The taxation in South Africa of business profits of controlled foreign companies: in conflict with international law?

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1. **Introduction**
2. **Brief history of Section 9D of the Income Tax Act**
   - i. **South Africa's international tax regime**
   - ii. **The problem with the separate entity approach and deferral**
   - iii. **Section 9D as a response to deferral**
   - iv. **The difficulty with section 9D**
3. **Application of treaties in the context of international law**
   - i. **Treaties and public international law**
   - ii. **The South African position regarding treaties and international law**
   - iii. **Section 9D and South Africa's double tax agreements**
4. **Treaty override**
   - i. **Definition**
   - ii. **How other jurisdictions approach treaty override**
   - iii. **Treaty override in South Africa and section 9D**
5. **Conclusion**

1. Introduction

The face of commerce has become progressively more globalised in the past decades, facilitated by among other factors, telecommunication improvements and the ease and speed of travel.[1] An increasing number of South African companies are expanding their business internationally, and directly controlled foreign investment is increasing consistently.[2] Whilst the economic activity generated by the global expansion of South African companies is positive, it creates a problem for the South African government, in that the flight of capital may erode the domestic tax base. To address this problem, South Africa replaced source-based taxation with residence-based taxation as of 1 January 2001, leading to the taxation of its residents' worldwide income.[3]

Although the shift to taxing residents' worldwide income addresses the loss of taxation on direct foreign investments caused by global expansion, the income earned indirectly by residents through investment in a company resident in another country would still fall through the South African tax net, until repatriated as a dividend. To solve that deferral problem, South Africa introduced section 9D to the Income Tax Act[4] (the ITA) which, in certain circumstances, imputes the income of foreign companies controlled by South African resident shareholders ('CFC's') to such shareholder as the income arises, not when repatriated as a dividend.

South Africa currently has an extensive double tax agreement ('DTA') network of 51 agreements in force, some concluded as long ago as 1956 in the case of the double tax agreement with Zambia, with a further 19 treaties currently in the process of negotiation.[5] DTAs are concluded '...with a view to the prevention, mitigation or discontinuance of levying, under the laws of the Republic and of such other country of tax in respect of the same income, profits or gains, or tax imposed in respect of the same donation or the rendering

[1] T T Mboweni 'Globalisation', address to the diplomatic forum, Rand Afrikaans University (25 October (2000)). Available at www.reservebank.co.za [accessed 7 January 2010].
[2] Linda Greenleaf 'Catch-22 : the deferral dilemma'(2003) 120 3 *SALJ* 580 at 580.
[3] This was achieved by the amendment of the definition of gross income in s 1 of the Income Tax Act 58 of 1962 ('ITA') by section 2(c)(i) of the Revenue Law Amendment Act 59 of 2000.
[4] Act 58 of 1962.
[5] SARS home page. Available at www.sars.gov.za [Accessed on 30 May 2009].

of reciprocal assistance in the administration of and collection of taxes under the said laws of the Republic and of such other country.'[6]

I will analyse the history and purpose of section 9D, as well as its interaction with double tax agreements, specifically in the context of the application of international law in the South African Constitutional legal framework and compare the manner in which foreign jurisdictions deals with the interaction between treaties and domestic law. It will be demonstrated that the application of section 9D, in the context of the business profits article as contained in the OECD model convention('OECD MC')[7] as well as the double tax agreement concluded between South Africa and Mauritius[8], may lead to treaty override, but that the legality of such override in South African law has not been tested.

I will conclude that the conflict between South Africa's CFC rules and the business profits provision of double tax treaties will only occur in limited circumstances, due to the manner in which the rules are structured, but that it is possible for such a conflict to occur. It will be suggested that the best way forward for the South African government in terms of the renegotiation of old double tax agreements and the conclusion of new agreements, would be to provide for the application of s 9D in such agreements so as to avoid possible conflict. This will create certainty regarding situations where there is a conflict between s 9D and double tax treaties and will enable s 9D to function as an effective anti-avoidance tool, without infringing on South Africa's treaty obligations.

[6] ITA s 108(1).
[7] OECD Articles of the model convention with respect to taxes on income and capital (2003). Available at www.oecd.org [Accessed on 12 March 2009] art 7.
[8] Agreement between the government of the Republic of South Africa and the Government of the Republic of Mauritius for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income GNR 915 GG 18111 of 2 July 1997 art 7.

2. Brief history of Section 9D of the Income Tax Act

i. South Africa's international tax regime

After South Africa's first democratic election in 1994, the new ruling coalition[9] made material changes to the governance of the Republic. Those changes included substantial reform of the Republic's tax system, the most substantial of which was the change of the basis of the country's tax system from source to residence. This became effective on 1 January 2001.[10]

In terms of international law, a country may have jurisdiction to tax based on sovereignty, and such jurisdiction extends only as far as that sovereignty extends, which is based on either the principle of source or residence.[11] The right of a country to tax income earned form a source within itself is warranted on the basis that the country provides the infrastructure for the generation of such income.[12] Therefore South Africa may tax foreign residents on their South African sourced income, as it does.[13] The right of a country to tax its residents on their income, regardless of the source of such income, stems from the benefit that such a resident derives from its allegiance to the country.[14] South Africa therefore has no justification based on either source or residence to tax a foreign resident on income derived from a foreign source, even when such foreign-sourced income is earned by a company wholly owned by South African residents, as such income lacks the requisite connection to South Africa based on source or residence.[15]

The Revenue Amendment Act 59 of 2000 provides for the taxation of all foreign sourced income of residents of South Africa, both so-called 'passive' and 'active' income.[16] Prior to 1997, only income that had its originating cause in South Africa was subject to tax in South Africa, with a few exceptions where non-South African sourced income was taxed,

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[9] ANC, Cosatu and the South African Communist Party.
[10] Revenue Law Amendment Act 59 of 2000 s 2(c)(i).
[11] RSJ Martha *The jurisdiction to tax in international law* (1989) 47.
[12] Greenleaf (note 2) at 584.
[13] ITA s 1 definition of gross income (ii).
[14] Greenleaf (note 2) at 584.
[15] Richard Jooste 'The imputation of income of controlled foreign entities' (2001) 118 2 *SALJ* 473 at 474.
[16] Passive income is generally investment income, in the form of dividends, interest, royalties and annuities. Active income would be income of a non-investment nature, generally business profits.

based on residency in South Africa, by imputing such income to the South African resident.[17] This was generally referred to as a source-plus system of taxation. The change towards a system of taxation based on residence began in 1997 when certain 'passive' income, which included interest, annuities, rentals and royalties received from a foreign source, became taxable in the hand of South African residents, by the insertion of sections 9C and 9D into the ITA.[18] Foreign dividends were subject to tax in South Africa in the hands of South African residents by virtue of Section 9E of the ITA from 23 February 2000 [19] and the taxation of foreign source 'active' income came into effect on 1 January 2001, completing the migration to a residence-based system of taxation.[20]

ii. The problem with the separate entity approach and deferral

The rationale of the government to migrate to a residence-based system of taxation was to widen the tax base so as to reduce overall South African tax rates.[21] However, the effectiveness of a residence-based taxation regime may be diluted if it is not possible to tax income earned by South African-owned companies resident abroad, as South African residents will be able to avoid South African tax simply by shifting their income to such companies and South Africa's right to tax will only eventuate when, and if, such income is repatriated as a dividend.[22]

