



**Characterisation for treaty purposes of manufactured dividends received in  
terms of securities lending arrangements**

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# PLAGIARISM DECLARATION

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## ABSTRACT

Equity securities lending arrangements are contracts whereby a shareholder lends his shares to a borrower for a period of time. If dividends are declared during that period, these accrue to the borrower, and the borrower pays a manufactured dividend to the lender as compensation.

The applicable income tax legislation deems manufactured dividends to be dividends for purposes of dividends tax. However, unless manufactured dividends are governed by Article 10 of a double tax treaty, South Africa may not have the right to tax manufactured dividends received by non-resident lenders. This would result in a loss of revenue for the South African *fiscus*.

This paper examined the qualification or characterisation for treaty purposes of manufactured dividend income earned by lenders in terms of securities lending arrangements. This examination was done through an analysis of the 'dividends' definition in Article 10 of the 2017 OECD model convention. It was found that manufactured dividends are not 'dividends' for treaty purposes, and are instead business income in terms of Article 7.

South African domestic tax legislation was analysed, together with publications by the South African Revenue Service and National Treasury, and demonstrated that there is a risk of taxation not in accordance with the provisions of a convention, as well as a risk of revenue losses to the South African *fiscus* where a non-resident lender has no permanent establishment in South Africa.

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## LIST OF DEFINITIONS

<b>Abbreviation</b>	<b>Meaning</b>
BPR	Binding Private Ruling, issued by SARS
CGT	Capital Gains Tax
DTT/s	Double Tax Treaty/-ies
EU	European Union
GAAR	General anti-avoidance rules
ITA	Income Tax Act, No. 58 of 1962, as amended
MLI	The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
OECD	Organisation of Economic Co-operation and Development
OECD MC	OECD Model Tax Convention on Income and on Capital
PE	Permanent Establishment, as defined in Article 5 of the OECD MC
PPT	Principal Purpose Test housed in Article 7 of the MLI
SARS	South African Revenue Service
STT Act	Securities Transfer Tax Act No. 25 of 2007
TLAA	Taxation Laws Amendment Act
TLAB	Taxation Laws Amendment Bill
UN MC	United Nations Model Double Taxation Convention between Developed and Developing Countries
VCLT	Vienna Convention on the Law of Treaties



# 1. CHAPTER 1: INTRODUCTION

## 1.1. Background

### 1.1.1. Securities lending arrangements

SLAs are investment transactions whereby an entity temporarily lends equity or debt securities to a borrower. The borrower may on-deliver the securities to a third party, and will typically recall the securities such that the borrower is in possession of the securities when dividends accrue. During the lending period, the borrower pays ‘manufactured’ dividends or interest to the lender to compensate the lender for distributions paid by the issuer in respect of the securities, as well as a lending fee. The manufactured dividends or interest amounts are not necessarily equal to the dividends or interest paid by the issuer of the instrument. Where the borrower provides an asset or cash deposit to the lender as collateral, the lender pays interest on this to the borrower. At the end of the specified lending period, the securities and any collateral are returned to the lender and the borrower, respectively.<sup>1,2</sup>

For the borrower of an equity SLA, the purpose of such an arrangement may be to settle another securities transaction, or may be for strategic or hedging purposes. In South Africa, the latter is the case in three out of four SLAs.<sup>3</sup> This is when the borrower believes that the price of the security will decrease during the lending period. He borrows the security, sells it to a third party buyer, and hopes to buy an identical security at the end of the lending period for a lesser price in order to fulfil his obligations under the SLA, while pocketing the difference. SLAs are a critical part of short-selling

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<sup>1</sup> Brink, J. (2018, June 4). *Securities Lending Arrangements Back in the Spotlight*. Accessed 1 October 2019. Available at <https://www.thesait.org.za/news/403497/Securities-lending-arrangements-back-in-the-spotlight-.htm>

<sup>2</sup> Musviba, N. (2 March 2015). *Securities Lending Arrangements*. Accessed 10 November 2019. Available at <https://www.sataxguide.co.za/securities-lending-arrangements/>

<sup>3</sup> SASLA (25 September 2015). *Securities Lending Guide for South Africa*. Accessed 30 November 2019. Available at <https://www.sasla.co.za/index.php/en/document>

transactions and enable sellers to deliver shares in terms of their contractual obligations, removing the risk of failed trades.<sup>4</sup>

For the lender, the receipt of lending fees provides additional and short-term cash flow on his long-term investment in the securities.<sup>5</sup> In South Africa, pension funds commonly act as lenders in SLAs, as the fees earned add to the returns of the fund.<sup>6</sup>

### **1.1.2. Summary of South African tax treatment of SLAs**

The ITA definition<sup>7</sup> of a ‘securities lending arrangement’ refers to the definition of a ‘lending arrangement’ in the STT Act. The key elements of the definition, as pertain to equity securities, are as follows:

- The security is listed on an exchange;
- The borrower will deliver the security to a third party within ten business days of transfer from the lender;
- The borrower will return the security (or one substantially the same) to the lender within 12 months;
- The borrower is contractually obliged to compensate the lender for distributions received in respect of the security.

Below, the South African income tax treatment arising from equity SLAs for various combinations of resident and non-resident borrowers and lenders is summarised. The tax consequences set out below are in respect of companies only. Debt SLAs, and borrowers and lenders that are individuals, are not considered. The summary below offers context for Chapter 2’s analysis of the OECD MC ‘dividends’

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<sup>4</sup> Edward Nathan Sonnenbergs for SAICA Integritax issue 193 October 2015. *2451. Loans over listed shares*; Accessed 17 December 2019. Available at [https://www.saica.co.za/integritax/2015/2451.\\_Loans\\_over\\_listed\\_shares.htm](https://www.saica.co.za/integritax/2015/2451._Loans_over_listed_shares.htm)

<sup>5</sup> Edward Nathan Sonnenbergs for SAICA Integritax, issue 135, November 2010. *Securities Lending*. Accessed 1 October 2019. Available at [https://www.saica.co.za/integritax/2010/1888\\_Securities\\_lending.htm](https://www.saica.co.za/integritax/2010/1888_Securities_lending.htm)

<sup>6</sup> *Supra* at 3 SASLA (2015)

<sup>7</sup> Section 1 of the ITA

definition, while Chapter 4 returns to this South African income tax treatment in greater detail. Please refer to Chapter 4 for references to applicable sections of the ITA which underpin the tax treatments summarised below.

***1.1.2.1. South African tax treatment of equity SLAs: Resident borrower and resident lender***

The dividend income will be included in the borrower's 'gross income'. The dividend will not be exempt from normal tax, and will thus be included in his 'income' for tax purposes. Consequently, the dividend will be exempt from dividends tax. Payment of a manufactured dividend and lending fees will be deductible expenditure incurred in the production of the borrower's 'income'.

The manufactured dividend and lending fee income will constitute 'gross income' of the lender. With no available exemptions, the manufactured dividend income will be included in his 'income'. For dividends tax purposes, the manufactured dividend is deemed to be a dividend paid by the borrower for the benefit of the lender, subject to dividends tax. The manufactured dividend will be exempt from dividends tax by virtue of the amount constituting 'income' of the beneficial owner (the lender).

From a dividends tax perspective, the above tax treatment aligns with the outcome that would have occurred had the SLA not been effected; that is, had the lender received the dividend paid by the issuer directly, the dividend would have been exempt from dividends tax, by virtue of the lender being a resident company.

***1.1.2.2. South African tax treatment of equity SLAs: Resident borrower and non-resident lender***

As above at 1.1.2.1, the borrower is subject to income tax on the difference between dividends received and manufactured dividends and fees paid to the lender. The borrower is exempt from dividends tax.

On the assumption that manufactured dividends and lending fees received by the non-resident lender will be considered to be of a South African source (refer to Chapter 4 for more detail in this regard), the amount will be 'gross income' in his hands. The manufactured dividend income will not be exempt

from normal tax and will be included in the non-resident lender's 'income'. The manufactured dividend is subject to dividends tax, but qualifies for exemption.

The borrower's dividend income is exempt from dividends tax but forms part of his 'income'. SARS will be able to tax the borrower's profits. That being said, his profits will not be significant, as they are reduced by manufactured dividends and lending fees paid to the lender.

The manufactured dividend income is exempt from dividends tax in the non-resident lender's hands. From a dividends tax perspective, this does not align with the outcome that would have occurred had the SLA not been effected. Had a non-resident shareholder received the dividend paid by the share issuer directly, he would have been subject to dividends tax on that dividend, and a DTT could possibly have been applied to reduce the rate of tax.

Furthermore, if the non-resident lender has no PE in South Africa, taxing rights in respect of his profits (that is, the manufactured dividend and lending fee income) would likely not be taxable in South Africa under a DTT.

#### ***1.1.2.3. South African tax treatment of equity SLAs: Non-resident borrower and resident lender***

The dividend income will be included in the non-resident borrower's 'gross income', it will not be exempt from normal tax, and will thus be included in his 'income'. It follows that the dividends will be exempt from dividends tax. Manufactured dividends and lending fees paid by the non-resident borrower to the lender will be deductible.

From the lender's perspective, the manufactured dividend and lending fee income received will be included in the lender's worldwide 'income'. The manufactured dividend is subject to dividends tax, but qualifies for exemption.

From a dividends tax perspective, this aligns with the outcome that would have occurred had the SLA not been effected. Had a resident shareholder received the dividend paid by the issuer, he would have been exempt from dividends tax, by virtue of the lender being a resident company. Where this lender

instead receives a manufactured dividend from the non-resident borrower, such lender is also exempt from dividends tax.

***1.1.2.4. South African tax treatment of equity SLAs: Non-resident borrower and non-resident lender***

From the borrower's perspective, the dividend income will be included in the non-resident borrower's 'gross income', it will not be exempt from normal tax, and will thus be included in his 'income'. The dividends will be exempt from dividends tax. Manufactured dividends and lending fees paid by the non-resident borrower to the non-resident lender will be deductible.

For the non-resident lender, on the assumption that manufactured dividends and lending fee income received by a non-resident lender from a non-resident borrower will not be considered to be of a South African source (refer to Chapter 4 for more detail in this regard), the amount will not constitute 'gross income' in his hands. The manufactured dividend is subject to dividends tax. This will not be exempt from dividends tax, as the amount is not 'income' of the beneficial owner (the non-resident lender).

The non-resident borrower's dividend income is exempt from dividends tax but forms part of his 'income'. If the non-resident borrower does not have a PE in South Africa, application of the business profits or other income articles of a DTT would most likely result in no allocation of taxing rights to South Africa in respect of the non-resident borrower's profits.

Turning to taxation of the lender, South African domestic tax law would like to subject his manufactured dividend income to dividends tax. However, if it is found that manufactured dividends are not 'dividends' for DTT purposes, South Africa's taxing position here is precarious. Thus, although the non-resident lender is not exempt from dividends tax on the manufactured dividend, South Africa may nevertheless have no right to receive dividends withholding tax on such amount. This is considered in detail in Chapter 2, where the OECD MC 'dividends' definition is analysed. If manufactured dividends are more appropriately characterised as business profits or other income when applying a DTT to allocate taxing rights between States, if the non-resident lender does not have a PE in South Africa, the

most likely result would be no allocation of taxing rights to South Africa in respect of the non-resident lender's profits.

