SHORTCOMINGS OF AND RECOMMENDATIONS TO IMPROVE DOUBLE TAXATION RELIEF MECHANISMS: A STUDY OF SOUTH AFRICAN RESIDENT COMPANIES ENGAGED IN THE EXPLORATION FOR AND PRODUCTION OF OIL AND GAS OUTSIDE OF SOUTH AFRICA.

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ABSTRACT

South African resident companies engaged in the exploration for and production of oil and gas outside of South Africa are subject to double taxation. This thesis evaluates whether South African resident companies engaged in the exploration for and production of oil and gas outside of South Africa receive full relief from double taxation in South Africa.

The thesis provides a qualitative examination of the fundamental legal designs used for the allocation of the right to mine oil and gas and the fiscal regimes applied to the taxation of oil and gas mining at the source. The thesis explores the basis for taxation of foreign oil and gas income in South Africa and the remedies for double taxation in terms of the domestic tax legislation. Assuming that a tax treaty exists between South Africa and the host government, qualification for double taxation relief and classification of income in terms of a double taxation agreement (DTA) are evaluated. It is anticipated that a South African resident Oil and Gas company will choose the most favourable method and form of double tax relief when filing its corporate tax return in South Africa based on the commercial impact thereof. To aid in this decision, the thesis contrasts the quantum of the double tax relief under the domestic tax legislation with that available under the DTA. Using an adaptation of the IMF's FARI methodology, a quantitative analysis of the economic impact for a South African resident Oil and Gas company mining in Egypt, Equatorial Guinea, Ghana and, Nigeria is examined.

The thesis concludes that there are circumstances where South African resident Oil and Gas companies are unable to achieve full double tax relief under the domestic tax legislation and make recommendations (where applicable) for amendments to the domestic tax legislation to achieve a form of full double tax relief as close as possible to the single tax principle.

Keywords:
Resident, Source, Jurisdiction to Tax, Conflicts in classification, double tax relief, interpretation, Oil and Gas taxation, section 6*quat,* Tax Treaties, Double Taxation Agreement (DTA).

DECLARATION

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ABBREVIATIONS AND GLOSSARY

(A)	Appellate Division
AETR	Average Effective Tax Rate
AEIT	Average Effective Income Tax Rate
AMT	Alternative Minimum Tax
AOA	Authorised OECD Approach for the attribution of business profits to a permanent establishment
ATAF	African Tax Administration Forum
2016 ATAF MTC	2016 ATAF Model Agreement for the Avoidance of Double Taxation and the prevention of fiscal evasion with respect to taxes on income
2019 ATAF MTC	2019 ATAF Model Agreement for the Avoidance of Double Taxation and the prevention of fiscal evasion with respect to taxes on income
bbl/d	Barrels per day
boe	Barrel of Oil Equivalent
bscf	Billion standard cubic feet
BE	Business Establishment
BEPS	Base Erosion and Profit Shifting
btu	British Thermal Units
BVI	British Virgin Islands
CFC	Controlled Foreign Corporation
CITA	Nigerian Companies Income Tax Act (Cap C21 of 2004)
CMC	Central Management and Control
Constitution	The Constitution of the Republic of South Africa, 1996
CSARS	Commissioner for the South African Revenue Service
CUP	Comparable uncontrolled price
DTA	Double Taxation Agreement
DWT	Dividends Withholding Tax
EGPC	Egyptian Petroleum Corporation
EI	Extractive industries
FARI	Financial Analysis of Resource Industries
GDP	Gross Domestic Product
GNPC	Ghana National Petroleum Company
GOG	Government of Ghana

GTLR	Gas to Liquids Refinery
IEA	International Energy Agency
IMF	International Monetary Fund
IOC	Independent Oil Company
IRA	Ghana's Internal Revenue Act (No.592 of 2000)
IRR	Internal Rate of Return
ITA	South African Income Tax Act (No.58 of 1962)
JOA	Joint Operating Agreement
JSE	Johannesburg Stock Exchange
km^2	Square Kilometre
MAP	Mutual Agreement Procedure
Minerals Act	Minerals Act (Act No.50 of 1991)
MLI	Multilateral Convention to Implement Tax Treaty related-Measures to Prevent Base Erosion and Profit Shifting
mmscf	Million Standard Cubic Feet
MPRDA	Mineral and Petroleum Resources Development Act (No.28 of 2002)
MPRRA	Mineral and Petroleum Resources Royalty Act (No. 28 of 2008)
MTC	Model Tax Convention
NCF	Net Cash Flow
NOC	National Oil Company
NNPC	Nigerian National Petroleum Company
NPV	Net Present Value
OECD	Organisation for Economic Co-operation and Development
2008 OECD MTC	2008 Model Tax Convention on Income and Capital of the Organization for Economic Co-operation and Development
2010 OECD MTC	2010 Model Tax Convention on Income and Capital of the Organization for Economic Co-operation and Development
2014 OECD MTC	2014 Model Tax Convention on Income and Capital of the Organization for Economic Co-operation and Development
2017 OECD MTC	2017 Model Tax Convention on Income and Capital of the Organization for Economic Co-operation and Development
PA	Petroleum Agreement
PE	Permanent Establishment
PetroSA	The Petroleum Oil and Gas Corporation of South Africa (SOC) Ltd
PITL	The Ghanaian Petroleum Income Tax Law (PNDC Law 188)
POEM	Place of Effective Management
PPTA	The Nigerian Petroleum Profits Tax Act (Cap P13 IFN 2004)

PRC	Peoples Republic of China
PSC	Production Sharing Contract
ROR	Rate of Return
SARS	South African Revenue Service
SCA	Supreme Court of Appeal
SIR	Secretary for Inland Revenue
SOC	State-Owned Company
STC	Secondary Tax on Companies
TAA	Tax Administration Act (No. 28 of 2011)
UK	United Kingdom
UN	United Nations
2011 UN MTC	2011 United Nations Model Double Tax Convention between Developed and Developing Countries
2017 UN MTC	2017 United Nations Model Double Tax Convention between Developed and Developing Countries
US or USA	United States of America
2006 US MTC	2006 United States Model Income Tax Convention
2016 US MTC	2016 United States Model Income Tax Convention
USD	United States Dollar
VCLT	Vienna Convention of the Law of Treaties
WACC	Weighted Average Cost of Capital
ZAR	South African Rand

PREFACE

The main purpose of this thesis is to determine whether double tax relief (DTR_a) under the domestic tax legislation in South Africa is greater or equal to the double tax relief (DTR_t) available under the South African double taxation agreements for resident Oil and Gas companies engaged in mining activities outside of the Republic. Double Tax (DT) arises when the same income is subject to taxation in both the country of source (T_a) and country of residence (T_b). The taxpayer has a choice of double tax relief (DTR_a) under the domestic tax legislation or the double tax relief (DTRt) available under the tax treaties. This thesis seeks to aid the taxpayer in its choice by conducting a qualitative and quantitative analysis of the double tax relief available.

A problem exists that there are differences between tax treaties and domestic rules to deal with cross-border transactions ($DTR_a \neq DTR_t$). The thesis attempts to solve these differences by making recommendations for change to the domestic tax legislation so that double tax relief under the domestic tax legislation may equate to the double tax relief available under the tax treaties ($DTR_a = DTR_t$).

To guide the reader, through the thesis (the chapter overview) is summarised in the following equation:

Solve for $DTR_a \geq DTR_t$ *Chapter 1*

Where DTR_a is double tax relief in South Africa under the domestic tax legislation

DTR_t is double tax relief available under the tax treaties

$DT = T_a + T_b$

Where T_a is the Tax on Income paid in the Source Country *Chapter 2*

T_b is the Tax on Income paid in South Africa *Chapter 3*

Due to systemic structural differences $T_a \neq T_b$

$DTR_t = T_b$ where $T_a > T_b$ and $DTR_t = T_a$ where $T_b > T_a$ *Chapter 4*

$DTR_a = T_b$ where $T_a > T_b$ and $DTR_a = T_a$ where $T_b > T_a$ *Chapter 5*

But $DTR_a \neq DTR_t$ *Chapter 6*

CHAPTER 1
INTRODUCTION

1.1 Background

Economic growth is defined as a long-term expansion of the productive potential of the economy (Soubbotina, 2004: Glossary). Sustained economic growth should lead to higher living standards and rising employment. Short-term growth is measured by the annual percentage (%) change in real Gross Domestic Product (GDP).

The causal relationship between economic growth and energy in a country represents a commonly studied topic in energy economics literature (Chontanawat et al., 2008:209). The economic studies show that there is interdependence between growth and energy use (Kraft & Kraft, 2003:401). On the finding that a country has unidirectional causality running from energy consumption to income, energy consumption represents a stimulus for economic growth (Guttormsen, 2004:24).

South Africa's GDP shrank an annualized 51% in Quarter 2 2020. The Quarter 2 2020 reduction in GDP is the steepest economic contraction since at least 1990, as the Covid-19 pandemic has extended South Africa's economic recession into a fourth quarter, the longest period of consecutive quarterly contractions since 1992 (Statistics South Africa, 2020:15). National Treasury (2020:6) forecasted that the South African economy was expected to contract by 7.2% in 2020. This is the largest contraction in nearly 90 years. In terms of the National Development Plan 2030, South Africa should target annual growth of 5.4% GDP from 2010 to 2030 (National Planning Commission, 2012:66).

The International Energy Agency (IEA) (2015:7) estimates that 86.7% of South Africa's energy demands are met by fossil fuels. Of the energy demand met by fossil fuels, 21.6% represents energy derived from oil and gas. Despite being rich in many hard minerals, South Africa has not experienced the same success in oil and gas reserves. Exploration over the past thirty years has revealed only small deposits of oil and gas (Explanatory Memorandum to the Revenue Laws Amendment Bill, 2006:15).

According to Tippee (2011:2), South Africa had proven oil reserves of 15 million barrels in January of 2011. These proven reserves are located offshore in the Bredasdorp basin (off the southern coast near Mossel Bay) and in the Orange basin (off the west coast of South Africa near the border with Namibia). In 2009, South Africa produced 28,000 barrels per day (bbl/d)

of oil, which represents only 5% of the total oil consumption in South Africa (Tippee, 2011:2).

South Africa's proven reserves are insufficient to sustain the growth targets of the country. Accordingly, it has become necessary for South African Oil and Gas companies to seek oil and gas reserves outside of the country's borders. In 2002, the Government of South Africa merged its Petroleum Exploration Company and the company that housed its Gas to Liquids Refinery (GTLR) to form a National Oil Company. The National Oil Company adopted the vision "to be the leading African energy company". Leveraged by a strong balance sheet, the National Oil Company embarked on a mandate to secure petroleum reserve additions through investments into oil and gas rights in Egypt, Equatorial Guinea, Gabon, Ghana, Namibia, Nigeria and, Sudan.

A concern for the National Oil Company and any other South African Oil and Gas company is the possibility of juridical double taxation, namely a company being taxed both in the country of source and the country of residence without tax relief (Olivier & Honiball, 2011:6).

Double tax relief is available in South Africa in the form of (i) a unilateral foreign tax rebate or deduction according to the domestic tax legislation or (ii) tax exemption, credit or, deduction in terms of a double taxation agreement (DTA) (SARS, 2015:4). A South African Oil and Gas company cannot claim tax relief under the domestic tax legislation in addition to relief under a DTA. The Oil and Gas company will need to choose which relief measure to invoke (Olivier & Honiball, 2011: 455).

According to Voget (2009:13), it is probable that companies will make their choice of double tax relief based on the commercial result of the double tax relief offered. To perform such an economic evaluation, an Oil and Gas company will first need to ascertain whether it qualifies for double tax relief and the scope of such relief (SARS, 2015:1-58). The scope of the double taxation relief available can be a weighty challenge due to differing fiscal regimes and taxation concepts (Brandsetter, 2010:3).

The international taxation of the exploration for and production of oil and gas is complex and dynamic. Whilst there are two fundamental legal designs for the allocation of the right to mine oil and gas, there are more fiscal regimes that tax Oil and Gas companies than there are countries because numerous vintages of contracts may be in force at any one time. Countries typically use more than one arrangement, and contract terms are often negotiated and

renegotiated as political and economic conditions change, or as better information becomes available (Kaiser & Pulsipher, 2004:1).

In addition to an understanding of the fiscal regime that taxes oil and gas mining at the source, companies will have to interpret taxation concepts in both the domestic tax legislation and DTAs. Assuming that a tax treaty is in place, the correct interpretation of the meaning of "resident", "tax" (Brandsetter, 2010), "right to tax", "year of assessment", "income" (Olivier & Honiball, 2011:45), "amount" (SARS, 2015:19) and "source" (SARS, 2015:10) as used in the domestic tax legislation and DTA becomes pivotal to being able to claim double taxation relief. Furthermore, problems with the classification of "income" may arise in the interpretation of the tax treaty, in which circumstance the general approach is to follow the source State classification. In the absence of a tax treaty, a company will need to satisfy the criteria for relief from double taxation and would be subject to the limitations of relief provided in the domestic tax legislation.

The concept of "taxable income" is a purely artificial and statutory definition and is by no means necessarily synonymous with "profits" or "gains". The "taxable income" of an Oil and Gas company can differ substantially from the net income calculated following generally accepted accounting practices. The amount determined as "taxable income" from the foreign mining operations will differ from the amount subject to taxation in the source country as determined according to the domestic tax legislation of that country.

This thesis evaluates whether South African resident companies engaged in the exploration for and production of oil and gas outside of South Africa receive full relief from double taxation in South Africa. The idea of "full relief" from double taxation is derived from the international single tax principle, namely that income will be subject to taxation only once (Gil Garcia, 2019:312). The "full relief" envisaged by this thesis is achieved either using the exemption or credit methods. The exemption method limits the taxation of income to only one country. Most of South Africa's DTAs provide only for the credit method. The credit method allows for the offset of taxes paid in the source country against the tax liability in the country of residence. This offset (known as a rebate) of foreign taxes paid is limited to the tax liability in South Africa, thus preventing base erosion. Accordingly, where full relief is achievable, the maximum amount of tax paid on foreign mining income is effectively the higher of tax in South Africa or tax in the source country (achieving "single tax" at the highest rate overall). However, this thesis will demonstrate that there are circumstances where South African resident companies are unable to achieve full relief from double taxation under the domestic

legislation and make recommendations for amendment to the domestic tax legislation to achieve full double tax relief.

Through the use of an adaptation of the IMF's FARI methodology, this thesis examines the economic impact of double tax relief in South Africa concerning income derived from the exploration for and production of oil and gas by a South African resident company in Egypt, Equatorial Guinea, Ghana and, Nigeria. The outcome of the economic modelling and qualitative examination of the domestic and DTA relief may guide Oil and Gas companies in their choice of which double taxation relief to apply for in the completion of their corporate tax return in South Africa.

1.2 Research hypothesis

The primary research hypothesis is whether or not the unilateral relief from double taxation under the South African domestic tax legislation and/or bilateral relief under DTAs serve to provide full relief from double taxation to a South African resident company engaged in the exploration for and production of oil and gas outside of South Africa.

This thesis does not promote or propose suggestions aimed at achieving no taxation in both the source and residence states (Gil Garcia, 2019:312). Appropriate relief from double taxation, following the international tax single tax principle, premises that the same income is subject to tax once. Application of the single tax principle ensures tax neutrality in the choice of operating jurisdiction thereby facilitating the South African headquartering of global investments, necessary to satisfy the country's energy demand for oil and gas reserves. The thesis furthermore does not open the discussion as to whether the allocation of taxing rights is appropriate under a tax treaty, it merely analyses whether full relief can be achieved based on the current allocation of taxing rights under a DTA.

1.3 Aim of the research

The aim of this thesis is:

1. To determine the availability and extent of double tax relief under the domestic tax legislation,
2. To ascertain what double tax relief the resident Oil and Gas company qualifies for and classification of its oil and gas income in terms of the tax treaties,
3. To identify the probable causes of a resident Oil and Gas company's inability to secure full double tax relief under the domestic tax legislation,

4. To contrast double tax relief under the domestic tax legislation with that available under a tax treaty and
5. To make recommendations for amendment to the South African domestic tax legislation to achieve full relief from double taxation.

1.4 Scope of the thesis

The thesis is confined in scope as follows:

1. The thesis will examine the corporate tax implications of the exploration for and production of oil and gas by resident Oil and Gas companies outside of South Africa's borders.
2. The thesis will address the fundamental legal designs used to tax the exploration for and production of oil and gas.
3. The thesis is based on the premise that such activities will be carried out by a legal entity such as a South African controlled foreign incorporated company or the branch of a South African company.
4. The thesis will consider the South African corporate taxation of such companies and branches. Other taxes, duties and levies such as employees' tax, VAT and sales taxes, customs and excise, signature and production bonuses and state royalties are not within the ambit of the thesis. The focus of the thesis is taxes on the income of South African resident Oil and Gas companies.
5. The quantitative evaluation of the economic impact of double tax relief in South Africa is limited to the corporate taxation of income from the exploration for and production of oil and gas in targeted jurisdictions of the National Oil Company namely Egypt, Equatorial Guinea, Ghana and Nigeria.
6. The thesis will examine the international tax principles of residence, source, POEM and DTAs including the definition of "permanent establishment" (PE) for attribution of business profits; but not any other international tax considerations concerning corporate taxation; such as thin capitalisation and CFCs and the term business establishment. Transfer pricing considerations are limited to an examination of the associated enterprises' article and mutual agreement procedure under the DTAs.
7. The thesis is confined to only those comprehensive DTAs in force, namely negotiated, ratified and signed by South Africa up to 8 January 2021; the ATAF MTC, OECD MTC, the UN MTC and the US MTC and their official commentary; and the domestic tax legislation as pertains to the taxation of oil and gas mining income derived from a source outside of South Africa and the double tax relief for

foreign taxes paid. No comparative analysis of the domestic tax relief available in other countries has been conducted.

8. The thesis will not deal with the taxation of Midstream and Downstream Oil and Gas activities (such as refining and marketing, distribution and sales of petroleum products).
9. Whilst the thesis is premised on the fact that fossil fuels are the primary source of energy in South Africa, the scope of the thesis is limited to the corporate taxation of foreign oil and gas income and does not extend to the taxation of other hydrocarbon fuel sources such as coal or bio-fuels.

1.5 Approach and research methodology

This thesis adopts both a scientific and a legal research paradigm. The specific typologies followed is that of “theoretical research” and “doctrinal research” under the legal research paradigm. The International Monetary Fund’s (IMF) Financial Analysis of Resource Industries (FARI) methodology is used under the scientific research paradigm.

Theoretical research will be used to foster a more complete understanding of the conceptual bases of legal rules and principles (McKerchar, 2008:19). Doctrinal research follows the process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary (McKerchar, 2008:18). The doctrinal research will be used to critically evaluate the legal rules and their interrelationship using both induction and deduction (McKerchar, 2008:19).

Proper evaluation of fiscal regimes for extractive industries (EI) requires economic and financial analysis at the project level, and FARI is an analytical tool that allows such fiscal regime design and evaluation. The FARI framework has been primarily used in the IMF’s Fiscal Affairs Department’s advisory work on fiscal regime design: it supports calibration of fiscal parameters, sensitivity analysis, and international comparisons (Luca & Mesa Puyo, 2016:3). An adaption of the FARI methodology will be used to demonstrate the economic impact of double tax relief in South Africa on a resident Oil and Gas company carrying on the exploration for and production of oil and gas outside of South Africa.

Appropriate double taxation relief ensures that income is subject to taxation once. The author will explore this hypothesis by a qualitative analysis of the available literature, legislation and model taxation conventions and by articulating the common interpretation, divergence in interpretation, practicalities and overrides concerning securing double tax relief from a South

African context. The author will also perform a quantitative analysis of double taxation relief in South Africa by examining the economic impact on a resident Oil and Gas company engaged in the exploration for and production of oil and gas outside of South Africa. The thesis will make recommendations for improvement where the domestic tax legislation fails to achieve full double taxation relief equivalent to that offered to Oil and Gas companies under the South African DTAs.

The research process begins with a literature review. By conducting a literature review, the author will analyse and interpret the commentary, case law, tracts of the legislation and conduct a comparative study of the South African DTAs in force namely negotiated, signed and ratified by South Africa and the two fundamental legal designs (namely concession and contract) used in the allocation of the right to mine oil and gas to provide a clear understanding of the double tax relief available to South African resident companies engaged in oil and gas mining activities outside of South Africa.

A literature review supplemented by the results of the economic evaluations is an appropriate cornerstone to the research design and research hypothesis of the thesis.

The literature review was conducted in two phases. In the initial phase, namely data collection, multiple databases and libraries were searched for data matching keywords. This phase was characterised by extensive reading to focus the direction of the research, the extent of commentary, academic debate and any dominating trends related to the proposed research topic. The first phase culminated in the articulation of the research hypothesis. In the second phase, all data collected was re-examined for its validity, reliability and relevance in responding to the formulated research hypothesis.

The test for the validity of data is that such source data depicts the historical aspects and current thinking around oil and gas taxation. In terms of reliability of data, the source data is categorised as primary, secondary and informative. Primary data sources are the tax legislation, judicial decisions, South Africa's DTAs and the ATAF, UN, US and OECD model tax conventions (MTCs). Secondary data sources are publications such as books, official commentaries, explanatory memoranda, the SARS interpretation and practice notes, SARS Binding Rulings, articles in specialist journals, research papers and research presented in the form of thesis or dissertation. Informative data is obtained from the internet, SARS notices, internal guidelines and standard operating procedures, newspapers, articles and commentary in the media. Preference in the utilisation of a data source is afforded per its categorisation. On a sliding scale of reliability, a primary data source is recognised as the

most reliable. With any quotes or references within a source data, the quote or reference will be verified to its origin. Informative data will be cross-referenced to ensure reliability. The test for relevance is the strength (namely frequency) of the match of the data to the keywords and the research hypothesis. Valid, reliable and relevant data was then documented on catalogue cards using the Harvard Reference Method.

The author made use of the IMF's FARI methodology to analyse the economic impact of double taxation relief in South Africa. Four countries, namely Egypt, Equatorial Guinea, Ghana and Nigeria were selected for the economic evaluation on the basis that 1) both the Concession Legal Design and Contract Legal Design are represented by the chosen countries, 2) the extent of double taxation relief under the domestic tax legislation (in terms of qualifying taxes, non-qualifying taxes and excess tax credits) is illustrated and 3) Egypt, Ghana and Nigeria have a DTA with South Africa to accommodate comparison with the double taxation relief under the domestic tax legislation.

A single set of inputs will be applied to the petroleum fiscal regimes of the selected countries. These inputs include macro-economic assumptions such as oil price and inflation rate, Weighted Average Cost of Capital (WACC) discount rate, hypothetical capital and operating expenditure, hypothetical P50 recoverable reserves estimation of an oil and gas field and hypothetical production profile. The hypothetical inputs will be based on a proposed South African field development with geology analogous to the petroleum provinces and hydrocarbon basins in the selected countries. The inputs are documented in an Assumptions Book (Annexure A) to allow reproduction of the economic results. To interrogate the veracity of the results multiple scenarios were examined, "oil" (this is the base case), "significant oil", "gas" and "oil and gas".

1.6 Outline of the research

The thesis is divided into seven chapters:

Chapter 1 – *Introduction* provides the background, research hypothesis, aim of the research and the scope of the research. This chapter also describes the approach, research methodology and the benefit of the thesis.

Chapter 2 – *Taxation at Source* considers the concept of "source" as the basis for the host Government's jurisdiction to tax oil and gas mining activities within its borders. Chapter 2 identifies that there are two fundamental legal designs for the allocation of the right to mine

oil and gas and multiple tax instruments used in the design of their tax regimes. Some countries have adopted hybrids of the fundamental legal designs. The economic impact of the tax instruments used at the source is evaluated using the FARI model for selected countries Equatorial Guinea, Egypt, Ghana and Nigeria.

Chapter 3 – *Taxation in South Africa* examines the concepts “resident” and “place of effective management” which serve as the basis for the taxation of foreign-source oil and gas income in South Africa. In chapter 3, the domestic taxation of oil and gas mining activities conducted outside South Africa is explained. The chapter confirms the presence of double taxation, namely that the same income of a resident Oil and Gas company will be subject to taxation both at source and in South Africa.

Chapter 4 - *Double taxation agreements* provides an analysis of the double tax relief available under the South African DTAs in the context of the exploration for and production of oil and gas. Chapter 4 examines the articles relevant to oil and gas enterprises contained in the ATAF MTC, OECD MTC, UN MTC and US MTC. The articles considered in detail are “permanent establishment” (PE), “business profits”, “associated enterprises” and “immovable property” articles. Chapter 4 will identify and describe the three (3) double taxation relief methods that are used in DTAs. The chapter assesses whether, if the source country has a DTA with South Africa, the DTA provides substantive to full relief from double tax in South Africa.

Chapter 5 – *Domestic tax relief* provides an analysis of the double tax relief available under the South African domestic tax legislation. The chapter also examines the forms of and limitations to relief and the detailed rules and requirements for relief under section 6*quat.* This chapter aims to demonstrate the ambit of domestic tax relief (including whether such relief is too restrictive). The economic impact of taxation in South Africa and domestic tax relief were evaluated using the FARI model for selected countries Equatorial Guinea, Egypt, Ghana and Nigeria.

Chapter 6 – *The cause of inadequate double tax relief* examines conflicts in interpretation, legislated limitations, conflicts of allocation and conflicts of classification. Chapter 6 will corroborate that problematic areas for double tax relief exist in the interpretation of the concept “year of assessment”, “tax” and “amount” concerning foreign income tax levied in terms of the concession agreements and production sharing contracts (PSCs) utilised in hydrocarbon-rich countries. Furthermore, chapter 6 explores the meaning of “tax on income” and “right of recovery”. Chapter 6 concludes on the appropriateness of the domestic tax

legislation providing relief from double tax in light of the peculiarities of the oil and gas legal designs.

Chapter 7 – *Conclusion and recommendations* aid the South African resident Oil and Gas company that claims tax relief in its choice of double taxation relief (domestic versus DTA, where an agreement is available). Chapter 7 contrasts the double tax relief under a South African DTA compared with that available under the South African domestic tax legislation. Chapter 7 will provide conclusions on both the quality of the double taxation relief under the domestic tax legislation and the quantification of double taxation relief under the domestic tax legislation.

1.7 Benefit of the research

This thesis is a systematic investigation of the double tax relief available to South African resident companies engaged in the exploration for and production of oil and gas outside of South Africa.

This research should benefit South African Oil and Gas companies (or South African controlled foreign companies (CFC)) in its critical examination of the two fundamental legal designs (namely Concession and Contract Legal Designs) in terms of which the right to extract Oil and Gas is allocated and the fiscal regimes applied to the taxation of Oil and Gas income in the host country. The research should also provide clarity as to, the South African domestic taxation of oil and gas income from mining activities carried on by resident Oil and Gas companies operating outside South Africa, and the available remedies for relief from double taxation. Finally, and critically, the research will contrast the forms of double tax relief under the South African domestic tax legislation with those under the South African DTAs in the context of oil and gas mining activities to overcome the practical difficulties in securing appropriate double taxation relief in the context of a multinational Oil and Gas company resident in South Africa. This research is aimed at influencing the taxpayer’s choice of which double tax relief to apply for in its South African corporate tax return.

