rule sets, which include a rule for those situations where income has been taxed in both states but where the deductions exceed this income.

Rule set adjustments

The primary adjustment in the D/NI targeted rules is to deny a deduction in the payor state and the defensive rule is to include the income for taxation in the payee state. The primary adjustment rule in the deductible hybrid payments rule is to deny the deduction in the parent state and a defensive rule to deny the deduction in the subsidiary state.

Definitions key to application of primary and defensive adjustments

Key to the application of the hybrid event rules is whether there has been a payment, deduction and non-inclusion in ordinary income. The recommendations include definitions for these terms.

Application limitations

In general the rule provides that an adjustment is only made to the extent there is hybrid mismatch outcome. A DD mismatch does not arise to the extent there is also a dual inclusion in “ordinary income” (OECD, 2014d:53). The deductible hybrid payments rule carve out deductions in excess of dual inclusion income where this is available for set-off against income of another period or is not available as a tax deduction in another period (OECD, 2014d:53). In addition the hybrid instrument rule provides that timing differences should not be treated as giving rise to a hybrid mismatch so long as it can be proved to the

satisfaction of the relevant tax authority that the timing difference is of a reasonable period (OECD, 2014d:37).

Scope limitations

The recommendations on specific legislation amendments do not propose scope limitations (OECD, 2014d:4 & 491). However, the hybrid event rules are limited in the scope of their application.

The hybrid instrument rule only applies if the instrument is between “related persons” and absent this only if the instrument is part of a “structured arrangement” and the taxpayer is party to this arrangement. The disregarded hybrid payments rule and reverse hybrid rule only apply if the parties to the arrangement are part of same “control group” and absent this only if a payment is made in respect of a “structured arrangement” and the taxpayer is party to this arrangement. The deductible hybrid payments rule applies the same “control group” and “structured arrangement” scope restriction to the defensive rule but does not restrict the primary response rule.

The definition rules set out definitions for “related persons”, “control groups”, “structured arrangement” and “a party to a structured arrangement”.

Observations

Certain observations may be made on the application of the recommended rules.

The rules link the treatment of a designated arrangement in one state with its treatment in another state. For this reason, these rules would appear to be suited to supplementing the hybrid rules in the Act, which as noted above do not always refer to the treatment in the other State.

The hybrid events are limited to those which were of most concern (OECD, 2014d:11) and thus may not capture all hybrid events. However, the Recommendations appear to be broad

enough to capture targeted arrangements routed through another state that does not adopt the Recommendations, because the various response and defensive rules apply regardless of whether the other State has adopted the Recommendations.¹²¹

A question arises as to whether key terms will in fact be defined in each adopting jurisdiction in line with the recommendations, leading to the possibility of mismatches arising from definitional differences.¹²²

A question is also raised as to whether these rules will reduce certainty for taxpayers. This is because taxpayers may not be able to obtain the information necessary to determine if a primary response or defensive adjustment is required and also because a prevailing legal interpretation underpinning a position at the time of filing may subsequently be found to be unwarranted.

Application to South Africa

An example of how the Recommendations might apply to South Africa can be found in the example of the repurchase agreement discussed in parts 3.3 and 4.2 of this dissertation. In this example the possibility was raised of this arrangement giving rise to an interest deduction in South Africa but an amount which is exempt from tax in both South Africa and the other State.

In this case a hybrid mismatch should arise in respect of a hybrid transfer as contemplated by the Hybrid Instrument Rule of Recommendation 1.

A hybrid mismatch would arise by reason of the deduction in South Africa without a corresponding inclusion in ordinary income in either South Africa or the counterparty state.

¹²¹ See for example the hybrid instrument response rule in Recommendation 1 (OECD, 2014d:37)

¹²² For example, Recommendation 1 applies to qualifying payments (OECD, 2014d:37) and Recommendation 12 includes a definition of the term “payment” (OECD, 2014d:74). An adopting country may however draw on its domestic law concepts to determine whether a payment has been made for these purposes, leading to the possibility that an arrangement could be considered by the State to give rise to a payment for purposes of the Recommendations as adopted by that country in circumstances where the other State does not consider a payment to have arisen.