From a dividends tax perspective, this does not align with the outcome that would have occurred had the SLA not been effected. Had a non-resident shareholder received the dividend paid by the share issuer, he would have been subject to dividends tax on that dividend, and a DTT could possibly have been applied to reduce the rate of tax.

## **1.2. Research question**

As outlined above, in the absence of an SLA, South African sourced dividend income<sup>8</sup> accruing to a non-resident shareholder of a South African listed equity share would be subject to dividends tax in South Africa.<sup>9</sup> The company that declared the dividend would be obliged to withhold dividends tax at 20 per cent, which could be reduced to a lower rate through application of a relevant DTT.<sup>10</sup>

Where a non-resident shareholder lends his South African listed shares to another party, whether resident or non-resident, over the period when a dividend is declared, the dividends tax outcome is altered.

Where the share has been lent to a resident borrower, the borrower is exempt from dividends tax on his dividend income, the non-resident lender is exempt from dividends tax on his manufactured dividend income, and a DTT is unlikely to allocate South Africa taxing rights in respect of the non-resident lender's profits.

Where the share is lent to a non-resident borrower, such borrower is exempt from dividends tax on his dividend income and, unless a manufactured dividend can be considered a 'dividend' for DTT purposes, South Africa will have no taxing rights in respect of the profits (which includes manufactured dividend income) of the non-resident lender.

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<sup>8</sup> As contemplated in section 9(2)(a) of the Act

<sup>9</sup> Section 64E of the ITA

<sup>10</sup> Section 64G(1), read with section 64G(3), of the ITA

By deeming the payment of a manufactured dividend by the borrower under an SLA to be a dividend paid to and for the benefit of the lender (outlined above at 1.1.2), the ITA apparently seeks to achieve the dividends tax position that would have occurred had there been no SLA – to treat the borrower as a conduit for the dividend, if you will. In its *Comprehensive Guide to Dividends Tax*, SARS notes that a manufactured dividend paid to a non-resident lender “may be subject to dividends tax at a reduced rate as a result of the application of a tax treaty”.<sup>11</sup>

Article 10 of the OECD MC allocates taxing rights over dividend income to both Contracting States, but places a limitation on the taxing rights of the source State. Application of Article 10 relies on its own ‘dividend’ definition, and not a Contracting State’s domestic law’s understanding of a ‘dividend’. If an amount of income does not fall into the definition of a ‘dividend’ in terms of the DTT, other articles of the DTT, such as Article 7 (Business Profits), would need to be considered. By contrast, Article 7 allocates taxing rights in respect of the profits of an enterprise to the State of residence, unless these profits are attributable to a PE carried on in the source State.

The question thus arises how manufactured dividend income should be characterised for DTT purposes. This study will therefore consider the ‘dividend’ definition housed in Article 10 of the OECD MC, with a view to concluding whether a manufactured dividend is a ‘dividend’ as defined in Article 10(3) of the OECD MC. If it is found that a manufactured dividend is not a ‘dividend’ for purposes of Article 10 of the OECD MC, this study will consider whether Article 7 may be applied to allocate taxing rights in respect of manufactured dividends.

### **1.3. Research method**

This study aims to determine the appropriate characterisation of manufactured dividends for DTT purposes, with a view to assessing whether South Africa is at risk of losing revenue in respect of SLAs involving non-resident lenders of South African listed equity shares. This study will encompass a

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<sup>11</sup> SARS (12 September 2019). *Comprehensive Guide to Dividends Tax*. Accessed 30 November 2019. Available at <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-IT-G19%20-%20Comprehensive%20Guide%20to%20Dividends%20Tax.pdf>

literature review to enable a qualitative analysis of international tax concepts. This study will take the form of a theoretical analysis of the domestic and international treaty tax treatment of a specific category of income.

This analysis will include the following steps:

- Analysis of applicable Articles of the OECD MC;
- Consultation of relevant commentaries, revenue authority guides and rulings, explanatory memoranda issued in conjunction with legislation, authoritative texts and journals;
- Examination of applicable domestic legislation;
- Consolidation of the information considered into a suitable conclusion;
- Presentation of considered suggestions and recommendations.

The OECD MC has been selected for this study by reason of its authority, and its broad level of influence and penetration in bilateral DTTs worldwide.<sup>12</sup> The wording in Article 10 of the OECD MC that is the core subject of analysis in this study is identical to the corresponding wording in the 2017 UN MC. It follows that references to wording of Article 10 of the OECD MC could apply equally to Article 10 of the UN MC. The commentaries to the UN MC in relation to the ‘dividends’ definition housed in Article 10(3) acknowledge the fact that this paragraph in the UN MC is a reproduction of the same paragraph in the OECD MC, and thus the UN MC commentaries reproduce the key portions of the OECD MC commentaries and do not offer any original views. The UN MC will therefore not be used for purposes of analysis of the ‘dividends’ definition.

#### **1.4. Limitations**

This study will analyse the income tax treatment of manufactured dividends in terms of South African domestic law only and will not extend to the domestic law of other countries.

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<sup>12</sup> Du Plessis, I. (2012). *Some Thoughts on the Interpretation of Tax Treaties in South Africa*. SA Mercantile Law Journal, Volume 24, Issue 1, Jan 2012, 31-52.



As the most current version at the time of writing, the 2017 issue of the OECD MC and its commentaries will be examined in this study.

The South African domestic tax law applicable to this study is the South African Income Tax Act of 1962, as amended by TLAAs up to and including the 2018 TLAA promulgated on 17 January 2019. It is noted that the 2019 TLAB does not contain any changes to the ITA may impact on the conclusions set out in this paper.

## **1.5. Chapter outline**

Chapter 2 will analyse Article 10 of the OECD MC in order to assess whether manufactured dividends can be characterised as ‘dividends’ for DTT purposes. This analysis will include consideration of the relevant OECD MC commentaries, and the GTTC chapter on dividends. The OECD MC will be interpreted in line with the principles set out in the VCLT.

Following from the conclusion reached through the analysis of Article 10, Chapter 3 will analyse Articles 7 and 21 of the OECD MC in order to assess whether manufactured dividend income can be characterised as business profits or other income for DTT purposes. This analysis will include consideration of the relevant OECD MC commentaries, the relevant GTTC chapters, and other authoritative literary sources.

Chapter 4 will examine the relevant components of South African tax legislation to assess the domestic taxation of manufactured dividends paid in terms of an SLA. This examination will include consideration of the explanatory memoranda published together with the TLAAs that introduced and amended relevant sections of the ITA. Additionally, SARS’s view on the application of DTTs to manufactured dividends will be introduced, and will be contrasted with the analysis of the OECD MC’s ‘dividends’ definition in Chapter 2.

Chapter 5 will draw conclusions as to the appropriate qualification of manufactured dividend income for DTT purposes. In the light of the possibility of no taxing rights for South Africa in respect of a non-resident lender in an SLA, the possible impact of South African GAAR and the MLI’s PPT on the taxation of manufactured dividends will briefly be considered. Recommendations will be offered as to

areas of the ITA that National Treasury could consider reviewing in order to mitigate the risk of revenue losses to the South African *fiscus* in respect of South African sourced manufactured dividends paid to non-resident lenders.

## CHAPTER 2: ARTICLE 10 DIVIDENDS

### 2.1 Introduction

Chapter 1 set out a brief summary of the South African income tax treatment of dividends and manufactured dividends that accrue under an SLA to resident and non-resident corporate borrowers and lenders. That chapter also showed that, depending on the proper characterisation of manufactured dividend income for DTT purposes, there is a risk that South Africa will have no right to tax local dividends or manufactured dividends paid under an SLA where the lender is a non-resident.

In this chapter, the validity of the characterisation of manufactured dividend income as ‘dividends’ for treaty purposes is analysed, using the interpretive principles espoused in the VCLT, with a view to assessing the risk of revenue losses for the South African *fiscus*.

What is not in dispute is the fact that a manufactured dividend paid by a borrower is not the same amount received by him from the share issuer. The dividend compensation payment does not retain the nature of the dividend itself when the manufactured dividend is paid to the lender.<sup>13</sup> Put another way, it is not suggested that the lender, as the recipient of a manufactured dividend, is the beneficial owner of the dividend (or part thereof) paid by the issuer. In SARS’s examples set out in its Comprehensive Guide to Dividends Tax, different Rand amounts are used to identify and differentiate the dividend received by the borrower and the manufactured dividend paid by him.

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<sup>13</sup>SA Tax Guide, 2013. *Changes to the taxation of dividend cessions and manufactured dividends*. Accessed on 17 December 2019. Available at <http://www.sataxguide.co.za/changes-to-the-taxation-of-dividend-cessions-and-manufactured-dividends/?print=print>

## 2.2 Interpretation of treaties

A DTT is an agreement between two contracting States. Historically, this principle has been born in mind by the courts when interpreting such agreements.<sup>14</sup> That is, DTTs are interpreted as agreements, rather than as acts of domestic legislation.<sup>15</sup>

In *Stag Line Limited v Foscolo, Mango and Co.*, on the interpretation of DTTs Lord MacMillian proffered that, “it is desirable in the interest of uniformity that their interpretation should not be rigidly controlled by domestic precedents of antecedent date, but rather that the language of the rules should be construed on broad principles of general acceptance.”<sup>16</sup>

In Article 31 of the VCLT, a general rule for the interpretation of treaties are set out, the first part of which reads thus:

*“A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”*

It is clear that the VCLT’s fundamental rule for treaty interpretation is that the text of a treaty should be presumed to be a reliable expression of the contracting States’ intentions, and thus the “ordinary meaning” of the text should serve as the foremost basis for treaty interpretation. This has been paraphrased as “the duty of giving effect to the expressed intention of the parties, that is, their intention as expressed in the words used by them in the light of the surrounding circumstances.”<sup>17</sup> This is opposed to an investigation into the contracting States’ intentions as may be evidenced through sources other than the treaty text itself.

When interpreting a DTT, it is possible that the contracting States’ domestic laws may have differing understandings of concepts and terms used in the DTT, and this may give rise to a conflict in

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<sup>14</sup> *Union Texas Petroleum Corp. v Critchley (Inspector of Taxes)* [1988] BTC 405; [1988] STC 691, at 707, Ch D.

<sup>15</sup> *Belgium Government v Postlethwaite* [1987] 2 All ER 985, HL.

<sup>16</sup> [1932] AC 328, HL.

<sup>17</sup> Schwarz, J. (2018) *Schwarz on Tax Treaties*, Fifth Edition. Croner-I Publishing. Refer to Chapter 4 12-100

qualification. For example, one State may characterise an amount as a royalty, while the other contracting State may consider it personal services income.<sup>18</sup> This presents a problem where the applicable DTT Articles for those alternate characterisations have different tax outcomes.

Where conflicts of qualification exist, contracting States can either qualify the term using domestic law, or both States can agree to apply the source State qualification, or the States can come to an agreement around the qualification for purposes of treaty application.<sup>19</sup>

However, Vogel (1997) notes that the problem of conflicts of qualification is solved by the treaty itself where a term is expressly defined in the treaty.<sup>20</sup> This is the case for the term ‘dividends’, which is defined in paragraph 3 of Article 10 of the OECD MC.

### **2.2.1 Taxing rights in respect of dividend income, as allocated between residence and source States in terms of the OECD MC**

Article 10 allocates taxing rights in respect of dividend income to both the residence State and the source State.<sup>21</sup> The source State’s taxing rights are limited to percentage thresholds agreed between contracting States, depending on characteristics of the beneficial owner of the dividend. Therefore, if it is found that manufactured dividends are governed by Article 10, manufactured dividends of a South African source paid to a non-resident will be fully taxable in that non-resident’s State and will also be taxable to a limited extent in South Africa.