This thesis should benefit both the National Treasury and the SARS by providing a South African interpretation of conflicting domestic and international tax concepts and terms, the legal context and status of tax treaties in South Africa and their treaty override, and an insight into the practical difficulties and inadequacies in the domestic tax legislation that have an economic impact on a South African Oil and Gas taxpayer’s success in securing double tax

relief. This research is aimed at making recommendations for change to the South African domestic tax legislation.

The author aims to create a reference work, both from a practical and academic perspective that will influence the fiscal design of double tax relief in the South African domestic tax legislation as it pertains to resident Oil and Gas companies operating outside of South Africa.

CHAPTER 2
OIL AND GAS LEGAL DESIGNS, SOURCE AND ECONOMIC IMPACTS

2.1 Introduction

Fiscal Jurisdiction, otherwise known as the jurisdiction to tax may be defined as the right and power of a country to impose taxes (Gadžo, 2018:198). Jurisdiction to tax emanates from either "source" (namely the power to tax objects or assets within its territory) or "residence" (namely the power to tax subjects within its territory). The principle of source-based taxation is that the country which provides the opportunity to generate income or profits should have the right to tax it (De Koker, 2005:1). Residence based taxation of income is premised on the principle that people and corporates should contribute towards the public services provided for them by the country where they live, on all their income wherever it comes from (De Koker, 2005:1).

There are two fundamental legal designs used in the allocation of the right to mine hydrocarbons in a host country, namely Concession and Contract Legal Designs. These legal designs inform the types of tax instruments that are likely to be used by the host county to tax income from oil and gas mining activities in their country.

In Chapter 2, the thesis will examine the concept of source, the two fundamental legal designs and the tax instruments used in four countries, namely Egypt, Equatorial Guinea, Ghana and Nigeria to tax oil and gas mining activities. At Africa Oil Week, from 4 to 8 November 2019 held in Cape Town, Nigeria, Egypt and Equatorial Guinea were identified as three of the top five of Africa's hottest regions for Oil and Gas investments. These countries were selected for an economic evaluation on the basis that 1) both the Concession Legal Design and Contract Legal Design are represented by the chosen countries, 2) the extent of double taxation relief under the domestic tax legislation (in terms of qualifying taxes, non-qualifying taxes and excess tax credits) is illustrated (at Chapter 5) and 3) Egypt, Ghana and Nigeria have a DTA with South Africa to accommodate comparison with the double taxation relief available under the domestic tax legislation (at Chapter 7).

2.2 Source

Establishing the source jurisdiction is important. By international custom, a country has the primary right to tax income that has its source in the country (Arnold & McIntyre, 1995:25).

Despite the priority given to source jurisdictions, the term "source" is not defined in the tax treaties. The meaning of "source" is derived from its meaning under the domestic laws of the Contracting States to the treaty.[1] The term "source" is not defined in the South African Income Tax Act (ITA) and it is left to the courts to decide the meaning of the source of income.

The sale of minerals taken from the ground gives rise to mining income.[2] But it may be argued that the productive operations of a mine are the main cause of income being earned. Accordingly, where the management and control of the business are exercised in a different country from that in which the mining activities are carried on, the latter will prevail as the critical location. The selling activities are in general relegated to a secondary plan and are disregarded as being incidental to the mining activities (Passos, 1986:6). In *ITC 985* [1963] the court held the source of mining income to be where the corporation's capital is employed namely where machinery, labour and supervision are employed in the extraction of minerals[3] and not the place where the contract for the sale of minerals is made.

Article 6 of the 2017 OECD MTC and 2017 UN MTC provides that the source of mining income is where the mine (namely immovable property) is situated[4]. Income derived from the direct use of immovable property in terms of the MTCs and DTAs (based upon the OECD MTC) is taxable in the State in which the immovable property is situated (namely the source State is given a primary right to tax).

Geology predicates the boundaries of an Oil and Gas reservoir and not the political borders of a country. In the circumstance that an Oil and Gas field straddles the border of two neighbouring States, the question arises as to which source State is given the right to tax the mining income? Is it the country in which the producing wellhead(s) is located (or if there are well head's in both countries is the source location determined (in the case of offshore mining) by the floating storage and production platform (FPSO))? The answer is that both countries have the right to tax that portion of the oil and gas production as located within their borders. In practise the delineation of the oil and gas production is agreed upon between the Oil and Gas right holders (in both countries) and takes the legal form of a Unitization Agreement. A percentage of the production from a field is allocated in terms of the

[1] Article 3(2) of the 2017 OECD MTC
[2] *Western Platinum Ltd v C: SARS* [2004] 4 All SA 611 (SCA), 67 SATC 1
[3] *ITC 985* [1963] (25 SATC 61)
[4] The term "immovable property" as defined in Article 6 of the 2017 OECD MTC, the SA /Egypt DTA, the SA /Ghana DTA and the SA /Nigeria DTA specifically includes rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources.

Unitization Agreement to Oil and Gas rights held in each source State. But this presupposes that there are Oil and Gas rights signed within each source State, the government(s) is represented as an Oil and Gas right holder and that there is no prevailing border dispute between the neighbouring States.

2.3 The fundamental legal designs for oil and gas

According to the Davis Tax Committee (2016:53), the international taxation of the exploration for, and production of oil and gas is complex and dynamic. Each year between 25-50 countries in the world offer license rounds; 20-30 countries introduce new model contracts or fiscal regimes; and nearly all countries revise their tax laws during their annual budgetary process (Kaiser & Pulsipher, 2004:1). There are more tax regimes applicable to the extraction of oil and gas in the world than there are countries because numerous vintages of contracts may be in force at any one time. Countries typically use more than one arrangement, and contract terms are often negotiated and renegotiated as political and economic conditions change, or as better information becomes available (Johnston, 1994:5).

The legal basis for hydrocarbon exploration, development and production is usually established in a country’s constitution. Normally, the hydrocarbon law, formulated at the parliamentary level, sets out the principles of law, while those provisions that do not affect principles of law, or that need periodic adjustments (such as technical requirements, administrative procedures, and administrative fees), are set in regulations. These are normally issued at the executive level or ministerial level and do not require the legislative branch’s approval. Governments grant exploration, development and production rights in particular areas or blocks using concessions or contracts, depending on their legal systems. Where no hydrocarbon law exists, comprehensive contractual agreements between host governments and investors are used. This approach may be preferred by those countries that face the uncertainty of entering the oil and gas sector for the first time or in cases where the importance of the petroleum activity may not justify the design of unique policy regimes (Tordo, 2007:7).

The different “combinations” of taxation and non-taxation instruments used to capture economic rent are controlled by the host country’s petroleum fiscal regime, which defines the tax structure (Johnston, 1994: 302) and influences the relationship between a host government and an Oil and Gas company. There are two generic legal designs for the allocation of the right to mine oil and gas, namely concessionary (royalty/tax) systems and contractual systems. The main distinction between the two relates to ownership (Johnston, 2003:10-11).

Under a concessionary (royalty/tax) system, ownership of the crude oil that is produced is assigned to the Oil and Gas company, which has to pay royalties and taxes on production. Under a contractual system, ownership of the oil produced is assigned to the host government (Johnston, 2003:11). A contractual system will either be a Production Sharing Contract (PSC) or a service contract (Mazeel, 2010:8-9). Under a PSC, an Oil and Gas company receives a share of production (compensation in oil) whereas, under a service agreement, the Oil and Gas company receives a share of the profits (compensation in cash).

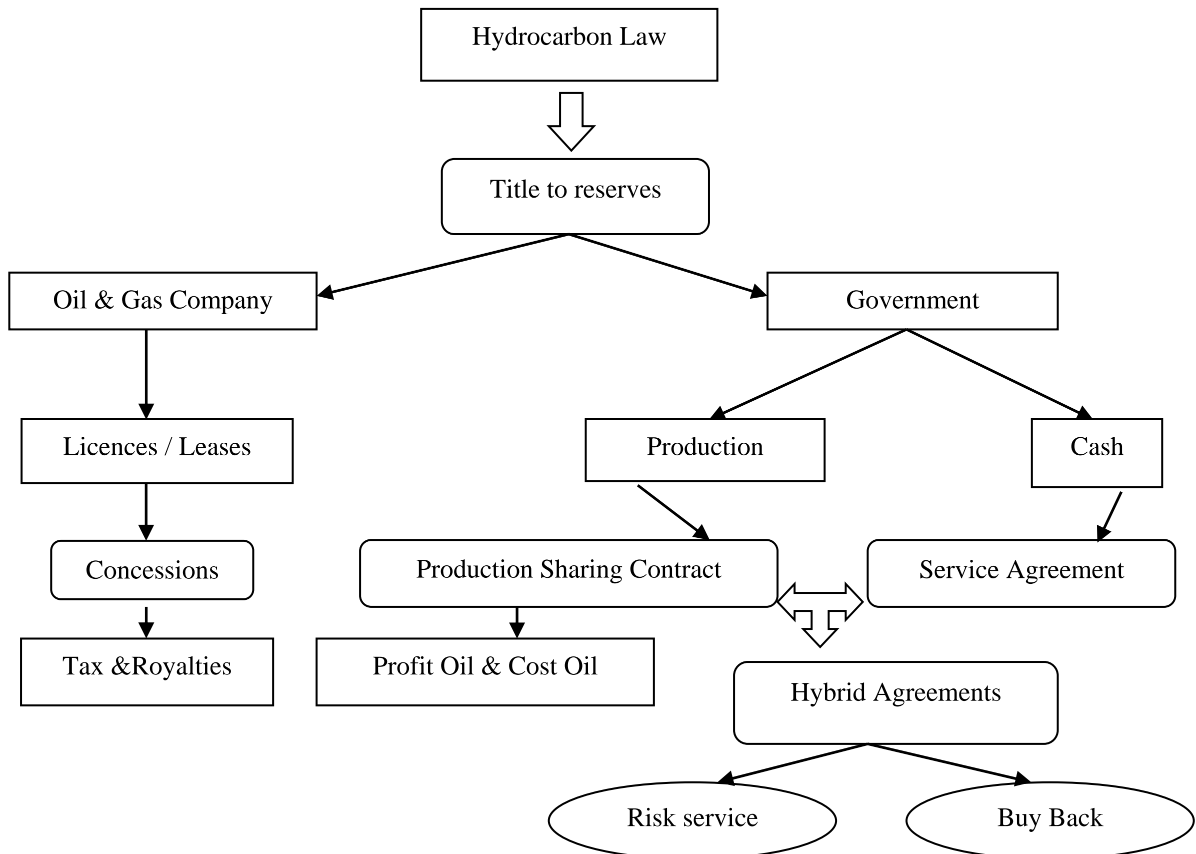


Figure 2.1 The fundamental legal designs for Oil and Gas (Davis Tax Committee, 2016:54)

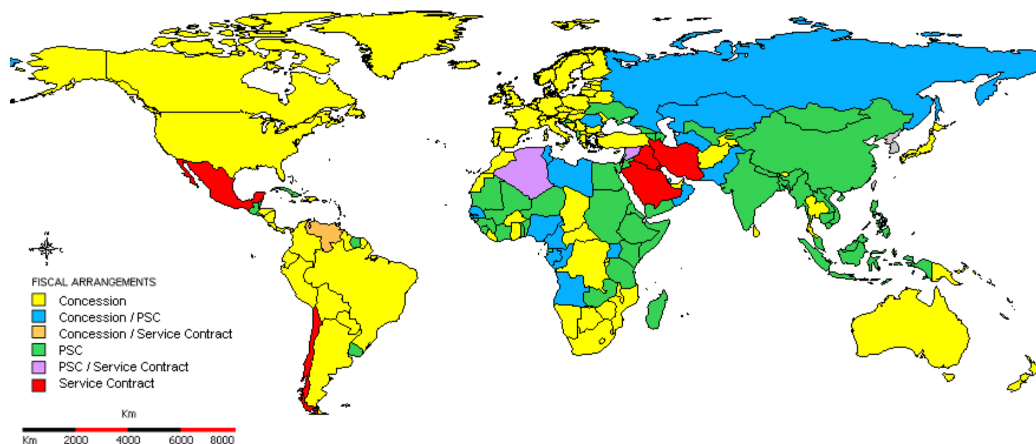


Figure 2.2 Distribution of the use of the fundamental legal designs for Oil and Gas (Adapted from Deutsche Bank, 2010:109)

2.4 Taxation instruments

Petroleum activities around the world are subject to a great variety of taxation instruments. These include taxes that apply to all other sectors of the economy as well as taxes that are specific to the oil industry. In addition, non-tax forms of rent collection (such as surface fees, bonuses, and production sharing) are common (Tordo, 2009:11).

2.4.1 Royalties

Royalties are an off-the-top take from each unit of production and are very widespread, being found in 71% of countries (Parish, 2011:2). Royalties are attractive to host governments, as the revenue is received as soon as production commences and they are easier to administer than many other fiscal instruments, at least for simple royalty regimes (Sunley & Baunsgaard, 2001:2). Furthermore, they ensure that oil and gas companies make a minimum payment for the minerals they extract. Royalties are typically either specific levies (based on the volume of oil and gas extracted) or *ad valorem* levies (based on the value of oil and gas extracted). Some countries have introduced a profit element in royalties by having them depend on the level of production (for example, Chile, Ecuador, Norway and Thailand) or a measure of nominal return such as the R factor (for example, Peru and Kazakhstan). The R factor equals cumulative revenues, net of royalties, divided by cumulative costs (Sunley et al, 2002:3).

More than half (58%) of PSCs include a royalty. The royalty under a PSC is taken directly from gross production, which has the effect of reducing the amount of oil production available for sharing between the host government and the contractor (international oil company (IOC)). A royalty under the concession legal design is a deductible expense in the determination of taxable income (Parish, 2011:2).

2.4.2 Corporate income tax

Corporate income tax is levied on Oil and Gas companies. It is not unusual for the income tax rate for Oil and Gas companies to be higher than the general rate for other companies. This is one way for host governments to capture a share of the resource rents from the project (Sunley et al, 2002:3). In 60% of countries, the income tax rate is higher for Oil and Gas companies than the general rate for other companies (for example Cameroon, India, Trinidad and Tobago, and Tunisia). In 33.3% of PSCs, the Oil and Gas company's income tax liability

is discharged by the host government from the NOCs share of production (for example Egypt) (Parish, 2011:3).

Many countries provide an incentive for exploration and project development by allowing exploration costs to be recovered immediately and allowing accelerated recovery of development costs, for example, over five years. Accelerated cost recovery brings forward payback for the investor and, possibly, the retirement of debt. It can therefore reduce both the Oil and Gas company's risk and the tax-deductible interest costs; it also facilitates project financing. Some countries offer special incentives to encourage exploration in particular regions (Sunley et al, 2002:3).

To protect the tax base, countries may place limits on the use of debt financing to limit "earning stripping" through the payment of interest abroad. For instance, in Norway, liberal rules (the current limit on external financing is 80%) for the deduction of financial costs from corporate income tax has been identified as one of the basic problems of Norwegian petroleum taxation (Noreng, 2002:1). To limit abusive transfer pricing between related companies, the tax authority has the power to adjust income and expenses where under- or overpricing between related companies has resulted in a lowering of taxable profit (Sunley et al, 2002:3)

2.4.3 Additional profits taxes

Additional profits taxes or windfall profits taxes are used in several countries to specifically target companies engaged in the exploration for and production of oil and gas. In most cases, this measure is enacted when profits, measured by the rate of return, exceed predetermined levels (for example, Kazakhstan), while in some, the simple breaching of an oil price threshold is sufficient to trigger liability for the windfall tax, such as in Algeria (1st-6th licensing rounds), Angola (onshore), China and Pakistan.

2.5 Non-tax forms of rent collection

2.5.1 Surface fees

Surface fees are usually based on land area and are calculated by multiplying a standard rate for that type of activity by km^2 of the land area being used for that activity.

2.5.2 Bonuses

Bonuses are commonly paid by an investing Oil and Gas company to the host government upon signature of an exploration and production agreement (Johnston, 1994:52). Such signature bonuses are attractive to host governments because they provide an early source of revenue whether or not hydrocarbons are discovered (Tordo, 2009:18). In some cases, bonuses may be paid upon discovery, declaration of commerciality, commissioning of facilities, start of production, and/or reaching target production levels (daily or cumulative) (Tordo, 2007:42).

2.6 Introduction to FARI economic modelling

The International Monetary Fund (IMF) Fiscal Affairs Department's (FAD) Financial Analysis of Resource Industries (FARI) model has become the gold standard for project lifecycle modelling; it supports the design of fiscal terms and negotiation of resource contracts. The model is used extensively across the 29 countries designated resource-rich by the IMF, as part of FAD's technical assistance to governments (Natural Resources Governance Institute, Nov 2014). The FARI model was used to evaluate the economic impact of fiscal regimes at the project level.

To illustrate the difference in the financial outcome of the concession and contract legal frameworks and the combination of instruments used to tax Oil and Gas mining at source, four countries were selected for an evaluation, namely Egypt, Equatorial Guinea, Ghana and Nigeria.

1) Egypt is Africa's largest non-OPEC oil producer. Since discovering the colossal Zohr Field in the Mediterranean, Egypt's gas-led transformation has been one of Africa's biggest success stories. Egypt now produces 1.7billion cubic metres of gas per annum. Egypt is the third largest of the Middle East and North Africa (MENA) region's biggest producers. In Egypt, the right to mine oil and gas reserves is awarded to contractors under a PSC for Petroleum Exploration and Exploitation entered into between the Arab Republic of Egypt (the Egyptian Government), the Egyptian General Petroleum Corporation (EGPC) and the Contractor.
2) Equatorial Guinea is Africa's smallest member of the Organization of Petroleum Exporting Countries (OPEC). Oil production in January 2020 in Equatorial Guinea was 166,000 barrels per day (bbl/d) (EIU, 5 May 2020). In Equatorial Guinea, it is mandatory to use the PSC model. The PSC is entered into between the Republic of Equatorial Guinea (represented by GE Petrol and SONAGAS, the national oil

companies (NOCs)) for Equatorial Guinea and the contractor. The fiscal regime that applies to the oil and gas industry is provided by the Equatorial Guinea Tax Code (No 4/2004) (The Tax Code) dated 28 October 2004, the Hydrocarbon Law (No. 8/2006) dated 3 November 2006, and production sharing or other similar contracts concluded between the Equatorial Guinea (EG) Government.

3) Oil production in Ghana was 214,000bbl/d in April 2019 (Africa Report, 8 October 2019) and it was anticipated that production would increase to about 420,000 bbl/d by 2023. The right to explore for and exploit Oil and Gas in Ghana is awarded through a Petroleum Agreement (PA) entered into between the Republic of Ghana, Ghana National Petroleum Corporation (GNPC) and the contractors (IOCs).
4) Nigeria's proven oil reserves are estimated by the United States Energy Information Administration (EIA: 2001) at between 22 and 35.3 billion barrels. With a maximum crude oil production capacity of 2.5 million bbl/d, Nigeria is Africa's largest producer of oil, and the 13th largest oil-producing country in the world (OPEC, 2017:1). Nigeria operates both a concession and a contractual regime. Under the concession regime, there are two arrangements. These are the joint ventures between the Federal Government of Nigeria and either an international oil company (IOC) or a sole risk operator (SRO). The contractual regime arrangements involve risk service contracts (RSCs) and production sharing contracts (PSCs). Of the four types of arrangement, those involving RSC operators are not deemed to be carrying on petroleum operations but are placed under performance schemes with the Federal Government and are paid as service providers; they are taxed under the Companies Income Tax Act at a far lower rate and not under the Petroleum Profits Tax Act. The Federal Government of Nigeria, under all the arrangements, operates through the Nigerian National Petroleum Corporation (NNPC).

A single set of inputs were applied to the petroleum fiscal regimes of the selected countries. These inputs include macro-economic assumptions such as oil price and inflation rate, and microeconomic assumptions such as Weighted Average Cost of Capital (WACC) discount rate, hypothetical capital and operating expenditure, hypothetical P50 recoverable reserves estimation of an oil and gas field and hypothetical production profile. The hypothetical inputs were based on a proposed South African field development with geology analogous to the petroleum provinces and hydrocarbon basins in the selected countries. The inputs are documented in an Assumptions Book (Annexure A) to allow reproduction of the economic results. To interrogate the veracity of the results multiple scenarios were examined, “oil” (this is the base case), “significant oil”, “gas” and “oil and gas”.

2.7 Tax instruments used in FARI modelling

The tax instruments for the selected countries used in the FARI modelling are tabulated below:

	Egypt	Equatorial Guinea	Ghana	Nigeria
Production Sharing Contract	Egypt makes use of a PSC in terms of which, the oil produced is divided between the recovery of production costs (35% maximum), and the remainder is labelled as profit oil. The government's share of the profit oil increases per the cumulative barrels of oil produced from the concession area. From Q1 2019 the Egyptian government began to roll out friendly terms for the PSCs such as raising the cost-recovery ceiling on contracts to 40% up from 35%. The purpose of these friendly terms is to encourage IOCs to invest in Egypt in the prevailing low oil price environment.	The government of Equatorial Guinea is entitled to a percentage of all hydrocarbons won and saved from the contract area, as agreed on in each particular PSC. The recovery of costs for purposes of determining Cost Oil is limited to a maximum of 70%. The government's share of Profit Oil from production is determined by the contractor's pre-tax rate of return (ROR). The allocation of the government's share of production varies with the vintage of PSC. In the PSC entered into between the Republic of Equatorial Guinea and Triton Equatorial Guinea, Inc. correlating with increases in ROR above 18% the government's share of profit oil increases from 10% up to a maximum of 35%.		
Corporate Income Taxes	In terms of the Egyptian Income Tax Law (No. 91 of 2005), The profits realised by the contractor from its exploration and exploitation activities under the PSC are subject to a	The Tax Code determines that the Oil and Gas companies are subject to corporate income tax at a rate of 35%.	Article 12 of the PA provides that Oil and Gas companies are subject to corporate income tax at a rate of 35%. Additional Oil Entitlement (AOE) is levied under the	The Petroleum Profit Tax Act ((Cap P13) LFN 2004, as amended) (PPTA) is the tax law that governs the taxation of Oil and Gas companies in Nigeria. PPT payments are made

	40.55% tax rate. The EGPC pays income tax on behalf of the contractor out of EGPC's share of the profit oil.		Petroleum Law and Petroleum Income Tax Law (PNDC, L188 of 1987) (PITL), at Article 10 of the PA. AOE can be taken in the form of production or received by the government as cash instead of production. The rate of AOE is determined following a sliding scale based on the contractor's -tax inflation-adjusted rate of return (ROR). The trigger for AOE in the West Cape Three Points Block Petroleum Agreement is 17.5% but this can vary by the specific terms negotiated in the PA.	either in cash or in-kind depending on the operating contract of the company. Variable tax rates are applicable for the different terrains as; (i) Onshore/Shallow offshore: First five years (producing companies) 85%, First five years (newcomers) 65.75%, Subsequent years (all companies) 85% (ii) Deep offshore (PSC):50%. A tertiary education tax is assessed alongside the PPT or income tax liability of an Oil and Gas Company. The tertiary education tax is levied at 2% of the assessable profits of a company. For a company subject to tax under the PPTA, the tertiary education tax paid is an allowable deduction under Section 10 of the PPTA in arriving at the adjusted profits of the company for tax purposes.
Royalties	The Egyptian Government receives royalties from the contractor (in cash or kind) equivalent to 10% of gross Oil and Gas produced from the area covered by the PSC. This royalty is paid by EGPC and not the contractor. In addition, the contractor must pay specific bonuses to EGPC. These	In terms of Article 57, of the Hydrocarbons Law of the Republic of Equatorial Guinea, (No. 8/2006) of 3 November 2006, PSCs must provide for increasing levels of royalty based on daily production rates with a minimum royalty of 13%. The state can request the royalty through the Ministry of Mines, Industry and	According to the provisions of PITL, at Article 10 of the PA, there is a royalty of 7.5% allocated to the government of Ghana from oil production and a royalty of 5% is allocated from gas production.	On 4 November 2019, the Deep Offshore and Inland Basin Production Sharing Contract Amendment Act was promulgated. The Amendment Act introduces a combined production and price-based royalty system to replace the existing production-based royalty system, which varies according to areas of

	include signature bonuses, bonuses payable on the approval of each development lease and production bonuses. The amount of the bonuses can vary from one PSC to another and their payment is not included in the expenses recoverable by the contractor.	Energy (MMIE) (Article 59). It can be paid in cash or kind, fully or partially (generally fully paid in cash).		operations. The new royalty regime specifies a baseline royalty of 10% for crude oil and condensates produced in the deep offshore (greater than 200-meter water depth) and 7.5% for the Frontier and Inland Basin. In addition to the baseline royalty, a royalty based on the applicable price of crude oil, condensate and natural gas will apply, but only when the price exceeds $20 per barrel. The graduated royalty rates are shown below: (i) Up to $20bbl – 0% (ii) Above $20bbl to $60bbl – 2.5% (iii) Above $60bbl to $100bbl – 4% (iv) Above $100bbl to $150bbl – 8% (v) Above $150bbl - 10% The Royalty on gas is based on gas sales. The volume of gas produced and sold from the fields within the concession is in line with the following fiscal terms: (i) Onshore Areas - 7% (ii) Offshore Areas - 5%.
Alternative minimum tax		The Alternative Minimum Tax (AMT) is based on 1% of the Oil and Gas companies		

		previous year's turnover. The AMT operates when the operations of the company result in a taxable loss or when the minimum tax is more than 35% of the taxable profits.		

Table 2.1 Tax instruments used in FARI economic modelling

2.8 Summary of the economic modelling results

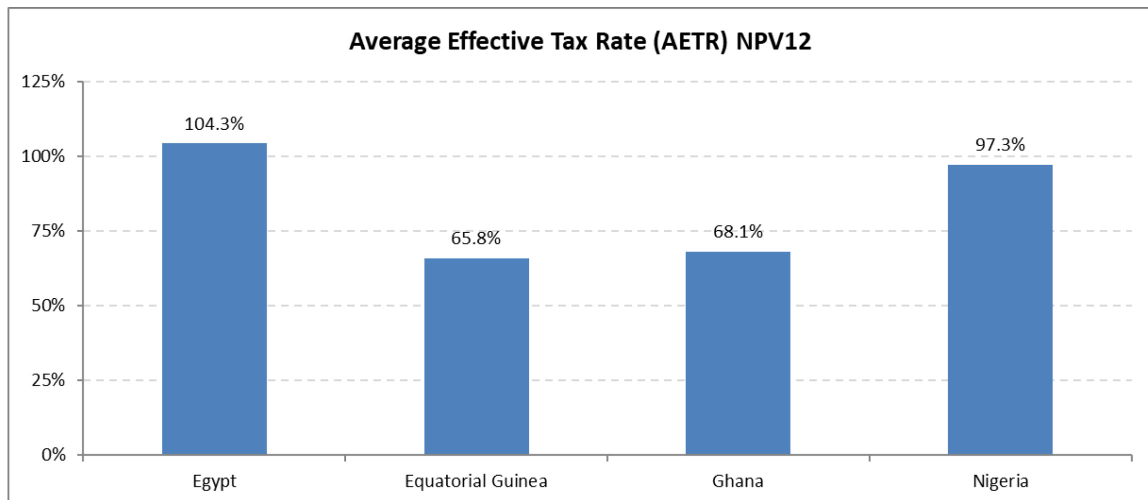
The Snapshot Results of the FARI Economic Modelling is documented in Annexure B. What follows is guidance in the interpretation of the Snapshot Results of taxation in the host country.