The sale should be a “hybrid transfer” on the basis that the share arrangement would contain the rights/obligations as contemplated in a “hybrid transfer”.¹²³

Accordingly a primary response would be triggered to deny this deduction in South Africa.¹²⁴

A further example in a hybrid entity context can be found in the partnership example set out in part 3.5 of this dissertation. In this instance the arrangement gave rise to a DD mismatch outcome.

In this instance Recommendation 3 would apply¹²⁵ to this scenario to require the other State to deny the deduction as a primary response (OECD, 2014d:44). Accordingly, the Recommendations would act to neutralise the D/NI outcome.

Where the other State does not apply the primary response, then the defensive rule may come into operation. However, its application in South Africa would depend on whether the arrangement gives rise to a “payment” from South Africa’s perspective. The definition of payment in Recommendation 12 requires that the amount be one which is capable of being paid, which may not be the case in the instance of a notional amount (OECD, 2014d:71). Therefore, unless this definition was amended to cater for such situation this defensive rule may not be of application in this scenario in South Africa.

¹²³ A “hybrid transfer” is defined in paragraph 2(b) of Recommendation 1 to be “any asset transfer arrangement entered into by a taxpayer with another party where:

- the taxpayer is the owner of the asset and the rights of the counterparty in respect of that asset are treated as obligations of the taxpayer; and
- under the laws of the counterparty jurisdiction, the counterparty is the owner of the asset and the rights of the taxpayer in respect of that asset are treated as obligations of the counterparty.

Ownership of an asset for these purposes includes any laws that result in the taxpayer being taxed as the beneficial owner of the corresponding cash-flows from the asset.”

¹²⁴ Refer paragraph 1 of Recommendation 1

¹²⁵ Recommendation 3 would apply to this scenario on the basis that the payment is one that is deducted in the country of payment but is not recognized in South Africa (para. 3).

Conclusions

The application of these rules are illustrated in part 8 of this dissertation as they relate to the selected scenario but do appear to be able to complement the measures adopted in the Act to neutralise mismatch outcomes from hybrid arrangements. South Africa's existing hybrid measures often focus on domestic impacts leaving them exposed cross border arrangements. The Recommendations could act as a bridge to the treatment in the foreign jurisdictions thereby compensating for this weakness.

However, the Recommendations may not be a complete solution as some hybrid arrangements may not be a designated hybrid event and also may fall within the scope limitations.

The Recommendations will likely impose additional complexity and possibly some uncertainty in the taxpayer's affairs.

7. TREATY RECOMMENDATIONS

Introduction

The Hybrid Report also includes recommended changes to the OECD Model in respect of dual resident entities and transparent entities (OECD, 2014d:79). Mismatch outcomes from dual residency is outside the scope of this dissertation and accordingly only the transparent entity recommendations are assessed.

The Hybrid Report recommends an addition to Article 1 of the OECD Model (OECD, 2014d:85) for purposes of ensuring that the income of transparent entities is treated in the line with the recommendation of the Partnership Report (OECD, 2014d:85). The Hybrid Report also sets out paragraphs to be included in the Commentary (OECD, 2014d:86 - 91).

Article 1 addition

The recommended insertion to Article 1 is as follows:

“For the purposes of this Convention, **income derived by or through** an entity or arrangement that is treated as **wholly or partly** fiscally transparent under the tax law of either Contracting State shall be considered to be income **of a** resident of a Contracting State but only to the extent that the **income is treated, for purposes of taxation by that State**, as the income **of a** resident of that State. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State’s right to tax the residents of that State.]” [my emphasis] (OECD, 2014d:86)

The application of this insertion is illustrated through the following example:

“State A considers that an entity established in State B is a company and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership and the two

members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B” (OECD, 2014d:87)

The impact of the addition to Article 1 is explained in the following proposed insertion into the Commentary”:

“ the paragraph ensures that the relevant income is attributed to that resident for the purposes of the application of the various allocative rules of the Convention [...] this will therefore allow the income to be considered [...] as [...] dividends or interest “paid to” for the purposes of Articles 10 and 11.” (OECD, 2014d:89)

This commentary confirms that the addition to Article 1 has limited ambit, being the attribution of income for purposes of the allocation rules of a DTC.