### **2.2.2 Definition of ‘dividends’ for treaty purposes**

Article 10(3) contains the dividends definition for treaty purposes, and reads as follows:

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<sup>18</sup> Vogel (1997) *Klaus Vogel on Double Taxation Conventions*, Third Edition. Kluwer Law International. Examples included at page 53, paragraph 92.

<sup>19</sup> *Supra* at 18. Vogel (1997) page 54 at paragraph 94.

<sup>20</sup> *Ibid*

<sup>21</sup> Paragraphs 1 and 2 of Article 10 of the OECD MC

*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 OECD acknowledges in the commentaries to this Article that “it is impossible to define ‘dividends’ fully and exhaustively.”<sup>22</sup> The dividends definition above attempts to cater for the different understandings of a ‘dividend’ as the case may be across different countries. It is not immediately apparent that manufactured dividends do fall into the ‘dividends’ definition above. As a result, the various elements of the definition need to be analysed, within the overarching principles and intentions of this definition.

The definition offers various sorts of income that should be considered ‘dividends’ for treaty purposes. These different components of the definition are examined in turn.

— *Income from shares*

The Article 10 commentaries begin with a preliminary remark, which states that by ‘dividends’ what is generally meant is “the distribution of profits to shareholders by companies limited by shares”.<sup>23</sup> It is submitted that any interpretation of the ‘dividends’ definition for purposes of application to atypical distributions, or for application to peculiarities in a relationship between distributor and recipient, should return to this preliminary remark as a guiding principle.

In the commentaries it is further stated that “the definition relates, in the first instance, to distributions of profits the title to which is constituted by shares, that is holdings in a company limited by shares”.<sup>24</sup> From this it is apparent that the right to participate in profits means a right

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<sup>22</sup> Paragraph 23 of the commentaries to Article 10(3)

<sup>23</sup> Paragraph 1 of the commentaries to Article 10

<sup>24</sup> Paragraph 24 of the commentaries to Article 10(3)

that has arisen from the holding of shares in that entity. This sentiment is echoed by Holmes when he notes, “A dividend is generally regarded as a formal payment, or transfer of value, by a company out of its shareholders’ funds to its shareholders in respect of their shareholding, for which the shareholder gives no consideration”.<sup>25</sup>

The term ‘share’ is not defined in the OECD MC, and the GTTC commentaries proffer that it is implied that the meaning should come from the domestic law of the source State.<sup>26</sup> In South African company law, a ‘share’ is defined as follows:

“share” means one of the units into which the proprietary interest in a profit company is divided.<sup>27</sup>

In the ITA, a share is defined as follows:

“share” means, in relation to any company, any unit into which the proprietary interest in that company is divided.<sup>28</sup>

GTTC commentaries note the following in relation to the meaning of a ‘share’: “At a minimum, it covers rights in the division of share capital of registered companies and partnerships limited by shares.”<sup>29</sup>

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<sup>25</sup> Holmes, K. 2007. *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application*. IBFD Publications BV. Refer to page 215.

<sup>26</sup> At 5.1.2.2

<sup>27</sup> As contained in section 1 of the Companies Act No. 71 of 2008

<sup>28</sup> As contained in section 1 of the ITA

<sup>29</sup> At 5.1.2.2

— *Income from... other rights... participating in profits*

Vogel interprets the commentaries such that this portion of the ‘dividends’ definition refers to rights that arise from “securities”.<sup>30</sup> In the GTTC commentaries, this limitation is considered “unnecessary and superfluous”.<sup>31</sup>

Vogel considers that only rights that participate in all profits, including surplus on liquidation, can fall within this part. The view expressed in the GTTC commentaries is once again divergent and considers that this level of profit participation should not be a requirement as it could preclude distributions on preference shares from falling into the ambit of this part.<sup>32</sup>

— *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 use of the word ‘other’ here suggests that the rights listed in the preceding portions of the definition must also be corporate rights.<sup>33</sup>

Reliance is made in this portion of the definition to tax treatment in accordance to the laws of the source State. Vogel (1997) notes the result of this is that **“any decision made by the State of source qualifying an item of income as a dividend, has, for treaty purposes, a binding effect on the recipient of such a dividend’s State of residence as well”** [emphasis in original].<sup>34</sup> However, he clarifies that income taxed as dividends in the State of source will nevertheless only constitute ‘dividends’ within the meaning of Article 10 if such income is ‘income from other corporate rights’<sup>35</sup>, that is, “income as arise from corporate rights in

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<sup>30</sup> *Supra* at 18. Vogel (1997) page 655 at paragraph 198

<sup>31</sup> GTTC Commentaries at 5.1.2.3

<sup>32</sup> At 5.1.2.3

<sup>33</sup> *Supra* at 18. Vogel (1997) page 649 at paragraph 185

<sup>34</sup> *Supra* at 18 Vogel (1997) page 656 at paragraph 199

<sup>35</sup> *Supra* at 18 Vogel (1997) page 650 at paragraph 186



companies”<sup>36</sup>. On this point, Vogel goes further to emphasise that “only income that flows to the recipient **because of his position as a shareholder** comes ‘from’ a corporate right”<sup>37</sup> [emphasis in original].

In their 2009 publication<sup>38</sup>, Avery Jones *et al* have an aligned view in this regard, and emphasise that this limb of the definition contains two requirements:

*“Treatment as a dividend therefore depends on both the income being from a corporate right... and also being treated in the same way as income from shares by domestic tax law.... Assuming that domestic law (whether this means non-tax law or tax law) categorizes what might otherwise be interest as a dividend when the lender does not share in the risks of the company, the loan is not a corporate right and the return on the loan is interest for treaty purposes.”*

It is submitted further that the use of the term ‘corporate rights’ in the ‘dividends’ definition is significant. Corporate rights are those governed by company law. It is apparent that the ‘dividends’ definition seeks to include rights that exhibit the same characteristics as rights afforded to shareholders in terms of the issuer’s domestic company law. Once again, this inclusion would cater for “peculiarities” of some domestic laws, but is perhaps not intended to broaden the scope of the concept of ‘dividends’ beyond the rights that are ensconced in the ownership of shares to participate in the issuer’s profits.<sup>39</sup>

In relation to the definition’s reference to the source State’s treatment of an amount as a dividend, it is submitted that this does not aim to include any and all deemed dividends, and that the core link to share ownership ensconced in ‘income from shares’ and ‘other corporate

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<sup>36</sup> *Supra* at 18 Vogel (1997) page 650 at paragraph 188

<sup>37</sup> *Supra* at 18 Vogel (1997) page 650 at paragraph 188

<sup>38</sup> Avery Jones et al. (2009). *The Definitions of Dividends and Interest in the OECD Model: Something Lost in Translation?* World Tax Journal.

<sup>39</sup> Commentaries to Article 10, paragraph 23

rights’ must be present in the transaction under review. Jones *et al* (2009) note that this limb of the ‘dividends’ definition was introduced in recognition of difficulties arising from domestic tax provisions to address thin capitalisation.<sup>40</sup> As thin capitalisation issues arise through a shareholder capitalising its subsidiary through excessive levels of debt in order to benefit from tax deductions on interest, the shareholder relationship is the source of distributions under consideration. This is not the case for a lender under an SLA once the securities have been transferred to the borrower. It is reiterated that reference made to source State characterisation of distributions in this limb of the definition should not be used to include all deemed dividends in the ambit of Article 10.

Jones *et al* (2009) also make a brief mention of manufactured dividends, and notes that “manufactured dividends are paid in respect of a contractual obligation, and not in connection with a debt-claim or a corporate right in the form of a membership right in the company paying the manufactured dividend.”

The GTTC commentaries note that it is not likely that the drafters of the ‘dividends’ definition considered its application to manufactured dividends.<sup>41</sup>

The Final Report on the OECD’s BEPS Action 2 analyses numerous examples of synthetic dividends, but the report’s focus was on domestic law treatment thereof, and did not extend to the application of Article 10 to any of the examples set forth.<sup>42</sup>

In Article 10(2), limitations are set out in respect of the source State’s rights to tax dividends. Beneficial owners are categorised on the basis of their shareholdings. The phrase used in subparagraph (a) is “if the beneficial owner is a company which holds directly at least 25 per

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<sup>40</sup> At 3.1

<sup>41</sup> At 5.1.2.4.2

<sup>42</sup> OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Available at <http://dx.doi.org/10.1787/9789264241138-en> (accessed 27 November 2019)

cent of the capital in the company paying the dividends”. While this reference to a direct holding in the capital of a company does not form part of the paragraph 3 ‘dividends’ definition, it does align with the overall direction of the dividends definition, and perhaps offers confirmation of the intention that this Article is to be applied to persons who are, in substance, shareholders. In the commentaries to paragraph 2, it is stated that the term ‘capital’ is intended to be understood as it is for company law purposes, and that this will typically be evidenced through the par value of shares issued, as disclosed on its balance sheet.

In respect of para 3 of Article 10, some countries (Australia, Belgium, Denmark, France, Mexico, Canada, Germany, Portugal, Chile and Luxembourg) reserved the right to expand the dividend definition to include certain other payments treated as distributions or income from shares in terms of their domestic law. However, South Africa made no reservations in respect of Article 10 and, by implication, accepts the definition as stated in Article 10(3) as reasonable.

### **2.2.3 Application of the OECD MC ‘dividends’ definition to manufactured dividends**

The first portion of the ‘dividends’ definition refers to “income from shares”. Manufactured dividends arise in terms of the SLA contract between the lender and borrower, and are thus income arising from a contract and not income from shares.

The definition also includes income from other rights “participating in profits”. The lender has a contractual right to receive a manufactured dividend as compensation for dividends paid by the issuer of the securities that are the subject of the SLA. One might infer from this that the lender has a right to participate in the issuer’s profits, albeit indirectly. However, the commentaries explain that the various portions of the ‘dividends’ definition are intended to “make allowance for peculiarities” of contracting States’ domestic laws.<sup>43</sup> It is submitted that the intention is not to include in the definition amounts calculated with reference to dividends and paid in terms of a contract to a person that is not himself a shareholder. Furthermore, it is submitted that the inclusion of different elements in the definition is not

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<sup>43</sup> Paragraph 23 of the commentaries to Article 10(3)

intended to cover the suite of specific anti-avoidance deeming provisions that may be included in a country's domestic law.

As noted above at 2.1, the beneficial ownership of the dividend paid by the issuer is not in dispute, and a separation between the dividend amount and the manufactured dividend amount is accepted. Nevertheless, the commentaries also address rights granted to non-shareholders, where the rights are substantially the same as those rights granted to shareholders. In this case, distributions made to the non-shareholders may constitute 'dividends' for treaty purposes if "the legal relations between such persons and the company are assimilated to a holding in a company ('concealed holdings'); and the persons receiving such benefits are closely connected with a shareholder... for example a company in the same group of companies as the company owning the shares."<sup>44</sup> It is submitted that the lender in terms of an SLA does not have the full suite of rights that a shareholder typically benefits. A lender is entitled to only a specified portion of a dividend paid by the issuer, and does not have any voting rights. Vogel (1997) considers that one should not take a narrow view when interpreting the concept of 'corporate rights', and that a shareholder need not be entitled to the full rights of a 'regular' shareholder in order for his income to have come from his corporate rights.<sup>45</sup> Here, Vogel uses as an example a situation where a shareholder's voting rights are subject to restrictions, and says that this may not result in disqualification from application of Article 10. That said, Vogel nevertheless repeatedly refers to the recipient of the income in question as a 'shareholder', which a lender under an SLA is not. The lender would not be able to utilise the shares as collateral, and would not be able to sell them. In summary, the lender does not have rights to the shares in the same way that a shareholder would have.