2.8.1 Average effective tax rate

Keen et al. (2014:20), define average effective tax rate (AETR) as "the ratio of the present value of government receipts over the lifetime of a project to the present value of pre-tax cash flows, both calculated at some common discount rate". In the case of the FARI economic modelling, the common discount rate used is a Weighted Average Cost of Capital (WACC) of 12%.

	Oil Base Case (AETR)	**Significant Oil (AETR)**	**Gas (AETR)**	**Oil & Gas (AETR)**
Egypt	104%	92%	103%	99%
Equatorial Guinea	66%	60%	96%	77%
Ghana	68%	48%	68%	60%
Nigeria	97%	91%	96%	96%

Table 2.2 Summary of results of FARI economic modelling in respect to taxation at source (AETR)



Graph 2.1 Summary of results of FARI economic modelling in respect to taxation at source (AETR) for Oil Base Case

The choice of fundamental legal design does not appear to influence the AETR of the selected countries in the case study. Both Egypt and Equatorial Guinea follow the contract legal design and their AETRs are comparable with those countries that follow the concession legal design, namely Nigeria and Ghana respectively. Whilst the sample of selected countries in the case study is small, the choice of legal design does not appear to be a differentiator in the economic modelling.

It is plausible that the AETR may be differentiated by a factor outside of the choice of legal design used to allocate the right to mine Oil and Gas at the source. Countries with less favourable geological conditions normally offer better fiscal terms, while those perceived to have more potential for significant commercial oil and gas discoveries offer tougher fiscal terms (Omar, 1998:2). Egypt and Nigeria are both in the top three of Africa's largest oil producers (with known attractive geological conditions) and correspondent thereto Egypt and Nigeria have the higher AETRs (104.3% and 97.3%, respectively) of the countries in the case study. Inversely, Ghana and Equatorial Guinea's AETRs are lower in comparison to their peers in the case study (65.8% and 68.1%, respectively) and correspondently their production rates are lower (and their geology relatively unknown in comparison to their peers in the case study).

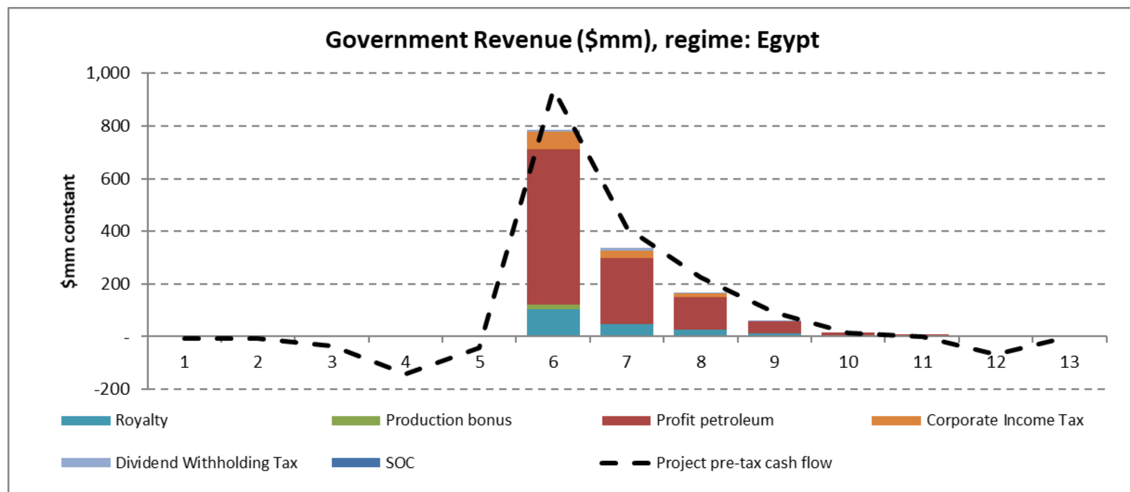
2.8.2 Average effective income tax rate

The AETR is the outcome of a basket of taxes applied in the source country. The Average Effective Income Tax Rate (AEIT) delimits the evaluation of tax exclusively to Corporate Income Tax. AEIT is defined for purposes of this thesis as "the ratio of the present value of

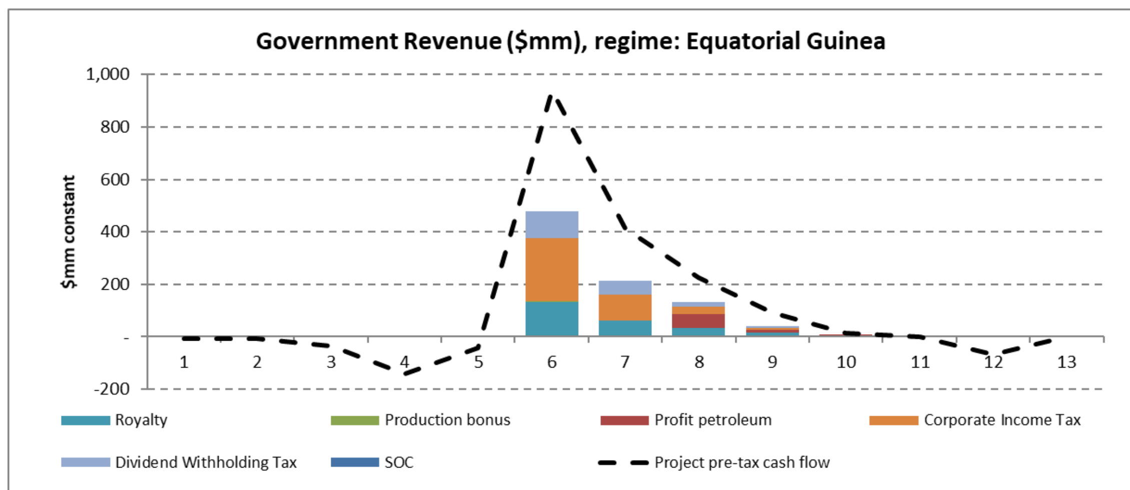
Corporate Income Taxes on income levied over the lifetime of a project to the present value of pre-tax cash flows, both calculated at the same common discount rate".

	Oil Base Case (AEIT)	Significant Oil (AEIT)	Gas (AEIT)	Oil & Gas (AEIT)
Egypt	14%	14%	7%	14%
Equatorial Guinea	49%	53%	14%	40%
Ghana	36%	51%	43%	50%
Nigeria	67%	83%	51%	62%

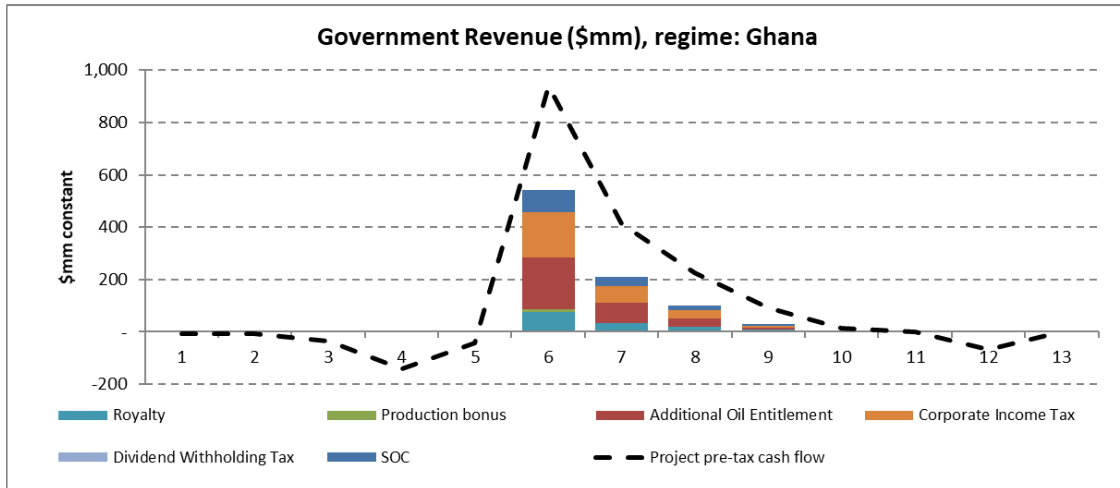
Table 2.3 Summary of results of FARI economic modelling in respect to taxation at source (AEIT)



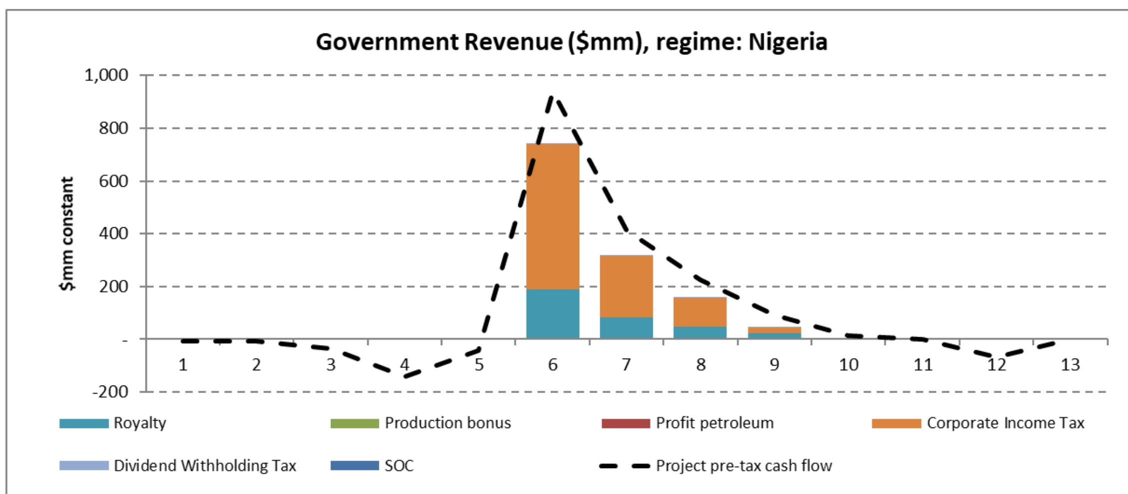
Graph 2.1 Summary of results of FARI economic modelling in respect to taxation at source (basket of taxes) for Egypt



Graph 2.2 Summary of results of FARI economic modelling in respect to taxation at source (basket of taxes) for Equatorial Guinea



Graph 2.3 Summary of results of FARI economic modelling in respect to taxation at source (basket of taxes) for Ghana



Graph 2.5 Summary of results of FARI economic modelling in respect to taxation at source (basket of taxes) for Nigeria

The AEIT will vary from the legislated official corporate tax rate in the sample countries as is levied upon taxable income (which is different from the project pre-tax cash flow). The taxable income is determined in the source country by taking into account, limitations on tax deductions, tax allowances, additional tax allowances, net losses that are not subject to taxation in the current tax year together with the carry-forward of any un-utilised net losses to subsequent tax years.

2.8.2 Net present value

The net present value (NPV) of a project may be defined as the difference between the present value of the cash-flows (inflows nett of outflows) at a required discount rate (for the project) and the initial capital invested by the Oil and Gas company. The NPV of a project is used by the Oil and Gas Company to decide whether or not it is commercially viable to

pursue the investment. If an investment does not yield a positive NPV it implies that the project fails to achieve its' "hurdle rate" or WACC. The Oil and Gas Company will not invest where NPV is negative. In the results presented below in Table 2.4, the Oil and Gas company would not invest in the "Oil Base Case" or the "Gas Case" in Egypt. An investment would be considered if the macro-economic outlook of the oil price (measured in $/bbl) or gas price (measured in $/mmbtu) were to improve to at least the required breakeven price for the project. In the Egypt case study, this would imply that the oil price improves from $56/bbl (as used in the economic modelling) to $68/bbl or the gas price improves from $4.44/mmbtu (as used in the economic modelling) to $5/mmbtu.

	Oil Base Case (NPV in $mil)	Significant Oil (NPV in $mil)	Gas (NPV in $mil)	Oil & Gas (NPV in $mil)
Egypt	-2 (breakeven $68/bbl)	335	-9 (breakeven $5/mmbtu)	33
Equatorial Guinea	266	1 593	42	247
Ghana	250	2 057	622	642
Nigeria	47	349	41	53

Table 2.4 Summary of results of FARI economic modelling in respect to taxation at source (NPV)

2.9 Conclusion

In this chapter, the thesis examines the concept of source. By international custom, a country has the primary right to tax income that has its source in the country (Arnold & McIntyre, 1995:25). The term "source" is not defined in the ITA and it is left to the courts to decide the meaning of the source of income. The source of mining income is determined to be the location of the mine, which may be contentious in the circumstance that the Oil and Gas field straddles the border of neighbouring States.

This chapter describes that there are two fundamental legal designs used by host countries for the allocation of the right to mine oil and gas, namely concession and contract legal designs. But there is a multitude of tax instruments that may be applied in the context of Oil and Gas companies. The tax instruments used in Egypt, Equatorial Guinea, Ghana and Nigeria were used as a case study to examine the economic impact of taxation at source. The results of the economic modelling in Chapter 2 serve as a baseline against which relief from double taxation will be measured in Chapter 5 and Chapter 7. In Chapter 3, the thesis will examine the South African taxation of income derived from foreign mining activities.

CHAPTER 3
TAXATION IN SOUTH AFRICA

3.1 Introduction

There are two fundamental domestic tax bases in terms of which countries tax income. These bases are known as the residence and source basis of taxation. Under the source basis of taxation, resident and non-residents are taxed on income derived from objects or activities in that jurisdiction. In contrast, the residence basis of taxation will subject persons, namely its residents, to tax on their worldwide income whilst non-residents are taxed on income sourced in that jurisdiction.

In *Kerguelen Sealing & Whaling Co. Ltd v CIR* [1939],[5] the (then) South African Appellate Division contrasted the basic rationale of a residence basis of taxation to that of a source-based system in the following terms (Katz et al., 1997:1.1.2):

> "In some countries, residence (or domicile) is made the test of liability for the reason, presumably, that a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him. In others (as in ours) the principle of liability adopted is "source of income"; again, presumably, the equity of the levy rests on the assumption that a country that produces wealth because of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live. In both systems, there is, of course, the assumption that the country adopting the one or the other has effective means to enforce the levy".

The source-based principle of taxation was originally adopted in South Africa in 1904 when it was promulgated in the Additional Taxation Act 36 of 1904 (Cape). All subsequent Union of South Africa legislation since the Income Tax Act 28 of 1914 retained the source principle (Danzinger, 1991:10). After South Africa was granted independence from Great Britain on 31 May 1961 it continued to maintain the source basis of taxation until the end of 2000. The source-based principle that was adopted by South Africa was a hybrid of the schedular tax system. Schedular tax systems subject different types of income for example dividends, royalties, business profits etc. to different types of tax treatment (Plasschaert, 1981:409). The connecting factor in the scheduler tax system is the source of the income - only domestic-source income is taxed. South Africa utilised a "source plus" form of the schedular tax system, namely in addition to the taxation of South African source income, South Africa

[5] [1939] AD 487, 10 SATC 363

deemed certain foreign source income to be from a South African source irrespective of its actual geographical location.

For years of assessment commencing on or after 1 January 2001, South Africa adopted the residence basis of taxation or a global tax system.[6] Global tax systems tax all income in the same way, with the connecting factor being the personal status of the taxpayer and, for corporate entities the taxpayer's place of incorporation or place of effective management and control (Plasschaert, 1981:409 & Passos, 1986:1). In South Africa, residents are taxed on their worldwide income.[7] Non-residents are taxed on their South African source income.

3.2 Resident

Internationally, different tests are applied to determine residency of a corporation in domestic law, for example, place of incorporation, registered office, place of residence of the shareholders, directors or managers or the place of management administration (Rohatgi, 2005:209-210).

A corporate person is "resident" for South African domestic tax purposes if it is incorporated, established or formed in the Republic of South Africa or its place of effective management (POEM) is situated in South Africa.[8] However, a person is deemed not to be a resident for tax purposes, if it is exclusively a resident of another country in terms of a bilateral tax treaty entered into between South Africa and that country.

Several of South Africa's tax treaties utilise the term "effective management" as a so-called "tie-breaker" where a person is deemed for purposes of a tax treaty to be resident in both Contracting States (Olivier & Honiball, 2011:32). Tax treaties modelled on the OECD (2014 and prior) and UN Model Taxation Conventions (2011 and prior) provide that a corporate entity is resident of the country in which its POEM is situated.[9] In converse, tax treaties

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[6] Revenue Laws Amendment Act, 2000 (Act No. 59 of 2000)

[7] Section 1 of ITA, definition of "gross income",

> '(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic […]'

[8] Section 1 of ITA, paragraph (b) of the definition of "resident",

> '(b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic,
> but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the Republic and that other country for the avoidance of double taxation.'

[9] Article 4(3) of the 2014 OECD and Article 4(2) 2012 UN Model Treaty Conventions,

modelled on the US Tax Treaty Convention (2006 and prior) provide that a corporate entity is a resident of the Contracting State in which it is created or organised, namely the country of its incorporation.[10]

The place of incorporation, establishment or formation is an objective question of fact. The test for POEM is subjective and will depend on the specific facts and circumstances of the corporation's operations. The POEM tie-breaker is limited in that it does not curb tax avoidance where corporates avail low tax jurisdictions as their POEM. POEM is not defined under the OECD MTC and accordingly, each contracting State determines POEM based on its domestic tax laws. This creates a lack of uniformity or clarity under the POEM tie-breaker test for determining the residency of a corporate person. Finally, the corporate person may have a third country as its POEM making it impossible to determine the entity's tax residence.

In 2014, the OECD Public Discussion Draft (2014:7) proposed that the POEM tie-breaker be abandoned in tax treaties and its place, OECD proposed that entities that are dual residents will be denied treaty benefits "except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States".[11]

The Model Tax Conventions released by the OECD (2017),[12] UN (2017), US (2016) and ATAF (2019) have since replaced the POEM criterion in favour of a case-by-case approach (or the Mutual Agreement Procedure (MAP) tie-breaker rule) as a result of the adoption of the report of Base Erosion and Profit Shifting (BEPS) Action 6 which was aimed at ensuring dual resident corporates due not obtain undue benefit from tax treaties.

The South African tax treaties with Belarus, Botswana, Bulgaria, Canada, China (PRC), Finland, India, Indonesia, Japan, Kuwait, Malaysia, Malta, Mauritius, Mexico, Norway, Poland, Singapore, Thailand, Turkey, Uganda and the United States of America already contain the 2017 OECD MTC type mutual agreement tie-breaker rules.

> '3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to a be resident only of the State in which its place of effective management is situated'

[10] Article 4(4) of the 2006 US Model Treaty Convention.

[11] Paragraph 38, the Public Discussion Draft OECD BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (14 March 2014)

[12] Article 4(3) of the 2017 OECD Model Treaty Convention reads as follows:

> '3. Where by reason of the provisions of paragraph 1 a person other than an individual is resident of both Contracting States, the competent authority of the Contracting States shall endeavor to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for purpose of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.'

On 7 June 2017, South Africa became a signatory to the Multilateral Instrument (MLI). The MLI implements tax treaty measures developed through the OECD BEPS project into existing South African tax treaties. One of the measures in the MLI (Article 4(1) of the MLI) provides that where a corporate person is a dual resident, the competent authorities of the tax treaty states shall endeavour to determine by mutual agreement the tax treaty residency of that person. In the absence of such agreement, such a dual resident person shall not be entitled to treaty benefits except to the extent and manner agreed by the competent authorities.

The MLI (at Article 4(2) of the MLI) has the effect of replacing the existing dual residency provisions (such as the POEM tie-breaker) in a tax treaty agreement (such as those of the selected countries, namely Egypt, Ghana and Nigeria) with a residency determination by the competent authorities following the MAP process. For South African tax treaties, that do not contain provisions for determining the residency of dual resident entities, the MAP process was added to those tax treaties.

South Africa has not exercised any of the reservation clauses (at Article 4(3) of the MLI) that allow it to opt-out of the MAP tie-breaker either in full or partially and has notified (together with its Contracting State counterparts) (at Article 4(4) of the MLI) that the MAP tie-breaker replaces the POEM tie-breaker in its tax treaties. On 25 July 2018, the South African Revenue Service (SARS) published its Guide on Mutual Agreement Procedures as general guidance on the MAP process, providing parameters in which competent authorities from the governments of contracting States can interact with the intent to resolve international tax disputes.

The MLI’s introduction of the MAP tie-breaker does not resolve the limitations of the POEM tie-breaker. In the absence of mandatory arbitration (South Africa opted out of Action 14) of unresolved issues arising in MAP, there is no obligation on the competent authorities to reach an agreement as they are only required to “endeavour to resolve” the dual residency cases that are presented to them.

3.3 Place of effective management

In determining (in South Africa) where a company is effectively managed one would consider the view of the South African *fiscus* and the views of the international community, the OECD, South African case law and international tax writers (Huxham & Haupt, 2016:31). The judgements from foreign courts will have persuasive value where there is no local precedence.

The term is used by various countries throughout the world, as well as by the OECD. This term however does not have a universal meaning (SARS, 2015:3). The various countries and the members of the OECD have attached different meanings to it, making its precise meaning unclear.

To understand the POEM test in a treaty context, one has to start with another test, namely the "central management and control" test (Olivier & Honiball, 2011:37). The latter test was first laid down in the United Kingdom in *De Beers Consolidated Mines Limited v Howe (Surveyor of Taxes)* [1906] AC 455. The facts of the *De Beers* case were briefly that a South African Company, De Beers Consolidated Mines, had its place of incorporation in South Africa with its head office in Kimberley. However, it also maintained an office in London. The activities of the company consisted of the mining and selling of diamonds in South Africa. The UK Revenue Authorities assessed De Beers Consolidated Mines on the basis that it was resident in England (Olivier & Honiball, 2011:39). The court held that "a company resides for income tax where its real business is carried on […] and the real business is carried on where the central management and control abides".[13]

In applying the *De Beers* rule in practice, the courts have looked to the place where the company's directors meet. The *De Beers* rule was applied by the South African Appellate Division in *Estate Kootcher v CIR* [1941] AD 256, where it was held, that a company which was incorporated in the United Kingdom and whose directors met in the United Kingdom, but which carried on business in South Africa through branches supervised by a South African general manager, was not ordinarily resident in South Africa. Delivering the judgment of the court, Watermeyer JA said[14], 'the residence of a corporation will be determined by the periodic, usual or habitual location of the directing mind'.

In *Boyd v CIR* [1951] 3 SA 525(A), the South African Appellate Division implicitly confirmed the application of the *De Beers* rule to the ITA. *Boyd's* case concerned the source of dividends paid by a company incorporated in South Africa and the directors of which met in South Africa. In the course of his judgment, Centlivres CJ said,[15] after referring to the *Estate Kootcher* case that "[t]he company is a legal *persona* resident in the Union, where its central management and control abides".

[13] At 458-459.
[14] At 260
[15] At 534

The *De Beers* rule, however, is formalistic and does not provide for the possibility that the management and control of a company might not be exercised by its directors, but by other persons, even though such exercise of control may conflict with the company's constitution. This may occur where a subsidiary is effectively controlled by the directors of its holding company.[16]

In *Wensleydale's Settlement Trustees v CIR* [1996] it was held that "effective" implies realistic positive management. The place of effective management is where the most vital management decisions are taken in the ordinary course of business (Olivier & Honiball (2011:29)).

In *Wood and Another v Holden* [2006],[17] the taxpayers entered into a complicated scheme to avoid paying capital gains tax in the United Kingdom. Chadwick LJ stated that:

> "in seeking to determine where the "central management and control" of a company incorporated outside the United Kingdom lies, it is essential to recognize the distinction between cases where management and control of the company are exercised through its constitutional organs (the Board of Directors or the General Meeting) and cases where the functions of those constitutional organs are "usurped" in the sense that management and control being exercised independently of or without regard to those constitutional organs. And, in cases that fall within the former class, it is essential to recognise the distinction between the role of an "outsider" in proposing, advising and influencing the decisions which are to be taken. In that context, an "outsider" is a person who is not himself, a participant in the formal process (a board meeting or a general meeting) through which the relevant constitutional organ fulfils its function".

The *Wood* case confirms that the taxpayer must pass a low threshold to show that the board of directors are doing more than rubber-stamping the decision of another person or persons and thus is not exercising the required central management and control. The *Wood* case provides an important indication that the amount of activity undertaken is not critical, provided the ultimate decisions on the key operations are genuinely taken in the jurisdiction (Carrell, 2005:11).

In *Indofood International Finance Ltd v JP Morgan Chase Bank* [2006][18] it was held that the place of effective management refers to the place where the key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. It

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[16] See *Bullock v Unit Construction Co Ltd* [1959] 38 TC 712.
[17] HMIT [2006] EWCA CIV 26
[18] UK Court of Appeal [2006] EWCA CIV 158

would not be sufficient if the directors who make the decisions regarding the keeping of books, management of the audit, handling charges and what to do with equity capital reside within a Contracting State (Olivier & Honiball, 2008:80). The 2008 OECD Model Commentary[19] explicitly agrees with the *Indofood* case.

In *Commissioner for Her Majesty's Revenue and Customs v Smallwood and Anor* [2020][20], the United Kingdom High Court held that the key features relating to the place of effective management of an entity are, *inter alia*, the following:

1. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made;
2. The place of effective management will ordinarily be the place where the most senior group of persons (e.g. a board of directors) makes its decision, where the actions to be taken by the entity as a whole are determined;
3. No definite rule can be given and all relevant facts and circumstances must be considered to determine the place of effective management of an entity; and
4. Although there may be more than one place of management, there may only be one place of effective management at any one time.

In *Laerstate BV v Commissioner for Her Majesty's Revenue and Customs* [2009][21], at issue was whether a capital gain realized by the Appellant, a Dutch holding company, from the disposal of shares in another company was subject to UK corporation tax. In determining that the Appellant was a UK resident under domestic law, the Tribunal stated that "there was no assumption that the CMC [central management and control] must be found where the directors meet' (SARS, 2011:9). Rather, 'it is entirely a question of fact" (SARS, 2011:9). The United Kingdom First-Tier Tax Tribunal concluded that the Appellant was a UK resident for UK tax purposes and purposes of the UK/Netherlands DTA, on the basis that the sole shareholder's activities in the UK were concerned with policy, strategic and management matters of the Appellant. These activities constituted 'the real top-level management (or realistic positive management) of the Appellant'.[22]

[19] Paragraph 24 in relation to Article 4
[20] [2010] *EWCA Civ 778*
[21] [2009] *UKFIT 209 (TC)*
[22] At paragraph 50

Vogel (1997:262)[23] shared a similar view to the *Laerstate* case, as he states that a controlling shareholder, for example, can be looked to if he can and does interfere with the usual conduct of the business, if he has arranged to be constantly informed of the various transactions, and if by his decisions he has a decisive influence on how current transactions are dealt with. Vogel does not consider that effective management is where the day-to-day decisions are made. His view is that effective management is located where the top management has the power and exercise the power to influence the usual conduct of the business. Top management would have to be constantly informed of the transactions of the business and their decisions would have a decisive influence on how transactions are arranged.