Such deferral is possible for two reasons, first, the accounting principle of a separate accounting basis for taxation of companies based on an arm's length, separate entity approach and, second, the manner in which corporate residence of entities is determined. The separate entity approach recognises that a company is an entity separate from its shareholders and that even when two companies wholly owned by the same person trade with each other, the transactions should be separately accounted for and taxed. [23] The corporate residence of a company is generally not determined by the residence of its shareholders, it is determined either by its place of incorporation or its place of effective management.[24] Because of those

[17] Jooste (note 15) at 473.
[18] Income Tax Act 28 of 1997 s 9(1).
[19] This was effected by the insertion of s 9E in the ITA by the Revenue Laws Amendment Act 59 of 2000, it has however been repealed since and foreign dividends are now taxable in terms of para (k) of the definition of gross income in s 1.
[20] Revenue Law Amendment Act 59 of 2000 s 2(i).
[21] South Africa. National Treasury *Detailed explanation to section 9D of the Income Tax Act* (2002) at iii.
[22] Jooste (note 15) at 474.
[23] Greenleaf (note 2) at 585.
[24] Ibid.

two factors a South African owned company resident abroad may not have the required connectivity to South Africa, based on either source or residence, for South Africa to be able to directly tax its income in terms of international law.[25]

If a South African resident has sufficient control over a company resident outside South Africa, that resident will be able to delay the repatriation of the income of that company and therefore South African taxation of that income.[26] The extent of the benefit of such deferral, if any, is dependent on the following factors: The amount of the income so deferred, the difference between effective domestic and foreign tax rates, the period of deferral achieved and the interest rates of the state trying to curb such deferral.[27] For a residence based taxation regime to be effective, such deferral must be addressed.[28]

iii. Section 9D as a response to deferral

To address the deferral problem, South Africa introduced section 9D, known as the controlled foreign company rules, into the ITA,[29] based on similar provisions found in several other nations' tax rules.[30] The effect of section 9D is to tax, as it is earned, the income of foreign companies controlled by South African residents, as if such income is immediately repatriated to South Africa. It does that by imputing the income as it accrues to the foreign resident company, to the South African resident or residents controlling it, in proportion to such resident's shareholding.[31] Such residents may then claim relief from double taxation by claiming foreign tax credit for the tax paid on the imputed income in the company's country of residence[32] and, if such income is actually repatriated as a dividend, such dividend income is exempted from South African taxable income.[33]

[25] Jooste (note 15) at 474.
[26] Jooste (note 15) at 474.
[27] OECD *Controlled foreign companies legislation: studies in taxation of foreign source income* (1996) at 16.
[28] For an in depth discussion regarding such deferral, see Linda Greenleaf 'Catch-22 : the deferral dilemma'(2003) 120 3 *SALJ* 580.
[29] Initially it was known as the controlled foreign entity rules, but changed to the controlled foreign company rules by s 14(1) of the Revenue Laws Amendment Act 74 of 2002.
[30] Countries with CFC type rules include the UK, the US, New Zealand, Australia and Hungary.
[31] Section 9D(2).
[32] Section 6quat(1A)(b).
[33] Section 10(k)(ii)(cc).

iv. The difficulty with section 9D

The imputation of the income of a CFC to a South African resident is not a problem in the absence of a DTA with the country such a company resides in. The South African receiver of revenue has sufficient control over the resident shareholder or participation right holder of the CFC not only to levy tax on the imputed income, but also to enforce such taxation. The situation becomes more complicated, however, when there is a binding DTA between South Africa and the country a CFC is resident in.

A DTA is meant to allocate taxing rights on income and capital where both states may have a right to tax, based either on the principle of source or residence, so as to avoid double taxation, but it also entails limiting domestic taxing rights regarding foreign-sourced income.[34] It is in the very nature of double tax agreements that the counties party to them agree to forgo certain taxing rights,[35] especially when both parties have a residence-based system of taxation. Treaties recognise that each contracting party applies its own laws regarding taxations, such as the section 9D rules, but the treaty then functions to limit the application of those laws, as agreed to between the contracting states.[36] In the absence of a DTA, the imputation only involves the rights of the South African resident and the fiscus. However, should a binding DTA be in existence with the country a CFC is resident in, the rights of that other country are also involved, and such imputation may be a breach of treaty obligations by the South African government.

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[34] Olivier, L and Honiball, M *International tax: a South African perspective* 3ed (2005) at 14.
[35] Olivier (note 34) at 1.
[36] Vogel et al *Klaus Vogel on double tax conventions* 3ed (1997) at 20 and 26.

3. Application of treaties in the context of international law

i. Treaties and public international law

Treaties are defined by the Vienna Convention on the Law of Treaties (VCLT)[37] as "an international agreement concluded between states in written form and governed by international law…".[38] Treaties are entered into by nations in a similar manner as individuals enter into a contract. The difference, however, is that whereas the working of a normal contract is subject to the legal jurisdiction of a specific state, treaties are not. They are applied within a framework of norms that occur on an international level, referred to as public international law.[39]

Public international law is that area of the law which deals with conduct of states and of international organisations and with their relations towards each other, and also with some of their relations with persons, natural or juridical.[40] It is generally the only law that applies to the conduct of states and international organisations in their relations with one another[41] and is considered to be a distinct legal system, comparable to a national system in its scope and function.[42] Thus, if on an international level two states have conflicting views regarding the allocation of taxing rights in a double tax agreement concluded between them, all the issues relating to the dispute, such as which rules will take precedence over other rules, will be determined by international law.[43] Treaties in general, including double tax agreements, are considered to be a primary source of public international law.[44]

The fact that international law is said to govern inter-state relationships, does not exclude it from having an effect on the national legal plane. The way that international law is applied on a domestic level will however differ from the manner applied on the international

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[37] 1969 (1969) 8 ILM 679.
[38] Art 2(1)(a).
[39] T Buergenthal and S D Murphy *Public international law* 3ed (2002) at 4.
[40] L Meintjies-Van der Walt et al *Introduction to South African law. Fresh perspectives* (2008) at 521.
[41] Some contracts concluded between states are, however, not governed by international law. For example, where the government of a state via its embassy in the South Africa concludes a service contract with Telkom for a telephone line. As it is a domestic contract, only South Africa's law of contract will govern it.
[42] Buergenthal (note 39) at 4.
[43] OECD Committee on Fiscal Affairs *Tax treaty override* (1989) at para 8.
[44] Statute of the International Court of Justice art 38(1).

plane.[45] Whilst international law is the only law applicable to the conduct of states in relation to each other, on a domestic level it is a part of the domestic legal system as a whole, and not a distinct legal system.[46] On a national level, the context for the application of international law is the domestic legal system and constitutional framework. International law can be seen as a branch of the domestic legal system and, in the same way you would refer to the law of contracts to resolve an issue that is governed by the law of contracts, international law will be used to resolve an issue where the situation requires it.[47] In such a situation, international law may be invoked in domestic litigation or other contexts where rights and obligations are to be defined, by individuals, private and public entities and the government if it appears relevant to the context.[48]