Commentary recommendations

The Hybrid Report provides further guidance on Article 1 insertion through proposed additions to the Commentary. Broadly these confirm that the Partnership Report provides guidance on the application of the Article 1 insertion (OECD, 2014d:86) and also applies to partly transparent entities (e.g. trusts) (OECD, 2014d:86). In addition guidance is provided on the meaning of the term “income derived by or through” (OECD, 2014d:88) as used in the Article 1 insertion and on the interaction with other articles of the OECD Model, including Articles 10 and 11. (OECD, 2014d:89)

Of particular interest given the uncertainties noted above on the meaning of the term “beneficial owner” in a hybrid entity context is the commentary on the meaning of “income derived by or through” and its interaction with Articles 10 and 11 (OECD, 2014d:90).

The proposed Commentary states that the term “income derived by or through” has “a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State” (OECD, 2014d:88). However, the proposed additions then go on to state that these allocation rules do not “prejudge the issue of whether the recipient is the beneficial owner of the relevant income” (OECD, 2014d:90). This confirms that the mere fact that an item of income is allocated to a hybrid entity for purposes of applying the allocation rules does not mean that they will then be the “beneficial owner” of this income.

Observation

The Article 1 insertion applies the objective approach but not to the extent that it protects residents of a state from tax imposed by that state. The insertion thus turns to the subjective approach to resolve this inconsistency.

Application to South Africa

Given that the above insertion to Article 1 follows the OECD income allocation approach as recommended in the Commentary and the Partnership Report, it largely acts, in a South African context, to reinforce (and perhaps clarify) the existing intended application of the OECD Model rather than to introduce a new treatment.

Applying this approach South Africa, as source state, would be required to take into account how the other Contracting State has allocated the income for its domestic tax purposes. The same approach would also apply to trusts.

As discussed in part 5.5 of this dissertation, the *Grundlingh* case should facilitate its support in the courts as this approach does initially follow an objective approach and the objective approach was applied in *Grundlingh*.

However, the Commentary makes it clear that this allocation of income to a hybrid entity does not mean that this hybrid entity is the “beneficial owner” of this income. Accordingly

the Hybrid Report has not resolved the uncertainties as discussed above in applying the term to hybrid entities.

Conclusion

On balance the treaty recommendations may not serve to introduce a new approach to applying DTCs to hybrid entities but could have import by clarifying the approach to be applied and the *Grundlingh* case. The application of this principle will be illustrated below.

Further the treaty recommendations do not resolve the uncertainty surrounding the application of term “beneficial owner” in a hybrid entity context.

8. CONCLUSION

In 2013 the OECD expressed that base erosion and profit shifting posed “a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike” and that one of the sources of this erosion was the use of hybrid entities and hybrid instruments in cross border arrangements to create mismatch outcomes across different tax jurisdictions.

In response the OECD issued the Recommendations to address mismatch outcomes from these hybrid arrangements. The Recommendations comprise domestic law measures as well as amendments to the OECD Model and the Commentary.

This dissertation set out to assess the potential impact of the Recommendations on South Africa’s tax laws and treaties as these relate to DD and D/NI mismatch outcomes in selected cross border financing arrangements between two taxpayers involving the use of hybrid instruments or hybrid entities.

It did so by way of assessing the sentiment of Government through publicly available documents towards the OECD’s BEPS proposals and thereafter by assessing how the Recommendations may interact with the Act and South Africa’s DTCs in addressing DD and D/DNI mismatch outcomes. .