South African authors differ on the meaning of the term. Olivier & Honiball (2011:28) are of the view that the place of effective management is "the place where the higher level of the day-to-day running of the business takes place". The running of a business is not limited to the implementation of decisions and administration. It also necessarily includes a range of decision-making steps necessary for the functioning of the business. However, it does not necessarily include strategic decision making.

Similarly, Meyerowitz (2003:5.19) believes that:

> "Effectively managed" is a term used in double taxation agreements following the Organisation for Economic Co-operation and Development (OECD) Model. I consider that the place of effective management is normally the place wherein the case of a company the directors meet on the business of the company, which may differ from the place where the company carries on business or is managed by staff or directors individually and not as a board. Where the company has executive directors, the facts may reveal that the company is effectively managed where such directors, in contrast to the board of directors as a whole, conduct the company's affairs".

Van Blerck & Horak's view is (1997:38):

> "Place of effective management" should be contrasted with the concept "management and control". On the one hand, the "place of effective management" is the place where the day-to-day running of the business takes place, while on the other, the place from which a business is controlled is where its board of directors normally meets to transact its business operations. The two will not necessarily coincide. This view coincides largely with that of the UK and New Zealand tax authorities… but does not take into account Vogel's subtlety regarding the interaction of top management with the day-to-day managers".

[23] At paragraph 106

De Koker (2005:13.6) also prefers a hands-on approach as opposed to the place where strategic decisions are taken.

The 2014 OECD Model Commentary on Article 4(3)[24] interprets POEM to mean "the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made". The Commentary also states that the place of effective management will ordinarily be where the most senior person or group of persons, for example, a board of directors, make decisions, the place where the actions to be taken by the entity as a whole is determined.

The 2014 OECD MTC does not define the term "effective management". In this regard, the 2014 OECD Model Commentary[25] provides that where a term is not defined in a tax treaty, it should:

> "[…] unless the context otherwise requires, have the meaning that has at that time under the law of that State for the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."

The OECD interpretation principle is upheld by the South African courts. In *ITC 789* [1954] 19 SATC 434, where the issue was whether a company was a public company, the South African court, relying on this provision in the United Kingdom DTA, stated that it was insufficient that the company was a public company within the meaning of the United Kingdom's commercial law, but that the issue was whether the company qualified in terms of the South African ITA. Adjudication on the same issue in *Baldwins (South Africa) Ltd v CIR* [1961] 3 SA 843 (A), the South African Appellate Division confirmed this approach and said that the term "public company" was not to be construed according to the law of the United Kingdom (UK), and there were no compelling reasons why the term should not be given the meaning assigned to it in the ITA. In addition, the court stated that there was a good reason why no other meaning was attributed to it, the UK legislature could, by altering the meaning of the term in their legislation, alter the incidence of South African tax in South Africa, and this possibility could never have entered the minds of the government of the two treaty states.

The term "place of effective management" is not explicitly defined in any of the South African DTAs and its contextual meaning for purposes of a treaty may be extrapolated from

[24] Paragraph 24.1 of the 2014 OECD Model Commentary (Page 91)
[25] Article 3(2) of the 2017 OECD MTC.

the Model Commentary to the Model Tax Convention upon which the DTA was based. The majority of South Africa's DTAs are based upon the OECD MTC.

The term place of POEM is not defined in the ITA. In the absence of a definition of POEM being introduced into the ITA, its meaning under the South African domestic law is indecisive.

Hitherto the only South African case that has considered the meaning of the term has been the case of *Oceanic Trust Co. Ltd N.O. (in its capacity as the trustee of Specialised Insurance Solutions (Mauritius) Trust) vs Commissioner for SARS* [2011] 74 SATC 127. The case involved an application for declaratory relief and unfortunately does not give a definitive view on the issue, but it would appear from the judgment that a South African court would be likely to favour the OECD's approach to POEM.

In the absence of definitive local court precedents to act as authority, the meaning of the term becomes open for discussion and subjective interpretation. Reliance must therefore be placed on secondary sources to substantiate the meaning, hence the ordinary meaning of the term POEM is taken into account in the SARS Income Tax Interpretation Note No 6 (Issue 2).

According to Traversa (2017:7), on the matter of different domestic meanings of the term POEM, 'There are two approaches to national definitions. Continental jurisdictions focus on the location where the day-to-day management is carried out. The Anglo- Saxon view appears to focus on a higher level of strategic management. Countries such as Austria, Germany, Denmark and Finland follow the Continental approach. Countries such as the United Kingdom, Belgium, Czech Republic, the Netherlands, France and Switzerland follow the Anglo-Saxon approach. The SARS Interpretation Note No 6 (Issue 2) follows the Anglo-Saxon approach.

In SARS' view (2015:4) a company's POEM is the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in *substance* made. According to SARS (2015:5), a company may have more than one place of management but it can only have one place of *effective* management at any one time[26].

SARS (2015:7) indicates that definitive rules cannot be laid down to determine the POEM and all relevant facts and circumstances must be examined. SARS (2015: 7-13) offer a list of

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[26] This is consistent with paragraph 24 of the *Commentaries on the Articles of the Model Tax Convention on Income and on Capital*, Condensed version, dated 15 July 2014 at page 91.

relevant facts and circumstances that should be used as a guideline to examine on a case-by-case analysis:

1. The location of a company's head office, being the place where a company's senior management and their support staff are predominantly located, is generally a major factor in the determination of a company's POEM because it often represents the place whether key company decisions are made;
2. The location where the members of the executive committee are based and where that committee develops and formulates the key strategies and policies will often be considered the company's POEM;
3. The location where a company's board regularly meets and makes decisions may often be the company's POEM provided the board retains and exercise its authority to govern the company and does, in substance, make the key management and commercial decisions necessary for the conduct of the company's business as a whole;
4. Changes in telecommunications, information technology, global travel and modern business practices have made it possible to manage without the need for a group of persons to be physically located or to meet in one place. Accordingly, it is important not to place undue focus on the location where the board meetings take place without considering the surrounding facts and circumstances of a particular case;
5. The location of shareholders is not relevant to the determination of a company's POEM, except in the circumstance of undue shareholder influence and usurpation of decisions made by the board;
6. Operational management decisions are generally of limited relevance in determining a company's POEM and must be distinguished from the key management and commercial decisions. Key management and commercial decisions are concerned with broader strategic and policy decisions and tend to be made by the senior management team;
7. Legal factors such as a company's place of incorporation, formation or establishment, the location of its registered office and the location of its public officer are not relevant in the determination of a company's POEM;
8. The extent of a company's economic nexus with a country is generally irrelevant in the determination of its POEM. This factor is only considered when the other factors are inconclusive;
9. The location where support services and a company's accounting records are retained will generally not be indicative of where the key management and commercial decisions are made and is therefore of limited relevance to the determination of a company's POEM.

Under section 1 of the Tax Administration Act (TAA) as read with section 5(1) of the TAA, 'a practice generally prevailing is a practice set out in an official publication regarding the application or interpretation of a Tax Act', therefore the SARS interpretation note concerning POEM could have a significant impact on the rights of an Oil and Gas company under the TAA.

One of the first references in South Africa to the term "effective management" was in the Fifth Interim Report of the Katz Commission, dealing with the then proposed change of the South African tax system from a source-based to a residence-based tax system. In paragraph 6.1.2.1 of the Report, the following is stated:

> "The current definition of a domestic (read "resident") company is a company incorporated in South Africa, or a company "managed and controlled" in South Africa. The main criticism of this definition is that it has proven subject to relatively simple, formalistic manipulation (Van der Merwe: 2006:124). This concept is also out of line with the commonly used, and much more substantial, tax treaty expression of "effective management". The Commission recommends that the concept of effective management as referred to in Article 4(3) of the OECD MTC be used consistently to designate the tax residence of persons other than natural persons. This may perhaps be best achieved through an appropriate definition in Section 1 of the Income Tax Act. Again, the change will have the benefit of employing international and therefore, commonly understood terminology".

By implication, the Katz report attaches a meaning to "effective management" which is different from the term "managed and controlled". It also seems to indicate a meaning similar to the tax treaty meaning (Olivier & Honiball, 2011:42).

In the context of treaty interpretation, the local courts are bound to consider international guidelines when they attempt to interpret the meaning of "effective management". This principle was confirmed by the Appellate Division in *CIR v Downing* [1975]. The court upheld the *dicta* of the lower court that in a treaty context, South Africa was bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts utilised in the OECD MTC, as South Africa had adopted that model for its tax treaties.

3.4 The interpretation of the domestic tax legislation

In South Africa, a "mixed" legal system, comprised of European civil law (namely Roman-Dutch law) and English common law is applied (Pistone et al. 2019:47). In respect to tax terms defined in the domestic tax legislation, taxpayers are required to apply within the

context of the ITA, the defined meaning of such terms. In respect to those terms not defined in the ITA, South African court precedence as established by the *ratio decidendi* of judges in the higher courts (Appellate Division (A) or Supreme Court of Appeal (SCA)) gives meaning to terms used in the domestic tax legislation.

There are two broad approaches to the interpretation of the statute as established by the South African courts, namely the traditional and the modern approach (Van Schalkwyk & Geldenhuys, 2009:169). Each of these approaches consists of two general theories to interpretation, that is, literalism and intentionalism in the case of the traditional approach, and purposivism and contextualism in the case of the modern approach (Du Plessis 2002:93-98). These theories are not mutually exclusive, because in many instances their application is inter-twined.

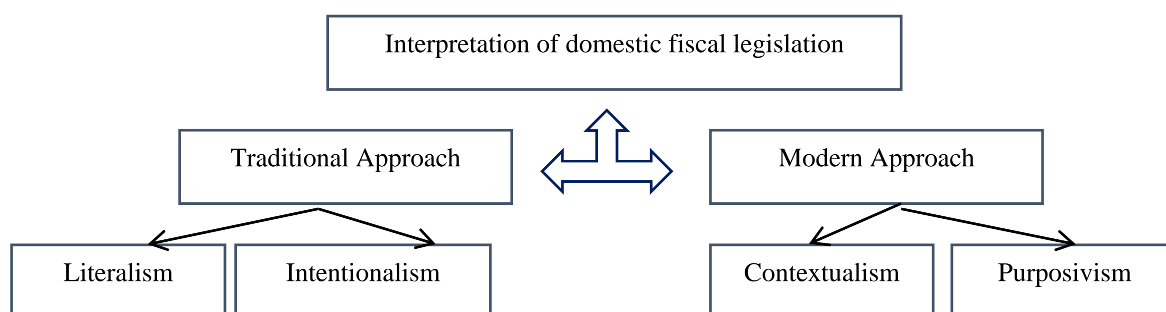

Figure 3.1 The broad approaches to the interpretation of domestic fiscal legislation (Adapted from van Schalkwyk & Geldenhuys, 2009:170)

3.4.1 The traditional approach

The traditional approach is to look for the meaning of a statutory provision from the words used by the Legislature (Steyn, 1993:4).

In *CIR v George Forest Timber Co Ltd* [1924][27] it is stated as follows: 'I apprehend the rule of construction of taxing statutes is as stated by Lord Cairns in *Partington v The Attorney-General'*.[28] The following formulation by Lord Cairns is then quoted:[29]

> "I am not at all sure that, in a case of this kind – a fiscal case – form is not amply sufficient, because as I understand the principle of all fiscal legislation, it is this: If a person sought to be taxed comes within the letter of the law, he must be taxed however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law, the case might otherwise appear to be. In other words, if there be an equitable

[27] [1924] AD 516, 1 SATC 20
[28] At 531
[29] 21 LT 370 at 375

construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute".

The spirit of the law cannot operate beyond the limits of its language. This principle was laid down in the South African courts by Innes CJ in *Dadoo Ltd v Krugersdorp Municipal Council* [1920] AD 530.[30] It implies that "a court cannot do violence to the language of the lawgiver by placing upon it a meaning of which it is not reasonably capable, to give effect to what he or she may think to be the policy or object of the particular measure".[31]

The words of the provision must be adhered to, regardless of manifestly unjust or even absurd consequences (Joubert & Faris 2001:282). In *CIR v Simpson* [1949][32] it was said,[33]

> "[i]n construing the definition regard must be had to the cardinal rule laid down by Rowlatt J in *Cape Brandy Syndicate v Inland Revenue Commissioners* [1921] (1 KB 64 at 71) and approved by Simon VC in *Canadian Eagle Oil Co Ltd v The King* [1946] (AC 119 at 140). That rule was as follows: (It simply means that) in a taxing Act one has to look merely at what is clearly said.[34] *There is no room for any intendment*. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing to be implied. One can only look fairly at the language used".

Intentionalism (also referred to as the subjective theory) holds that the meaning of a statutory provision is governed by what the Legislature intended as disclosed by the wording of the provision (Kellaway, 1995:63). Deviation from a literal interpretation is justified only if the intention of the legislature can be ascertained beyond doubt from other sources (Steyn, 1993:4). In *ITC 1396* [1984],[35] the President handed down the judgement in the South African Income Tax Case said:

> "In interpreting a statutory provision the cardinal or golden rule of interpretation is to arrive at the intention of the legislature. This is done, in the first instance, by having regard to the words used in the statute in question and giving them, unless they have been specifically defined their ordinary grammatical meaning. It is only when giving them such a meaning would lead to absurdities or anomalies which could not have been contemplated by the legislature that one may depart of such meaning and rely on the other canons of interpretation to determine the legislature's intention".

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[30] At 544
[31] *Dadoo Ltd v Krugersdorp Municipal Council* at 543
[32] [1949] (4) SA 678 (A), 16 SATC 268
[33] At 695
[34] at 71
[35] [1984] 47 SATC 141

The real intention of the Legislature is, accordingly discerned by judges who look for the overall purpose of the legislation in its original context, but also the law in force at the time of its application (Pistone et al, 2019:54). Since the Republic of South Africa Constitution, 1996 (the Constitution) the courts have begun moving away from "the intention of the legislature" toward the modern approach of applying a purposive or teleological approach to statutory interpretation (Pistone et al, 2019:54).

3.4.2 The modern approach

Over time the traditional approach has been modified and "softened" and the Constitution and the Bill of Rights lent an impetus to the change to the modern approach which is characterised by a requirement that the interpretation of legislation must promote the values that underlie an open and democratic society based on human dignity, equality and freedom (Goldswain 2009:69).

Purposivism attributes meaning to a statutory provision in the light of the purpose it seeks to achieve (Joubert & Faris 2001:285). Legislative purpose is a more general and far more objective concept than that of legislative intent (Devenish 1992:35). In *SIR v Sturrock Sugar Farm (Pty) Ltd* [1965], Ogilvie Thompson AJ[36] said:

> "Even where the language is unambiguous, the purpose of the Act and other wider contextual considerations may be invoked in aid of a proper construction".

In *Metropolitan Life Ltd v CSARS* [2008], Davis J indicated[37] that the Act and its amendments should be "interpreted purposively and holistically and that provisions should be given a clear meaning whenever plausible".

Contextualism is often advanced as the interpretive twin of purposivism, the argument being that the purpose of a provision can only be ascertained by looking at it in context (Du Plessis 2002:97). The "context" of a statute refers not only to the language of the rest of the statute, but also to the 'matter of the statute, its apparent scope and purpose, and, within limits, its background'. This principle was laid down by Schreiner JA in *Jaga v Dönges, N.O. and Another; Bhana v Dönges, N.O. and Another* [1950][38] (Joubert & Faris 2001:297).

In *De Beers Marine (Pty) Ltd v CSARS* [2002], Nienaber JA emphasised the cardinal importance of the context in which the words or phrases are used when interpreting tax statutes. He stated, in paragraph 7, that the language of a provision must "take its colour, like

[36] At 903
[37] At 170
[38] At 662

a chameleon, from its setting and surrounds in the Act". Further in support, in *Norden & Another NNO v Bhanki & Others* [1974],[39] the former South African Appellate Division said the following: "However sophisticated the methods of construction of a statute employed by any court, the object of interpretation must ever be the ascertainment of the meaning of the language in its context".

In *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] 4 SA 593 (SCA), Willis JA said that:

> "Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective, not subjective. A sensible meaning is to be preferred to one that leads to insensible or un-business-like results or undermines the apparent purpose of the document. Judges must be alert to and guard against, the temptation to substitute what they regard as reasonable, sensible or business-like for the words used. To do so with a statute or statutory instrument is to cross the divide between interpretation and legislation; in a contractual context, it is to make a contract for the parties other than the one they made. The "inevitable point of departure is the language of the provision itself", read in context and having regard to the purpose of the provision and the background to the preparation and production of the document."

This approach was reaffirmed in *The City of Tshwane Metropolitan Municipality v Blair Atholl Homeowners Association* (106/2018) [2018] ZASCA 176 (3 December 2018) where the court comments that the Supreme court[40] has constantly stated that in the interpretation exercise the point of departure is the language of the document. Without the written text there would be no interpretive exercise.

3.5 The taxation of foreign mining income in South Africa

A South African resident Oil and Gas company is subject to taxation in South Africa on its income derived from worldwide mining operations.[41] The Oil and Gas company's liability for

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[39] At 655B

[41] Definition of "gross income" in Section 1 of the ITA.

tax on foreign mining operations is determined and interpreted following the domestic tax legislation, namely the income to be included and deductions allowed are based on the South African Income Tax Act and the domestic interpretation thereof.

The concept of "taxable income", derived ultimately from the definition of "gross income", is a purely artificial and statutory definition and is by no means necessarily synonymous with "profits" or "gains". Moreover, the taxable income of an Oil and Gas company may not correspond with income in the colloquial sense of money that the recipient receives during the year. In other words, the "taxable income" of an Oil and Gas company can differ substantially from the net income calculated under generally accepted accounting practices. The amount determined as taxable income from the foreign mining operations will furthermore differ from the amount subject to taxation in the source country as determined under the domestic tax legislation of that country.

As a result of these structural differences in the manner in which taxable income is derived in South Africa in comparison to the calculation of taxable income in the source country, it can be anticipated that there are systemic differences that cannot be resolved alone through amendment of the domestic tax provisions as pertain to relief from double taxation.

3.5.1 Gross income

Section 1 of the Income Tax Act (ITA) defines "Gross Income", "[…] in the case of any person resident" as "[…] the total amount, in cash or otherwise, received by or in favour of such resident". "Income" is defined[42] as the amount remaining of the "gross income" of any person for any year or period of assessment after the deduction therefrom of all amounts exempt from normal tax in terms of the Act. Receipts and accruals that are exempt from normal tax are contained in section 10 of the ITA.

The principal elements for inclusion in "Gross Income" are that there should be an *amount* of income that has been *received by* or *accrued to* the resident Oil and Gas company.

3.5.1.1 Amount

The term "cash or otherwise" includes anything which has an ascertainable value or money's worth, and specifically, the word "otherwise" refers to benefits received *in natura.* The courts have given a wide meaning to the word "otherwise". The reference to "total amount" does not imply that the benefit should be an amount of money. As long as what is received has an

[42] Section 1 of the ITA, definition of "income"

ascertainable monetary value, it may be of any nature. It may be a thing or right of action, and the fact that it may be difficult to ascertain the monetary value of a benefit is immaterial.[43] If the benefit has no ascertainable monetary value, however, it cannot form part of gross income.[44]

3.5.1.2 Received by

A receipt takes place for domestic tax purposes when an amount is received by the Oil and Gas company on its behalf and for its benefit (*Geldenhuys v CIR* [1947] (3) SA 256 (C).

3.5.1.3 Accrued to

In the case of *Lategan v CIR* [1926] CPD 203 it was held that accrual meant "become entitled to" but that something would have to be deducted from the face value of an amount that had accrued during the year of assessment because it only became payable in the future. The opinion of the court in the *Lategan case* was that an amount accrued to a taxpayer once he became entitled to claim payment of that amount notwithstanding that such payment may take place in the future

It is important to note that a taxpayer cannot be said to be entitled to an amount for tax purposes until his right to claim payment is unconditional.[45]

In *Mooi v CIR* [1972] (1) SA 675 (A) it was held that accrual could take place only when a taxpayer becomes unconditionally entitled to an amount. Conditional entitlement therefore would not constitute an accrual until the condition has been satisfied.
This does not mean that the taxpayer can be taxed on an amount when it is received and again when it accrues, as this would amount to double taxation. This principle was established by the court in *CIR v Delfos* [1933] AD 242.

In *SIR v Silverglen Investments (Pty) Ltd* [1969] the Secretary for Inland Revenue established that it does not have a choice to include an amount either when it is received or when it accrues. Whichever event occurs first will determine the date of inclusion of the amount.

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[43] *Lategan v CIR* [1926] CPD 203 (2 SATC 16), *CIR v Delfos* [1933] AD 242 (6 SATC 92), *Mooi v SIR* [1972] (1) SA675 (A) (34 SATC 1), *People's Stores (Walvis Bay) (Pty) Ltd* [1990] (2) SA353 (A) (52 SATC 9).
[44] *CIR v Butcher Brothers (Pty) Ltd* [1945] AD 301 (13 SATC 21).
[45] *Mooi v CIR* [1972] (1) SA 675 (A) (34 SATC 1, *Ochberg v CIR* [1933] CPD (6 SATC 1), *CIR v Golden Dumps (Pty) Ltd* [1933] (4) SA 110 (A).

3.5.2 Income denominated in a foreign currency

Amounts accrued or received in a currency other than South African Rand must be converted to Rand and included in the resident Oil and Gas company's gross income. To regulate the conversion process, foreign currency conversion rules were inserted into the ITA. The provisions of section 24I apply to Oil and Gas companies[46] to their foreign source taxable income.[47] Following accounting principles, transactions are recorded at the spot when the reporting currency is South African Rand. Section 24I taxes both realised exchange differences and unrealised exchange differences. Unrealised exchange gains arise when for reporting purposes open foreign balances such as trade debtors or loans are converted at year-end to South African Rand.

In the context of a "controlled foreign company", Clegg & Stretch (2011:8-6) state that the computation of net income requires the net amount to be determined in the functional currency of the CFC (namely the currency of the primary economic environment in which the business operations are conducted)[48] and this net amount is translated to Rand[49]at the average exchange rate for the year.

3.5.3 Allowable deductions

"Taxable income" as defined[50] means the aggregate of the amount remaining after deducting from the "income" of any person all amounts allowed to be deducted or set off in terms of the ITA and all amounts to be included or deemed to be included in the taxable income of any person in terms of the ITA.

Having established that foreign mining income falls within the definition of "gross income", the next step in the calculation of taxable income is to deduct all amounts allowed as tax deductions in terms of the ITA. The Tenth Schedule to the ITA deals only with the taxation of oil and gas income derived from South African oil and gas rights. Accordingly, for the taxation of foreign-source oil and gas income, an Oil and Gas company should revert to the body of the ITA for the allowable deductions in the calculation of "taxable income".

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[46] Section 24I(2)(*a*) of the ITA
[47] Note that in relation to the domestic source taxable income paragraph 4 of the Tenth Schedule to the ITA would be applied in the context of determining the tax payable by an oil and gas company.
[48] Section 1 of the ITA, definition of "functional currency"
[49] Section 9D(6) of the ITA
[50] Section 1 of the ITA, definition of "taxable income"

Taxable income from foreign mining operations as included in the Oil and Gas company's South African taxable income is equal to "income" minus "deductions". These deductions are allowed in terms of:

- The general deduction formula – section 11(a)[51] read with section 23(g)[52] of the ITA[53] and
- Specific deductions for mining companies as contained in sections 15 and 36 of the ITA.

However proper a deduction may be from the point of view of an accountant or prudent trader it cannot be deducted if it falls outside the permitted deductions (*Sub-Nigel v CIR* [1948] (4) SA 580 (A)).

The requirements for deductibility under the general deduction formula are that the expenses must be *incurred, in the production of income, in the furtherance of carrying on a trade* of the resident Oil and Gas company and not be *of a capital nature*. Each of these requirements is examined in further detail:

3.5.3.1 Actually incurred

Expenditure may be deducted in the year in which an unconditional obligation to pay exists. In *Port Elizabeth Electric Tramway Co Ltd v CIR* [1936] CPD 241,[54]

> "[. . .] the words of the statute i.e. section 11(a) are "actually incurred" not "necessarily" incurred. The use of the word "actually" as contrasted with the word "necessarily" may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses, therefore, are not "necessary" but they are actually incurred and therefore deductible".

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[51] Section 11(a) of the ITA:

> '11. General deductions allowed in the determination of taxable income.- For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived-
> Expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;'

[52] Section 23(g) of the ITA:

> '23. Deductions not allowed in determination of taxable income. – No deductions shall in any case be made in respect of the following matters, namely-
> [...] (g) any moneys, claimed as a deduction from income derived from trade, to the extent which such moneys were not laid out for expended for the purposes of trade;'

[53] Deductions in relation to the domestic oil and gas expenses of an oil and gas company are dealt with in accordance with section 26B, under paragraph 5 of the Tenth Schedule to the ITA.

[54] At 15

In *CIR v Golden Dumps (Pty) Ltd* [1993] (4) SA 110 (A) (in the South African Court *a quo ITC 1499* [1989]) it was held that when an expenditure is the subject of a *bona fide* dispute, it lacks the degree of finality to render it actually incurred.

In *KBI v Nasionale Pers Bpk* [1984] (4) SA 551 (C) (on appeal as *Nasionale Pers Bpk v KBI* [1986] (3) SA 549 (A) the taxpayer, a company, claimed a deduction for the portion of annual bonuses is considered to be appropriate to the period ending on the last day of each year of assessment. Its employees, however, could at those dates claim bonuses, becoming eligible for the bonuses some months later. It was held that no liability existed at the relevant dates and that there was no expenditure actually incurred.

In *Edgars Stores Ltd v CIR* [1988] (3) SA 876 (A) [55] (on appeal from *CIR v Edgars Stores Ltd* [1986] (4) SA 312 (T)), it was held that only expenditure in respect of which the taxpayer had incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of section 11(a) from income returned for the year. Where the existence of liability is certain and established within the tax year in question, but the amount of the liability cannot be accurately determined at the tax year-end, in which event the liability is nevertheless regarded as having been incurred in the tax year in question.

3.5.3.2 In the production of income

An expense is in the production of income in a business operation if any *one* of the following requirements are met-

1. The expense is *necessary* for the performance of the business operation;
2. The expense is attached to the business operation by *chance*; and
3. The expense is genuinely incurred to carry on the business operation more *efficiently.*

The *locus classicus* on the deductibility of expenditure and losses is *Port Elizabeth Electric Tramway Co Ltd v CIR* [1936], where it was held that expenditure will be deductible if it was incurred with the purpose to earn income and is sufficiently closely related to this purpose. The ultimate use of the expenditure is not decisive (*CIR v Allied Building Society* [1963] (4) SA 1 (AD), *CIR v Standard Bank of South Africa Ltd* [1985]).