As a primary source of international law, it could be said, in an international legal context, that treaties have a similar role as a state's domestic laws have in a domestic context.[49] This is reflected by the practice of many countries, including South Africa, to incorporate treaties into their domestic statutes.[50] The other sources of international law include international custom and the general principles of law as recognised by civilised nations.[51] Judicial decisions and the teachings of the most highly qualified publicists of various nations are considered not to be sources of international law, but are used as subsidiary means for establishing what international law is.[52] Public international law therefore basically consists of treaties, which are the reflection of express agreements between states, and custom, which are those rules of international conduct to which states have given their tacit consent.[53]

ii. The South African position regarding treaties and international law

Prior to the current constitutional dispensation in South Africa, treaties were entered into by the executive without endorsement of the legislature, but in most circumstances treaties did not become part of domestic law without some act of legislative transformation. In *Pan*

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[45] Buerganthal (note 39) at 3.
[46] Ibid.
[47] Buergenthal (note 39) at 5.
[48] Ibid.
[49] John Dugard *International law: A South African Perspective* 3ed (2005) at 27.
[50]In the case of double tax agreements, this is effected by section 108(2) of the ITA which provides that the agreement becomes part of the ITA.
[51] Ibid.
[52] Dugard (note 49) at 40.
[53] Dugard (note 49) at 51.

American World Airways Incorporated v SA Fire and Accident Insurance Co Ltd[54], Steyn CJ stated that it was:

> ...trite law...that in this country the conclusion of a treaty, convention or agreement by the South African government with any other government is an executive and not a legislative act. As a general rule, the provisions of an international instrument so concluded, are not embodied in our law except by legislative process...In the absence of any enactment giving [its] relevant provisions the force of law, [it] cannot affect the rights of the subject.[55]

The position of the courts, regarding the rules of customary international law, was that it should be applied as if they were part of South African law, and it was generally applied without questioning its place in the legal order.[56] Because customary international law is a form of common law, it was subordinate to all forms of legislation, but there was a statutory presumption that the legislature did not intend to violate international law.[57]

The current position of international law in the South African legal system is now found in the final Constitution.[58] The starting point for the determination of the applicable approach in South Africa regarding treaties in general is contained in Section 231 of the Constitution, which provides for their negotiation and conclusion as well their legal effect. The responsibility of negotiating and signing all international agreements rests upon the national executive, consisting of the President and the Cabinet of South Africa. [59] In the case of double tax agreements, this requirement is echoed in section 108(1) of the ITA. The Constitution also provides the requirements for the timing and manner in which treaties become effective as part of South African domestic law.[60] South Africa is bound by agreements existing at the date of adoption[61] of the Constitution.[62] With regards to treaties entered into after the adoption of the constitution, it distinguishes between treaties in general (s 231(2)), those with a technical, administrative or executive nature, or that do not require either ratification or

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[54] 1965(3) SA 150 (A).
[55] At 238B-F
[56] Dugard (note 49) at 51.
[57] Dugard (note 49) at 52.
[58] The Constitution of South Africa Act 108 of 1996 ss 231, 232, 233.
[59] Section 231(1).
[60] Section 231 (2), (3), and (4).
[61] 4 February 1997.
[62] Section 231(5).

accession (s 231(3)).[63] Treaties, in general, will only become binding upon South Africa after they have been approved by Parliament, in contrast to those governed by s 231(3) which become binding once entered into and where the only requirement is that they must be tabled in parliament within a reasonable period.[64] It is not clear whether double tax agreements are considered to fall under s 231(3), as distinguished from general treaties, as the concept of international agreements of a technical, administrative or executive nature is not defined.[65] The implication of the classification of double tax agreements as such would be to enable the executive to bind South Africa in terms of such an agreement without parliamentary approval, however, in practice tax treaties are dealt with under s 231(2) and will only become binding on the South Africa after approval by Parliament.[66]

Section 231(4) reflects the position stated in *Pan American World Airways*[67], that a treaty does not become part of domestic law until enacted into law by national legislation, which, in the case of double tax agreements, is done in terms of the ITA.[68] It is required that double tax agreements be notified by publication in the Gazette '…as soon as may be after the approval by Parliament…as contemplated in section 231 of the Constitution...'[69] and an agreement so notified is deemed to be enacted under the ITA.[70] Double tax agreements therefore only become binding on the Republic on the international plane, after approval by Parliament[71] and then become part of the domestic law after being published in the Government Gazette in terms of the ITA.[72]

The rules which govern the making, observance, interpretation, validity and termination of treaties are found in customary international law.[73] Section 232 of the Constitution states that: 'Customary international law is law in the Republic, unless it is inconsistent with the Constitution or an Act of Parliament.' Even though the constitution makes it clear that customary international law is binding on South Africa, it is not helpful in determining what is considered to be customary international law, and it will be necessary to

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[63] Section 231(3).
[64] However, provisions of such agreements, which are inconsistent with the Constitution or an act of Parliament, do not become law s231(3).
[65] Olivier (note 34) at 25.
[66] Ibid.
[67] See note 52.
[68] Dugard (note 49) at 61.
[69] Section 108(2) of the ITA.
[70] Ibid.
[71] Dugard (note 49) at 62.
[72] Constitution of South Africa Act 108 of 1996 Section 231(4).
[73] Dugard (note 49) at 406.

turn to judicial precedent to determine which rules of customary international law are to be applied and how they are to be proved.[74] Courts have recognised two key requirements for the existence of a customary rule: it must be a general and consistent practice (*usus*), and such a practice must follow from a sense of legal obligation (*opinio juris sive necessitites*).[75] A rule or principle that a state follows in practice must be accepted by them, tacitly or expressly, as legally binding on them for such a rule or practice to be considered a rule of international law. If a state follows a practice out of courtesy, but does not consider it binding, it will not be considered international customary law, as it does not satisfy the requirement that the state practises it out of a sense that it is legally binding.[76] The interpretation of what is and what is not customary international law may thus differ between states, depending on their past behaviour and the reason why they follow such practices. The practices a state considers binding may be determined by examining a wide range of materials, including treaties, official statements at international conferences, diplomatic exchanges and instructions to diplomatic agents, as well as national court decisions and legislative measures.[77] An international custom does not have to be universally accepted to become part of an individual state's applicable international law, but it must receive general or widespread acceptance.[78] Customary international law is, however, consensual in nature and if a state consistently rejects a rule, it will not be bound by it.[79]

The crystallisation of a practice into a rule of customary international law is a nuanced, lengthy and uncertain process, and the development of such practices is often too slow to meet the modern international community's need for new law.[80] In an attempt to overcome the shortcomings of the development of customary international law, a number of treaties have been entered into between states which codify existing rules of customary international law or which create new rules of law.[81] These types of treaties are called legislative or law-making. Formally, such legislative treaties only bind states party to them, but when a large body of states are party to such a treaty, and states that are not party to it informally accept the provisions of such conventions as law, it may be considered a source of