To assess the interaction between the Recommendations, the Act and DTCs the treatment of cross border hybrid instrument and hybrid entity arrangements in the Act was reviewed to assess whether or not these provisions demonstrate an apparent potential to not effectively address cross border DD and D/NI mismatch outcomes, the WHT measures in the Act were then reviewed to assess whether or not these have the apparent capacity to preserve the tax base against cross border hybrid arrangements, then the treatment of these arrangements in the OECD Model was reviewed to assess how DTCs concluded by South Africa may influence the outcomes of measures in the Act to address hybrid mismatch arrangements and lastly the Recommendations were reviewed to assess how these may interact with the

Act and the DTCs in addressing DD and D/NI mismatch outcomes that may otherwise arise. This potential impact was demonstrated with the aid of illustrative examples.

The publically available documents indicated that Government supports the OECD's BEPS measures and has committed itself to considering these measures within the boundaries of its tax sovereignty and subject to the countries national interests.

The review of the Act revealed that the legal substance of a financing instrument has an important role in the characterisation of income arising therefrom as interest, dividends, foreign dividends, return of capital and foreign return of capital and that accordingly, absent specific provisions to the contrary, the Act would appear to have the potential to not effectively address all D/NI outcomes from cross border financing arrangements involving hybrid instruments in those instances where the other country taxes these arrangements on a basis other than legal substance.

This review also revealed the provisions in the Act targeted at hybrid instruments appear to be most effective in neutralising D/NI mismatches when the domestic treatment is linked to the foreign treatment or when the provisions do not permit a deduction that would otherwise have been allowed. This review found that these qualities were not present in sections 8F, 8FA and 24J and that accordingly the Act has an apparent potential in these instances to not effectively address all D/NI mismatches apparently targeted by these measures.

As regards entities, the review found that the fiscal transparency of partnerships in the Act may not be linked in all cases to the fiscal treatment of these entities in other states resulting in the Act, in some instances, having the apparent potential to not effectively address mismatch outcomes in cross border transactions involving the use of partnerships.

The review of DT and WHTI provisions found that, absent DTC considerations, while WHT prima facie has an apparent potential to preserve the tax base against cross border hybrid financing arrangements it may not do so in all instances. This suggests that National Treasury may not be able to rely on WHT to compensate in full for any loss in normal tax collections from cross border hybrid financing arrangements.

The review of the OECD Model found that a DTC would not neutralise DD or D/NI mismatch outcomes. In addition a review of a sample of DTCs concluded by South Africa demonstrated that in general DTCs reduce the WHT that would otherwise be collected in financing arrangements. Further, it was found that the OECD Model characterisation of interest and dividends could also override the section 8F/8FA characterisation for DTC purposes, thus exposing the WHT levied thereon to the more favourable relief of Article 11 and thereby further reducing WHT collections from hybrid instrument arrangements.

As regards the impact of DTCs on WHT collected on financing arrangements through hybrid entities a review of the commentators, the Commentary and foreign and local case law found there remains considerable uncertainty on two key elements, namely whether the person or the income is the subject matter of DTC relief and the meaning of “beneficial owner”. This uncertainty rendered the DTC impact of WHT collections on financing arrangements through partnerships uncertain.

Taking the above into account it was therefore found that DTCs either diminished the apparent potential of WHT to preserve the tax base against cross border hybrid arrangements in some instances or had an uncertain impact, thus giving more potential significance to the Recommendations.

The review of the domestic law aspects of the Recommendations found that the recommended rules link the treatment of a designated arrangement in one state with its treatment in another state and accordingly appear to be suited to complementing the hybrid rules in the Act, which do not refer to the treatment in the other State in all instances. However, it was also found that the proposed rules may not cover all mismatch arrangements, that they would likely introduce additional complexity and perhaps some uncertainty into taxpayer’s affairs and may not be adopted by states in exactly the same manner leading to concerns of mismatch within these rules.