Expenditure to earn an income is deductible although income is not immediately produced or even if no income is produced as a result of the particular expenditure. The actual receipt or accrual of income is not an essential requisite for the deduction of expenditure (*Sub-Nigel v*

[55] At 90

CIR [1948] (4) SA 580 (A)). For expenditure to be deductible it must be incurred to earn income as defined or be so closely connected to the income-earning operations that it can be regarded as part of their cost, that is, it must be a necessary concomitant of the carrying on of the particular business. Expenditure need not, however, give rise to income to be deductible.

Where the requirements of the general deduction formula are met, foreign taxes paid are deductible as an expense. According to Olivier & Honiball (2008:327), "[f]urther support of this view is found in the fact that foreign taxes are not specifically prohibited from the deduction. Section 23*(d)*, which contains a list of specific taxes that are not allowed to be deducted, does not mention foreign taxes".

3.5.3.3 In the furtherance of carrying on a trade

The term "trade", as defined in Section 1 of the ITA, includes every profession, trade, business, employment, calling, occupation or venture, including the letting of property and the use of any patent, design, trademark, copyright or any other property of a similar nature. In *De Beers Holdings (Pty) Ltd v CIR* [1984] the judge accepted that a company could carry on a non-profit making trade although the trade must generate some sort of business benefit.

Pre-trade expenditure is not deductible under the general deduction formula. Pre-trade expenditure is carried forward for deduction in terms of section 11A of the ITA until the commencement of trade.[56]

3.5.3.4 Of a capital nature

Expenditure "of a capital nature" is not deductible under the general deduction formula. A deduction for such expenditure should be claimed under sections 15 and section 36 of the ITA, in the case of Oil and Gas mining companies.

There is no definition in the ITA of what constitutes capital expenditure, and it was said in *Sub-Nigel Ltd v CIR* [1948] (4) SA 580 (A) that it is "impossible to define what is an

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[56] Section 11A of the ITA provides for the deduction of

'expenditure and losses –

(a) Actually incurred […] prior to the commencement of an in preparation for the carrying on […] trade;

(b) Which would have been allowed as a deduction in terms of section 11[…], had the expenditure or losses been incurred after […] commenced carry on […]trade'

expenditure of a non-capital nature which will act as a touchstone in deciding all possible cases". The true nature of the transaction needs to be examined. Its' true nature is a matter of fact and the purpose of the expenditure is an important factor, if it is incurred to acquire a capital asset for the business it is capital expenditure even if paid in annual instalments (*New State Areas Ltd v CIR* [1946] AD 610).

Money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield a future profit; and while the outlay does not recur the income does (*CIR v George Forest Timber Co Ltd* [1924] AD 516).

In *British Insulated and Helsby Cables Ltd v Atherton* [1925], it was indicated that when an expenditure is made not only once and for all but to bring into existence an asset or advantage for the enduring benefit of the trade that expenditure must, in the absence of special circumstances leading to the opposite conclusion, be treated as an expenditure of a capital nature.

In *CIR v Manganese Metal Company (Pty) Ltd* [1996] it was held that "it is not necessary to turn to the "enduring benefit" test where you have a permanent capital asset. It is only when you are dealing with some other form of property that you have to enquire whether it is a benefit or advantage which endures in the way that fixed capital does".

In *Phalaborwa Mining Company Limited v Secretary for Inland Revenue* [1973], the South African court held that capital expenditure will generally result in the creation of a lasting benefit for the taxpayer. Payments made to accelerate the earning of profits are not capital. In the *Phalaborwa Mining* case, the company incurred expenditure to build a barrage across a river merely to provide the company with the water necessary to bring forward its production date by eight months. This expenditure was held to be of revenue nature as it did not create an enduring benefit. Expenditure of a capital nature produces income or a lasting benefit to the taxpayer for a reasonably long period (Sturdy & Cronje, 2013: 334).

Payments made as part of the operations of the taxpayer's business as opposed to the improvement of the taxpayer's profit-making machine are not capital. In *COT v Rhodesia Congo Border Timber Company Ltd* [1961], the method of construction and durability of roads built to remove timber were essential facts in arriving at the finding that their construction was not an improvement of the profit-making machine but was part of its operation.

3.5.3.5 Mining

To qualify for the tax deductions under section 15 and section 36 of the ITA, the Oil and Gas company must be recognised as conducting "mining" or carrying on "mining operations". To decide whether an Oil and Gas company derives income from mining operations there are two steps necessary to determine mining income (Van Blerk, 1992:10-2).

Firstly, it is necessary to define the term "mining operations" and secondly to determine what income is derived from these activities. In this context, "mining" or "mining operations" is defined in section 1 of the ITA as including 'every method or process by which any mineral is won from the soil or any substance or constituent thereof'. In *Commissioner of Taxes (COT) v Nyasaland Quarries and Mining Co Ltd* [1960][57], Spencer Wilkinson CJ[58] stated the following:

> "In my opinion there can be no doubt whatever that in defining the expressions "mining operations" and "mining" as it has done, the legislature intended to give these expressions, when used elsewhere in the Act, a meaning wider than the ordinary everyday meaning of those terms. Moreover, the extension of the usual meaning of those expressions is intended to be a wide one, for the words used are very general. "Mining operations" and "mining" are to include every method or process by which any mineral is won. It is hardly possible to imagine more general words".

The definition of "mining" and "mining operations" may, thus, be seen as extremely comprehensive.

The meaning of the words "mining" and "mining operations" was also the subject of a judgment in *ITC 1572* [1994],[59] in which the taxpayer had received an insurance pay-out under a loss of profits policy following an interruption in mining operations as a result of a machinery breakdown. Revenue contended that the amount so received was not income from mining. The Court held that the risk insured against was very real in the industry and that the amount received by the taxpayer was to fill the hole in receipts left in the mining activities of the taxpayer as a result of the machinery breakdown. This amount was in turn held to be income derived from mining for gold on the basis that references in the Act to "mining" and "mining operations" are to trade and not merely to the physical activity of ore extraction (Clegg & Stretch, 2011:20-22).

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[57] 24 SATC 579

[58] At 582

[59] [1994] 56 SATC 175

To determine mining income, it is necessary to determine what income is derived from the mining activities. In a Privy Council judgement in 1900 the following was stated (Van Blerk, 1992:10-3):

> "Their Lordships attach no special meaning to the word "derived" which they treat as synonymous with arising or accruing". In *Port Elizabeth Municipality v Union Government (Minister of Railways & Harbours) Respondent*,[60] Innes CJ[61] expressed the following: "The income of a trading business is not derived from the shop in which it is carried on, but from where the sales there transacted".

According to van Blerk (1992:10-3):

> "To put the matter simply, where income is derived directly from the utilisation of mining assets (including intangible assets such as mining rights for the taxpayer's mining operations) such income will be mining income; where income is only indirectly derived from such assets or is derived from other assets, this income will tend to be non-mining income".

In *Western Platinum Limited v Commissioner for SARS* [2004][62] the court considered the interpretation of the phrase "income derived from mining operations". In the *Western Platinum case,* a mining company had received interest from a variety of sources. It was held that income directly connected with the mining operations would be mining income while any intermediate event which broke the direct connection, typically an investment decision that was not influenced by mining considerations, would result in the interest being disregarded as "mining income". The company had earned money on overnight calls, through a cash management scheme whereby several accounts were "pooled", on foreign current bank accounts and a refund of mining lease rentals. Further interest was earned on late payments from customers for mineral sales and escrow accounts for certain loans raised to finance mining operations and on export incentive scheme balances. The former sources of interest were held not to be directly connected to mining operations whereas the latter were, and hence constituted mining income (Clegg & Stretch, 2011:20-2).

The *Western Platinum case* confirmed "income derived from mining operations" to mean income derived from the business of mining operations in the sense of extracting minerals from the soil. Accordingly, only income directly derived from or connected to the business of mining operations would qualify as mining income.

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[60] 1918 AD 237
[61] At 244
[62] 4 All SA 611 (SCA) [2004]

3.6 Life cycle of an oil and gas project

The domestic taxation of foreign oil and gas mining income is dependent upon the stage in the life cycle of an oil and gas project. According to the Davis Tax Committee (2016:32-34) the stages of a typical oil and gas project can be described as follows:

1. *Licensing*: In most cases, the host government grants a license or enters into a contractual arrangement with the Oil and Gas company to explore for and develop a field without transferring the ownership of the mineral resources.
2. *Exploration*: After acquiring the rights the Oil and Gas company carries out geological and geophysical surveys such as seismic surveys and core borings. The data so acquired is processed and interpreted and, if a play appears promising, exploratory drilling is carried out. Depending on the location of the well a drilling rig, drillship, semi-submersible, jack-up, or floating vessel will be used.
3. *Appraisal*: If hydrocarbons are discovered, further delineation wells are drilled to establish the amount of recoverable oil, production mechanism, and structure type. Development planning and feasibility studies are performed, and the preliminary development plan is used to estimate the development costs.
4. *Development*: If the appraisal wells are favourable and the decision is made to proceed, then the next stage of development planning commences using site-specific geotechnical and environmental data. Once the design plan has been selected and approved, contractors are invited to tender. Normally, after approval of the environmental impact assessment by the relevant government entity, development drilling is carried out and the necessary production and transportation facilities are built.
5. *Production*: Once the wells are completed and the facilities are commissioned, production starts. Work-overs must be carried out periodically to ensure the continued productivity of the wells, and secondary and/or tertiary recovery may be used to enhance productivity at a later time.
6. *Abandonment*: At the end of the useful life of the field which for most structures occurs when the production cost of the facility is equal to the production revenue (the so-called “economic limit”), a decision is made to abandon. For a successful removal, Oil and Gas companies generally begin planning one or two years before the planned date of decommissioning (or earlier depending on the complexity of the operation).

3.6.1 Operating expenditure

Operating expenses incurred whilst still in the exploration, appraisal and development stages (namely pre-trade revenue expenses) are accumulated until the production stage (namely trade

commences), and then the total is claimed as a single deduction.[63] When in production, the operating expenses are deductible under the general deduction formula in the year that they are incurred.

3.6.2 Exploration and appraisal capital expenditure

Section 15(b) of the ITA allows for the deduction of prospecting expenditure (including surveys, boreholes, trenches, pits and other prospecting work preliminary to the establishment of a mine) in respect of any area within the Republic. Accordingly, exploration and appraisal expenditure incurred by the Oil and Gas company for its foreign mining activities is not tax-deductible under section 15(b) of the ITA.

The question arises as to whether the exploration and appraisal expenditure incurred outside the Republic could be regarded as deductible capital expenditure as envisaged in section 36(11) of the ITA. Section 15(b)(iii) of the ITA provides that "any expenditure which has been allowed in terms of this paragraph [section 15(b)] shall not be included in such person's capital expenditure as defined in subsection (11) of section thirty-six".

"Capital expenditure" does not, it is submitted include all expenditure which is of a "capital nature" but only the particular expenditure as defined in section 36(11) of the ITA, which cannot be construed to include "prospecting expenditure". As such the denial of the prospecting deduction under section 15(b) of the Income Tax Act would result in the Oil and Gas company not being able to claim any tax deduction for prospecting expenditure.

3.6.3 Mining capital expenditure

The capital expenditure incurred during the development and production life cycle stages is deductible in terms of section 15(a) and section 36 of the ITA and includes, inter alia, expenses on:

1. Shaft sinking and mine equipment;[64]
2. Cost of laying pipelines from the mining block to the marine terminal or refinery or the onshore processing facility;[65]
3. Expenditure on development, general administration and management (including any interest and other charges on loans utilised for mining purposes) before the commencement of production, or during any period of non-production;[66]

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[63] Section 11A of the ITA.
[64] Section 36(11)(a) of the ITA.
[65] Section 36(11)(d)(v) of the ITA.
[66] Section 36(11)(b) of the ITA.

4. Costs incurred in connection with:
    i. Viability studies;
    ii. The design, procurement, management (including project management), transport and construction of the constituent parts (from after raw material stage and including the piles and other foundations) of any marine or onshore receiving installations erected or to be erected on the mining block or onshore to exploring for natural oil;
    iii. Costs of training of personnel for any purpose in connection with the abovementioned installations, at any time before the successful commissioning of such installations but excluding any assets belonging to another taxpayer; and
5. Expenditure on various qualifying assets such as mine housing, mine hospitals, schools, and other facilities owned and operated by the taxpayer for the benefit of its employees spread in equal instalments over ten years (five years in the case of motor vehicles)[67].

Some of the above categories are interpreted widely and include items that may not appear to be included at first glance. For instance, according to Van Blerck (1992:12-7), shaft sinking costs can include expenditure incurred on mining access, equipping the shaft, handling of materials, sub-surface equipment, treatment and utility plant, civil engineering services, architectural services, mechanical and electrical services, refrigeration and financial costs.

Although mining equipment is not defined in the ITA, its meaning has been widely defined by the courts and even more liberally interpreted by the SARS. The SARS interpretation includes all plant and machinery used on the mine, mine housing and expenditure on the infrastructure of roads and railways necessary to run the mine. It has been established that the mere fact that capital expenditure is incurred in respect of work situated upon the land of another does not of itself exclude the deductibility of such expenditure. However, it can lead to difficulties in establishing that the expenditure relates to equipping the mine (Clegg & Stretch, 2011:20-4).

It is also important to note that the equipment should consist of tangible assets and that intangible assets would not qualify for deduction (Van Blerck, 1992: 12-11). In terms of the International Accounting Standard 38 (2011: 1571), an intangible asset is defined as an

[67] Section 36(11)(d) of the ITA.

"identifiable non-monetary asset without physical substance". In the mining context, intangible assets may include items like patents, goodwill and mining licenses (Ramboll, 2009: 11)[68].

Furthermore, foreign mining capital expenditure will not qualify for unredeemed capital allowances under section 36(11)(c) as such allowance are limited to mining operations carried on under the Minerals Act, 1991 (No.50 of 1991) (Minerals Act); or the Mineral and Petroleum Resources Development Act, 2002 (No.28 of 2002) (MPRDA).

3.6.4 Abandonment expenditure

Amounts paid to a rehabilitation company or trust to make provision for abandonment liabilities for foreign mining operations would not be deductible under section 37A, as section 37A only accommodates mining operations conducted under the Minerals Act or the MPRDA. Provisions for abandonment held on the balance sheet are also not allowed as a deduction in terms of section 23(e). And when abandonment expenditure is incurred in the rehabilitation of land etc. these activities take place at the end of the commercial useful life of the oil and gas well. It may be argued that at this point the expenditure is no longer in the production of income and that the trade activity has ceased to exist[69].

3.7 Ring-fencing

The deduction for capital expenditure for any mine or mines is limited to the taxable income derived from mining.[70] Any excess of accumulated capital expenditure which is not deductible ("unredeemed capital expenditure") is carried forward and deducted in succeeding years against the taxpayer's taxable income from mining. This is known as the mining ring-fence. The effect of this limitation is to prevent the deduction of capital expenditure resulting in a tax loss that could be set off against other, non-mining income.[71]

Proviso (b) to Section 20 of the ITA contains a similar provision for foreign losses. In terms of this proviso, an assessed loss incurred during the year of assessment or any balance of an assessed loss incurred in any previous year of assessment from carrying on trade outside of the Republic shall not be offset against income derived from carrying on a trade within the Republic. Accordingly, foreign losses can only be offset against foreign source income.

[68] Section 37 may allow for the deduction of the market value of that portion of the acquisition cost of a foreign producing mine as relates to capital assets as contemplated in section 36(11).
[69] Section 23(g) of the ITA.
[70] Section 36(7E) of the ITA.
[71] Section 36(7E) of the ITA.

The domestic tax legislation also restricts foreign tax relief to the specified category of income. Section 6*quat* provides a rebate to the extent that there is an inclusion of a specific category of income into taxable income. Consequently, if the taxpayer has an assessed loss carried forward which is set off against taxable income in terms of section 20 with the result that there is no taxable income (and therefore no South African tax liability), a section 6*quat* rebate cannot be claimed in that tax year, but the foreign taxes may be carried forward to the next tax year (for up to seven years).

3.8 Controlled foreign companies

The foreign mining operations of a resident Oil and Gas company may be conducted via a branch of the resident Oil and Gas company or a foreign incorporated subsidiary of the resident Oil and Gas company. In the context of the foreign incorporated subsidiary, assuming that such subsidiary is not a tax resident in South Africa under the POEM rules, it is necessary to consider whether the foreign incorporated subsidiary is a "controlled foreign company" for domestic tax purposes.

In terms of section 9D (1) of the ITA, a "controlled foreign company" (CFC)[72] is any foreign company where—

- More than 50% of the total "participation rights" are held, directly or indirectly, by one or more South African residents other than a headquarter company (as defined);[73] or
- More than 50% of the voting rights are directly or indirectly exercisable by one or more residents other than a headquarter company. In determining whether and to what extent voting rights are exercisable with indirectly held companies, if a resident company can indirectly exercise the votes of an underlying company, then it is deemed to directly hold the same proportion of votes that the subject company's direct shareholder holds.

Example 3.1
A resident company A holds 60% of CFC B, which in turn holds 70% of C, A is deemed to hold 70% of C for purposes of this definition (as opposed to 60% × 70% = 42%). Hence, C is a CFC[74]. However, if the foreign company is a listed company or the voting rights are exercised indirectly through a listed company, the voting rights concerned are ignored in determining CFC status[75].

[72] Section 9D(1) of the ITA
[73] Section 1 of the ITA, definition of a "headquarter company"
[74] Proviso (*b*) to the definition of "CFC"
[75] Proviso (*a*) to the definition of "CFC"

In determining whether more than 50% of the rights of a foreign listed company are held directly or indirectly by residents, persons holding less than 5% of the participation rights in the listed company, will usually be ignored. However, if more than 50% of the participation rights or voting rights of the listed company or company being examined are held by connected persons, of whom some must (in context) be non-resident, then all holdings of less than 5% are taken into account in the determination. In the case of other companies and schemes, there is no *de minimus* limit on the holdings taken into account. An "indirect" interest in a company can be via a shareholding in another company[76] (Clegg & Stretch, 2011:8-6).

Section 9D(1) furthermore defines "Participation rights" as follows:

- "[T]he right to participate in all or part of the benefits of the rights attaching to a share (other than voting rights) or any similar interest, in [a] company;"[77] or
- Where no person has such rights or they cannot be determined for any person, the voting rights. Such a situation might arise in certain hybrid companies where shareholders have no financial rights and the identity of persons to whom profits may be distributed is discretionary (with that discretion exercised by other persons holding the voting rights).

The reference in the first bullet point is clearly to the total of what is generally referred to as "owner's equity".

Therefore, if more than 50% of the owners' equity of a foreign company is owned, in aggregate, by residents (generally irrespective of the size of the holding), whether directly or indirectly through rights in another company, then the company will be a CFC.

Any resident Oil and Gas company holding (whether alone or together with a resident or non-resident connected person, and whether directly or indirectly through other companies) 10% or more of the participation rights or voting rights in a CFC must include a proportionate amount of the net income of that CFC for the foreign tax year concerned, following the rules set out below and unless an exemption exists[78]. Note that the attribution takes place at the level of the first South African resident shareholder[79]. Accordingly, even though a resident holding company A owns 100% of another resident company B, which in turn holds participation rights in an offshore group, the attribution from the offshore group takes place in

[76] Section 9D(1) of the ITA, definition of "controlled foreign company"
[77] Section 9D(1) of the ITA
[78] Section 9D(2) of the ITA
[79] Proviso (B) to section 9D(2) of the ITA

B, notwithstanding that A also has indirect participation rights in the offshore companies (Clegg & Stretch, 2011:8-6).

The 10% participation rights must be held by the resident at the close of business on the last day of the CFC's foreign year-end or, if the entity is no longer a CFC at that date, immediately before it ceased to be a CFC[80]. The effect of this rule is that where a company is a CFC as at its foreign year-end, a proportionate amount of the net income of the CFC will be attributed to each of its resident participants holding 10% or more. Residents who were participants during the year, but disposed of their rights before the foreign company's year-end, will have no income attributed to them. On the other hand, if the company ceases to be a CFC before its year-end, then the residents who were participants at that time will have a proportionate amount of net income up to that date attributed to them – they may, of course, continue as shareholders, but if the company is no longer a CFC, no attribution can occur thereafter.

For all these calculations, the net income of a CFC is determined on the same basis as for the computation of taxable income and, in the case of certain provisions, as though the CFC was a resident.

Section 9D (9) sets out exemptions to the CFC rules. The exemptions require the designated amounts to be omitted from the computation of net income rather than being attributed to the resident Oil and Gas holding company.

Per section 9D(12) and (13), where a resident (together with any connected person) holds at least 10% but not 20% or more of the participation rights and voting rights of a CFC, it can elect to ignore all (but not only a part of) the exemptions in subsection (9). Moreover, where the required holding is in a foreign company that is not a CFC, the resident can elect that the company should be treated as a CFC[81]. The election can be changed from year to year.

These elections (either singly or jointly) will enable a resident who wishes to be taxed on an attribution basis, rather than on dividends declared basis (possibly in later years), to achieve that aim. This may be a practical expedient where the tax accounting record keeping which is required to determine the taxable amount of dividends flowing up in later years through a stream of companies, is complex and expensive. It may also be appropriate in situations where there is little or no tax to pay in any event because the attributed income is taxed at a relatively high rate, so there is little timing disadvantage in the acceleration of tax payments.

[80] Proviso (A) to section 9D(2)
[81] Section 9D(1) and (13) of the ITA

An exemption applies if any amount (or capital gain or loss) is attributable to a foreign "business establishment" of the CFC. A "business establishment" (BE) is tightly defined in section 9D(1) and bears some relationship to the "permanent establishment" (PE) definition used in most double taxation treaties (see chapter 4) and which forms an integral part of section 31 "transfer pricing"[82]. It is necessary to note that the exemption will not apply to the extent that (broadly) net income derives from transactions undertaken with resident connected persons at non-arm's length prices, or where the BE has no real economic nexus with the country in which it is located. The country of location is the "country of residence", determined by the POEM of the entity.

Section 9D (1) defines a "foreign business establishment" for a CFC as follows:

a) a "fixed place of business located" in a foreign country, used for carrying on of the business of the CFC for not less than one year, […]
b) any place of exploration for or extraction of natural resources outside South Africa, where that CFC carries on those exploration or extraction operations.

In the context of a foreign incorporated subsidiary engaged in foreign mining activities, the exemption under paragraph (b) of the definition of foreign business establishment read with section 9D(9) will provide for exemption from attribution to the resident Oil and Gas holding company. The CFC rules should be considered from the standpoint that the resident Oil and Gas holding company has an election under section 9D(12), whether or not it will treat a foreign subsidiary engaged in Oil and Gas mining in another country as a CFC.

3.9 Conclusion

In Chapter 3, the author examines how income from foreign mining activities of a resident Oil and Gas company is taxed in South Africa. In Chapter 2, the author examined how such mining income is subject to tax in the source country. The taxation of the same income in both the country of residence and the country of source leads to double taxation. The thesis aims to determine whether resident Oil and Gas companies engaged in the exploration for and production of Oil and Gas outside of South Africa received full relief from double taxation. Chapters 4 and 5 will evaluate the mechanisms that provide relief from double taxation in terms of the tax treaties and domestic tax legislation.

The concepts "resident" and "place of effective management" are examined in Chapter 3 in the context of establishing a liability to tax from a South African perspective. The concept of "resident" is defined in both the ITA and in the tax treaties. A company is "resident" for

[82] A comparative of the terminology of the two phrases in instructive in their interpretation

South African domestic tax purposes if it is incorporated, established or formed in the Republic of South Africa or its POEM is situated in South Africa. However, a person is deemed not to be a resident for tax purposes, if it is a resident of another country in terms of a bilateral tax treaty entered into between South Africa and that country. Tax treaties historically utilised the term "effective management" as a so-called "tie-breaker" where a person is deemed for purposes of a tax treaty to be resident in both Contracting States (Olivier & Honiball, 2008:65).

The concept of "effective management" and "place of effective management" is not defined in the ITA nor the tax treaties and the court precedents are ambiguous, accordingly, the meaning of these concepts may remain unclear and tax specialists should be engaged by Oil and Gas companies with regards to the arrangement of their activities to avoid inadvertent adverse income tax consequences stemming from tax residency based on POEM. The SARS interpretation of "effective management" has transitioned from an interpretation that had initially pointed to the senior management *implementation* of key commercial and strategic decisions in the day to day operations as being indicative of the POEM to an interpretation that is now more aligned with the international interpretation that POEM is where the top-level management *make* the key commercial and strategic decisions.

There is a conflict in the domestic interpretation of the term POEM used by countries that adopt the Continental approach and domestic SARS interpretation which follows the Anglo-Saxon approach to the interpretation of the term POEM. The Anglo-Saxon approach is consistent with the tax treaty interpretation (OECD 2014 and prior) and is accepted by the South African courts. The possibility exists that a company may find itself to be a dual resident based on the domestic interpretation of POEM where one country follows an interpretation that the POEM is where top-level management makes the key commercial and strategic decisions and the other country follows the interpretation that the POEM is where senior management implement such decisions in the day to day business operations.

Based on case law an understanding of the meaning of gross income is obtained and the criteria for deduction of expenses within each stage of the life cycle of an oil and gas well in the domestic legislation is considered.

A specific concern is raised that the deduction of capital expenditure, in section 15(b) is limited to the deduction of prospecting and appraisal expenditure conducted in the Republic. These limitations and specific references to the South African mining legislation could easy be interpreted by an overzealous SARS auditor as a legislative intent to limit the deduction of

mining capital expenditure only to South African mining activities, which would lead to the absurd result that income from foreign mining activities is taxable without the allowed deductions for capital expenditure. It is therefore recommended that section 15(b) is amended by the deletion of the reference to mining activities within the Republic, as follows:

15. Deductions from income derived from mining operations. - There shall be allowed to be deducted from the income derived from mining operations –

(*a*) an amount to be ascertained under the provisions of section 36, in lieu of allowances in section 11(*e*), (*f*), (*g*A), (*o*), 12D, 12DA, 12F and 13quin;

(*b*) any expenditure incurred by the taxpayer during the year of assessment on prospecting operations (including surveys, boreholes, trenches, pits and other prospecting work preliminary to the establishment of a mine) in respect of any mining area ~~within the Republic~~ together with any other expenditure which is incidental to such operations to the extent that income from such operations will become taxable when the mine commences production…

Foreign losses arising from the deduction of capital expenditure against income derived from foreign mining operations will be ring-fenced by section 20, for offset against foreign taxable income in prospective years of assessment.