Vogel (1997) also analyses the interaction of the dividends and interest articles of the OECD MC. He puts forward that if the company making the payment is allowed to deduct the amount from its tax base, this is indicative of the amount not being a 'dividend' within the meaning of Article 10.<sup>46</sup> As South

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<sup>44</sup> Paragraph 29 of the commentaries to Article 10(3)

<sup>45</sup> *Supra* at 18 Vogel (1997) page 650 at paragraph 189

<sup>46</sup> *Supra* at 18 Vogel (1997) page 651 at paragraph 189

African domestic law allows the borrower to deduct<sup>47</sup> from income any manufactured dividends paid to the lender (which is discussed in more detail in Chapter 4), it follows that this could support a view that manufactured dividends are not ‘dividends’ for purposes of Article 10.

## **2.3 Conclusion**

Although Article 10(3) provides a definition for the term ‘dividends’, there has historically been difficulty in defining this concept comprehensively. The definition endeavours to provide overarching principles with which to characterise amounts of income, while attempting to cater for idiosyncrasies in domestic law.

In this chapter, it has been shown that a ‘dividend’, as considered in the OECD MC, emanates at its core from the ownership of shares. It is share ownership that gives a shareholder the right to participate in the company’s profits. Crucially, it is this link between the income and share ownership that is absent in the case of a manufactured dividend.

The Article 10(3) definition does make room for peculiarities in domestic law where income from corporate rights are treated as dividends for tax purposes. This is particularly applicable in the case of hybrid instruments. It has been shown in this chapter, however, that the OECD MC ‘dividends’ definition does not include manufactured dividends, as it is a corporate right in respect of which this income accrues.

In conclusion, the lender in a SLA is not a shareholder and does not receive dividends. The lender is merely a party to an agreement, and receives income, but not a ‘dividend’ as envisioned in Article 10 of the OECD MC. This leaves the question of the nature of the income that the lender receives. If this is not a dividend as defined, what is it, and what are the consequences for the allocation of taxing rights for the residence and source States? These questions are addressed in Chapter 3.

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<sup>47</sup> Section 11(a) of the ITA, read with section 23(g)

### 3 CHAPTER 3: APPLICABILITY OF OTHER ARTICLES

Where manufactured dividend income earned by a non-resident lender is found to be of a South African source in terms of domestic law, that non-resident lender will be subject to tax in South Africa on that income. This is discussed in greater detail in Chapter 4. Following from Chapter 2, where it was concluded that manufactured dividends are not ‘dividends’ for DTT purposes, Chapter 3 will assess whether this income could be characterised as business profits in terms of Article 7 of the OECD MC, or as other income in terms of Article 21 of the OECD MC, in the case where a DTT is able to be applied. It is submitted that there are no other relevant articles of the OECD MC that require consideration in characterising manufactured dividends.

#### **3.1 Article 7 of the OECD MC: Business profits**

Paragraph 1 of Article 7 allocates taxing rights in respect of business profits earned by an enterprise to the country of residence, unless such profits are attributable to a PE situated in the country of source, in which case that country shall enjoy the taxing rights in respect of such profits.

This Article allocates business profits between States to the extent that other more specific Articles do not apply first and allocate such profits differently.<sup>48,49</sup>

The key aspects of this allocation are whether the non-resident lender carries on an enterprise through a PE situated in South Africa, and whether and to what extent the manufactured dividend income is attributable to such PE. These elements are considered below.

##### **3.1.1 Does the non-resident lender carry on an enterprise through a PE situated in South Africa?**

The OECD MC Article 3 definitions specify that “the term ‘enterprise’ applies to the carrying on of any business”. Vogel notes that, “traditionally, this concept is centred around commerce, including banking

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<sup>48</sup> Paragraph 1 of the OECD MC Commentaries to Article 7

<sup>49</sup> *Supra* at 18 Vogel (1997) page 401 at paragraph 8a

and finance”.<sup>50</sup> Schwarz (2018) notes that, in *Fowler v HMRC*<sup>51</sup>, the South Africa-UK DTT in question did not define the term ‘enterprise’, nor the term ‘business’, and the court turned to UK domestic law, whereby it was held that “a business comprises trades, professions, vocations and investment”.<sup>52</sup>

SLAs are investment transactions. It is thus submitted that the lending of shares in return for a fee would be considered an ‘enterprise’ as envisioned by Article 7, and manufactured dividend income would be business profits earned in the course of conducting such enterprise.

Article 5 of the OECD MC defines the concept of a PE. A PE represents “a distinct ‘*situs*’, a ‘fixed place of business’.”<sup>53</sup> The Commentaries offer insight into the reasoning behind the fact that the country of source may not tax the business profits of an enterprise in the absence of a PE situated therein: “Until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits.”<sup>54</sup>

Vogel notes that the inclusion of the PE requirement in Article 7 “preclude[s] an enterprise from being taxed in the other contracting State merely because the contracts on which the business profits are based were concluded in that State (as provided for under the domestic tax laws of some States, in particular common law States)”.<sup>55</sup>

This Chapter will not analyse the PE definition in any detail as that is beyond the scope of this paper, but will consider at a very high level whether it is plausible for a non-resident lender to carry on business operations through a PE in South Africa.

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<sup>50</sup> *Supra* at 18 Vogel (1997) page 406 at paragraph 23

<sup>51</sup> Per Schwarz (2018) (*Supra* at 17), *Fowler v Revenue and Customs* [2016] UKFTT 234 [2016] SFTD 535, 18 ITL Rep 644, [2016] TC 05009 at para. 107, 109 and 111

<sup>52</sup> *Supra* at 17 Schwarz (2018) Refer to Chapter 9 17-050

<sup>53</sup> Paragraph 6 of the OECD MC Commentaries to Article 5

<sup>54</sup> Paragraph 11 of the OECD MC Commentaries to Article 7

<sup>55</sup> *Supra* at 18 Vogel (1997) page 399 at paragraph 5

Whether a non-resident lender operates an enterprise through a PE situated in South Africa would be a question of fact. A multinational financial services enterprise, that regularly enters into SLAs where the subject of the transaction is South African listed shares, may well have a physical South African presence for ease of gathering market data, trading, interactions with investors, effecting payments, compliance with regulations, and so on. It may thus be commercially expedient for a non-resident lender to carry on the lending of South African shares through that PE. This may involve the use of human resources, licences, trading platforms, and so on, situated in South Africa. If this were the case, the first element required for Article 7 to allocate taxing rights in respect of the non-resident lender's business profits to South Africa would be met.

On the other hand, in the modern day, it is equally likely that a multinational financial services enterprise would not require any physical South African presence in order to own and lend South African listed shares. The Internet allows for online data and trading platforms, email correspondence and contact via remote teleconferencing facilities, and the signing of contracts through protected document programs. A multinational is perhaps more likely to operate with a central server in an practical location that is not South Africa; Europe and South-East Asia are the world's most prolific data and web server hosts.<sup>56</sup> The result may be that the enterprise does not have a PE in South Africa<sup>57</sup>, and no taxing rights would be allocated to South Africa through application of a DTT.

### **3.1.2 Could the manufactured dividend income be attributed to a PE situated in South Africa?**

As outlined above, if it is established that a non-resident lender does not have a PE in South Africa, there will be nothing to which to attribute the profits of that non-resident lender, and South Africa will receive no taxing rights in that regard.

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<sup>56</sup> Lago, C, 19 September 2019. *Why Southeast Asia is the new Mecca for data centres*. Available at <https://www.cio.com/article/3296099/why-are-businesses-relocating-data-centres-to-southeast-asia.html>. Accessed 28 December 2019.

<sup>57</sup> Paragraph 123 of the Commentaries to Article 5 of the OECD MC, which houses the PE definition



However, if it is found that the non-resident lender has a PE in South Africa, it must be assessed whether and to what extent the manufactured dividend income can be attributed to that PE. Depending on the activities performed by the PE, there could be a sufficiently strong link between the earning of manufactured dividend income and the PE in question. If that is the case, attributable profits will need to be quantified.

The OECD MC does not embody a ‘force of attraction’ principle. That is, only the profits that can be economically connected to the PE will be taxable in the State of source, and business profits that cannot be attributed to the PE will be taxable in the State of residence.<sup>58</sup> The business profits attributable to the PE must be carved out from the overall profits of the business, and this exercise can be “controversial and awkward”.<sup>59</sup>

In an SLA, the amount of profits attributable may be simple to determine, as the income flows are discrete and do not represent a variety of risks, assets and functions of the lender. However, when attributing overhead costs in order to reduce the revenue down to profits, one must consider what an independent enterprise would incur in engaging in a similar business in similar circumstances, which delves into the realm of transfer pricing.<sup>60</sup>

### **3.1.3 Conclusion as to the application of Article 7**

As discussed above, it is quite possible that a non-resident lender can earn manufactured dividend income from an SLA, the subject of which is a South African listed share, while not creating a PE situated in South Africa. In such case, South Africa would have no taxing rights in respect of the manufactured dividend income. Had that non-resident lender earned dividends directly from the issuer of the share, South Africa would have had the right to tax those dividends at 20 per cent, with a possible reduction in rate through application of Article 10 of a DTT.

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<sup>58</sup> *Supra* at 18 Vogel (1997) page 409 at paragraph 32

<sup>59</sup> *Supra* at 17 Schwarz (2018) Refer to Chapter 9 17-150

<sup>60</sup> Paragraph 15 of the Commentaries to Article 7 of the OECD MC

Alternately, it is plausible that such a non-resident lender could have a PE situated in South Africa, and that his manufactured dividend income could be attributed to such PE. In that case, a DTT would dictate that South Africa would have taxing rights over this business income. Qualifying expenditure would be able to be deducted, and the resultant taxable income would be taxed at 28 per cent.

### **3.2 Article 21 of the OECD MC: Other income**

Article 21 is a ‘catch all’ Article that serves to allocate taxing rights in respect of items of income that are not addressed by the foregoing Articles of the OECD MC.

This Article allocates taxing rights in respect of other income to the country of residence, unless the resident carries on business through a PE situated in the country of source, and such profits are earned in terms of a right that is effectively connected with that PE, in which case that source country is allotted the taxing rights.

The key considerations in this allocation are whether a non-resident lender carries on business through a PE situated in South Africa, and whether the right in terms of which the manufactured dividend income is earned is effectively connected with such PE. These elements are substantially the same as the key points for consideration under Article 7, where taxing rights are allocated to the State of source in the presence of a PE to which profits can be attributed. In both cases, these Articles essentially allow the source State to tax the profits of a non-resident enterprise where those profits are sufficiently closely linked to operations situated in that State. It is submitted that, if manufactured dividend income is not found to be governed by Article 7 of the OECD MC, that application of Article 21 would be appropriate, and would have the same outcome insofar as allocation of taxing rights between States.