[74] Dugard (note 49) at 56.
[75] Dugard (note 49) at 29.
[76] Ibid.
[77] Ibid.
[78] S v Petane 1988 (3) SA 51 (C) at 56-7.
[79] Dugard (note 49) at 32.
[80] Burgenthal (note 39) at 24.
[81] Dugard (note 49) at 28.

customary international law in those states as well.[82] The treaty that is most widely utilised in that manner is the Vienna Convention on the Law of Treaties.[83] 110 countries are party to the treaty,[84] and it is considered that this convention is a definitive statement on the law of treaties by both signatories and non-signatories.[85] South Africa is not a signatory to the VCLT, but in *Harksen v President of the Republic of South Africa*[86] Goldstone J stated that he was prepared to accept that section 46(1) of the VCLT, which provides that a state may not invoke its internal law to overrule its consent to be bound by a treaty, reflected customary international law. He did, however, warn that 'the extent to which the Vienna Convention reflects customary international law is by no means settled'.[87]

iii. Section 9D and South Africa's Double tax agreements

Treaties, including tax treaties, are thus part of South African law, and governed by customary international law. The following is an example of how the provisions of section 9D may conflict with the provisions of a double tax agreement. A later section will deal with the consequences of such a conflict.

For this example the interaction between the South African/Mauritian DTA with the s 9D rules will be considered. South Africa and Mauritius concluded a double tax agreement, based on the OECD model convention.[88] The Minister of Finance signed the agreement on 5 July 1996 and it was duly tabled and approved by Parliament and published in the Government Gazette.[89] The agreement is therefore properly incorporated into South African domestic law and has been applicable from 20 June 1997. The treaty is currently being renegotiated.

A South African resident, Mr A, who is a natural person, invested capital in a company, named CFC, incorporated and resident in Mauritius. Mr A is the sole equity investor and thus holds all the participation rights of CFC. The purpose of CFC is to manufacture painted palm leaf fans, for sale in Mauritius. It is framed that it will take three years, from the date Mr A

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[82] Ibid.
[83] See note 37. Other treaties that also fall into this category are the Vienna Convention on Diplomatic Relations and the Convention on the Prevention and Punishment of the Crime of Genocide.
[84] See www.treaties.un.org [accessed on 16 December 2009]
[85] Dugard (note 49) at 406.
[86] 2000 (2) SA 825 (CC).
[87] At 835-6.
[88] See note 7.
[89] See note 8.

initially made his capital investment, for CFC to reach its full production capacity. In the meanwhile, capital investment is made for training the painters and promoting the product. At the date Mr A made his investment, CFC entered into a lease agreement to rent a factory for a period of nine months. At the expiration of the lease, CFC rented another, larger premises also for nine months. CFC has bought premises where a factory is being constructed and expects to be able to move its business into that factory permanently when the lease over the second property expires.

On the last day of Mr A's year of assessment in South Africa, he had held his interest in CFC for a full calendar year. CFC's tax year happens to end on the same date as Mr A's year of assessment. On that day the net income of CFC, as calculated in terms of the ITA, is R6 million, consisting of R5 million in profit from the sale of the fans and R1 million interest income. As Mr A owns more than 50% of the participation rights of CFC, it is a controlled foreign company as defined.[90] Section 9D provides that there will be included in Mr A's income for the year of assessment:

> ... an amount equal to... the proportional amount of the net income of that controlled foreign company determined for that foreign tax year, which bears to the total net income of that company during that foreign tax year, the same ratio as the percentage of the participation rights of that resident in relation to that company bears to the total participation rights in relation to that company on that last day...[91]

Mr A holds 100% of CFC's participation rights, therefore the total net income of CFC will be included in the taxable income of Mr A 'as if that controlled foreign company had been a taxpayer, and as if that company had been a resident for the purposes of the definition of gross income'. [92] The departure point of s 9D in this example is thus that the total net income of CFC, calculated in terms if the ITA, is assessed as part of Mr A's taxable income. That amount may however be subject to certain exemptions found in Section 9D(9).

Subsection 9D(9)(b) allows income attributable to a foreign business establishment not to be taken into account for the determination of net income of a CFC. A foreign business establishment is defined in section 9D(1) as:

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[90] Section 9D(1).
[91] Section 9D(2)(a)(i).
[92] Section 9D(2A).

(a) a place of business with an office, shop, factory, warehouse or other structure which is used or will continue to be used as by that controlled foreign company for a period of not less than one year, whereby the business of such a company is carried on, and where that place of business-

(i) Is suitably staffed with on-site managerial and operational employees of that controlled foreign company and which management and employees are required to render services on a full-time basis for the purposes of conducting the primary operations of that business;

(ii) is suitably equipped and has proper facilities for such purposes; and

(iii) is located in any country other than the Republic and is used for *bona fide* business purposes (other than the avoidance, postponement or reduction of any liability of this act or any other act administered by the commissioner).

In this example CFC's activities satisfies most of the requirements for the business establishment exemption, as it has a place of business, a suitably equipped factory, with on-site staff conducting the primary operations of the business of CFC and that place of business is located in Mauritius. The problem is, however, that the factory CFC started its business in is only utilised for 9 months, and the second interim factory it will lease, will not be used for a period of at least a year. The result is that none of CFC's income will be excluded from the income attributed to Mr A in terms of the foreign business establishment exemption, regardless of the fact that such income is subject to tax in Mauritius. The other exemptions in s 9D(9) are also not applicable to any of the income of CFC attributed to Mr A. Mr A will, however, be allowed a tax credit for the tax due to be paid to the Mauritian receiver.[93]

Therefore, in the South African domestic legal framework, the total net income of CFC as calculated, amounting to R6 million, is assessable and chargeable to income tax in the hands of Mr A. There is, however, a binding treaty between South Africa and Mauritius, so the provisions of the treaty must also be taken into account to determine whether the taxation of the income so calculated by the receiver of revenue is permissible in light of South Africa's treaty obligations, in terms of international law.

The DTA between Mauritius and South Africa will apply to both Mr A, a South African resident, and CFC, a Mauritian resident company, as provided for within the scope of the treaty in terms of art 1, are: '...persons who are residents of one or both of the Contracting States.'

[93] ITA s 6quat(1)(b).

Article 2 of the double tax agreement provides for the relevant taxes covered by it and reads as follows:

> 1. This Agreement shall apply to taxes on income imposed on behalf of a Contracting State or its political subdivisions, irrespective of the manner in which they are levied.
> 2. There shall be regarded as taxes on income all taxes imposed on total income or on elements of income.
> 3. The existing taxes to which this Agreement shall apply are in particular:
> (a) in Mauritius, the income tax; (hereinafter referred to as "Mauritius tax");
> (b) in South Africa:
> (i) the normal tax; and
> (ii) the secondary tax on companies;'

The treaty is applicable to the Mauritian income tax levied on the income of CFC in terms of article 2(3)(a). The ITA is divided into chapters, chapter II is called 'the taxes' and section 9D falls under part I of that chapter which is labelled 'Normal Tax'. The South African tax levied on Mr A's income, as calculated in terms of s 9D, would therefore fall under article 2(3)(b)(i). The next step in applying the treaty is to determine whether the amount of income taxed in the hands of Mr A, in terms of section 9D, is subject to an exclusive taxing right by either Mauritius or South Africa, as agreed to in the treaty.