The review of the treaty recommendations found that these did not introduce a new approach to applying DTCs to cross border hybrid arrangements but rather reinforced and clarified the existing approach intended by the OECD, and likely Government. It was also

found that these recommendations would help to clarify the approach adopted by the Free State High Court in the *Grundlingh* case. It also found that the treaty recommendations did not assist in resolving the uncertainty in the application of the “beneficial owner” requirement to interest and dividends flowing through hybrid entities. Accordingly, it was found that overall the treaty recommendations would appear unlikely to alter the incidence of WHT collections from cross border hybrid arrangements.

This dissertation has therefore demonstrated that the Recommendations would likely be seriously considered by Government and if adopted should impact on the Act to neutralise, some but not necessarily all, DD and D/NI mismatch outcomes arising from two country cross border financing arrangements between two taxpayers using hybrid instruments or partnerships when the Act would otherwise not do so. However, this dissertation also found that this benefit could be at the cost of increased complexity and possibly uncertainty for taxpayer’s. This could be offset to a degree if the OECD published detailed guidance on the Recommendations and by facilitating comparative analysis of case law between the various jurisdictions. It was also found, that the treaty elements of the Recommendations that were within the scope of this dissertation did not appear to assist in improving WHT collections or alter the relief granted in South Africa’s DTCs against WHT levied on interest and dividends on hybrid instruments or which flowed through partnerships.

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ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

“Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping”. (OECD, 2013a:15)

DTC DEFINITIONS OF DIVIDEND AND INTEREST

Significant variations to the 2014 OECD Model are highlighted in *bold italics*

| DTC | Dividend definition | Interest definition |
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| 1963 OECD Model | The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident.” | The term “interest” as used in this Article means income from Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises. |
| 1977 to 2014 OECD Model | The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident | The term “interest” as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article |
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| Botswana | The term “dividends” as used in this Article means income from shares, mining shares, founders’ shares or other rights participating in profits (not being debt-claims), as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident. | The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purposes of this Article. |
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| China | The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident. | The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article. |
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| France | The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, <i>as well as</i> | The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular income from |

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| | <p><i>income treated as a distribution</i> by the taxation laws of the Contracting State of which the company making the distribution is a resident. The term "dividends" shall not include income mentioned in Article 16</p> | <p>government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.</p> <p><i>The term "interest" shall not include any item of income which is treated as a dividend under the provisions of Article 10.</i></p> |
| Germany (In Force) | <p>The term "dividends" as used in this Article means, income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident. <i>It includes the income derived by a sleeping partner (stiller Gesellschafter) from his participation as such and income from distribution on certificates of an investment trust.</i></p> | <p>The term "interest" as used in this Article means income from Government securities, from bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind <i>as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises.</i></p> |
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| <p>Germany (Signed but not in force)</p> | <p>The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or <i>other income which is subjected to the same taxation treatment</i> as income from shares by the laws of the State of which the company making the distribution is a resident. <i>The term "dividends" includes also income derived by a silent partner ("stiller Gesellschafter") from that partner's participation as such or from a "partiarisches Darlehen", "Gewinnobligationen" or similar payments and distributions on certificates of an investment fund or investment trust.</i></p> | <p>The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purposes of this Article. <i>However, the term "interest" shall not include income dealt with in Article 10.</i></p> |
| <p>Ireland</p> | <p>The term "dividends" as used in this Article means income from shares or other rights participating in profits (not being debt-claims), as well as income from other corporate rights and <i>any income or distribution assimilated to income from shares</i> by the laws of the Contracting State of which the company paying the income or making the distribution is a resident</p> | <p>The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures, <i>as well as all other income assimilated to income from money lent by the laws of the State in which the income arises but does not</i></p> |