### **3.3 Conclusion**

In Chapter 2 it was shown that manufactured dividends are not ‘dividends’ as envisioned in the definition housed in Article 10(3), and would thus not be considered ‘dividends’ for treaty interpretation purposes. It followed that it must be considered whether manufactured dividend income is more

appropriately characterised as ‘business profits’ in terms of Article 7, or as ‘other income’ in terms of Article 21 of the OECD MC.

In this chapter, the requirements were discussed for the source State to be entitled to tax the business profits or other income earned in that State by a non-resident. It was noted that such income must be attributable to (in the case of business profits) or effectively connected with (in the case of other income) a PE situated in that source State. It was shown that the business of engaging in SLAs would constitute a ‘business’ or ‘enterprise’ for treaty purposes, which would result in the qualification or characterisation of manufactured dividends as ‘business profits’ in terms of Article 7.

It was then discussed whether it is possible that a non-resident lender may have a PE through in South Africa which he conducts his enterprise. It was shown that it is feasible that such a non-resident lender could have a physical presence in South Africa that would create a PE there. It was considered equally likely in the digital age, however, that a non-resident lender’s ‘fixed’ presence in South Africa could be insufficiently manifest to warrant the allocation of taxing rights to South Africa.

Chapter 4 will review the South African domestic tax treatment of manufactured dividends, including the impact for non-resident borrowers and lenders that are party to SLAs. This chapter will examine publications available for evidence of the views of SARS and lawmakers insofar as the interaction of domestic law and DTTs are concerned. This chapter will then conclude as to whether there is a risk of taxation by SARS not in terms of a convention.

## 4 CHAPTER 4: TAXATION OF SECURITIES LENDING ARRANGEMENTS IN SOUTH AFRICA

### 4.1 Introduction

The foregoing chapters provided the context that gives rise to the importance of proper qualification or characterisation of manufactured dividend income for treaty purposes, and then went on to examine Articles 10, 7 and 21 to for purposes of such characterisation. In Chapter 2, it was shown that manufactured dividends are not ‘dividends’ for treaty purposes, and in Chapter 3 it was shown that they would instead constitute business profits. It was highlighted that, if a non-resident lender earned manufactured dividends not through a PE situated in South Africa, South Africa would not have the right to tax that income.

This chapter will examine the South African domestic tax treatment of manufactured dividends paid in terms of an SLA, of which a South African listed equity security is the subject. Specifically, this analysis will include the examination of the relevant portions of South African domestic tax law, as well as consideration of how SARS would be likely to tax manufactured dividends paid in terms of an SLA where the lender is a non-resident company.

The explanatory memoranda published with DTLAAs can offer insight into the reasons behind additions and changes made to South African tax legislation, and can provide an idea of what legislators believe will be the impact of SLA transactions on the South African *fiscus*. Additionally, guides, interpretation notes and rulings published by SARS provide an expectation of how SARS might assess the taxation on manufactured dividends paid to non-resident lenders.

The purpose of this analysis is to examine whether taxation not in accordance with the provisions of a double tax convention is likely to occur on the part of SARS, in the light of the conclusions drawn in the previous chapters. In terms of Article 25 of the OECD MC, this could lead to a mutual agreement procedure being requested by an affected taxpayer.

## 4.2 South African tax treatment of equity SLAs: Resident borrower and resident lender

### 4.2.1 Tax consequences for the resident borrower

From the borrower's perspective, as the holder of the equity share, the relevant South African tax implications for an equity SLA transaction are as follows:

— *A dividend is declared in respect of the share.*

- Through application of the 'gross income' definition in section 1 of the ITA, this dividend income will be included in the borrower's 'gross income'<sup>61</sup>.
- Section 10(1)(k)(i) of the ITA exempts dividend receipts from normal tax. However, proviso (ff) to this section specifically provides that the exemption does not apply to dividends received in respect of borrowed shares. As such, the dividends received by the borrower will be included in his 'income'<sup>62</sup> for tax purposes.
- As the dividend constitutes 'income' of the borrower, it is exempt from dividends tax.<sup>63</sup>

— *The borrower pays a manufactured dividend to the lender.*

- Following from the above, a manufactured dividend paid by the borrower constitutes expenditure incurred in the production of 'income', making this expenditure deductible in terms of the ITA's 'general deduction formula'<sup>64</sup>.
- For the purposes of dividends tax, because the dividend received constitutes 'income' of the borrower, the manufactured dividend paid by the borrower is deemed to be a dividend paid to and for the benefit of the lender.<sup>65</sup> The beneficial owner of a dividend is liable for the related dividends tax, which must be withheld by the company paying

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<sup>61</sup> Paragraph (i) of the section 1 definition of 'gross income', and by specific inclusion through part (k) of this definition.

<sup>62</sup> Defined in section 1 of the ITA as 'gross income', less exempt amounts.

<sup>63</sup> In terms of section 64F(1)(l) of the ITA.

<sup>64</sup> Section 11(a) read with section 23(g)

<sup>65</sup> Section 64EB(2) of the ITA

the dividend.<sup>66</sup> In the case of a manufactured dividend paid in terms of an SLA, the lender is the deemed beneficial owner of the deemed dividend, and is thus subject to dividends tax.

On an overall basis, the borrower is therefore subject to income tax on the difference between dividends received and manufactured dividends and fees paid to the lender, as well as any movements in the price of the share if he sells the share to a third party at some point during the SLA.

#### **4.2.2 Tax consequences for the resident lender**

From the lender's perspective, the relevant South African tax implications for equity SLA transactions are as follows:

— *The lender disposes of his South African listed equity security to the borrower.*

- While legal ownership transfers from the lender to the borrower, this transaction is not treated as a 'disposal' for CGT purposes.<sup>67</sup>
- The transfer is exempt from STT.<sup>68</sup>

— *The lender receives a manufactured dividend from the borrower.*

- The manufactured dividend income will constitute 'gross income'<sup>69</sup> in the hands of the lender.
- Section 10(1)(k) of the ITA provides for the exemption of dividends received. However, manufactured dividends are only deemed to be dividends paid for purposes of Part VIII of the ITA, in other words, for purposes of Dividends Tax. Therefore, for normal tax purposes, no exemption is available and the manufactured dividend income will be included in the lender's 'income'.

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<sup>66</sup> Sections 64EA and 64G of the ITA

<sup>67</sup> It is specifically excluded by paragraph 11(1)(h) of the Eighth Schedule to the ITA.

<sup>68</sup> In terms of section 8(1)(b) of the STT Act.

<sup>69</sup> Paragraph (i) of the ITA's section 1 definition of 'gross income'

- For the purposes of dividends tax, the manufactured dividend is deemed to be a dividend paid by the borrower for the benefit of the lender.<sup>70</sup>
- It follows that dividends tax will be levied on the manufactured dividend<sup>71</sup>, subject to various exemptions that are dependent on characteristics of the beneficial owner thereof.<sup>72</sup> Where the lender is a resident company, the manufactured dividends will be exempt from dividends tax, either by virtue of the beneficial owner being a resident company,<sup>73</sup> or by virtue of the amount constituting ‘income’ of the beneficial owner (discussed above).<sup>74</sup>

— *The lender receives a lending fee from the borrower.*

- The lending fee income will constitute ‘gross income’<sup>75</sup> in the hands of the lender.

In summary, the lending fees and manufactured dividends received by a resident lender will be included in his gross income for tax purposes, and the manufactured dividends will be exempt from dividends tax.

#### **4.2.3 Comparison to tax consequences in the absence of an SLA**

From a dividends tax perspective, the above tax treatment aligns with the outcome that would have occurred had the SLA not been effected. That is, had lender received the dividend paid by the issuer, the dividend would have been exempt from dividends tax.

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<sup>70</sup> Section 64EB(2)(b) of the ITA

<sup>71</sup> Section 64E(1) of the ITA

<sup>72</sup> Section 64E(1) read with section 64F(1) of the ITA

<sup>73</sup> Section 64F(1)(a) of the ITA

<sup>74</sup> Section 64F(1)(l) of the ITA

<sup>75</sup> Paragraph (i) of the ITA’s section 1 definition of ‘gross income’, and by specific inclusion through part (k) of this definition.

## **4.3 South African tax treatment of equity SLAs: Resident borrower and non-resident lender**

### **4.3.1 Tax consequences for the resident borrower**

As above at 4.2.1, on an overall basis, the borrower is subject to income tax on the difference between dividends received and manufactured dividends and fees paid to the lender, as well as any movements in the price of the share if he sells the share to a third party at some point during the SLA.

### **4.3.2 Tax consequences for the non-resident lender**

For a non-resident lender, the relevant South African tax implications for equity SLA transactions are as follows:

— *The lender disposes of his South African listed equity security to the borrower.*

- While legal ownership transfers from the lender to the borrower, this transaction is not treated as a ‘disposal’ for CGT purposes.<sup>76</sup>
- The transfer is exempt from STT.<sup>77</sup>

— *The lender receives a manufactured dividend from the borrower.*

- As the payment is received from a resident borrower, and as the subject of the SLA is a South African listed share, it is likely that the manufactured dividend income would be considered to be from a South African source (refer to 4.6.4.3 below for more detail on this point). On the basis of this assumption, the manufactured dividend will constitute ‘gross income’<sup>78</sup> in the hands of the lender.
- As above at 4.2.2, the manufactured dividend income will not be exempt from normal tax and will be included in the lender’s ‘income’.

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<sup>76</sup> It is specifically excluded by paragraph 11(1)(h) of the Eighth Schedule to the ITA.

<sup>77</sup> In terms of section 8(1)(b) of the STT Act.

<sup>78</sup> Part (ii) of the ITA’s section 1 definition of ‘gross income’



- For the purposes of dividends tax, the manufactured dividend is deemed to be a dividend paid by the borrower for the benefit of the lender.<sup>79</sup>
- It follows that dividends tax will be levied on the manufactured dividend<sup>80</sup>, subject to various exemptions and reductions in rate that are dependent on characteristics of the beneficial owner thereof.<sup>81</sup> As the manufactured dividends form part of the beneficial owner's 'income', they will be exempt from dividends tax.<sup>82</sup>

— *The lender receives a lending fee from the borrower.*

- If considered to be from a South African source, the lending fee income would constitute 'gross income'<sup>83</sup> in the hands of the lender.

In summary, on the basis that they constitute income from a South African source, the lending fees and manufactured dividends received by a non-resident lender will be included in his 'income' for tax purposes, and the manufactured dividends will be exempt from dividends tax.

### **4.3.3 Comparison to tax consequences in the absence of an SLA**

This does not align with the outcome that would have occurred had the SLA not been effected. Had a non-resident lender received the dividend paid by the share issuer, he would have been subject to dividends tax on that dividend, and a DTT could possibly have been applied to reduce the rate of tax.

Where a non-resident lender instead receives a manufactured dividend from the borrower, such lender is exempt from dividends tax. Furthermore, where a DTT is applicable, if the lender does not have a PE in South Africa, application of the business profits or other income articles of a DTT would most likely result in no allocation of taxing rights to South Africa in respect of the manufactured dividend income and lending fee income earned by the non-resident lender.

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<sup>79</sup> Section 64EB(2)(b) of the ITA

<sup>80</sup> Section 64E(1) of the ITA

<sup>81</sup> Section 64E(1) read with section 64F(1) and section 64G(3) of the ITA

<sup>82</sup> Section 64F(1)(l) of the ITA

<sup>83</sup> Paragraph (ii) of the ITA's section 1 definition of 'gross income'

The borrower's dividend income is exempt from dividends tax but forms part of his 'income'. SARS will be able to tax the borrower's profits. That being said, his profits will not be significant, as they are reduced by manufactured dividends and lending fees paid to the lender.