The R1 million interest income earned by CFC is not subject to the interest provision, art 11, of the double tax agreement, as the interest is not only earned by a Mauritian resident, its source is also Mauritian. Article 11 will only be relevant if the interest was paid to a South African resident, or arose in South Africa. The income attributable to the sale of fans by CFC will, however, be subject to the business profits article which provides as follows:

> 1. The profits of an enterprise of a Contracting State shall be taxable only in that State, unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State, but only so much of them as is attributable to that permanent establishment.[94]

The R5 million earned from the sale of fans constitutes business profits of CFC, as it is income from a trade or business. The interest CFC earned is however not subject to the business profits provision, as it is dealt with under a separate treaty provision. The business profits are earned by CFC which is a Mauritian enterprise, and none of those profits are attributable to a permanent establishment of CFC in South Africa. Mauritius will therefore

[94] Article 7(1).

have the sole right to levy income tax on those business profits and it follows that there is no scope in the treaty for South Africa to levy tax on the business profits of CFC.

Though at first blush it seems clear that South Africa should not be levying tax on the business profits of CFC, there is English case law that asserts that it is not actually such profits CFC rules are levying tax on, but a notional amount, calculated with reference to such profits. In the English Court of Appeals the relationship between their CFC legislation and double tax agreements arose in the case *Bricom Holdings v IRC* (*'Bricom'*).[95] The facts are briefly that the taxpayer is incorporated and resident in the United Kingdom, and is an indirect, wholly-owned subsidiary of The Bricom Group Limited ('BGL'). The taxpayer has a wholly-owned, direct subsidiary, Spinneys International BV ('Spinneys'), which is incorporated and resident in the Netherlands. Spinneys lent money to BGL at interest, duly paid by BGL, and Spinneys' interest income was taxable in the Netherlands. Spinneys was a CFC, in terms of the UK CFC legislation, and the Revenue raised an assessment on the taxpayer by reference to the UK source interest received by Spinneys from BGL. The taxpayer disputed the assessment on the basis that the interest income so attributed, itself was exempted from corporation tax in the United Kingdom by the double tax agreement between the Netherlands and the United Kingdom. Therefore the treaty applied not only to the resident of the Netherlands, who received the income, but that the benefit of the treaty exemption extended to the taxpayer to whom the income was attributed.[96]

Spinneys was a CFC in terms of s 747 of the UK Taxes Act,[97] which contains the CFC rules of that act, and that was not disputed by the taxpayer.[98] Under s 747 a UK parent company is taxable in respect of certain income of a controlled foreign company in which it holds an interest. After analysing the statutory process through which the income of Spinneys is attributable to the tax payer, the court came to the conclusion that:

> The correct analysis is that the interest received by Spinneys is not included in the sum apportioned to the taxpayer on which tax is chargeable. It merely provides a measure by which an element in a conventional or notional sum is calculated, and that it is that

[95] [1997] STC 1179 CA.
[96] At 1189.
[97] 1988 Part XVII.
[98] *Bricom Holdings v IRC* (note 93) at 1195.

> conventional or notional sum which is apportioned to the taxpayer and on which tax is charged.[99]

This judgement, though not binding on South African courts, raises the question of whether the amount s 9D includes in the income of a taxpayer, such as Mr A, is the income of the foreign resident CFC, or whether it is just a measure by which a notional amount is calculated. The approach of the court in *Bricom,* that the nature of the 'chargeable profits' in terms of the UK CFC legislation is a purely notional sum, has been criticised because they are, actually, the profits of the CFC calculated in terms of the UK corporate tax laws and are no more notional than ordinary UK corporate tax.[100]

Subsequent to the *Bricom* decision, the charging provision of s 9D was amended to reflect the UK provision's wording.[101] Before the amendments s9D(2) used to read:

> There shall be included in the income of any resident contemplated in the definition of 'controlled foreign entity' in subsec (1), a proportional amount of any investment income received by or accrued to such entity, which bears to the total investment income received by or accrued to such entity, the same ratio as the percentage of the participation rights of such resident, in relation to such entity, bears to the total participation rights in relation to such entity: Provided that the provisions of this subsection shall not apply to any amount of investment income to which the provisions of subsec(4) are applicable.

Section 9D(2)(a) now provides for the inclusion of 'an amount equal to... the proportional amount of the net income of that controlled foreign company determined for that foreign tax year...'. Therefore it may be argued that before the amendment, the amount that was included in the income of Mr A was the actual amount of foreign investment income of the CFC and that if there is a double tax agreement between South Africa and the country the CFC is resident in, it will make s 9D ineffective in the light of the *Bricom* judgement.[102] Due to the amendment, however, it may be argued that the amount included in Mr A's income is a notional amount, and not the income of the CFC and that, according to *Bricom*, the treaty is not applicable.[103]

I am of the view that the approach adopted in *Bricom* is not substantially persuasive and that the 'notional amount' argument should not be accepted in South Africa. The income

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[99] Ibid.
[100] See Daniel Sandler Tax treaties *Controlled foreign company legislation: pushing the boundaries* 2nd ed (1998) at 206.
[101] The Revenue laws Amendment Act 59 of 2000 s 10(1).
[102] Olivier (note 34) at 394.
[103] Ibid

protected by the double tax agreement is a *sine qua non* for the calculation of the amount attributable to residents in terms of section 9D. If there were no such income, no amount would be attributable to the resident shareholder. If the 'notional amount' argument is accepted regarding section 9D, any provision of a double tax agreements may be circumvented by simply adding the words 'an amount equal to' before any charging provision and creating a calculation that refers to such income.

For example, art 6 of the OECD model convention[104] regulates the taxation of income derived from immovable property. On the country in which such immovable property is situated is conferred the sole right to tax income arising from such property,[105] and this provision is part of most of the double tax agreements South Africa has entered into, including the Mauritian treaty.[106] If the reasoning in the *Bricom* matter is followed, this article may be circumvented by simply adding a provision to the ITA which deems 'an amount equal to the foreign sourced net income from immovable property' to be included in the income of a owner resident in South Africa and which provides that the amount will be calculated with reference to certain sections of the ITA. Even though such a provision is clearly in conflict with art 6 of the double tax agreement, the reasoning in *Bricom* will allow such taxation, as it is not the income derived from immovable property that is subject to tax in South Africa, but a notional amount calculated with reference to that income.