CHAPTER 4
DOUBLE TAXATION AGREEMENTS

4.1 Introduction

The tax treaties do not impose taxes on income[83]. Taxes are imposed under the domestic laws of the Contracting States. The basic aim of many double tax treaties is the avoidance of international juridical double taxation, which is broadly defined by Passos (1986:77) as the charging of comparable taxation for the same periods by both contracting states on the same income or capital accruing to a single taxpayer. International juridical double taxation occurs most frequently when the same income is taxed in one country on a source basis, while the other country exacts taxation on the principle of residence. The treaty provisions, reduce the effects of double taxation by allocating the right to tax various items of income between the country of source and the country of residence.

In chapter 4, the thesis provides an analysis of the double tax relief available under the South African Double Taxation Agreements (DTAs) in the context of the exploration for and production of oil and gas. Chapter 4 does this by examination of the articles relevant to oil and gas as contained in the 2017 OECD, 2017 UN, 2016 US and 2019 ATAF Model Taxation Conventions (MTCs). The majority of South Africa's double taxation agreements are based on the OECD MTC. The specific articles considered in detail are "enterprise", "permanent establishment", "business profits", "immovable property", "associated enterprises" and "territorial extension".

4.2 Double taxation agreements

Double taxation agreements (DTAs) are bilateral or multilateral treaties negotiated between two or more countries for the primary purpose of resolving double taxation problems which arise from the assertion by more than one country to tax the same item of income (Bensouda, 2011:1).

Such overlapping or double taxation arises generally from the fact that most countries exercise jurisdiction to tax income on two bases, one derived from the source of the item of income, the other from the residence of the recipient of that item of income (Bensouda, 2011:1). In essence double taxation agreements "create an independent voice to avoid double

[83] *The Queen v Melford* 82 DTC 6281 at 6285 [1982]

taxation through restriction of Contracting States' tax claims where there could be an overlapping of these claims" (Amatucci, 2006:153).

According to Danziger (1991: 327), while focusing on double taxation issues, DTAs also aim at:

1. The facilitation of international trade and investment by the removal of procedural and substantive tax barriers;
2. The achievement of simplification and harmonisation of rules governing international taxation;
3. The allocation of the right to impose income tax in the case of business income. Thus the permanent establishment rule provides a threshold test for determining what degree of economic activity is sufficient to justify taxation of the activity, as well as encouraging preparatory activities by ensuring that they do not result in tax liabilities;
4. The allocation of expenditure between permanent establishments (PE) and head offices, the recognition of the right of revenue authorities to reallocate expenses between related entities, and the provision of non-discriminatory treatment in the case of expenditure deductions;
5. The provision of non-discriminatory provisions providing the same tax treatment for residents and investors of the other treaty state;
6. The facilitation of enforcement of taxation by way of the exchange of information relating to taxpayers resident or carrying on business in treaty countries;
7. The creation of procedures for dispute resolution, for the tax liabilities of residents of the Contracting States, under the competent tax authority provisions of the DTA.

Although there is no accurate count of the number of DTAs that are in force around the world, it has been estimated that the number may approach 2 500-3 600 (SCOF, 2017:9), most of which are based on a version of the OECD MTC[84]. This would include those based on the UN MTC and the ATAF MTC, as they are also based on the OECD MTC, and their commentaries reflect and largely mirror the OECD Model Commentaries.

4.2.1 The relationship between double taxation agreements and the domestic tax legislation

A DTA does not form part of South African law until it is incorporated in domestic law by legislation (Danziger, 1991:329). In *Pan American World Airways Incorporated v SA Fire and Accident Insurance Co Ltd* [1965][85], the Appellate Division confirmed the rule that in

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[84] In *SIR v Downing* 1975 (4) SA 518 (A), the court acknowledged the widespread use of the OECD MTC by stating: "This model has served as the basis for the veritable network of double taxation conventions existing between this country and other countries and between many other countries".
[85] [1965] 3 SA 150 (A)

South Africa, the conclusion of a treaty was an executive and not a legislative act and that as a general rule, the only way in which the provisions of a treaty concluded by the executive could be embodied in domestic law was by incorporation in the legislation. Consequently, in the absence of legislation giving the treaty the force of law, the treaty provisions cannot affect domestic law or prejudice the legal rights of persons in South Africa. Once a DTA has been included in domestic law by way of its inclusion in legislation (through ratification and gazetting), it enjoys equality of treatment with domestic tax law, provided that the agreement:

a) Has the effect of exempting or relieving the burden of tax; and
b) Also has the effect of law in the other Contracting State.

As a general rule of law, a DTA's provisions do not have the effect of imposing a liability for tax where that liability does not exist under the domestic tax law[86]. Thus, DTAs relieve double taxation but are not interpreted as imposing taxation which would not be imposed in the absence of the DTA[87].

The distributive rules of DTAs, on the other hand, form a self-contained system and are therefore by their very nature barred from the application of domestic definitions and concepts. Vogel & Prokisch (1993:62) noted that "types of income designated by treaties […] should by no means be confused with those of domestic law, even where they do exist in domestic law; any resemblance that may show up will be superficial and accidental"[88]. To safeguard effective application of DTAs to domestically taxable items, the terminology of DTAs should in principle be seen as autonomous from the phraseology of domestic tax legislation. Only where a term is not defined in the treaty, the definition of the term (if any) in the domestic law should be applied[89].

The OECD (2000:7) comments that the outcome of a conflict between DTAs and domestic law depends on the ranking which conventional provisions have in the normal hierarchy of the State in question:

> "Treaty overrides" under domestic law can be automatically avoided if, under a State's Constitution, a higher value is attributed to a treaty obligation than to domestic law or if a State regards treaty law as *lex specialis* to which priority is given in domestic law. If treaty obligations are considered as having […] at most […] the same rank as domestic law, they

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[86] *The Queen v Melford* 82 DTC 6281 at 6285

[87] Costa & Stack (2014:272)

[88] Vogel (1997:398) states:

> 'Since these types of income, profit or capital are often not recognized by the domestic tax laws of Contracting States, or defined differently, it is necessary to interpret the substantive requirements in the context without reference to domestic law. The term "enterprise" in Article 7 Model Convention, for example, presupposes a common understanding in the international community.'

[89] Article 3(2) of the 2017 OECD MTC

> may, within some national legal systems be subject to the rule *lex posterior degat legi priori* (namely later law overrides prior law). However, the situation is less simple to determine in practice since this principle applies only when inconsistencies arise between the new law and the prior law and courts are reluctant to construe treaties as inconsistent with domestic law (and *vice versa*)".

In *Commissioner for the South African Revenue Service v Tradehold Ltd* [2012] op cit note 36 in par 17, the court ruled that a DTA will always apply in preference to domestic law in the case of conflict:

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

4.2.2 Procedure for entering into double taxation agreements

Specific authority for the conclusion by the South African executive of DTAs is contained in section 108 of the ITA and section 231 of the Constitution of the Republic of South Africa[90] (the Constitution).

Under section 231 of the Constitution, the authority to negotiate and sign international agreements rests with the executive. In South Africa, the executive consists of the President and Cabinet. A treaty is usually submitted by Cabinet Memorandum for consent to submit it to Parliament for ratification. Before submission to the Cabinet, the agreement must have been considered by the law advisors of both the Department of Justice and the Department of Foreign Affairs. The agreement itself is negotiated by the law advisors of the National Treasury with the other Contracting State's competent authority. The agreement is also presented by National Treasury for consideration by Parliament's Standing Committee on Finance (SCOF) and SCOF may make comments thereto after the document goes through the Cabinet. Once Cabinet has approved the agreement it may be submitted to Parliament. The agreement is tabled by way of notice of motion together with a draft resolution and an Explanatory Memorandum, which sets out the history, purposes and consequences of the agreement and whether its incorporation into domestic law is sought (Botha, 2000:79). The agreement is not subject to discussion and approval by Parliament. Therefore no amendments

[90] Act 108 of 1996

may be introduced by Parliament to the text of a treaty negotiated and drafted by the South African executive body (Passos, 1986:63).

Section 108(1) of the ITA empowers the National Executive to conclude agreements with the governments of other countries or territories whereby arrangements are made with those governments with a view to the prevention, mitigation or discontinuance of the levying under the South African law and the law of other countries or territories, of tax in respect of the same income, profits or gains, or donations, or to the rendering of reciprocal assistance in the administration of and collection of taxes under the laws of South Africa and the other countries or territories.

Section 108(2) of the ITA mandates the National Executive to proclaim the terms of agreements in the Government Gazette. On proclamation, the arrangements notified in the Gazette is treated as if they were enacted in the Income Tax Act, in so far as they relate to immunity, exemption or relief from South African tax. Treaty arrangements remain effective until the treaty is terminated by the State.

4.3 Interpretation of double taxation agreements

Vogel (1997:33-34) stresses the fact that “tax treaty interpretation is a process regulated by law, not art like the interpretation of poetry! For the effective interpretation of international treaties, it is necessary to reconcile the various national methods of interpretation”.

Treaties have a dual nature. On one hand, they are classified as international agreements and are concluded between participating states in written form (Vogel, 1997: 21). On the other hand, once approved by Parliament[91] and published in the Government Gazette, a DTA becomes part of domestic law (Du Plessis, 2012:31). In *Commissioner for the South African Revenue Service v Tradehold Ltd* [2012][92] the Court had the opportunity to pronounce on the status of double taxation treaties in South Africa. The Court referred to section 108 of the ITA, calling it “enabling legislation”, and then held at para 16 that “once brought into operation a double tax agreement has the effect of law”. The Court described the “legal effect” of a double taxation treaty by quoting a passage from *SIR v Downing*[93], which also stated that a treaty is treated as if enacted in the Act.

[91] Section 108(2) of the ITA

[92] *Commissioner for the South African Revenue Service v Tradehold Ltd* [2012] 3 All SA 15 (SCA) at para 17: “A double tax agreement thus modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict."

[93] *SIR v Downing* 1975 (4) SA 518 (A)

Because a DTA is made part of the domestic law the ordinary rules of statutory interpretation should apply (see Chapter 3- 3.4 Interpretation of domestic tax legislation).

International agreements are governed by international law (OECD, 1977:5). International law[94] is defined as a legal system and principles which are binding upon States in their relations with each other (Dugard, 2000:52). This legal system consists essentially of treaties, reflecting the express agreement of States, and customary rules of international law (Chaskalson et al, 1997: para 13.3). Customary rules of international law, referred to as the "common law" of public international law, consist of rules generally accepted, often tacitly, by most countries as binding when they enter into international relations (Olivier & Honiball, 2011:32). Section 232 of the Constitution provides that customary international law is a source of South African law unless it is inconsistent with the Constitution or an Act of Parliament. Furthermore, section 233 of the Constitution provides that, in interpreting legislation, a court must prefer any reasonable interpretation that is consistent with international law over any alternative interpretation that is inconsistent with international law. Therefore, in interpreting domestic legislation, South African courts are constitutionally bound to take international customary law into account and give preference to an interpretation that is consistent with international law.

The interpretation of tax treaties is governed by customary international law, as embodied in the Vienna Convention on the Law of Treaties (VCLT). The VCLT is an international treaty adopted on 22 May 1969 at the United Nations Conference on the Law of Treaties held in Vienna (United Nations, 2005: 331). Bederman (2001:26) writes that "the VCLT is, quite literally, a treaty on treaties. Almost every question of treaty law is settled in that document". The International Court of Justice stated in the Judgment on the *Arbitral Award of 31 July 1989* that "Articles 31 and 32 of the Vienna Convention on the Law of Treaties may in many respects be considered as a codification of existing customary international law"[95]. South Africa is not a signatory to the VCLT but it is submitted that it may be bound by the provisions of the VCLT because the Convention's provisions represent a codification of customary international law[96].

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[94] Since about 1840, the term "international law" has replaced the older terminology "law of nations" or "*droit des gens*". In the German, Slavic, Dutch and Scandinavian languages, the older terminology is still in use ("*Völkerrecht*", "*Volkenrecht*", etc.). International law has traditionally been defined as a system of equal and sovereign states whose actions are limited only by rules freely accepted as legally binding. See thereto the decision of the PCIJ in *Lotus*, Judgment No. 9 (1927):18.
[95] *I.C.J. Reports 1991:*69-70, para. 48.
[96] Scholtz (2004: 207); Olivier & Honiball (2011: 308); Dugard (2000:406)

The basic rule of interpretation in Article 31(1) of the VCLT provides as follows:

> "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 the light of its object and purpose."

Prokisch (1998:103) noted that "in case of interpreting tax treaties we must read Article 31(1) as follows: a term must be interpreted under the ordinary meaning given to it by international tax language". Prokisch (1998:104) defines "international tax language" as "the common international understanding of terms which are used within the formulation of tax treaties". There is consensus, explicitly confirmed by the courts in the United Kingdom[97] (Olivier & Honiball, 2008:44), India (Butani, 2004:62), New Zealand,[98] Australia (Olivier & Honiball, 2008:41)[99], the Netherlands[100] and South Africa,[101] concerning the existence of an "international tax language" used in the interpretation of DTAs (Vogel, 2000:612).

Amatucci (2006:157) & Vogel (1997:30) clarify further that the reference in Article 31(1) of the VCLT to the "ordinary meaning" of terms does not necessarily refer to the everyday use of the term (Hattingh, 2021:3.4.4). Rather, it refers to the international uniform legal use of the term. Waters (2005:677) agrees that when looking for the "ordinary meaning" of words used in tax treaties it is warranted under Article 31(1) of the VCLT to take account of the international context in which the words are used.

The context under Article 31(2) of the VCLT includes the test of the treaty and any agreements between the parties made in connection with the conclusion of the treaty and any instrument made by one of the parties and accepted by the other party (Hattingh, 2021: 3.4.5.1). In addition, under Article 31(3) of the VCLT subsequent agreements between parties and subsequent practice in respect to the interpretation of the treaty and any applicable rules of international law must be taken into account together with the context (Hattingh, 2021: 3.4.5.4). South African courts are starting to identify the relevance of subsequent agreements and practice in the application and interpretation of tax treaties. In *ABC (Pty) Ltd v. Commissioner for the South African Revenue Service* [2021], the South African

[97] In *Ostime v. Australian Mutual Provident Society* 38 TC 492, Lord Radcliffe noted: "The language employed in this agreement is what may be called international tax language and … such categories as 'enterprise', 'industrial or commercial profits' and 'permanent establishment' have no exact counterpart in the taxing code of the UK."

[98] *Commissioner of Inland Revenue v JFP Energy Incorporated* [1990] 3 NZLR, at page 536.

[99] *Thiel v. Federal Commissioner of Taxation* [1990] 21 ATR 531, at page 537.

[100] *Indofood International Finance Ltd. v. JP Morgan Chase NA, London Branch* 2006 8 ITLR 653 (A).

[101] *In SIR v Downing* 1975 SA 518(A) Corbett JA remarked, *'The convention makes liberal use of what has been termed "international tax language"'* and *Krok v CSARS* [2015] *4 All SA 131 (SCA) (20 August 2015) at para 27.*

Tax Court accepted that the OECD's 1995 transfer pricing guidelines represented a custom in the application of the arm's length principle for purposes of interpreting the domestic legislation that enables transfer pricing adjustments.

Under Article 32 of the VCLT, other material, referred to as supplementary means of interpretation, which include the *travaux préparatoires* (preparatory work) of the treaty, are only to be considered to confirm the meaning established according to Article 31, or to establish the meaning when Article 31 produces an ambiguous, obscure, or unreasonable result (Hattingh: 2021: 3.5.1.1). McNair (1961:410) defines *travaux préparatoires* as "an omnibus expression which is used rather loosely to indicate all the documents, such as memoranda, minutes of conferences, and drafts of the treaty under negotiation, to interpret the treaty". The use of supplementary means of interpretation is not limited to material expressly mentioned in Article 32 of the VCLT. In the case *AB LLC and BD Holdings LLC v The Commissioner of the South African Revenue Service* [2015][102], the court recognizes that if tax treaty negotiations are based on the OECD MTC, the OECD MTC and the OECD Model Commentary may guide in establishing the meaning of treaty provisions[103]. Consequently, the OECD MTC and the OECD Model Commentary qualify as supplementary means of interpretation under Article 32 of the VCLT, provided that the treaty provision in question is based on the OECD MTC (Vogel, 1997:614). This is also recognized by the High Court of Australia in the *Thiel* case[104], which held that

> "[T]he Model Convention and Commentaries are documents which form the basis for the conclusion of bilateral double taxation agreements of the kind in question and provide a guide to the current usage of terms by the parties. They are, therefore, a supplementary means of interpretation to which recourse may be had under Article 32 of the Vienna Convention".

But in the case of DTAs not modelled on the OECD MTC, the OECD Model Commentaries[105] are not materials that originated in the context of negotiations of those tax treaties and therefore they cannot be seen to be interpretative materials acceptable under the VCLT (Gloria, 1988:90).

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[102] *AB LLC and BD Holdings LLC v The Commissioner of the South African Revenue Service* (13276) 2015 SATC 2 (15 May 2015) at para 2, the court opined '[t]he explanations provided in the Commentary are of immense value in understanding or interpreting any article contained in the treaty'.

[103] In *ITC 1503*[1990] 53 SATC 342 (T), the court at 348 relied on the commentaries to the OECD Model in support of its conclusion in deciding the treaty interpretation of relief from double taxation in respect to income and profits derived from sea or air transport.

[104] *Thiel v Federal Commissioner of Taxation* [1990] 171 CLR 338 at 350.

[105] The place of the Commentaries under the VCLT has been the subject of debate. For a summary of some of the sources that deal with this debate, see Du Plessis (2014:100) South African Perspective on Some Critical Issues. There is also a question on whether the Commentaries can be taken into account as "context" under art 3(2) of the OECD MTC, in respect of which see the discussion by Rust (2015:123) "Article 3(2) OECD and UN MTC" and Avery Jones (2019) "Treaty Interpretation" para 5.1.1

The general rule of interpretation is based on the view that a treaty must be presumed to be the authentic expression of the intentions of the parties (Vogel *et al,* 1993: 73). Accordingly, the investigation into the intention of the parties should not be the initial aim of the interpreter, which should be the clarification of the meaning of the text. In any event, the *travaux préparatoires* being a supplementary means of interpretation do not represent an alternative, autonomous method of interpretation divorced from the general rule of interpretation (Passos, 1986:69).

In *SIR v Downing* [1975] and *Krok v CSARS* [2015], the South African Appellate Division of the Supreme Court[106] considered the interpretation of tax treaties. The inferences that may be drawn from these cases include the following:

1. The reaffirmation of the statutory principle that the treaty provisions cannot be interpreted as creating or increasing a tax liability;
2. The recognition by the court that the model convention adopted by the OECD has served as the basis for the more modern treaties signed by South Africa;
3. Treaty definitions were used by the court and translated into language appropriate to the facts of the case;
4. The words included in the definition of the treaty provision in question were ascribed their natural meaning;
5. Reference was made to the intention of the contracting parties in drafting the treaty provision whose meaning the court tried to establish;
6. The existence of an "international tax language" of which the treaty makes use was acknowledged by the court.

Based on these inferences, it may be concluded that the South African judiciary accepts the principle that when a term is defined in a treaty that definition must apply (authentic interpretation), and the words used in the definition must be given their ordinary meaning. Furthermore, the intention of the contracting parties seems to have a role in the interpretation of the treaties.

The following specific interpretative clauses are in general included in the South African DTAs:

1. The contracting parties have agreed to the meaning of some of the terms used in the treaties. Consequently, and unless the context otherwise requires, the terms are used as defined in the treaties. Examples of definitions include the terms "permanent establishment" and "immovable property".

[106] *SIR v Downing* [1975] SA 518(A) and *Krok v CSARS* [2015] 4 All SA 131 (SCA) (20 August 2015)

2. Most treaties embody a clear and general *renvoi* clause to operate if the terms used in the treaty are not specifically defined. A *renvoi* clause calls for the domestic tax law to be consulted for the interpretation of such a term. This is in line with Article 3(2) of DTAs drafted based on the 2017 OECD Model Tax Convention (MTC) which specifically provides that where a term is not defined in the double taxation agreement, it should be interpreted according to domestic law unless the context otherwise requires. Specific *renvoi* clauses for certain terms are also found in some treaties. Of all the South African DTAs in force, only the treaty with the United States does not include a general *renvoi* clause.

   Two problems may arise in connection with *renvoi* clauses:

   a) The treaties may include certain concepts and technical terms that have no counterpart in the South African domestic tax law. It is submitted that the alternative for the revenue authorities and the South African courts will be to accept such a term based on its international usage, if there is one, or to accept its meaning under the domestic tax law of the other Contracting State.
   b) When the concept is known within the South African domestic tax terminology a decision has to be made whether that concept should be applied according to its meaning as at the date at which the particular treaty became law or on which the convention is being applied. In other words, the question is whether the "static" or "ambulatory" meaning of a term under the tax law should be used (Vogel, 1997:64). Apart from the treaty with the United States, which in Article 4(2) specifically states that the concept of the source should be used with the meaning it had at the date that the treaty entered into force, the other treaties are silent on the issue.

      Olivier & Honiball (2008: 46) argue in favour of and against both approaches. The main argument in favour of a static approach is legal certainty and *pacta sunt servanda* as a treaty is an agreement entered into by the two Contracting States, and should therefore be interpreted based on the intentions of the parties at the time it was entered into. Subsequent developments are irrelevant as the parties at the time the treaty was entered into and neither did Parliament consider such developments. There is one court case, *Baldwins (South Africa) Ltd vs the Commissioner for Inland Revenue* [1961], in which the South African Appellate Division declined to apply later UK domestic law as it would allow the United Kingdom to determine the scope and incidence of an exemption from tax in South Africa.

On the other hand, the main argument in support of the ambulatory approach is that as tax laws are applied to an ever-changing environment, not adapting tax laws to these changes may result in a situation that was never intended by the Contracting States.

3. A joint interpretation of a treaty by the Contracting States is also possible. The treaties provide that the administrative authorities may consult each other for purposes of carrying out the objectives of the treaty. Apart from this general authorisation for a joint interpretation of a treaty provision, specific rules are sometimes introduced that provide for a joint agreement, for instance, the determination of fiscal residence when various alternative bases provided in the treaty have been exhausted. Although there is scope for an exchange of information, the courts are not necessarily bound by an agreement reached by the Contracting States, especially when such an agreement is not consistent with the wording of the treaty.

The 2017 OECD MTC provides no guidance where an application of the domestic law of the Contracting States leads to different interpretations. In this regard, the 2017 OECD Model Commentary states the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over the other meanings[107]. In other words, the term should be interpreted according to the domestic law of the Contracting State which has the right to tax the income or capital.

Olivier & Honiball (2008:45) submit that as is it clear that the tax law meaning of terms should be applied, it is irrelevant whether this tax law meaning is obtained from statutory law or whether it is obtained from case law. In circumstances where the domestic law of both the Contracting States provides the right to tax the income or capital, Avery Jones (1993:252) believes that Article 3(2) of the 2017 OECD MTC and DTAs based on the 2017 OECD MTC and is predecessors means that the source State has the first right to classify income according to its domestic tax law. In the absence of a conflict of classification (see chapter 6 – 6.2.1 Residence-residence conflicts and 6.2.2 Source-source conflicts), in the circumstance that the source State taxes the income, an obligation exists on the residence State to either exempt the income or if it also taxes the income, it should give credit for taxes paid in the source State. Where there are difficulties or doubts about the application of Article 3(2) of the 2017 OECD MTC, for example where there is more than one domestic tax law meaning, the competent

[107] See para 13.1 of OECD Commentary to Article 3

authorities can agree to a different meaning according to the provisions of Article 25 of the 2017 OECD MTC.

4.4 Model tax conventions

In an attempt to achieve a degree of standardisation of contents of treaties by their members, model tax conventions (MTCs) were published by international organisations. The best-known MTCs are those of the Organisation for Economic Co-operation and Development (the OECD MTC), the United Nations (the UN MTC), the United States of America (the US MTC) and, within Africa, the models include the African Tax Administration Forum (the ATAF MTC) Model, the Southern Africa Development Community (SADC) Model and the East African Community (EAC) tax agreement, amongst others.

4.4.1 The OECD convention

The 2017 OECD MTC is a proposed format for tax treaties prepared by the OECD Member States, representing developed economies. The model also assumes a high degree of sophistication on the part of the revenue authorities who apply those rules.

The 2017 OECD MTC rests essentially on two fundamentals: (i) the country of residence will eliminate double taxation through a foreign tax credit or the exemption of foreign income from tax; and (ii) in turn, the country of source concerning active income limits its jurisdiction to tax at source and at the rates of tax applicable in that country (Bensouda, 2001:3).

The 2017 OECD MTC is accompanied by a set of commentaries on each article of the model, which was compiled by the experts who drafted the convention and which is useful in interpreting the provisions of DTAs which are based on the Model (Lang, 2002:56).

4.4.2 The UN convention

The 2017 United Nations Model Double Tax Convention between Developed and Developing Countries (the 2017 UN MTC) follows a similar format to the OECD MTC but attempts to reflect the interest of developing countries, which as importers of technology, capital, goods and services have attempted to emphasize source taxation, as opposed to the residence taxation bias of the OECD MTC.

Under the 2017 UN MTC, the source country is awarded taxing rights in more instances. On practical grounds, the source jurisdiction should have a prior right to tax because it has the right to tax income derived from within it (Avi-Yonah, 1996:1304).

4.4.3 The US convention

The 2016 US MTC was issued on 17 February 2016 (the 2016 US MTC), accompanied by a comprehensive technical explanation (the 2016 US Model Technical Explanation). Although the 2016 US MTC is strongly influenced by the OECD MTC, it reflects the peculiarities of US tax policy. For example, anti-treaty shopping and anti-abuse rules are emphasized.

4.4.4 The ATAF convention

South Africa is a participating member of the African Tax Administration Forum (ATAF). The 2019 ATAF MTC is a draft treaty prepared by some ATAF members. The 2019 ATAF MTC is aimed at furthering the economic relationships of African countries and enhancing cooperation between their revenue authorities. The purpose of the 2019 ATAF MTC is to provide the framework of an agreement between African countries that eliminates double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or tax avoidance. The 2019 ATAF MTC is based largely on the 2017 OECD MTC.

4.5 Relief mechanisms under double taxation agreements

There are three main relief methods found internationally, namely the exemption method, the credit method and the deduction method.

1. *Deduction method.* The residence State allows its taxpayers to claim a deduction for taxes, including income taxes, paid to a foreign government in respect of foreign-source income;
2. *Exemption method.* The residence State provides its taxpayers with an exemption for foreign-source income; and
3. *Credit method.* The residence State provides its taxpayers with a credit against taxes otherwise payable in the country for residence in respect of income taxes paid in the source State.

As of 8 January 2021, South Africa had double taxation agreements (DTAs) with 79 countries in force as notified by publication in the Government Gazette (Annexure B). South Africa’s DTAs all employ the credit method of relief.

In examples, 4.1 to 4.4 below it is evident that the combined foreign and domestic tax rate under the deduction method is higher than it would be under either the credit method or the exemption method. The exemption method and credit method typically give equivalent results whenever the effective foreign tax rate is equal to or greater than the domestic effective rate. The exemption method is generally the most favourable to the taxpayer when the foreign effective rate is less than the domestic effective tax rate (Arnold & McIntyre, 1995:38).