#### **4.4 South African tax treatment of equity SLAs: Non-resident borrower and resident lender**

##### **4.4.1 Tax consequences for the non-resident borrower**

From the borrower's perspective, despite the fact that the borrower is a non-resident, local dividends are specifically included in the 'gross income' of non-residents. As such, the tax consequences set out above at 4.2.1 for a resident borrower will apply equally to a non-resident borrower. That is, the dividend income will be included in the borrower's 'gross income'<sup>84</sup>, it will not be exempt from normal tax, and will thus form part of his 'income. The dividend will consequently be exempt from dividends tax.<sup>85</sup> Manufactured dividends and fees paid to the lender will thus be deductible expenditure incurred in the production of income.

For dividends tax purposes, the manufactured dividend is deemed to be a dividend paid to and for the benefit of the lender, which will be subject to dividends tax.<sup>86</sup>

##### **4.4.2 Tax consequences for the resident lender**

From the lender's perspective, the tax consequences set out above at 4.2.2 will apply. That is, the manufactured dividend and lending fee income received will be included in the lender's 'income'. The manufactured dividend is deemed to be a dividend paid by the borrower for the benefit of the lender, which is subject to dividends tax. The manufactured dividends will then be exempt from dividends tax,

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<sup>84</sup> Paragraph (ii) of the section 1 definition of 'gross income', and by specific inclusion through part (k) of this definition.

<sup>85</sup> In terms of section 64F(1)(l) of the ITA.

<sup>86</sup> Section 64EB(2) of the ITA

either by virtue of the beneficial owner being a resident company, or by virtue of the amount constituting ‘income’ of the beneficial owner (discussed above).

#### **4.4.3 Comparison to tax consequences in the absence of an SLA**

This aligns with the dividends tax outcome that would have occurred had the SLA not been effected. Had the resident lender received the dividend paid by the issuer, he would have been exempt from dividends tax on that dividend. Where this lender instead receives a manufactured dividend from the borrower, such lender is exempt from dividends tax.

### **4.5 South African tax treatment of equity SLAs: Non-resident borrower and non-resident lender**

#### **4.5.1 Tax consequences for the non-resident borrower**

As discussed above at 4.4.1, the dividend income will be included in the borrower’s ‘gross income’<sup>87</sup>, it will not be exempt from normal tax, and will thus form part of his ‘income’. The dividend will consequently be exempt from dividends tax.<sup>88</sup> Manufactured dividends and lending fees paid to the lender will be deductible expenditure incurred in the production of the borrower’s income.

For dividends tax purposes, the manufactured dividend is deemed to be a dividend paid to and for the benefit of the lender, which will be subject to dividends tax.<sup>89</sup>

#### **4.5.2 Tax consequences for the non-resident lender**

From the lender’s perspective, the relevant South African tax implications for equity SLA transactions are as follows:

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<sup>87</sup> Paragraph (ii) of the section 1 definition of ‘gross income’, and by specific inclusion through part (k) of this definition.

<sup>88</sup> In terms of section 64F(1)(l) of the ITA.

<sup>89</sup> Section 64EB(2) of the ITA

— *The lender disposes of his South African listed equity security to the borrower.*

- While legal ownership transfers from the lender to the borrower, this transaction is not treated as a ‘disposal’ for CGT purposes.<sup>90</sup>
- The transfer is exempt from STT.<sup>91</sup>

— *The lender receives a manufactured dividend from the borrower.*

- As the manufactured dividend income is received from a non-resident borrower, it is likely that the manufactured dividend income would be considered to be not from a South African source (refer to 4.6.4.3 below for more detail on this point). On the basis of this assumption, the manufactured dividend will not constitute ‘gross income’<sup>92</sup> in the hands of the non-resident lender.
- For the purposes of dividends tax, the manufactured dividend is deemed to be a dividend paid by the borrower for the benefit of the lender.<sup>93</sup>
- It follows that dividends tax will be levied on the manufactured dividend<sup>94</sup>, subject to various exemptions and reductions in rate that are dependent on characteristics of the beneficial owner thereof.<sup>95</sup>
- The manufactured dividends will not be exempt from dividends tax, as the beneficial owner is not a resident company,<sup>96</sup> and the amount does not constitute ‘income’ of the beneficial owner (discussed above).<sup>97</sup>

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<sup>90</sup> It is specifically excluded by paragraph 11(1)(h) of the Eighth Schedule to the ITA.

<sup>91</sup> In terms of section 8(1)(b) of the STT Act.

<sup>92</sup> Part (ii) of the ITA’s section 1 definition of ‘gross income’

<sup>93</sup> Section 64EB(2)(b) of the ITA

<sup>94</sup> Section 64E(1) of the ITA

<sup>95</sup> Section 64E(1) read with section 64F(1) and section 64G(3) of the ITA

<sup>96</sup> Section 64F(1)(a) of the ITA

<sup>97</sup> Section 64F(1)(l) of the ITA

— *The lender receives a lending fee from the borrower.*

- As the lending fee income is received from a non-resident borrower, it will likely be considered income not from a South African source, and will thus not constitute ‘gross income’<sup>98</sup> in the hands of the non-resident lender.

In summary, the lending fees and manufactured dividends received by a non-resident lender from a non-resident borrower will not be included in his gross income for tax purposes, and the manufactured dividends will be subject to dividends tax, with the possibility of a reduction in the dividends tax rate through application of a DTT.

### **4.5.3 Comparison to tax consequences in the absence of an SLA**

The borrower’s dividend income is exempt from dividends tax but forms part of his ‘income’. If the borrower does not have a PE in South Africa, application of the business profits or other income articles of a DTT would most likely result in no allocation of taxing rights to South Africa in respect of the borrower’s profits. This is examined in Chapter 3.

Turning to taxation of the lender, it may be that manufactured dividends are not ‘dividends’ for DTT purposes. This is considered in detail in Chapter 2. Thus, although the lender is not exempt from dividends tax on the manufactured dividend, South Africa may nevertheless have no right to receive dividends withholding tax on such amount. If the lender does not have a PE in South Africa, application of the business profits or other income articles of a DTT would most likely result in no allocation of taxing rights to South Africa in respect of the lender’s profits.

From a dividends tax perspective, this does not align with the outcome that would have occurred had the SLA not been effected. Had a non-resident shareholder received the dividend paid by the share issuer, he would have been subject to dividends tax on that dividend, and a DTT could possibly have been applied to reduce the rate of tax.

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<sup>98</sup> Part (i) of the ITA’s section 1 ‘gross income’ definition in the case of a resident borrower, and part (ii) of the definition in the case of a non-resident borrower.

## **4.6 Views of National Treasury, SARS, and experts as to interaction of domestic and international tax treatment of manufactured dividends**

In Chapter 2 it was concluded that a manufactured dividend is not a ‘dividend’ for DTT purposes. There should therefore be no cause to consider applying a DTT to reduce the dividends tax rate in respect of manufactured dividends paid to a non-resident lender. Despite this, in documents published by National Treasury and by SARS make mention of doing exactly this. The views of National Treasury, SARS and tax practitioners are discussed and considered below.

### **4.6.1 Explanatory Memoranda to DTLAAs**

Dividends tax was introduced in South African tax legislation in 2012, replacing the Secondary Tax on Companies. Section 64EB is an anti-avoidance section<sup>99</sup> that was subsequently introduced to the ITA through the 2012 TLAA<sup>100</sup>. In the related EM<sup>101</sup>, National Treasury identified a series of tax schemes that had precipitated the amendments to relevant tax legislation:

*“A tax scheme has emerged for the benefit of foreign shareholders that arguably reduces the Dividends Tax rate to zero (without any reliance on a tax treaty). These schemes essentially seek to convert the taxable payment of dividends into exempt compensation, gains or income upon disposal.”*

The EM provides an example of such a tax scheme, and demonstrates how the new legislation will address the undesirable outcome. This is summarised below.

- A non-resident company lends its South African listed shares to a resident company for a period during which a dividend is declared. The dividend paid to the resident borrower of the share is exempt from dividends tax, and the manufactured dividend paid to the non-resident lender is

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<sup>99</sup> Musviba, N. (2012). *Dividends Tax*. Accessed 1 October 2019. Available at <http://www.sataxguide.co.za/dividends-tax/>

<sup>100</sup> Section 85 of the TLAA No. 22 of 2012

<sup>101</sup> National Treasury (12 December 2012). *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012*

deductible. No dividends tax is paid, despite the fact that the non-resident company would not have been entitled to an exemption from dividends tax.

- National Treasury notes in the EM that such transactions “could arguably be attacked under the General Anti-avoidance Rule (and under common law substance-over-form principles)”.
- After the application of the new section 64EB, National Treasury demonstrates that the net manufactured dividend paid by the borrower is now deemed to be a dividend, subject to dividends tax “with possible relief should the scope of a tax treaty cover the payment”.

National Treasury appears to have made this change on the assumption that South Africa would have the right to tax such a deemed dividend. It appears from the above conclusion, however, that National Treasury has not gone further to offer a firm view as to whether the scope of a tax treaty does, in fact, cover a manufactured dividend, but does provide for the possibility thereof.

When changes<sup>102</sup> were made to section 64EB in the 2018 TLAA, the accompanying EM<sup>103</sup> reiterated National Treasury’s aim with this anti-avoidance legislation:

*“Dividends that would otherwise be subject to dividend tax are in terms of these schemes converted into payments that are exempt from dividend tax. For example, a foreign shareholder takes out a loan with a South African resident company and transfers South African listed shares as collateral during the period of the loan. The resident company receives the dividend in respect of those shares tax free (company to company exemption) and pays an amount (a manufactured dividend) based on the dividend received by that resident company to that foreign shareholder, free of dividends tax.”<sup>104</sup>*

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<sup>102</sup> The changes to s64EB(2) between 2012 and 2018 relate to the timing of the implementation of SLAs and collateral arrangements as it relates to the timing of dividend declarations. These changes in and of themselves are thus not relevant for purposes of this study.

<sup>103</sup> Section 2.6 of EM to 2018 TLAA

<sup>104</sup> National Treasury (17 January 2019). *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018*

It is clear that National Treasury wishes to combat the possibility of circumvention of dividends tax through schemes that interpose an entity exempt from dividends tax between the issuer (that declares the dividend) and the lender (the original shareholder), where such lender is an entity that would not be exempt from dividends tax.

It could be inferred from this intention that National Treasury wishes to maintain the dividends tax consequences that would have prevailed had there been no SLA, that is, had the borrower not been interposed between the issuer and the lender. In the case of a non-resident shareholder, a DTT would typically be able to be applied to assign taxing rights over dividends paid in respect of those shares. However, the question remains whether a manufactured dividend, deemed to be a dividend for dividends tax purposes in terms of domestic law, can be characterised as a ‘dividend’ for DTT purposes, or whether characterisation as another income type is more appropriate.

In its EM to the 2018 TLAA, National Treasury once again offers no concrete view as to whether a DTT may or may not be applied to a manufactured dividend.

#### **4.6.2 SARS Comprehensive Guide to Dividends Tax**

A SARS Guide is not binding on SARS, nor on taxpayers, but can be used to assist with “practical interpretation and application”.<sup>105</sup> A guide issued by the revenue authority is a one-sided view of the correct interpretation of tax law, and taxpayers and indeed a Court may well arrive at a different conclusion on an issue.