It may seem more acceptable to use the 'notional amount' argument when it comes to s 9D rules, as it was enacted as an anti-avoidance measure, but the reasoning of the court in *Bricom* did not mention the nature and purpose of the CFC rules in their interpretation of the nature of the income apportioned to the taxpayer; they simply referred to the wording of the statute. If that argument is accepted in the case of the CFC rules, the interpretation may be abused by the legislature for the netting of foreign source income by means of provisions that clearly do not have an anti-avoidance purpose. I therefore support the statement that:

> ...the relationship between controlled foreign entity...legislation [and double tax agreements] cannot be resolved by reference to the manner or form in which the domestic legislation operates. If the states party to a convention have agreed that certain income shall be taxable only in one contracting state, that precludes the taxation of the income in

[104] See note 7.
[105] Article 6(1).
[106] Mauritian treaty (note 8) art 6.

the other state (whether directly or indirectly through the attribution of the income to a resident entity).[107]

In my opinion, therefore, the amount included in Mr A's income by section 9D is the amount that Mauritius has the sole right to tax under the business profits article in the double tax agreement and the treaty will therefore be applicable to the net income of CFC as included in Mr A's assessable income.

The business profits article contained in the Mauritian treaty, allows no scope for the income from the sale of fans, or a part or portion thereof, not to be exempt from South African tax. As CFC is a Mauritian resident, only Mauritius has the right to tax its business profits, unless there is a permanent establishment in South Africa,[108] which there is not. Section 9D includes that income, which Mauritius has the sole right to tax in terms of the treaty, in Mr A's income and levies tax on that income. Regardless of how such income is attributed to Mr A, only Mauritius should be allowed to tax that income in terms of the binding DTA between South Africa and Mauritius. South Africa has given up its right to tax such income by entering into the DTA, and allocating the taxing rights to Mauritius. The corollary is also true; where such profits are earned by a Mauritian owned business which is resident in or has a permanent establishment in South Africa, and such income is effectively connected to the permanent establishment or resident company, South Africa will have the sole right to tax that income.

The taxation of income protected by the business profits article of DTAs does not unavoidably occur when s 9D is applied. This is because of the range of exclusions allowed when calculating the net income of a CFC that will be proportionately attributed to its participation rights holders. The principle exclusion is the income attributable to a foreign business establishment in subsec 9D(9)(b). This provision generally allows for business profits to be excluded from the amount imputed to a South African resident participation rights holder of a CFC. However, this provision does not exclude income which amounts to business profits in all cases. The application of the exemption is narrower than the application of business profits in terms of a treaty, as shown here. It is in the cases where there is a discrepancy between income attributable to a foreign business establishment and the business profits of a CFC where a conflict between section 9D and a DTA will occur.

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[107] Baker, Philip *Double taxation conventions* (2008) at F10-F11.
[108] Olivier (note 34) at 73.

If the South African government assesses tax on the income, as set out in the example, and enforces such assessment, they are disregarding art 7 of the binding double tax agreement with Mauritius which does not allow it to tax the business profits of a Mauritian resident, unless that resident has a permanent establishment in South Africa. The question is then, whether such taxation is legal in terms of South African domestic law. And what about the legality of such taxation on the international legal plane? The following section will examine these questions.

4. Treaty override

i. Definition

The model treaties that most double tax agreements between nations are based on, were designed so that the treaty should be durable and outlast domestic law reform, at least in the medium term.[109] This is indicated by Article 2(4) of the OECD MC which provides for the treaties to also apply to identical, or substantially similar, taxes imposed after the date of signature of the treaty by either country.[110] It is however important to keep in mind that two competing interests of the signatory counties stand opposed to one another when negotiating DTAs. The one is the desire to create an agreement that is durable and creates certainty regarding the countries' respective rights and obligations and the other is the need for the agreement to be practicable regarding domestic reform.[111]

When a party to a treaty amends its domestic rules subsequent to the conclusion of such a treaty, and the treaty is applied with reference to the rules as amended, an ambulatory interpretation is used. Any subsequent changes to domestic references are thus applicable to both parties, regardless of the unilateral nature of the amendment.[112] This was the accepted approach regarding the application of treaties until the early 1980s when the Canadian Court of Appeals, in the matter of *The Queen v Melford Developments Inc*[113], applied its law as it stood at the time of the conclusion of the treaty. This is referred to as the static approach to the application of treaties.[114] Both approaches have their shortcomings. The obvious problem with the ambulatory interpretation is that it allows the scope of a state's treaty obligations to be unilaterally altered. This was the reason why the Canadian court supported the static interpretation, with reference to domestic law, in the *Melford* matter.[115] On the other hand,

[109] Vogel (note 36) at 63.
[110] Ibid.
[111] Vogel (note 36) at 65.
[112] Vogel (note 36) at 64.
[113] *The Queen v Melford Developments Inc* [1982] 2 S.C.R. 504
[114] Vogel (note 36) at 64.
[115] *The Queen v Melford Developments Inc* (note 113) at 513.

certain terms of the model conventions are only meaningful if the static model is applied, such as article 2(4).[116]

The commentary to the OECD MC now calls explicitly for an ambulatory approach, as long as the context does not require a static interpretation.[117] The issue regarding static and ambulatory reference to domestic law was discussed in dept by the 'International Tax Group'.[118] Their conclusion is that the ambulatory reference is preferable, but with an 'implied limitation' that domestic amendments do not interfere with the balance of the taxing rights allocated by the convention or affect the substance of the convention.[119] If an ambulatory interpretation is applied in terms of South Africa's domestic tax laws, any change in such laws will be applicable to DTAs concluded before and after the amendment of the domestic laws, unless they interfere with the balance of taxing rights allocated by such treaties. The taxing of the business profits of a CFC, where the county it is resident in is allocated the sole right to tax such profits, will however interfere with the balance of taxing rights, as the CFC legislation allocates taxing right to South Africa, which it is not entitled to in terms of the treaty.

The ideal would be that a country which wishes to amend their domestic law in a manner that is contrary to its treaty obligations should approach the competent political authorities of the other countries that will be affected for renegotiation of such treaties. Should such negotiations fail, a country may generally terminate the treaty in terms of article 31 of the OECD MC.[120] In practice, however, it often happens that a party to a treaty, whether bilateral or multilateral, makes unilateral changes to its domestic law that contradict its treaty obligations, without notice or attempts at renegotiation. This is referred to as treaty override.[121]

Treaty override has been defined as the enactment of subsequent domestic legislation which conflicts with obligations undertaken in a prior and binding treaty.[122] It has also been defined as a situation where a contracting state intentionally applies domestic law or

[116] Vogel (note 36) at 64.
[117] Vogel (note 36) at 65.
[118] See John F. Avery Jones et al 'The Interpretation of tax treaties with particular reference to article 3(2) of the OECD Model' (1984) *British Tax Review* 14-54 and 90-108.
[119] Vogel (note 36) at 65.
[120] Vogel (note 36) at 67.
[121] Ibid.
[122] Baker (note 107) at F-3.

regulation to accomplish specifically what a treaty forbids.[123] The latter definition is preferable, as the unilateral changing of the agreed terms of the treaty may be accomplished in manners other than the enactment of contradicting legislation.[124] Regarding the qualifier 'intentionally' in the latter definition, some consider that treaty override may be intentional, where a legislature specifically enacts laws which are contrary to the country's treaty obligations or unintentional, where the legislation was enacted without that specific intention.[125] An example of unintentional override may be where the legislature aims to promote a legitimate objective and an incidental effect thereof is that the act impinges on the country's treaty obligations. In such a situation it may possible to reconcile the legislation with a treaty by examining the purpose of both the act and the treaty. However; where the override is intentional, a clear conflict exists and the issue becomes one of deciding whether the treaty or the domestic law prevails.[126]