4.5.1 Deduction method

Countries using the deduction method tax their resident Oil and Gas companies on their worldwide income and allow those Oil and Gas companies to take a deduction for taxes paid in the source State in the computation of their taxable income. In effect, foreign taxes are treated as current expenses of doing business in the foreign jurisdiction. The deduction method is the least generous method of granting relief from international double taxation. The effect of the deduction method is illustrated by way of example.

Example 4.1
R, a resident of South Africa, earns 100 of income from the United Kingdom on which it pays 19 of tax to the United Kingdom. Under the deduction method, R will pay tax to South Africa on the net of income of 81 (100-19). As R is taxable in South Africa at a rate of 28%, it will pay a tax of 22.68 to South Africa and a total tax of 41.68 on its income of 100, for a combined foreign and domestic rate of 41.68%.

The effect of the deduction method is that resident Oil and Gas companies earning foreign source income and paying taxes in source States on the income are taxable at a higher combined tax rate than the rate applied to domestic source income. As a result, the deduction method creates a bias in favour of domestic investment over foreign investment whenever the foreign investment is likely to attract tax in the source State.

The deduction method is avoided in the MTCs for active investments because the deduction method is not neutral in terms of the allocation of resources between countries. The deduction method may be applied in the MTCs usually for passive investments, such as at Article 23A (2) of the 2017 OECD MTC which provides that in the case of dividends (Article 10) and interest (Article 11) which may be taxed in the other Contracting State, the residence State must allow as a deduction from taxable income an amount equal to the tax paid in the source State.

Only the exemption method and credit method are sanctioned by the 2017 OECD MTC, the 2017 UN MTC and the 2019 ATAF MTC as methods of granting double-tax relief. Article 23A of the 2017 OECD MTC provides for the exemption method, and Article 23B provides

for the credit method. South African DTAs all apply the credit method. The 2016 US MTC and 2019 ATAF MTC contains the credit method in Article 23 thereof. Article 5 of the Multilateral Instrument (MLI) (see 6.8) converts the DTAs of signatory countries (who have made this election) to the credit method.

4.5.2 Exemption method

Under Article 23A(1) of the 2017 OECD MTC, where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in terms of the tax treaty, then the first-mentioned State must exempt such income or capital from tax. This is the exemption method. The exemption method terminates residence-source double taxation because only one jurisdiction is imposing a tax. Under Article 23A(3) of the 2017 OECD MTC, where income is exempted by the treaty, the State granting the exemption may nevertheless take into account the exempted income or capital when calculating the amount of tax on the remaining income or capital of the resident Oil and Gas company. The effect of the exemption method is illustrated by way of example.

Example 4.2
R, a resident of South Africa, earns 100 of income from the United Kingdom on which it pays 19 of tax to the United Kingdom. Under the exemption method, R will pay no tax to South Africa in respect of its foreign–source income of 100 and the total tax payable on the income will be 19, for a combined foreign and domestic rate of 19%.

Paragraph 34 of the 2017 OECD Commentary on Article 23A states that the exemption method is the most practical method of providing relief from international double taxation because it relieves the residence State from undertaking investigations of the actual taxation position in the source State. The operation of the exemption method depends on whether the income may be taxed in the source State. If so, there is an absolute obligation to exempt. According to Mabasa (2015:35), the exemption method is the method that is traditionally used in continental Europe.

A variation of the exemption method is found at Article 23A(3) of the 2017 OECD MTC, in terms of which foreign-source income, although exempt, is taken into account in determining the rate of tax applicable to the taxpayer's other income[108]. This practice is referred to as "exemption with progression". In such systems, the foreign-source income is initially included in the income for the limited purposes of determining the average tax rate at which the taxpayer would pay tax if the foreign income were taxable. This average is then used to

[108] Paragraph 55 of the 2017 OECD Commentary on Article 23A.

compute the actual tax due on domestic-source income. Some countries, including the Netherlands, use the exemption-with-progression method.

Example 4.3
Assume that the Netherlands levies tax at 15% on the first 200 of income and 21.7% on the income over 200. T, a taxpayer resident in the Netherlands has 200 domestic-source income and 200 exempt foreign-source income. T would pay a tax of 30 (15% of 200) under the regular exemption system. Under the exemption-with-progression system, T must determine the average tax rate that would apply if this entire income of 400 were domestic-source income. In this example, the average rate would be 18.35% ((200 x 15% + 200 x 21.7%) divided by 400). The tax payable in the Netherlands would be determined by applying the 18.35% average rate to the domestic-source income of 200, for a tax payable of 36.7.

The exemption method is relatively simple for the tax authorities to administer and is effective in eliminating international double taxation. The exemption-with-progression system is more complex because it requires the tax authorities to obtain information about the amount of foreign-source income earned by resident Oil and Gas companies. But it does mitigate somewhat the unfairness of a pure exemption system on the residence State (Arnold & McIntyre, 1995:42).

Although the exemption method is widely used and is sanctioned by the 2017 OECD MTC, 2017 UN MTC and 2019 ATAF MTC, it offends against the tax policy objectives of fairness and economic efficiency[109]. To the extent that taxes in the source State are lower than domestic taxes, resident Oil and Gas taxpayers with exempt foreign-source income are treated more favourably than other residents. Moreover, an exemption system encourages resident taxpayers to invest abroad in countries with lower tax rates, and it encourages them to divert domestic-source income to such countries.

It should be noted that the 2016 US MTC does not provide for the exemption method (Rohatgi, 2002:117). The US/South Africa DTA contains only the credit method which is consistent with South Africa’s policy of only using the credit method when concluding tax treaties and is consistent with the 2016 US MTC (Olivier & Honiball, 2008:329).

4.5.3 Credit method

Under Article 23B of the 2017 OECD MTC, where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State, then the residence State must allow as a deduction from its tax an amount equal to the income tax paid in that other State. Similarly, in respect of capital, the residence State must allow as a deduction from

[109] The MLI effectively converts all DTAs of signatory countries (who have made this election) to the credit method.

the tax on the capital of that resident, an amount equal to the capital tax paid in the source State. The deduction may not exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable to the income or capital which may be taxed in the source State. In summary, under the credit method, foreign-source income earned by resident Oil and Gas companies is generally taxed at the higher domestic and foreign tax rates.

Example 4.4
R, a resident of South Africa, earns 100 of income from the United Kingdom on which it pays 19 of tax to the United Kingdom. Under the credit method, R will pay tax to South Africa at 28% on its total worldwide net income (100) with no deduction for the taxes paid in the United Kingdom. R will receive a credit, however, against the tax otherwise payable to South Africa for the taxes paid to the United Kingdom. The result is that R will pay tax to South Africa of only 9 (28-19) and a total tax of 28, for a combined foreign and domestic rate of 28%.

According to Vogel (1997:1124), allowing a credit or rebate of the actual tax due is the traditional method employed to avoid international double taxation in the Anglo-American States (as opposed to continental Europe). Article 23 of the 2016 US MTC exclusively uses the term "credit" and not the term "deduction" as used in both the 2017 UN MTC and 2017 OECD MTC (except in the heading to Article 23B).

The credit method avoids the shortcomings of the deduction method. Residents are treated equally from the perspective of the total domestic and foreign tax burden, subject only to an exception for the situation when foreign taxes exceed domestic taxes. Moreover, subject to the same exception, the credit method is neutral for any resident Oil and Gas company's decision to invest domestically or abroad.

Paragraph 60 of the 2017 OECD Model Commentary on Article 23B states that the article sets out the main rules of the credit method, but does not give detailed rules on the computation and operation of the credit, which is "consistent with the general pattern of the Convention". The 2017 OECD MTC, leaves how credit relief is to be obtained, to the Contracting State to determine either in the treaty itself or through domestic implementation provisions. This gives rise to various interpretative problems, especially where the domestic laws of one of the Contracting States contains credit provisions that do not directly refer back to tax treaties. For example, in South Africa there are no detailed credit relief provisions within any of the relevant treaty articles and all such provisions are contained in section 6*quat* to the ITA. The credit or rebate calculated in terms of section 6*quat* may be carried forward for up to seven years if not utilized. However, no South African DTA which contains Article 23B or its equivalent allows the carry forward of credits, and because there is no domestic law

provision that specifically allows a tax treaty credit to be carried forward. Accordingly, where the treaty relief is elected it is not possible to carry forward such credit, and tax treaty credit(s) not utilised will be lost.

Further, the tax treaty credit for foreign tax paid is limited to the domestic tax liability in respect of the same foreign income, with no possibility of a refund or utilisation of the excess unless the relevant treaty provides specifically so. For example, Article 24(b) of the South Africa/Ghana DTA provides that taxes paid by South African residents in respect of income taxable in Ghana, under the provisions of the DTA, shall be deducted from the taxes due according to the South African fiscal law. In terms of Article 3(2), the term income must be interpreted under the South African domestic tax law as it is not defined in the South Africa/Ghana DTA. The result is that if a South African tax resident recipient of Ghana-source income is in a tax assessed loss position no credit for taxes paid in Ghana is available and no carryover is allowed.

Paragraph 66 of the 2017 OECD Model Commentary on Article 23B states that solutions to the credit carry-forward problem must be left to each Contracting State, to be dealt with either in their domestic tax law or bilateral negotiation by amending Article 23B to provide for a carry forward of tax credits. As stated, South Africa has not yet negotiated any such specific provision in any of its tax treaties. The US 2016 MTC, on the other hand, specifically provides for this issue by stating that the US domestic tax law will apply. The credits allowed under Article 23(2) of the US 2016 MTC are specifically stated to be allowed in terms of US domestic tax law and are therefore subject to the various limitations of the US domestic tax law. For example, US domestic tax law will apply to determine the carry-over periods for excess credits and other inter-year adjustments (US 2016 Model Technical Explanation, 2016:59).

4.6 The pattern of South Africa’s double taxation agreements

The pattern and contents of most present-day treaties on Income and Capital Taxes are to a large extent designed on the lines of the OECD MTC. The UN MTC and the US MTC, while departing somewhat in their contents from the OECD Models, have largely adopted their schematic structure (Vogel, 1997:vii).

In general, South Africa’s DTAs follow the OECD MTCs, notwithstanding that South Africa is not a member[110] of the OECD. The reasons for this appear to be the influence which the

[110] South Africa was awarded OECD observer status during 2004.

OECD models have acquired, South Africa's desire to participate in the harmonization of the international DTA system, and the fact that many of South Africa's treaty partners are themselves members of the OECD (Danziger, 1991:331).

The pattern of South Africa's DTAs, with the exception (and only in certain respects) of the US/SA DTA, is as follows (Johannes, 2013:13):

i) The first two articles generally specify the persons entitled to the benefits conferred and the taxes covered by the treaty. Provisions resolving conflicts of dual residence are added.

ii) Articles follow defining certain key terms and expressions of the treaty. The most usual terms defined include "permanent establishment" and "person". Certain terms, however, are defined in the separate articles dealing with the taxation of specific items of income, for instance, "immovable property".

iii) The specific elimination of double taxation for certain types of income or gains is dealt with in separate articles. These articles determine the jurisdiction of the two Contracting States in taxing specific types of income and capital. Through the allocation of the right to tax those items or gains exclusively to one country or the placing of a ceiling on the rates of tax to be charged by the country, relief from double taxation is achieved. These provisions are also set out rules determining the source of income.

iv) The specific items of income for which separate taxing rules are adopted usually include:

    1. *Income from immovable property*. No limitation is imposed on the right of the country where the property is located to tax this type of income;
    2. *Business profits*. The country of source is granted the right to tax business profits only if and to the extent that they are attributable to a local permanent establishment;
    3. *Investment income*: dividends, interest and royalties. Except for royalties, the country of source agrees to a reduction of its taxes. An exemption is usually granted by the country of source for royalties.
    4. *Earned income*, with separate provisions covering independent personal services; dependent personal services; public entertainers; professors and students; directors' fees; government services; and pensions (including annuities).
    5. *Any other type of income not covered by other provisions*. The country of residence is usually granted the exclusive right to tax this income.

6. *Capital gains*. The right to tax capital gains on a property of a given kind is in general granted to the state that in terms of the treaty is entitled to tax the income derived from it.

v) An article is included dealing with the general method of eliminating double taxation. South Africa usually accepts the following alternative methods: the exemption from tax of income from a foreign source or the granting of a credit relief for foreign taxes paid on foreign income.

vi) Administrative provisions are included relating to guarantees of non-discrimination; mutual agreement procedures (MAP); exchange of information; diplomatic agents; and entry into force and termination of the treaties.

4.6.1 The personal scope of treaties

Tax treaties based on the 2019 ATAF MTC, 2016 US MTC, 2017 UN MTC and 2017 OECD MTC all limit the persons who may benefit from their provisions to persons who are residents of one or both of the Contracting States[111]. The treaty provisions allocating the right to tax specific classes of income or establishing the rules applying to the method for elimination of double taxation are directly or indirectly limited in their application to a resident of one of the contracting states. This restriction is usually affected by the restriction of the benefit of the reduced rate or tax or even exemption from tax on income arising in a contracting state to a resident of the other contracting state (Passos, 1986:83).

According to Danziger (1991:331), the purpose of the limitation is to prevent the abuse of the treaty by residents of third states for tax avoidance or evasion. The reason why such abuse occurs is that although DTA's are intended to be bilateral agreements applying to the residents of the treaty states, they can be used by non-residents of those states to obtain benefits granted by the treaties. This can occur through the creation of a legal entity in one of the treaty states and channelling income through that entity.

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[111] Article 1 of the 2017 UN Model Taxation Convention provides as follows:
'This Convention shall apply to persons who are residents of one or both of the Contracting States'.
Article 1 of the 2016 US Model Taxation Convention provides as follows:

> 'This Convention shall apply only to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention'.

Article 1 of the 2017 OECD Model Taxation Convention provides as follows:

> 'This Convention shall apply to persons who are residents of one or both of the Contracting States'.

Article 1 of the 2019 ATAF Model Agreement for the Avoidance of Double Taxation provides as follows:

> 'This Agreement shall apply to persons who are residents of one or both of the Contracting States'.

The term "resident" is defined in the 2019 ATAF MTC, 2016 US MTC, 2017 UN MTC and 2017 OECD MTC for tax treaty purposes. Article 4(1) of the 2019 ATAF MTC[112], 2017 UN MTC[113] and 2016 US MTC[114] specifically provides that a person is considered to be a tax resident in a Contracting State if the entity is liable to tax in that State because of the place of incorporation or place of management. Whilst the 2017 OECD MTC[115] provides that a person is considered to be a tax resident in a Contracting State if the entity is liable to tax in that State because of the place of management. The rate of tax imposed by that State is immaterial, as well as how the tax is imposed. As long as the person is liable to tax on the basis referred to in the definition, it will be a resident of that country for its treaties. The 2017 OECD Commentary does not guide the meaning of the phrase "liable to tax". Shelton (2004:287) believes that the term liable to tax should be widely interpreted to include all persons which one of the Contracting States has the free and unencumbered right to tax as it wishes. Shelton's view is based on the argument that the fundamental purpose of Article 4(1) is to determine which categories of persons worldwide are covered by the treaty.

The domestic laws of both Contracting States may indicate that the person is tax resident in both Contracting States, namely dual residency.). The dual residence is dealt with in the tax treaties either by general exclusion, in a POEM tie-breaker test or MAP tie-breaker test.

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[112] Article 4(1) of the 2019 ATAF Model Agreement for the Avoidance of Double Taxation provides as follows:

> 'For the purposes of this Agreement, the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that Sate or any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State'.

[113] Article 4(1) of the 2017 UN Model Taxation Convention provides as follows:

> 'For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein'.

[114] Article 4(1) of the 2016 US Model Taxation Convention provides as follows:

> 'Except as provided in this paragraph, for the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature…'.
>
> a) The term "resident of a Contracting State" does not include any person who is liable to tax in that State in respect only of income from sources in that State or of profits attributable to a permanent establishment in that State…'

[115] Article 4(1) of the 2017 OECD Model Taxation Convention provides as follows:

> 'For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein'.

To break the deadlock of dual residency, the 2006 US MTC, 2012 UN MTC and 2014 OECD MTC all provided for a residence override clause. Article 4(3) of the 2006 US MTC[116] stipulated that a person was deemed to be resident in the State of its incorporation. Whilst the 2012 UN MTC[117] and 2014 OECD MTC[118] both provided that a person was deemed to be a resident of the State in which its POEM was situated. Following the OECD BEPS Action 6 report, the 2016 US MTC, 2017 UN MTC and 2017 OECD MTC together with the 2019 ATAF MTC[119] no longer provide any residence override clause, and it is now up to the competent authorities of the Contracting States to resolve the deadlock concerning dual residency by mutual agreement[120]. Historically, South Africa has preferred the use of the OECD MTC (2014 and prior) as the basis for its treaty negotiations (Danziger, 1991:331). Accordingly, the POEM is the tiebreaker used dominantly in the South African DTAs. Although the place of incorporation test provides simplicity and certainty to both government and taxpayers, it may not necessarily reflect the economic reality due to the ease of incorporation and lack of formal connecting factors for incorporation in most jurisdictions (OECD, 1996:13).

Van der Merwe (2006:121) shares this view, namely that place of incorporation, establishment or formation is a formal test that is generally straightforward in its application. However, it is also open to manipulation, particularly in the modern global environment, and may have 'little or no connection with the entity's actual economic business links'. POEM has been recognized as a 'less artificial measure' that looks to 'substance over form' (Van der Merwe, 2006:122). For this reason, POEM is generally considered less easy to manipulate.

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[116] Article 4(3) of the 2006 US Model Taxation Convention provides as follows:

> 'Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then if it is created under the laws of one of the Contracting States or a political subdivision thereof, it shall be deemed to be a resident of that State'.

[117] Article 4(3) of the 2012 UN Model Taxation Convention provides as follows:

> 'Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated'.

[118] Article 4(3) of the 2014 OECD Model Taxation Convention provides as follows:

> 'Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated'.

[119] Article 4 (3) of the 2019 ATAF Agreement for the Avoidance of Double Taxation provides as follows:

> 'Where by reason of the provisions of paragraph 1 a person other an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavor to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for purposes of the Agreement, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors.'

[120] The Multilateral Instruments (MLI) as discussed in further detail in Chapter 6 are set to change the South African DTAs to the mutual agreement.

Under the general exclusion, specifically excluded from the residence requirement are persons who are liable to tax in a Contracting State on the basis that income was received or accrued based on being sourced in that State (Olivier & Honiball, 2011:21). As a result, a person who is resident in the one Contracting State and is liable to tax on income sourced in the other Contracting State will not be regarded as a resident of the latter State. The source of income is therefore also a determinate factor in exclusion from residence.

4.6.2 Taxes covered

Taxes covered by the DTA are laid out in Article 2 of a DTA modelled on the 2017 OECD MTC. According to the 2017 OECD Commentary (2017:75), Article 2 is intended to

> "widen as much as possible the field of application of the DTA by including, as far as possible, and in harmony with the domestic laws of the contracting States, the taxes imposed by their political subdivisions or local authorities, to avoid the necessity of concluding a new DTA whenever the contracting States' domestic laws are modified".

The 2017 OECD Commentary (2017:75) explains that paragraph (1) of the 2017 OECD MTC:

> "[A]voids the use of imprecise terms to define the taxes on income and on capital covered, the authority on behalf of which such taxes are imposed and even the method of levying the taxes".

Paragraph (2) of the 2017 OECD MTC defines taxes on income and capital. Such taxes comprise taxes on total income and elements of income, on total capital and elements of capital. They also include taxes on profits and gains derived from the alienation of movable or immovable property, as well as taxes on capital appreciation. In the DTA between South Africa and Ghana, Article 2(1) regards taxes covered by the Agreement as "taxes on income and on capital gains […] irrespective of how they are levied", and Article 2(2) states that "there shall be regarded as taxes on income and on capital gains all taxes imposed on total income, and on total gains, or elements of income or elements of capital gains, including taxes on gains from the alienation of movable and immovable property and taxes on the total amounts of wages and salaries paid by enterprises".

The 2017 OECD Commentary (2017:76) observes that "some countries have chosen to at paragraph (3) to list specific taxes, these are the taxes in force at the time of signature of the treaty", for example, South Africa's DTAs with Egypt and Nigeria. In the DTA between South Africa and Egypt, at Article 2(3) the taxes covered by the Agreement in Egypt are the existing taxes at the time of signature of the Agreement on income derived from immovable property (at sub-paragraph a (i)), the tax on corporation profits (at sub-paragraph a (iii)), and

supplementary taxes imposed as a percentage of these taxes or otherwise (at sub-paragraph a (v)). In South Africa, the taxes covered by the Agreement are limited to the "normal tax" (which reference is understood to mean "taxes levied in terms of the income tax act") and the secondary tax on companies (STC) (which was after the signature of the Agreement replaced by withholding tax on dividends). The list is not exhaustive. The list merely serves to illustrate the preceding paragraphs of the Article. But Lang (2005:220) submits that the omission of a tax in existence at the time of signature is indicative that the relevant contracting State sought to omit that tax from the scope of the DTA. Countries that have taken this approach to clarify in paragraph (4) that the treaty shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the treaty and are in addition to, or in place of, the existing taxes (Vogel, 2005:63). The DTA between South Africa and Egypt, at Article 2(4) provides that the Agreement shall also apply to any other taxes of a substantially similar character that are imposed after the date of signature of the Agreement in addition to, or in place of, the existing taxes.

Vogel (2005: 156-158) provides clarity on the meaning of "identical or substantially similar taxes". He states that the essential elements in deciding whether a new tax is identical or substantially similar to the previous tax are as follows:

1. The name and rate of tax has no bearing on the decision;
2. The new tax should be reviewed referring to all taxes historically developed by that State; by States with related tax systems; and, referring to the other Contracting States taxes listed in the equivalent of paragraph 3;
3. The tax should not have been deprived of its essential features, especially in the case of a tax that replaces another.

4.6.3 Non-discrimination

The primary goal of a DTA is to avoid double taxation. Subsidiary to this goal, its non-discrimination rules and equal treatment clauses were designed to contribute towards developing economic ties between contacting states (Vogel, 2005:1282).

Article 24(1) of a DTA modelled on the 2017 OECD MTC provides that:

> "The nationals of one State may not be subjected, in the territory of the other state, to any taxation or connected requirement which is other or more burdensome than the taxation and connected requirements to which nationals in the other state in the same circumstances, in particular for residence, are or may be subjected".

This article is commonly referred to as the "non-discrimination" article and was the subject of dispute in *ITC 1544* [1992][121]. In this case, the appellant claimed a refund of non-resident shareholders' tax (NRST) which had been paid in terms of section 42(1) of the ITA. The Commissioner rejected the claim and the matter went on appeal. The appellant argued that as a non-South African company it was required to pay NRST and was discriminated against compared with a South African company. The court held that the non-discrimination article of the DTA between South Africa and the Netherlands (Article 25(1)) governs the provisions of the ITA, through section 108 which means that such provisions (more specifically s 42(1)(iii)) cannot be applied in a manner which results in discrimination[122]. Not long after *ITC 1544*, South Africa abolished NRST *in toto* and introduced Secondary Tax on Companies (STC). Similarly, the tax on a PE which an enterprise of one State has in the second state may not be less favourably levied than the tax levied on enterprises of the second state carrying on the same activities (Article 24(3)).

STC was replaced by dividends withholding tax (DWT) from 1 April 2012. It is to be seen whether the DWT will be subject to the non-discrimination clause. South Africa does not levy a branch remittance withholding tax but does charge a DWT at 20% on dividends declared to non-resident companies. By accessing relief under a tax treaty the DWT rate could be lower. Dividends declared to resident companies are exempt from the DWT[123]. The liability for tax rests with the beneficial owner of the dividend[124]. In this context, non-resident companies that derive their profits via a branch in South Africa are treated in a more favourable tax position than a resident that declares a dividend to a non-resident holding company. Where a dividend declared is subject to foreign taxes, a rebate must be deducted from the dividends tax in respect of the foreign taxes paid. The rebate may not exceed the amount of the dividends tax imposed in respect of the dividend[125].

Where a provision applies to all taxpayer's irrespective of their nationality, the non-discrimination clause cannot be invoked (Olivier & Honiball, 2008: 369). In *ITC 1364* [1980][126] a taxpayer was obliged under the UK law to pay maintenance to his ex-wife. He subsequently immigrated to South Africa where he became ordinarily resident. Under South

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[121] 54 SATC 456

[122] See also *Boake Allan v IRC* (UK House of Lords, 2007) and Zimbabwean case, *BAT v Commissioner of Taxes* (57 SATC 271)

[123] Section 64F(a)

[124] Section 64EA

[125] Section 64N

[126] 45 SATC 23

African domestic law, the maintenance payments were not deductible for tax purposes. The taxpayer argued that he was subjected to double tax on the basis that he could not claim a deduction under the South African domestic law and in addition, his ex-spouse was taxable on the amounts under the UK domestic law. He argued that as a result he was discriminated against as contemplated under Article 23(1) of the DTA between South Africa and the United Kingdom. The Tax Court rejected the taxpayer's argument. Double tax means the same income is taxed twice in the hands of the same taxpayer. In addition, the taxpayer's burden was not more burdensome than that of other individuals in the same position.

4.7 Articles specific to the activities of Oil and Gas companies

Although in theory, the principle that a country's right to tax depends on the nature of income derived is sound, in practice it is not easy to characterise income of a specific nature (Olivier & Honiball, 2011: 16). Income derived from the exploration for and production of oil and gas may be subject to three possible classifications, namely as "business profits" of a "permanent establishment" of an "enterprise", as income from "immovable property" or as income from "offshore activities".

4.7.1 Enterprise

The term "enterprise" applies to the carrying on of any business (Article 3(1) (c) of the 2017 OECD MTC, Article 3(1) (f) of the 2019 ATAF MTC and Article 3(1) (f) of the SA/Ghana DTA). There is no definition of "enterprise" in the 2017 UN MTC, in the SA/ Egypt DTA and the SA/Ghana DTA. The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, in Article 3 (1)(d) of the 2017 OECD MTC, Article 3(1)(c) of the 2017 UN MTC, Article 3(1)(g) of the 2019 ATAF MTC, Article 3(1)(f) of the SA/Egypt DTA, Article 3(1)(g) of the SA/Ghana DTA and Article 3(1)(f) for the SA/Nigeria DTA, respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State.

The US 2016 MTC contains the further definition that the term also includes an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State.

Where there is no definition of "enterprise" in the tax treaty, the term should be interpreted based upon the provisions of the domestic laws of the Contracting States[127] which is why there is no exhaustive definition of the term in the 2017 OECD MTC.

The concept of an "enterprise" is unknown in South African domestic income tax law and, being a civil law concept, there are few other common law jurisdictions to aid in interpretation. Consequently, regard must be had to the other sources to determine the meaning of the term in a South African tax treaty context (Olivier & Honiball, 2011:88).

Overseas case law would be of persuasive authority for a South African tax court. However, there seems to be very little overseas case law on the meaning of the term. In the Canadian case of *Rutenberg v M.N.R* [1979][128], a passive investment in Canadian immovable property by a US tax resident individual was held not to be a business activity of a US enterprise. The meaning of the term "enterprise" was not, however, comprehensively considered in this case.