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| | | <i>include any income which is treated as a dividend under Article 10.</i> Penalty charges for late payment shall not be regarded as interest for the purposes of this Article. |
| Italy | The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights participating in profits (not being debt-claims), as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident | The term "interest" as used in this Article means income from government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind as well <i>as all other income assimilated to income from money lent by the taxation law of the State in which the income arises</i> |
| Japan | The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident. | The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. |
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| Luxembourg | The term "dividends" as used in this Article means income from shares, founders' shares or other rights participating in profits (not being debt-claims), as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident. | The term "interest" as used in this Article means income from debt -claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article. |
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| Mauritius (In force but effective from 1 January 2016) | The term "dividends" as used in this Article means income from shares or other rights (not being debt-claims) participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident | The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purposes of this Article. <i>The term "interest" shall not include any item which is treated as a dividend under the provisions of Article 10 of this Agreement.</i> |
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| Netherlands | The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights participating in profits, as well <i>as income from debt-claims participating in profits</i> and income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident. | The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage, <i>but not carrying a right to participate in the debtor’s profits</i> , and in particular income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article. |
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| Nigeria | The term “dividends” as used in this Article means income from shares or other rights participating in profits (not being debt-claims), as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident. | The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purposes of this Article. |
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| Saudi Arabia | The term “dividends” as used in this Article means income from shares or other rights participating in profits (not being debt-claims), as well as income from other corporate rights which is subjected to the same taxation treatment | The term “income from debt-claims” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, |

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| | as income from shares by the laws of the Contracting State of which the company making the distribution is a resident. | income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as income from debt-claims for the purposes of this Article. |
| United Kingdom | The term “dividends” as used in this Article means income from shares, or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident and also includes <i>any other item which, under the laws of the Contracting State of which the company paying the dividend is a resident, is treated as a dividend or distribution of a company</i> | The term “interest” as used in this Article means income from debt - claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures. <i>The term “interest” shall not include any item which is treated as a dividend under the provisions of Article 10 of this Convention.</i> |
| United States | The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as <i>income that is subjected to the same taxation treatment as income from shares under the laws of the State of which the payor is a resident</i> | The term "interest" as used in this Convention means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits and, in particular, income from government securities and income from bonds or debentures, including |

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| | | <p>premiums or prizes attaching to such securities, bonds or debentures, <i>and all other income that is subjected to the same taxation treatment as income from money lent by the taxation law of the Contracting State in which the income arises. Income dealt with in Article 10 (Dividends)</i> and penalty charges for late payment <i>shall not be regarded as interest for the purposes of this Convention.</i></p> |
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DTC: ARTICLE 1 AND DEFINITIONS OF PERSON AND RESIDENT OF A CONTRACTING STATE

Beneficial Owner

The requirement that interest or dividend be paid to a “beneficial owner” of a resident of a Contracting State in order for the reduced DTC rate to apply is found in all of the below DTCs. In addition the term is not defined in these DTCs. The “beneficial owner” requirement was introduced into the OECD Model in 1977.

Article 1, “Person” and “resident of a Contracting State”

Significant variations to the 2014 OECD Model are highlighted in *bold italics*

| DTC | Article 1 | "Person" | "resident of a Contracting State" |
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| 1963 OECD Model | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term “person” comprises an individual, a company and any other body of persons | For purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. |
| 2014 OECD Model | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term “person” includes an individual, a company and any other body of persons | For purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political |

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| | | | subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. |
| Botswana | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term "person" includes an individual, a company, <i>a trust, an estate</i> and any other body of persons <i>that is treated as an entity for tax purposes.</i> | For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, place of management, <i>place of incorporation</i> or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources therein. |
| China | This Agreement shall apply to persons who are residents of one or both of the Contracting States | the term "person" includes an individual, a company and any other body of persons; | For the purposes of this Agreement, the term "resident of a Contracting State" means: a) in China, any person who, under the laws of China, is liable to tax therein by reason of his domicile, residence, <i>place of head office</i> or any other criterion of a similar nature; <i>b) in South Africa, any individual who is ordinarily resident in South Africa and any other person which has its place of effective management in South Africa;</i> c) that State and any political subdivision or local authority thereof. |