Through examination of examples included in SARS’s Comprehensive Guide to Dividends Tax, it is possible to gain insight into SARS’s view as to the answer to the above question as to the proper characterisation of manufactured dividend income for treaty purposes.

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<sup>105</sup> SARS (20 April 2018). *Published Binding Rulings*. Accessed 3 September 2019. Available at <https://www.sars.gov.za/AllDocs/LegalDoclib/Rulings/LAPD-IntR-R-BPR-2018-14%20-%20BPR%20301%20Taxation%20of%20dividends%20received%20by%20a%20borrower%20under%20a%20securities%20lending%20arrangement.pdf>



At 3.8.2 on pages 92 and 94 of the guide<sup>106</sup>, SARS sets out examples involving a dividend of R800 000 received by a resident borrower under an SLA, and a net manufactured dividend of R740 000 paid by such borrower to a non-resident lender. SARS states that the borrower must withhold dividends tax from the manufactured dividend, and that such manufactured dividend “may have been subject to dividends tax at a reduced rate as a result of the application of a tax treaty under s 64G(3)”. (SARS, 2019)

It is apparent that it is SARS’s view that a DTT *can* be applied to reduce the dividends tax rate applicable to manufactured dividends paid to non-resident lenders in an SLA. A process of reasoning could conclude that it would have to be inferred that SARS considers a manufactured dividend to be a ‘dividend’ for DTT purposes, although no further detail is offered in the examples provided as to the theoretical application of Article 10 of a DTT to manufactured dividends.

#### **4.6.3 SARS Practice Note 5**

SARS Practice Note 5 was issued in 1999<sup>107</sup>, and addresses legislation that has changed significantly since then. Nevertheless, the Practice Note has not been withdrawn, and may offer insights into SARS’s views on proper taxation of manufactured dividends. Therein, SARS states:

*“Any payment made by the borrower to the lender as a ‘manufactured dividend’ is not a dividend for Income Tax purposes and must not be treated as a dividend by either the lender or the borrower. ...The borrower will, therefore, not be liable for the payment of STC on the “manufactured dividend” paid to the lender.”*

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<sup>106</sup> Although these examples are in respect of transactions entered into before 1 January 2019, the changes to section 64EB(2) before 1 January 2019 relate to the relationship between the timing of the dividend declaration and the timing of the SLA transaction, which are not principles that would have an impact on whether a DTT can apply to a manufactured dividend.

<sup>107</sup> SARS Practice Note 5 (issued 14 April 1999) *Stamp Duty, Income Tax, Secondary Tax on Companies, Tax On Retirement Funds, Value-Added Tax And Uncertificated Securities Tax Implications of Lending Arrangements in Respect of Marketable Securities*. Available at <https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-PrN-2012-09%20-%20Income%20Tax%20Practice%20Note%205%20of%201999.pdf>. Accessed 24 December 2019.

Unfortunately, SARS only talks to the domestic law position at the time, which has subsequently been changed through the introduction of the deeming provision discussed previously. No mention is made of the interaction of the domestic law with DTTs.

#### **4.6.4 SARS BPR301**

A BPR is binding on the applicant and on SARS, but not on other taxpayers entering into like transactions. While a taxpayer cannot rely on another taxpayer's BPR for certainty, BPRs can provide insight into how SARS might assess the tax on transactions where substantially the same background facts and principles are at play.

To date, only one BPR has addressed the taxation of manufactured dividends. BPR 301<sup>108</sup>, issued by SARS on 20 April 2018, addressed the taxation of an SLA transaction from the borrower's perspective. This ruling involved an SLA, wherein both lender and borrower were non-residents. The background facts relevant to the prospective transaction are set out below:

- The borrower would borrow South African listed equity securities from the lender, and on-deliver these instruments to a third party.
- The borrower would provide instruments as collateral in respect of the equity securities borrowed. To the extent of any dividends or interest paid by issuers of those instruments during the SLA, the lender would make a manufactured payment to the borrower.
- Prior to the last date to register, the borrower would recall the securities from the third party, such that the borrower would receive dividends paid by the issuer of the securities. In terms of the SLA, the borrower would then be contractually required to pay a manufactured dividend to the lender.

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<sup>108</sup> SARS BPR301 (20 April 2018) *Taxation of dividends received by a borrower under a securities lending arrangement*. Available at <https://www.sars.gov.za/AllDocs/LegalDoclib/Rulings/LAPD-IntR-R-BPR-2018-14%20-%20BPR%20301%20Taxation%20of%20dividends%20received%20by%20a%20borrower%20under%20a%20securities%20lending%20arrangement.pdf> Accessed 1 December 2019.

SARS's ruling in respect of the tax consequences of the above prospective transaction from the perspective of the borrower went as follows:

- The dividend received by the borrower from the issuer of the equity securities will form part of his 'gross income', and will not be exempt from normal tax. This dividend will thus be included in the borrower's 'income', and will be exempt from dividends tax.<sup>109</sup>
- The manufactured dividend and other fees paid by the borrower to the lender will be deductible from the borrower's 'income'.

As the applicant in this ruling is the borrower, no pronouncement is made by SARS on the tax consequences for the lender, and therefore no certainty as to SARS's views on the taxation of manufactured dividends can be gleaned.

Of interest is that SARS included the following note at the end of the ruling:

*"The proposed transaction has not been considered from the perspective of whether it will be entered into with the purpose of avoiding dividends tax."*

The above statement is curious and, with very limited background facts provided, there are a number of possible reasons that SARS may have included it in the BPR. These are pondered below.

#### ***4.6.4.1 The manufactured dividend is quantitatively smaller than the actual dividend***

The borrower's net profit from the transaction is reduced by the deduction of both the manufactured dividend and lending and other fees paid to the lender, leaving limited taxable income in the borrower's hands. In this case, SARS's opportunity to tax the transaction may be through dividends tax on the manufactured dividend paid to the lender. However, it may be that the quantum of the manufactured dividend is comparatively small when contrasted against the principal dividend paid to the borrower. This would result in a diminished amount of dividends tax being paid on the overall transaction.

This is considered by tax consultant Jerome Brink in his analysis of BPR301, where he said:

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<sup>109</sup> Section 64F(1)(j) of the ITA, read with paragraph (b) of the section 64D definition of a 'dividend'

*“The key issue, in addition to the potential application of any tax treaty, is that the taxable income in the hands of the Applicant may be immaterial - the result being that one may then potentially obtain a tax benefit compared to the scenario where the dividend declared would otherwise be subject to 20% dividends tax.”<sup>110</sup>*

#### **4.6.4.2 The borrower is in a more beneficial DTT position than the lender**

It may be that the borrower is resident in a jurisdiction with which South Africa has a DTT, while the lender is not. Alternately, it may be that the borrower is able to apply a DTT that reduces the dividends tax payable in South Africa to a lower level than would have been the case in the DTT available to the lender.

That being said, the manufactured dividend in BPR301 is a payment made by a non-resident borrower to a non-resident lender, and it is thus questionable whether a South African DTT would be relevant in assessing the taxing rights on such a transaction. Indeed, the DTT between the countries of residence of the borrower and lender may be applicable, and application thereof may result in a favourable tax outcome for the lender in the specific circumstances.

In the GTTC chapter on Article 10, it is noted at 5.1.1 that “Arguably, it is also implicit that the ‘company’ [paying the dividend] must also be a ‘resident’ of one of the contracting states.” As such, for it to be possible for a South African DTT to govern the taxing rights over a manufactured dividend, and assuming that a manufactured dividend would be a ‘dividend’ for DTT purposes, the borrower would need to be a South African resident. This is not the case in BPR301. Therefore, depending on how SARS assesses the tax on the transaction, the interposition of a non-resident borrower may introduce the risk that the lender is unable to claim treaty relief. Further discussion is set out below at 4.6.4.3 in respect of whether the manufactured dividend would be taxable under South African domestic law.

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<sup>110</sup> J, Brink for Cliffe Dekker Hofmeyr, 1 June 2018. *Securities lending arrangements back in the spotlight*. Available at <https://www.cliffedekkerhofmeyr.com/en/news/publications/2018/Tax/tax-alert-1-june-securities-lending-arrangements-back-in-the-spotlight-.html>. Accessed 1 December 2019.

#### ***4.6.4.3 The manufactured dividend is not considered to be of a South African source***

Non-residents are taxed in South Africa on their South African sourced income.<sup>111</sup> The South African domestic tax source rules have their roots in case law, which assigns the source to the location of the originating or dominant cause of the income.<sup>112</sup> Aside from these source principles, certain items of income are deemed to be from a South African source<sup>113</sup>, such as dividends paid by South African companies.<sup>114</sup>

A payment from a non-resident borrower to a non-resident lender, may well not be considered to be from a South African source. While the subject of the SLA is the lending of South African listed shares, it is likely that the SLA itself was negotiated and entered into in the country of residence of either the borrower or the lender. If this negotiation and agreement is considered the originating cause of the manufactured dividend income, and that this is found to have occurred outside of South Africa, then the lender's manufactured dividend income will not be taxable in South Africa.

It is then also questionable whether SARS has the jurisdictional authority to deem a non-resident borrower to have paid a South African dividend to a non-resident lender such that this deemed dividend is subject to dividends tax in South Africa.

With the dividend received by the borrower being exempt from dividends tax, and limited taxable income remaining in the borrower's hands after deducting the manufactured dividend and other fees paid to the lender, the revelation that the lender is not taxable in South Africa means that SARS will receive substantially less revenue from this transaction than it would have had the lender received the principal dividend directly.

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<sup>111</sup> Part ii of the ITA's section 1 definition of 'gross income'

<sup>112</sup> CIR v Lever Brothers and Unilever Limited. 1946 AD 441, 14 SATC 441

<sup>113</sup> Section 9(2) of the ITA

<sup>114</sup> Section 9(2)(a) of the ITA

#### ***4.6.4.4 The manufactured dividend is not a ‘dividend’ for DTT purposes***

An SLA with a borrower and lender that are both non-resident could result in the avoidance of dividends tax if the view was taken that the manufactured dividend was not a dividend for DTT purposes. The result could be that the manufactured dividend would be characterised as either business profits in terms of Article 7 or as other income in terms of Article 21 of a DTT and, with no PE in South Africa, South Africa would have no taxing rights over this income. If the lender had received the dividend directly from the issuer of the share, dividends tax would have been applicable, with the possibility of reduction in terms of a DTT.

It may be that SARS is concerned about this possibility, and has thus included the statement regarding possible avoidance of dividends tax.

### **4.7 Conclusion**

This chapter examined the South African domestic tax treatment of manufactured dividends paid in terms of an equity SLA. Scenarios with resident and non-resident borrowers and lenders were considered. Through analysis of material published by National Treasury, SARS, and tax professionals, it emerged that there is a level of uncertainty as to how SLA transactions involving non-residents should be treated for tax purposes.

Based on an examination of EMs to DTLAAs published by National Treasury, it is apparent that National Treasury considers that various amendments to the legislation governing SLAs have served a purpose of ensuring the dividends tax outcome that would have prevailed for a non-resident lender in the absence of an SLA. Indeed, SARS notes that a DTT “may” be applied to reduce the rate of dividends withholding tax applicable to a payment of a manufactured dividend to a non-resident. While neither party is explicit in setting out the thought process that would result in such conclusions, it is necessarily implied that a manufactured dividend would constitute an Article 10 dividend for DTT purposes in order for such conclusions to hold true.