The legal consequence of treaty override, it being, by definition, an infringement of an international obligation, is that it gives the aggrieved treaty partner the right to invoke sanctions against the offending state.[127] In the context of double tax agreements this can lead to a complaint under the mutual agreement procedure of the treaty, or to a reference of the matter to an international arbitral body, should the parties fall under such a body's jurisdiction.[128] Article 60 of the VCLT provides that the party may suspend the operation of the treaty or, more drastically, terminate the treaty where the treaty is breached by the other contracting party.[129] It is considered that corresponding retaliatory measures are also an acceptable response to the disregard of treaty obligations.[130] The domestic application of laws that are considered a breach of international law will depend on the country's internal

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[123] R Doernberg, 'Overriding tax treaties: the US perspective' (1995) 9 *Emory International Law Review* 71 at 74 quoted in Baker (note 107) at F-3.

[124] Where a new law continues to correspond to the wording of the treaty, but due to the change of purpose thereof, it will be applied differently than the previous act would, if treaty override may occur. A judicial precedent may alter a contracting party's domestic interpretation of a term contained in the treaty, and that may also constitute treaty. For example, if a court widens the definition of residence, it may erode tax concessions it made to another state when it entered into a DTA with such state.

[125] Baker (note 107) at F-3.

[126] Ibid.

[127] Vogel (note 36) at 70.

[128] Baker (note 107) at F-11.

[129] Vogel (note 3) at 70.

[130] Ibid.

constitutional law, as the violation of a country's treaty obligations on an international plane does not automatically lead to invalidity of the treaty violating domestic law.[131]

The practical consequences of treaty override are not limited to the reactive consequences of actual treaty override, but it reflects badly on the credibility of a state for future conclusions of treaties. This sentiment is expressed in a memorandum signed by the ambassadors of European Union countries addressed to the US:

> The violation of a double tax treaty by unilateral action of one contracting party undermines the basis of trust that exists between the two countries involved, erodes the certainty and security intended by international agreements and ultimately poses the question as to whether an international convention for the avoidance of double taxation serves any purpose at all if it can be altered at will by one of the contracting parties.[132]

Because the practice of treaty override may be a threat to the efficacy and certainty provided by double tax agreements, the OECD issued a report regarding treaty override in which urged its member countries to desist from such practices.[133] Contained in that report is a recommendation by the business and industry advisory committee of the OECD that the following clause be included in future revisions of the OECD model convention: 'This convention shall not be overruled by any legislation subsequently enacted by a contracting state, unless a contracting state has notified the other contracting state of such change and the other contracting state has agreed to appropriate treaty modifications.'[134] This suggestion has not been included in any subsequent model treaty,[135] but the OECD council adopted a recommendation for member countries 'to avoid enacting legislation which is intended to have effect in clear contradiction to international treaty obligations'.[136]

ii. How other jurisdictions approach treaty override

The principle of *pacta sunt servanda,* which means that a treaty in force is binding upon the parties to it and must be performed in good faith,[137] is a recognised custom of international law for a great number of nations, and it may be reasonably inferred that those

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[131] Ibid.
[132] Quoted in R. Doernberg, 'Legislative Override of Income tax treaties'(1989) 42 *Tax Lawyer* 173 at 208.
[133] OECD Tax treaty override (note 43) at annex A .
[134] Ibid at para 34.
[135]Baker (note 107) at F-12.
[136] On 2 October 1989, OECD Tax treaty override (note 43) in Annex A at para I(2).
[137] VCLT (note 76) art 26.

nations will not give effect to domestic laws that override their treaty obligations. There are however exceptions, such as the United States, which in the past have quite candidly admitted to their intention to override their existing double tax agreements.[138]

Some jurisdictions afford special status to treaties in general, such as France, and the Netherlands, or in the context of double tax agreements in particular, the German General Tax Code which provides that the provisions of double tax agreements, properly incorporated in the domestic law, will takes precedence over national laws.[139] Any conflict existing between amended domestic law and the provisions of a treaty will be resolved by applying the maxim *lex posterior generalis non degorat legi priori speciali* (a subsequent general law does not override a prior special law) and disregarding treaty-violating legislation on a domestic level.[140]

Patently treaty override is not an issue in the above situations, as the treaty will prevail over domestic amendments, but some countries lack clarity regarding the status of treaties in comparison to domestic laws. This problem may arise in common law countries, where treaties have no higher status than any other law.[141] In those countries the conflict may be resolved by applying the maxim *"lex posterior degorat legi priori"* (A subsequent law overrides a prior law).[142] This application will lead to a breach of international law, but the treaty overriding provision will be domestically binding.[143] This is the position in the USA where international law is 'the supreme law of the land' in terms of its constitution, which has equal status to federal laws, and a later federal law can override a treaty and have binding domestic effect.[144] In Australia, however, the provisions of double tax agreements are to operate notwithstanding any domestic legislation to the contrary[145] and in Canada the specific

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[138] The foreign investments in Real Property Act of 1980 provided explicitly that some of its provisions, to the extent that they contradicted existing treaties, would be suspended for 5 year after their passage, but thereafter would become effective without regard to contradicting treaties. In a 1990 hearing of the Senate Foreign Relations Committee, US senator Sarbanes ventured the opinion that treaty override by the USA was not really a treaty violation, as 'the parties entering into these treaties know, and full well, that Congress has been prepared to override these tax treaties, and therefore they go into them with that knowledge'.
[139] Baker (note 107) at F-4.
[140] Ibid.
[141] Baker (note 107) at F-3.
[142] Baker (note 107) at F-3.
[143] Vogel (note 36) at 70.
[144] Baker (note 107) at F-5.
[145] International Tax Agreements Act 1953, s 4(2).

act that introduces each treaty to domestic law provides that the treaty will prevail over domestic law.[146]

In Belgium, as in South Africa, neither the constitution nor any domestic act regulates the situation where a domestic law overrides a treaty provision. In Belgium, however, there is certainty regarding the position found in case law. A treaty provision in Belgium, properly approved by the Belgian parliament, will prevail over both subsequent laws that conflict with a treaty, as well as the law as it stood at the time of the approval of the treaty.[147]

iii. Treaty override in South Africa and section 9D

The question of whether a treaty provision will prevail over a conflicting domestic provision has not been decided in a South African court yet. It must be kept in mind that DTAs have a dual nature, both as an international agreement and as part of domestic tax law, and once a treaty is incorporated into domestic law, it remains an international agreement and is binding on all parts of the governments of the contracting states.[148] The fact that section 108(2) deems double tax agreement to be enacted in the ITA, does not denude the treaty of its role as an international agreement, rather it is the mechanism whereby it becomes part of domestic law.