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| France | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term "person" includes an individual, a company and any other body of persons <i>which is treated as an entity for tax purposes;</i> | For the purposes of this Convention, the term "resident of a Contracting State" means: (a) in the case of France, any person who, under the French laws, is liable to tax in France by reason of his domicile, residence, place of management or any other criterion of a similar nature; <i>(b) in the case of South Africa, any individual who is ordinarily resident in South Africa, and any person, other than an individual, which has its place of effective management in South Africa.</i> |
| Germany (In Force) | This Agreement shall apply to persons who are residents of one or both of the Contracting States | the term "person" <i>includes any body of persons, corporate or not corporate;</i> | <i>(aa) the term "resident of South Africa" means any person (other than a company) who is ordinarily resident in South Africa for the purposes of South African tax and any company which is incorporated, managed or controlled in South Africa;</i> <i>(bb) the term "resident of the Federal Republic" means any person who is resident in the Federal Republic (subject to unlimited tax liability) for the purposes of German tax;</i> |
| Germany (Signed but not in force) | This Agreement shall apply to persons who are residents of one or both of the Contracting States | the term "person" includes an individual, a company and any other body of persons | For the purposes of this Agreement, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, place |

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| | | <i>that is treated as an entity for tax purposes;</i> | of management or any other criterion of a similar nature, and also includes that State itself, a Land and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. |
| Ireland | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term "person" includes an individual, a company, <i>an estate, a trust</i> and any other body of persons <i>but does not include a partnership.</i> | For the purposes of this Convention, the term "resident of a Contracting State" means: (a) in Ireland, any person who, under the laws of Ireland, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, but this term does not include any person who is liable to tax in Ireland in respect only of income from sources in Ireland; <i>(b) in South Africa, any individual who under the laws of South Africa is ordinarily resident in South Africa and any other person which has its place of effective management in South Africa;</i> (c) that State and any political subdivision or local authority thereof |
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| Italy | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term "person" includes an individual, a company and any other body of persons <i>which is treated as an entity for tax purposes.</i> | For the purposes of this Convention the term "resident of a Contracting State" means: (a) in the case of Italy, any person who, under the law of Italy, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature; but the term does not include any person who is liable to tax in Italy in respect only of income from sources in Italy; and <i>(b) in the case of South Africa, any individual who is ordinarily resident in South Africa and any other person which has its place of effective management in South Africa;</i> |
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| Japan | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term "person" includes an individual, a company and any other body of persons <i>which is treated as an entity for tax purposes</i> | For the purposes of this Convention, the term "resident of a Contracting State" means: (a) in relation to Japan, any person who, under the laws of Japan, is liable to tax therein by reason of his domicile, residence, place of head or main office or any other criterion of a similar nature; <i>(b) in relation to South Africa, any individual who, under the laws of South Africa, is ordinarily resident in South Africa and any person other than an individual which has its place of effective management in South Africa.</i> |
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| Luxembourg | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term "person" includes an individual, a company and any other body of persons <i>which is treated as an entity for tax purpose</i> | For the purposes of this Convention, the term "resident of a Contracting State" means: a) in Luxembourg, any person who, under the laws of Luxembourg, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, but this term does not include any person who is liable to tax in Luxembourg in respect only of income from sources in Luxembourg or capital situated therein; <i>b) in South Africa, any individual who is ordinarily resident in South Africa and any other person which has its place of effective management in South Africa</i> ; and c) in either case, that State and any political subdivision or local authority thereof |
| Mauritius (In force but effective from 1 January 2015) | This Agreement shall apply to persons who are residents of one or both of the Contracting States. | the term "person" includes an individual, a company and any other body of persons <i>which is treated as an entity for tax purposes</i> | For the purposes of this Agreement, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State. |
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| Netherlands | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term “person” includes an individual, a company and any other body of persons | For the purposes of this Convention, the term “resident of a Contracting State” means: a) any person who, under the laws of that State, is liable to tax therein by reason of that person’s domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein; <i>b) a pension fund that is recognised and controlled according to the statutory provisions of a Contracting State and the income of which is generally exempt from tax in that State.</i> |
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| Nigeria | This Agreement shall apply to persons who are residents of one or both of the Contracting States | the term “person” includes an individual, a company and any other body of persons <i>which is treated as an entity under the taxation laws in force in each Contracting State</i> | For the purposes of this Agreement, the term “resident of a Contracting State” means: (a) in Nigeria, any person who, under the laws of Nigeria, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation or any other criterion of a similar nature, but this term does not include any person who is liable to tax in Nigeria in respect only of income or capital gains from sources in Nigeria; <i>(b) in South Africa, any individual who is ordinarily resident in south Africa and any person other than an individual which</i> |