Given the analysis of the Article 10 ‘dividends’ definition in Chapter 2, and the conclusion that this definition cannot find application to manufactured dividends, it is significant that the South African revenue authority and the relevant lawmaker are of a different view. These divergent positions present the risk that SARS would levy dividends tax on manufactured dividends paid to a non-resident lender, which would, it is submitted, amount to taxation not in accordance with the provisions of a double tax convention.

Confirmation of the proper characterisation of manufactured dividend income for DTT purposes would provide greater certainty to taxpayers and to SARS.

Chapter 5 will revisit the context and purpose of this paper, and will summarise the portions of the OECD MC and South African domestic tax law that have been examined, as well as the literature that was reviewed in order to assess the proper tax treatment of manufactured dividend income earned in terms of a SLA. The chapter will consider the risk to the South African *fiscus* of a loss of revenue when domestic and international tax principles are properly applied to manufactured dividends paid to non-resident lenders, and will offer recommended next steps in this area.

## 5 CHAPTER 5: CONCLUSIONS AND RECOMMENDATIONS

Chapter 5 concludes on the characterisation of manufactured dividend income for DTT purposes, and offers recommendations for areas of ITA for National Treasury to review in order to counter the risk of a loss to the South African *fiscus* when manufactured dividends are paid to non-resident lenders.

### 5.1 Introduction

The purpose of this paper has been to establish how manufactured dividend income should be characterised for DTT purposes. This determination was made following the investigations outlined below.

Chapter 2 considered whether manufactured dividends received by a non-resident lender fall into the ‘dividends’ definition in Article 10 of the OECD MC. Through a thorough analysis of the definition, it was concluded that manufactured dividends are not ‘dividends’ for treaty purposes as envisioned by Article 10.

Chapter 3 assessed whether this income could be characterised as business profits in terms of Article 7, or as other income in terms of Article 21, of the OECD MC. It was shown that manufactured dividends would form part of the business profits of a lender, and would thus be governed by Article 7.

Following from Chapter 3, Chapter 4 included a detailed analysis of South African taxation of manufactured dividends paid in terms of an SLA. It was shown that the tax position of a shareholder when dividends are paid can be altered by the interposition of a borrower in terms of an SLA.

The discussion, as set out in this research paper, revealed there is a risk that SARS would tax manufactured dividends paid to non-resident lenders not in accordance with the provisions of an applicable DTT. Furthermore, SLAs with non-resident lenders present a risk of a loss of revenue to the South African *fiscus*. The issues, conclusions and recommendations arising from this discussion is outlined below.



## 5.2 Chapter 2

This chapter considered the validity of the characterisation of manufactured dividend income as ‘dividends’ for treaty purposes. The relevance of this income characterisation was highlighted as it was shown that Article 10 of the OECD MC would afford South Africa limited taxing rights over South African sourced dividends paid to non-residents whereas, as set out in Chapter 3, Articles 7 and 21 do not allow South Africa to tax business profits or other income not effectively connected with a PE in South Africa. Whether manufactured dividends meet the OECD MC’s definition of ‘dividends’ is therefore of great significance when determining taxing rights in respect of cross-border manufactured dividends payments.

The principles of treaty interpretation contained in the VCLT were applied to the ‘dividends’ definition that is included in Article 10 of the OECD MC.

Though it was noted that Article 10(3) of the OECD MC does not achieve a complete and exhaustive ‘dividends’ definition, the key principles of the definition were examined.

The definition lists types of income that would be included in the concept of ‘dividends’ for treaty purposes, which were each considered. Through this examination it was found that ‘dividends’ should be applied to amounts of corporate profits that flow to shareholders by virtue of their ownership of a portion of the capital of the paying company. Latitude in the ‘dividends’ definition was shown to have been included to cater for peculiarities that may exist in domestic law constructs of the relationship between payer and recipient.

The fundamental elements of the ‘dividends’ definition were then contrasted against those of manufactured dividends. It was shown that it is not sufficient that manufactured dividends are treated as dividends for domestic tax purposes, but that the link to corporate rights held by the recipient must exist. It was demonstrated that a lender’s contractual rights to receive manufactured dividends under an SLA do not rise to the corporate rights of a shareholder to participate in the ownership of a company, and that manufactured dividend payments do not amount to distributions of profits made by the payer of the dividend (the borrower). Indeed, manufactured dividends are compensation for the lender not

receiving dividends from the issuer, and do not take on the characterisation of dividends themselves. In an SLA, a lender's participation in the issuer's profits is indirect at best.

It was concluded that the lender in a SLA is not a shareholder and does not receive 'dividends' as envisioned in Article 10 of the OECD MC. This left the question of the nature for treaty interpretation purpose of the income that the lender receives, which was considered in the chapter that followed.

### **5.3 Chapter 3**

Following from the conclusion in the foregoing chapter that manufactured dividends are not 'dividends' for DTT purposes, this chapter considered whether manufactured dividend income could be business profits or other income, and thus governed by Articles 7 or 21, respectively.

First, it was shown that engaging in the business of SLAs from which manufactured dividend income emanates would be considered a 'business' for purposes of Article 7, and that this Article will therefore find application to manufactured dividends.

Article 7 allocates taxing rights in respect of such income types to the country of residence, unless, in simple terms, the income is attributable to a PE in the country of source, in which case that country will enjoy the taxing rights. This is based on the principle that the enterprise must participate in the source State's economic infrastructure at a sufficient level before that State should be allowed to enjoy taxing rights over the income generated by that enterprise.

The practical possibility of a non-resident lender's manufactured dividend income being closely enough linked to a PE in South Africa was examined, and it was concluded that it is equally possible that a non-resident lender may or may not have a PE in South Africa and that manufactured dividend income could be attributable to such PE or could be independent thereof. It was considered that, in the digital age in which we live, entities have the ability to earn income from a State without any fixed presence there, but that there may also be commercially expedient reasons for creating a more permanent operating structure in that State.

Therefore, it was noted that, if a non-resident company with no PE in South Africa, lent its South African listed shares in terms of an SLA, and earned South African sourced manufactured dividends, South Africa would not have any taxing rights in respect of that income. This was then juxtaposed against the fact that South Africa would have been able to levy dividends withholding tax on a non-resident shareholder of South African shares, albeit at a reduced rate through application of a DTT.

## **5.4 Chapter 4**

This chapter examined the South African domestic tax treatment of manufactured dividends paid in terms of an SLA, the focus of which is a South African listed equity security. This analysis included consideration of documents authored by SARS and National treasury, in order to obtain a view of how SARS may levy tax on manufactured dividends paid to a non-resident lender company.

Through a thorough examination of the ITA, it was shown that South African domestic tax legislation subjects manufactured dividends to dividends tax. Through the mechanisms of the applicable legislation, resident lenders will be exempt from such dividends tax. Non-resident lenders earning South African sourced manufactured dividends will likewise be exempt from dividends tax and, in the absence of a PE to which to attribute their business income, South Africa will have no taxing rights in that regard either. Non-resident lenders earning manufactured dividends not from a South African source will not be exempt from dividends tax. However, as manufactured dividends are business profits for DTT purposes, in the absence of a PE to which to attribute this income, South Africa will have no taxing rights in respect of these manufactured dividends either.

That being said, it is apparent that SARS considers that application of a DTT in the case of a non-resident lender would result in reduction of dividends tax. This necessarily means that SARS considers that Article 10 of a DTT would apply to manufactured dividend income from a South African source. This is in contravention with the conclusion reached in Chapter 3 of this paper, where it was shown that manufactured dividends are not ‘dividends’ for treaty purposes but rather business profits.

## 5.5 Discussion of the results

The conclusions drawn in Chapters 2, 3 and 4 raise the risk that SARS will levy tax in a manner that is not in accordance with the provisions of a convention. Furthermore, and perhaps more importantly, there is also a risk of a loss to the South African *fiscus* where non-resident shareholders with no PE in South Africa lend South African listed securities in terms of an SLA, as a DTT may not allow South Africa to tax the income of such a lender.

## 5.6 Consideration of anti-abuse mechanisms

South African domestic tax law's GAAR provisions provide that where the Commissioner is satisfied that an agreement was entered into solely or mainly to obtain a tax benefit, the Commissioner may disallow such tax benefit.<sup>115</sup> Depending on the particulars of an individual case, the GAAR provisions could be found to apply to the interposition of a non-resident lender in a SLA.

The MLI's Article 6 talks to the purpose of a covered tax agreement, and includes that DTTs should not create opportunities for double non-taxation. It is possible that one could interpret such a preamble in a DTT to mean that the non-application of the Article 10 'dividends' definition to manufactured dividends is not in accordance with the intention of that DTT. However, it is submitted that this interpretation requires inferences to be made about the contracting States' intentions being divergent from the ordinary and accepted meanings of the terms used in Article 10, which would be contrary to the principles espoused in the VCLT.

The MLI's Article 7 aims to prevent treaty abuse through its PPT, which provides that treaty benefits may not be granted where it is "reasonable to conclude" that one of the principal purposes for an arrangement was the obtaining of such treaty benefits. This is one of the MLI's 'minimum standards', and this test arguably sets a lower threshold than South African GAAR when considering abuse by taxpayers. However, as discussed in the forgoing chapters, it is unlikely that a DTT would apply to manufactured dividends in any event, given the mismatches between the 'dividends' definition housed

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<sup>115</sup> Summarised and paraphrased from section 103(2) of the ITA

in Article 10 of the OECD MC, and the core characteristics of manufactured dividends. The MLI's PPT is therefore unlikely to find application in addressing the possible loss to the South African *fiscus*.

## **5.7 Recommendations**

As shown in this paper, a loss of dividends tax revenue to the South African *fiscus* arises where a non-resident lender is interposed between a resident entity paying a dividend and a resident or non-resident borrower of the shares in question. Perhaps the simplest solution to this issue would be to amend the exemption provisions applicable to dividends paid to such borrowers. In terms of the current domestic tax legislation, as set out at 1.1.2 above, because a dividend received by a borrower is exempt from normal tax, it is included in his 'income', which in turn exempts the dividend from dividends tax.

If the borrower's dividends tax exemption were refined to apply only where the lender is subject to dividends tax on the manufactured dividend he receives, this may mitigate the loss to the South African *fiscus*. Manufactured dividends would be subject to dividends tax in the absence of a DTT between South Africa and the State of residence of the non-resident lender.

However, as manufactured dividends are often quantitatively diminished when compared to their dividend counterparts, the South African *fiscus* may nevertheless be prejudiced in cases where the manufactured dividend attracts dividends tax and the dividend paid to the borrower does not.

Another approach might be for South Africa to address the application of Article 10 to manufactured dividends when conducting bilateral treaty negotiations. It would need to be considered whether South Africa would want to use its bargaining power in this direction, and this would depend on the quantum of revenues that could be gained by broadening the 'dividends' definition in Article 10 of relevant DTTs. It may be that this issue is not significant enough to receive substantial focus, or it may be that these sorts of transactions are limited to one or two of South Africa's treaty partners, in which case it may be worth looking into a revision of Article 10 of those DTTs. Further research into the extent of the possible loss to the South African *fiscus* is therefore recommended.

It is further recommended that the approach of other countries to taxation of manufactured dividends is examined and considered for possible application to South Africa's domestic law and/or DTTs.

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