As treaties do not have privileged status in South Africa, as they do in some other countries, national law may in principle be applied to override a treaty,[149] but it must be kept in mind that the Constitution provides that customary international law is the law of South Africa[150] and, if it can be shown that customary international law dictates that a treaty should override national law, a court should rule that a treaty provision will prevail over a conflicting domestic provision.

The nature of international law is consensual, which is why treaties and international custom are considered the two most important sources of international law.[151] In terms of international law, a treaty is not binding on a state when it is concluded under the threat of

[146] Baker (note 107) at F-4. It is proposed that Parliament is however still able to override a treaty if it provides for the override expressly.
[147] Baker (note 107) at F-4.
[148] Baker (note 107) at F-11.
[149] Wally Horak 'STC case- threat to the new dividend withholding tax?' (2008) October *The taxpayer* 189 at 189.
[150] Section 232.
[151] Dugard (note 49) at 27.

violence directed at a representative of that state[152] and an international custom is not binding on a state if it persistently objects to it.[153] In accordance with the consensual nature of international law, treaties are binding upon states based on the principle of *pacta sunt servanda* which 'constitutes the foundation stone of international law'.[154] Articles 26 and 27 of the VCLT contain rules on the performance of treaties. The principle of *pacta sunt servanda* is codified in article 26 which reads: 'Every treaty in force is binding upon the parties to it and must be performed by them in good faith.' Article 27, which in my view is an amplification of article 26, deals with internal law and observance of treaties which states: 'A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty...'. If a state considers itself bound by treaties which are in force, it follows logically that it will not invoke its domestic law to make a treaty provision inapplicable, as that would lead to the state dishonouring its treaty obligation.

As section 9D may tax income of a CFC, as shown in the above example, South Africa has agreed not to tax in terms of a binding double tax agreement, its enforcement in such situations by the government constitutes treaty override per definition. If article 27 of the VCLT is found to be part of customary international law in South Africa, the provisions of a treaty will prevail over conflicting domestic provisions. It has been submitted that, to give effect to section 233 of the Constitution, which requires South African courts to prefer any reasonable interpretation that is consistent with international law over any alternative interpretation that is inconsistent with international law, art 27 of the VCLT should be applied in situations where there is a conflict.[155]

The South African National Treasury has asserted that the application of s 9D in situations where there is a binding double tax agreement with the state that the CFC is resident in, does not amount to treaty override.[156] It defends its position by arguing that the income of the CFC is not taxed in the hands of the CFC in South Africa, but in the hands of its resident shareholders. This would amount to economical double taxation in the absence of a foreign tax credit, but not juridical double taxation.[157] What detracts from the argument that the application of section 9D does not lead not juridical double taxation and is not subject to

[152] Dugard (note 49) at 414.
[153] Dugard (note 49) at 32.
[154] Dugard(note 49) at 406.
[155] Horak (note 149) at 189.
[156] Section 9D explanation (note 21) at 2.
[157] Ibid

treaty provisions, is actually the fact that a foreign tax credit is creditable to taxpayers in terms of section 9D. If the distinction between the fact that the income is taxable in the hands of the resident shareholder instead of the foreign company is so fundamental, there would be no grounds to allow the resident shareholder a tax credit for foreign tax paid by the CFC. A further problem with the argument that the application of s 9D does not constitute treaty override because it only amounts to economic double taxation, is that the business profits article applies not only to juridical double taxation, but also economic double taxation.[158] The admission that the application of s 9D constitutes economic double taxation, therefore confirms that its enforcement, where income is protected by the business profits article in a double taxation agreement, is in conflict with such a treaty.

In France the question of whether an assessment under CFC rules constitutes treaty override in terms of art 7, regarding business profits, of the treaty between France and Switzerland , was answered in the affirmative.[159] The Administrative Court of Appeal in Paris ruled that article 209B of the French tax code, the CFC rules, was not compatible with the provisions of the France-Switzerland treaty.[160] The court decided that the taxpayer benefitted from the treaty since it was a French tax resident, and that article 7(1) of the treaty prevented the taxation in France of the income of its Swiss subsidiary, even though the tax was levied on the French parent company.[161] The French tax authorities, similar to the argument of the South African National Treasury as to why section 9D does not constitute treaty override, argued that the purpose of tax treaties was not to prevent economic double taxation. The court, however, rejected this argument.[162] The court further rejected the argument that the treaty had a general objective of tax avoidance, which overruled its other provisions.[163] The court found that the French CFC rules were in violation of the treaty, as under art 7(1) business profits were taxable in Switzerland only, unless a permanent establishment exists in France, and there was no such permanent establishment.[164] As the French constitution confers special status to treaties, and it was found that the French CFC

[158] Olivier (note 34) at 390.
[159] Olivier (note 34) at 392.
[160] *Re Schneider SA* (2001) 8 Droid Fiscal 164.
[161] Olivier (note 34) at 392.
[162] Olivier (note 34) at 393.
[163] Ibid.
[164] Ibid.

rules were in violation of the Swiss treaty, the treaty provision had to prevail over the CFC legislation.[165] The approach of the French court has found favour with some commentators.[166]

With regards to controlled foreign company legislation, such as section 9D, it is sometimes suggested that it is a special instance of treaty override and that the anti-avoidance element thereof places it in a special category, which should be allowed to prevail over treaty obligations.[167] This is the position in Australia where it is regulated by legislation.[168] In South Africa there is, however, no such regulation.

The current position, regarding the status of a domestic law that conflicts with a provision of a binding treaty provision, is therefore uncertain. As South African courts are bound to take international customary law into account when interpreting domestic legislation, and it finds that art 27 of the VCLT is law in South Africa, it will be required to decide that a treaty provision will prevail over a conflicting domestic provision. However, if the court finds that art 27 is not part of South African law, a treaty provision will not prevail in terms of that rule. As a treaty provision has the same status as a conflicting domestic law, i.e. no special status is conferred on treaties in terms of South African law and the conflict cannot be resolve by the normal rules of interpretation, the principle *lex posterior degorat legi priori* will have to be applied.[169] The result will be that, if the treaty was incorporated in domestic law after the CFC provisions, the treaty will prevail and, in the case of the Mauritian double tax agreement, the CFC rules will override the treaty, as they were enacted after the CFC rules were enacted.

[165] Ibid.
[166] See eg Baker (note 107) at F10.
[167] Baker (note 107) at F-9.
[168] Ibid.
[169] L Du Plessis *Reinterpretation of Statutes* (2002) at 73.

5. Conclusion

In terms of the above, it may therefore be asserted that the application of section 9D rules, where the business profits article of a double tax treaty applies, in certain circumstances constitutes treaty override. The incidence of treaty override will however only occur in the event that the business profits of a CFC are not excluded from the amount of its income attributed to a South African participation right holder by the foreign business establishment exemption of section 9D(9)(b). It is still to be determined whether treaty override is consistent with the South African Constitution, but, until the question is answered, it will be prudent for the government to insert a provision in treaties it enters into and those that are being renegotiated, allowing for the application of section 9D wherever it may conflict with the business profits article. The government is currently renegotiating several of its DTAs, including the example of the Mauritian treaty used above, so it may be the appropriate time for it to insert such a provision.

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