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| | | | <i>has its place of effective management in South Africa</i> ; (c) that State itself and any political subdivision or local authority thereof |
| Saudi Arabia | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term “person” includes any individual, any company or any other body of persons, <i>including the State, its political or administrative subdivisions or local authorities, estates, trusts and foundations</i> | For the purposes of this Convention, the term “resident of a Contracting State” means: (a) any person who, under the laws of that Contracting State, is liable to tax therein by reason of that person’s domicile, residence, place of management or any other criterion of a similar nature, and also includes that Contracting State and any political or administrative subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that Contracting State in respect only of income from sources in that Contracting State or capital situated therein; <i>(b) a legal person organised under the laws of a Contracting State and that is generally exempt from tax in that Contracting State and is established and maintained in that Contracting State either: (i) exclusively for religious, charitable, educational, scientific, or other similar purposes; or (ii) to provide pensions or other similar benefits to employees pursuant to a plan</i> |
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| United Kingdom | This Convention shall apply to persons who are residents of one or both of the Contracting States | the term "person" includes an individual, a company and any other body of persons and does not include a partnership. | For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, place of management, place of incorporation or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof |
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| United States | This Convention shall apply to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention. | the term "person" includes an individual, an estate, a trust, a partnership, a company and any other body of persons | For the purposes of this Convention the term "resident of a Contracting State" means: a) in the case of the United States, i) any person who, under the laws of the United States, is liable to tax therein by reason of his domicile, residence, citizenship, place of incorporation, or any other criterion of a similar nature, provided, however, that this term does not include any person who is liable to tax in the United States in respect only of income from sources therein or of profits attributable to a permanent establishment in the United States; and ii) a legal person organised under the laws of the United States and that is generally exempt from tax in the United States and is established and maintained in the United States either: aa) exclusively for a religious, charitable, educational, scientific, or other similar purpose; or bb) to provide pensions or other similar |

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| | | | <p><i>benefits to employees pursuant to a plan;</i></p> <p><i>b) in the case of South Africa, any individual who is ordinarily resident in South Africa and any legal person which is incorporated or has its place of effective management in South Africa;</i> c) that State, and any political subdivision or local authority thereof; <i>d)</i></p> <p><i>in the case of an item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State, that income shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.</i></p> |
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SOURCE STATE TAXATION – MAXIMUM DTC RATES

| DTC | Dividend Major holding | Dividend Minor holding | Interest |
|---|---------------------------------------|---------------------------------------|-----------------|
| | % | % | % |
| 1963 OECD Model | 5 | 15 | 10 |
| 1977 to 2014 OECD Model | 5 | 15 | 10 |
| Botswana | 10 | 15 | 10 |
| China | 5 | 5 | 10 |
| France | 5 | 15 | 0 |
| Germany (In force) | 7.5 | 15 | 10 |
| Germany (Signed but not in force) | 5 | 15 | 0 |
| Ireland | 5 | 10 | 0 |
| Italy | 5 | 15 | 10 |
| Japan | 5 | 15 | 10 |
| Luxembourg | 5 | 15 | 0 |
| Mauritius (In force but effective from 1 January 2015) | 5 | 10 | 10 |
| Netherlands | 5 | 10 | 0 |
| Nigeria | 7.5 | 10 | 7.5 |
| Saudi Arabia | 5 | 10 | 5 |
| United Kingdom | 5 | 10 | 0 |
| United States | 5 | 15 | 0 |
| Average (In force DTCs only) | 5.7 | 12.2 | 5.2 |