Olivier & Honiball (2011:89) submit that in the context of the use of the term "enterprise" in Article 7 of the 2017 OECD MTC (namely the "business profits" Article, see below), the term does not require that the business be conducted in the home or residence State. All that is required, is that there be an enterprise that carries on business in the other Contracting State (the source State) through a PE situated therein. This view is supported by the 2017 OECD Commentary at Article 5 (paragraph 1(6)), which gives an example of business carried on exclusively in the source State.

4.7.2 Permanent establishment

A "permanent establishment" is defined in Article 5 of the 2017 OECD MTC, the 2017 UN MTC, the 2016 US MTC, the 2019 ATAF MTC, the SA/Egypt DTA, the SA/Ghana DTA and the SA/Nigeria DTA as a fixed place of business through which the business of an enterprise is wholly or partly carried on. The definition of "permanent establishment" as contained in Article 5 of the 2017 OECD MTC, the 2017 UN MTC, the 2016 US MTC, the 2019 ATAF MTC, the SA/Egypt DTA, the SA/Ghana DTA and the SA/Nigeria DTA specifically includes a mine, oil or gas well, a quarry or any other place of extraction of natural resources (Article 5(2) of the 2017 OECD MTC). The 2017 OECD Model commentary (OECD, 2017:90) elaborates that "any other place of extraction of natural resources" should be interpreted broadly. It includes for example all places of extraction of hydrocarbons whether on or off-

[127] Article 3(2) of the 2017 OECD Commentary.
[128] [1979] C.T.C 459 (Federal Court of Appeals)

shore. But the mere ownership of a place of natural resources should in itself be insufficient to create a PE (Passos, 1986:143).

The concept of "permanent establishment" is used to represent the level of contact required to justify a source State's tax jurisdiction over business activities undertaken in that State. How business activities are carried on in a State will give rise to taxation there only if a definite, organised contact or presence is established. This minimum business presence forms the concept of a "permanent establishment". Its existence shows a continued and lasting kind of business presence, as opposed to casual or sporadic activities, which do not justify the allocation of taxing rights to the source State.

A "permanent establishment" is not a legal entity independent of the enterprise but a mere extension of that enterprise in the other Contracting State. A construction or assembly project or a building site constitutes a place of business that by nature is temporary in duration. Article 5 of the 2017 OECD MTC provides further that a building site or construction or installation project constitutes a PE only if it lasts more than twelve months. South Africa has a stated position to the 2017 OECD MTC Article 5(2), that a PE will exist for enterprises conducting activities for more than six months related to the exploration or exploitation of natural resources. The SA/Egypt DTA, the SA/Ghana DTA and the SA/Nigeria DTA all use a minimum period of six months. This aligns with the 2017 UN MTC that uses a minimum period of six months. The 2019 ATAF MTC allows for the Contracting States to specify the number of days for an installation or structure used in the exploration of natural resources. Most of South Africa's DTAs follow either the 2017 OECD MTC or 2017 UN MTC in this regard. The 2016 US MTC deals specifically with offshore drilling sites in Article 5(3) and uses a minimum period of twelve months. The notable exception is the Romania/South Africa DTA that provides for a minimum period of nine months.

The 2017 OECD Model Commentary (OECD: 90) attests that it has not been possible to arrive at a common view of the basic questions of the attribution of taxation rights and the qualification of income from exploration activities. By inference whilst still in the exploration stage of the oil and gas life cycle (see Chapter 3), the activities of the Oil and Gas company do not constitute a PE provided that such activities do not subsist for more than the minimum period allotted in the DTA. The minimum period test applies to each site or project unless various sites or projects are connected. The 2017 UN MTC Article 5(3)(b) overtly connects contacts, stating that a PE only exists "if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than

six months within any twelve months"[129]. The decision whether they are connected and therefore form part of the same single unit depends on whether they form a "coherent whole commercially and geographically" according to the 2017 OECD Model Commentary. Commercial and geographical interdependence thus constitutes the key in deciding whether a series of construction projects must be treated as one in a determination of the existence of a PE. Example drilling activities for a succession of oil and gas wells in the same oil and gas block. The interpretation followed by the 2016 US Model Technical Explanation is based on the 2014 OECD Model Commentary, which contains language substantially the same as that in the 2016 US MTC (except for the absence in the 2017 OECD MTC of a rule for drilling rigs).

When a series of construction projects are treated as one unit the fact that they arise from separate contracts is disregarded. Paragraph 19 of the 2017 OECD Model Commentary on Article 5 provides that the period is counted from the date on which the contractor begins his work, including preparatory work, in the country where the construction or project will take place. The completion of the work or its permanent abandonment marks the end of the period. Seasonal or other temporary interruptions of work are disregarded. Inclement weather, work stoppages or shortages of materials may cause these temporary interruptions (Passos, 1986:145).

The subcontracting of the work cannot be used by an Oil and Gas company as a device to avoid the creation of a PE. The period spent by a subcontractor working on the site or project may be considered to be time spent by the Oil and Gas company or enterprise itself.

The fact that the work is not performed in one particular place but is relocated from time to time or even continually does not preclude the existence of a PE, since it is the project as a whole that is taken into account. When the project lasts for the minimum required period, a PE exists, even though the enterprise operated in no particular place for the minimum period. For example, the prefabrication of pipeline casings and subsea valves that will be later integrated into the oil and gas infrastructure during the pipeline lay from a producing well to the platform.

In conclusion, an Oil and Gas company will have a PE in the source State at the earlier of satisfying the minimum period of continuous exploration activity in an oil and gas block or

[129] South Africa has elected option A of Article 13 of the MLI to apply in respect to deeming exceptions of certain physical activities from the term "permanent establishment" at Article 5(4) of the OECD MTC. Option A in substance limits the exceptions from applying unless each of the activities undertaken or the combination of activities is of a preparatory or auxiliary nature.

upon entering the production stage of the oil and gas life cycle (see chapter 3). If the minimum period is exceeded, a PE is deemed to exist from the beginning of that period (Rohatgi, 2002:76).

4.7.3 Business profits

None of the three primary MTCs (namely 2017 OECD MTC, 2017 UN MTC and 2016 US MTC) nor the selected country DTAs (namely the SA/Egypt, the SA/Ghana and the SA/Nigeria DTA) specifically define the term "business profits", although what is meant by the term may be inferred from Article 7 as a whole, coupled with the definition of the term "business" in Article 3(1)(*h*) of the 2017 OECD MTC and Article 3(1)(*e*) of the 2016 US MTC. In terms of both Article 3(1) (*h*) of the 2017 OECD MTC and Article 3(1) (e) of the 2016 US MTC, the term "business" includes the performance of professional services and other activities of an independent character. The US 2016 Model Technical Explanation states that the term "business profits" is intended to cover "income derived from any trade or business." None of the selected country DTAs (namely the SA/Egypt, the SA/Ghana and the SA/Nigeria DTA) define the term "business".

In terms of Article 7(1) of the 2017 OECD MTC, 2017 UN MTC, 2019 ATAF MTC, SA /Egypt DTA, SA /Ghana DTA and SA /Nigeria DTA, 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 PE situated therein. The profits that are attributable to the PE may be taxed in that other state. Business profits that are not attributable to a PE in the State of the source are taxable only in the State of residence. Under the 2016 US MTC, the State in which the PE is situated may tax the enterprise but only on a net basis and only on the income that is attributable to the PE.

When the words "shall only be taxed" are used in the treaty (without the assistance of domestic tax law) the words provide relief that only one State has the right to tax, the other being prohibited from taxing. The phrase "shall only be taxed" is referred to by Vogel (1997: 30) as a rule with complete legal consequences. Under Article 7 of the 2017 OECD MTC, both States have a right to tax the profits attributable to a PE, namely, the treaty does not prohibit the taxing in any one of the States. Vogel (1997: 30) refers to the phrase "may be taxed" as a rule with "incomplete"' or "open" legal consequences which must be completed by an Article (usually Article 23A or Article 23B) in the agreement which then requires one of the States (usually the State of residence) to provide relief in terms of its domestic law or

terms of the treaty by either exempting the income from tax or by granting credit in respect of tax paid in the other State.

The Authorised OECD Approach (AOA) is to treat a PE as a "functionally separate entity" (OECD, 2010:12). According to the AOA, the business profits that are to be attributed to a PE are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2) of the 2017 OECD MTC, the SA /Egypt DTA, the SA /Ghana DTA and the SA /Nigeria DTA. The phrase "profits of an enterprise" in Article 7(1) should not be interpreted as affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that "the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment" (namely, there should be no "force of attraction principle") (OECD, 2010:13).

The AOA is a two-step approach. First, a functional and factual analysis must be performed to hypothesise appropriately the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises (OECD, 2010:14-18). Under the second step, the remuneration of any dealings between the hypothesised enterprises is determined by applying the OECD Transfer Pricing Guidelines (2017:101-145) by reference to the functions performed, assets used and risk assumed by the hypothesised enterprises (OECD, 2010:20).

The AOA was introduced with the 2010 OECD MTC[130]. The "Relevant Business Activity Approach" (RBAA), was the standard for the allocation of profits to PEs in the OECD MTC and its Commentary before the 2010 OECD MTC was implemented (Nexia, 2017:2). While application of the AOA in comparison to the RBAA may produce similar outcomes it is important to note that, both some member and non-member states of the OECD (such as South Africa) have included reservations to express their disagreement with certain aspects of the AOA and accordingly these countries would likely apply an alternative approach to the attribution of profits consistent with their domestic legislation's transfer pricing rules.

[130] The AOA got a boost by the OECD activities within the "Base Erosion Profit Shifting" (BEPS) project, which received final approval at the end of 2015. Many countries have either started to implement the AOA concept into national law or just refer to this concept as the new standard. Others are still waiting and sticking to their traditional national interpretation (Nexia, 2017:2). Of 42 countries surveyed by Nexia in 2017, only 25 had adopted the AOA.

Article 7(2) of the US 2016 MTC also refers to profits which the PE

> "might be expected to make if it were a distinct and independent enterprise engaged in the same or similar conditions. For this purpose, the profits to be attributed to the permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment".

Only those profits derived from the assets or activities of the PE which are economically attributable must be attributed. According to Vogel (1997: 409), a distinction must always be made between those profits which result from the activities of the PE and those profits which result from the head office or any other part of the enterprise (for example, a PE situated in another country).

Article 7(3) of the 2017 OECD MTC makes provision for a reciprocal adjustment in a Contracting State, to the extent necessary to eliminate double taxation, where the other Contracting State has adjusted the profits that are attributable to a PE of an enterprise in one of the Contracting States and has taxed accordingly profits of the enterprise that have been charged to tax in the other State. In determining such adjustment, the competent authorities of the Contracting States shall if necessary (as provided for under Article 25 Mutual Agreement Procedure) consult each other.

Article 7(3) of the 2017 UN MTC, the 2016 US MTC, the 2019 ATAF MTC, the SA /Egypt DTA, the SA /Ghana DTA and the SA /Nigeria DTA allows for the deductibility of expenses incurred for the business of the PE, including executive and general expenses. The 2016 US MTC goes further to specifically allow for research and development expenses, interest and other expenses incurred for the enterprise as a whole (or the part thereof which includes the PE), whether incurred in the State in which the PE is situated or elsewhere. According to the US 2016 Model Technical Explanation (2016: 21), the US MTC does not limit the deduction of expenses, to those expenses incurred exclusively for the PE, but includes a reasonable allocation of expenses incurred for the enterprise as a whole, or that part of the enterprise that includes the PE. This is known as the "relevant business activity" approach. Whilst the 2017 UN MTC, the 2019 ATAF MTC and the SA/Nigeria DTA specifically provide that the following amounts (other than actual expenses) paid or charged by the PE to the head office or other office may not be deducted:

a) Royalties, fees or other similar payments in return for the use of patents or other rights;
b) Commissions, for specific services, performed or for management; or

c) Interest on monies lent to the PE, other than in the case of a banking enterprise.

The aim of these prohibitions is no doubt to protect the source State's tax base. According to Rohatgi (2002:85), these types of expenses are deductible under the 2017 UN MTC if payable to third parties when they are incurred by the head office on behalf of the branch, and maybe deducted on an apportionment or actual basis without any mark-up.

Where profits include items of income which are dealt with separately in other Articles of the 2017 OECD MTC, such as the "immovable property" Article concerning oil and gas income (see 4.7.4 below), then the provisions of those Articles are not affected by the "business profits" Article (Isenbergh, 2000:209). The result is that Article 7 will apply to business profits that do not belong to categories of income covered by those articles which apply to specific income. It is submitted that this rule is merely an application of the general international and domestic interpretation rule of *generalia specialibus non derogant.* This interpretation rule states that a subsequent general provision does not repeal or override an earlier specific provision[131]. Paragraph 35 of the 2017 OECD Model Commentary on Article 7 states that this interpretative rule conforms with the practice generally adhered to in DTAs and that it is understood that the items of income covered by special articles, may be taxed either separately, or as business profits, in conformity with the tax laws of the Contracting States. In this regard, Baker (2005:78.32) comments as follows:

> "The order of priority is thus as follows. First, it is necessary to decide whether an item of income falls within one of the specific Articles […]. If it does, then that Article applies unless the enterprise has a permanent establishment in that State and the income is effectively connected with that permanent establishment. In that event, Article 7 will apply and the income will be taxed as the profit of the permanent establishment or separately."

4.7.4 Immovable property

In terms of Article 6 of the 2017 OECD MTC, the 2017 UN MTC, the 2016 US MTC, the 2019 ATAF MTC, the SA /Egypt DTA, the SA /Ghana DTA and the SA /Nigeria DTA income derived from the direct use, letting or use in any other form of immovable property by a resident of a Contracting State from immovable property situated in the other Contracting State may be taxed in that other State.

Article 6 of the 2017 OECD MTC goes further to define the term "immovable property" as having the meaning which it has under the law of the Contracting State in which the property

[131] See *Khumalo v DG of Co-operation and Development* 1991 1 SA 158 (A) and *Sappi v ICI Canada* 1992 3 SA 306 (A).

in question is situated. The term “immovable property” as defined in Article 6 of the 2017 OECD MTC, the SA /Egypt DTA, the SA /Ghana DTA and the SA /Nigeria DTA specifically includes rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Movable vessels such as ships and boats (such as drill rigs and production platforms) are not regarded as immovable property.

The DTA between South Africa and Egypt at Article 6(2) defines the meaning of the term “immovable property” as inclusive of rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. The allocation to mineral rights under the Contract Legal design in Egypt is in the form of a PSC. Under the PSC, ownership of the oil produced vests with the host government and the Oil and Gas company receives a share of production (compensation in oil) (Sunley & Baunsgaard, 2001:11-14).

4.7.5 Offshore activities

In the absence of a “permanent establishment”, a “territorial extension” article such as that for “offshore activities” in the SA /Netherlands DTA[132] aimed at taxing services rendered to an Oil and Gas company engaged in the exploration for and production of Oil and Gas in a Contracting State may be applied to deem the Oil and Gas company to have a “permanent establishment” and accordingly it would be taxed under the “business profits” article. None of the selected countries DTAs (namely the SA /Egypt DTA, the SA /Ghana DTA and the SA /Nigeria DTA) has a “territorial extension” article for “offshore activities”.

The term “offshore activities” is defined as those activities which are carried on offshore in connection with the exploration or exploitation of the seabed and its subsoil and their natural resources, situated in a Contracting State.

The “offshore activities” article provides that an enterprise of a Contracting State which carries on offshore activities in the other Contracting State shall be deemed to be carrying on, in respect of those activities, business in that other State through a PE situated therein, unless the offshore activities in question are carried on in the other State for a period or periods not exceeding in the aggregate thirty days in any period of twelve months.

[132] Article 24 of the Convention between the Republic of South Africa and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the prevention of Fiscal Evasion with respect to taxes on income and on capital, dated 23 January 2009.

4.7.6 Associated enterprises

Multinational Oil and Gas companies such as the large Independent Oil Companies (IOCs) and National Oil Companies (NOCs), typically operate a head office in one jurisdiction whilst conducting physical mining operations in another. The "associated enterprises" Article should be considered for the head offices charges to the source jurisdiction.

The "associated enterprises" Article is intended to combat the making of non-arm's length terms in transactions between entities that are related or are subject to common control, by compulsorily imposing arm's length conditions for the determination of the profits of the enterprises in question.

Article 9 of the 2017 OECD MTC, the 2017 UN MTC, the 2016 US MTC, the 2019 ATAF MTC, the SA /Egypt DTA, the SA/Ghana DTA and the SA/Nigeria DTA provides that where a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case, conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would have accrued to one of the enterprises and have not so accrued as of the result of such conditions, may be included in the profits of that enterprise and taxed accordingly.

The effect of the "associated enterprises" Article is to empower the revenue authorities of a Contracting State to re-write the accounts of an enterprise in calculating its tax liabilities, where the accounts do not reflect the correct taxable profits derived in that State, and the discrepancy arises due to the existence of a special relationship between the enterprise in question and another enterprise. Before the Article can be utilised by the revenue authorities, however, the enterprises concerned must be related, that is, the relationship of holding company and subsidiary or companies under common control must exist. The provisions of the Article apply only where special conditions (that is, non-arm's length conditions) have been made or imposed between the two enterprises. The revenue authorities may not re-write accounts of associated enterprises if the transactions between the enterprises have taken place on normal open market commercial terms. The revenue authorities in virtually all developed countries have adopted the arm's length standard for transfer pricing between related parties recognising the OECD principles as articulated in the OECD Transfer Pricing Guidelines.

According to Raby (2009:24), the arm's length principle is usually applied by comparing the "conditions" (for example price or margin) of a controlled transaction with those of independent transactions. The OECD Transfer Pricing Guidelines allow the use of inexact comparables that are "similar" to the controlled transaction but not the use of 'unadjusted industry average returns'. The factors that should be considered when assessing the comparability of a transaction include:

1. The specific characteristics of the goods or services;
2. The functions that each enterprise performs, including the assets used and the risks, undertaken;
3. The contractual terms;
4. The economic circumstances of different markets, for example, differences in geographic markets, or differences in the level of the market such as wholesale *vs.* retail; and
5. Business strategies, for example, market penetration schemes when a price is temporarily lowered.

The OECD Transfer Pricing Guidelines (OECD, 2017:101-145) recognise five methodologies for determining the arm's-length price (or sometimes the profits derived) of similar transactions between unrelated parties:

1. *Comparable uncontrolled price (CUP)*. The CUP method compares the price charged for goods or services transferred in a controlled transaction to the price charged for goods or services transferred in a comparable uncontrolled transaction.
2. *Resale price method*. An arm's length price is determined by deducting an appropriate discount for the activities of a reseller from the actual resale price. The appropriate discount is the gross margin, expressed as a percentage of the net sales, earned by a reseller on the sale of goods that is both purchased and resold in an uncontrolled transaction in the relevant market.
3. *Cost-plus method*. This method is typically applied in analysing the activities of a contract manufacturer or when determining the arm's length charge for services. The cost-plus method determines the arm's length price by adding an appropriate mark-up to the cost of production. The appropriate mark-up is the percentage earned by the manufacturer on unrelated party sales that are the same or very similar to the inter-company transaction.
4. *Profit split method*. This method establishes transfer pricing by dividing the profits of a multinational enterprise in a way that would be expected of independent enterprises in a joint venture relationship.

5. *Transactional Net Margin Method.* This method looks at the net profit margin relative to an appropriate base (for example, costs, sales, assets) that the taxpayer makes from a controlled transaction.

The OECD endorses the CUP method as the most direct and reliable method for establishing an arm's-length price if comparable uncontrolled transactions can be identified. It also endorses the application of the resale price method and cost-plus method in appropriate circumstances. The OECD offers a qualified endorsement of the profit split method and the transactional net margin method suggesting that ordinarily they should only be used when data for applying the three transaction-based methods are not available.

Article 9(2) of the 2017 OECD MTC makes provision for a reciprocal adjustment to avoid economic double taxation which may occur where one Contracting State revises the profits of an enterprise upwards, but the other Contracting State does not make a parallel adjustment to the enterprise's profits which are taxable in that State, by revising them downwards. In determining such adjustment, the competent authorities of the Contracting States may if necessary (as provided for under Article 25 Mutual Agreement Procedure) consult each other.

4.8 Conclusion

When South African Oil and Gas companies seek reserves beyond our borders and make an outbound investment in the exploration for or production of oil and gas in a foreign country it is likely they will suffer double tax. Income from oil and gas mining in a foreign jurisdiction will be taxed both in the jurisdiction of source and in South Africa under the residence basis of taxation. In Chapter 2, the thesis examined the taxation of the oil and gas income in its source jurisdiction and Chapter 3 the thesis examined the taxation of the oil and gas income in its residence jurisdiction, namely South Africa.

Should a tax treaty exist, such South African Oil and Gas companies might seek relief from tax in South Africa in respect to foreign tax on income that was levied by the source jurisdiction. The South African DTAs form part of the statutory body of the South African national law. Under no circumstances can they extend beyond the framework authorized by the national law. The DTAs also form part of the South African domestic tax law but are at the same time international treaties. The interpretation of the South African DTAs is governed by the VCLT as the agreements from part of international customary law. The fact that the tax treaties are incorporated in the South African statutory law makes the South African courts

competent to decide a claim founded on a treaty. The South African courts[133] have held in favour of DTA override of the domestic tax treatment.

The DTAs aim to provide treaty relief in the country of residence in respect of taxes charged in the country of source. The DTAs do not impose taxes. Four Model Taxation Conventions (MTCs), namely the 2017 OECD MTC, the 2017 UN MTC, the 2016 US MTC and the 2019 ATAF MTC were examined with those articles relevant to Oil and Gas mining. The South African DTAs are modelled primarily on the 2017 OECD MTC and its predecessors. As such, the relief mechanisms allowed under DTAs based on the 2017 OECD MTC are the exemption and credit mechanisms. Of these two mechanisms, the credit mechanism is most favoured by tax policy. The examples (Example 4.1 to 4.4) considering the combined tax rate of the three types of relief mechanisms shows that the deduction mechanism is the least beneficial to the taxpayer.

In Chapter 6, the thesis will examine the causes of inadequate double tax relief (even with the presence of DTAs) and at Chapter 7 will contrast the double taxation relief under the DTAs examined in this chapter with the domestic tax relief examined in Chapter 5, to aid Oil and Gas companies in their election of which tax relief to apply.

[133] *AM Moola Group Ltd v CSARS* [2003] 65 SATC 414

CHAPTER 5
DOMESTIC TAX RELIEF

5.1 Introduction

In Chapter 5, the thesis provides an analysis of the double tax relief available under the South African Income Tax Act (ITA) in respect to a foreign tax levied on income from oil and gas mining activities. The chapter examines the forms, limitations of relief and the detailed requirements for relief under section 6*quat.* Chapter 5 explores the meaning of the concepts, "tax on income" and "right of recovery".

In Chapter 5, the corporate tax calculation of a resident Oil and Gas company under the South African Income Tax Act is applied to an adaptation of the FARI methodology to illustrate the economic effect of the tax relief available under section 6*quat* for mining activities conducted in Egypt, Equatorial Guinea, Ghana and Nigeria.

5.2 Domestic double tax relief

South Africa's domestic tax laws provide for relief from double taxation by way of two different methods, namely a rebate for qualifying foreign taxes on income or a deduction for non-qualifying foreign taxes on income. The rebate method employed is housed in section 6*quat* (1) of the ITA and is the principal mechanism used to provide relief for foreign taxes proved to be payable on income derived from a foreign source that is included in a resident's taxable income (SARS, 2015:5). The deduction form of relief is embodied in section 6*quat* (1C) and allows a resident to claim a deduction for foreign taxes on foreign source income from the determination of taxable income (rather than as a set-off against the South African taxes) that does not qualify for a rebate under section 6*quat* (1).

5.2.1 The credit method of relief

Under section 6*quat* (1) any foreign taxes payable on foreign-sourced amounts included in the resident Oil and Gas company's taxable income is set-off (credited) against normal tax payable.

Section 6*quat* (1)(a) allows for a:

> "[R]ebate *to* be deducted from the normal tax payable by any resident in whose taxable income there is included – (a) any income received by or accrued to such resident from any

source outside the Republic; or any proportional amount contemplated in section 9D (namely CFCs)".

Entitlement to a foreign tax credit under section 6*quat*(1) arises for a resident Oil and Gas company in the year of assessment in which a foreign-sourced amount on which foreign taxes are payable is included in the resident Oil and Gas company's taxable income. Foreign taxes payable must be taken into account in the year of assessment in which the foreign-sourced amount is included in taxable income and not the year of the assessment in which the foreign taxes are incurred (SARS, 2009:5).

Section 6*quat* (1A) limits the rebate to an amount equal to the sum of the foreign taxes on income proved to be payable. In terms of section 6*quat*(1B)(ii), where the sum of any foreign taxes proved to be payable exceeds the rebate limit, the excess amount may be carried forward to the immediately succeeding year of assessment and is deemed to be a tax on income paid to the government of any other country in that year. It may then be set off against the normal tax payable by the resident Oil and Gas company in that year.

The foreign tax credit mechanism under section 6*quat* (1B) is the same as the tax relief credit method used in the tax treaties discussed in Chapter 4, 4.5.3 - Credit method.

Example 5.1 Credit Method
R, a resident of South Africa, earns 100 of income from the Republic of Ireland, on which it pays 25 of tax that qualifies for rebate under section 6*quat* to the Republic of Ireland. Under the credit method, R will pay tax to South Africa at 28% of its total worldwide net income (100) with no deduction for the taxes paid in the Republic of Ireland. R will receive a credit, however, against the tax otherwise payable to South Africa for the taxes paid to the Republic of Ireland. The result is that R will pay tax to South Africa of only 3 (28-25) and a total tax of 28, for a combined foreign and domestic rate of 28%.

5.2.2 The deduction method of relief

If a foreign tax does not qualify for rebate under section 6*quat* (1), section 6*quat* (1C) of the ITA allows for a deduction of foreign taxes from the income of the resident Oil and Gas company.

The application of section 6*quat* (1C) is limited to foreign taxes other than taxes contemplated in section 6*quat* (1A). Broadly speaking, section 6*quat* (1) considers income and capital gains from a foreign source and accordingly the deduction under 6*quat* (1C) is essentially limited to foreign taxes levied in respect of South African-source income derived from trade operations (SARS, 2015:77). Any part of the foreign taxes that were not laid out or expended for trade

will not qualify for deduction (section 23(g)). No deduction is permissible against passive income.

A resident Oil and Gas company may not choose between the rebate method of relief under section 6*quat* (1) and the deduction method of relief under section 6*quat* (1C). The deduction method only applies to taxes that are not contemplated in section 6*quat* (1). Therefore, if the income has a foreign source, the resident Oil and Gas company can only consider the availability of a rebate under section 6*quat* (1) – a deduction under section 6*quat* (1C) is not available (SARS, 2015:77).

The deduction available under subsection (1C), in terms of section 6*quat* (1D), may not in aggregate exceed the total taxable income attributable to the income which is subject to foreign taxes. Any excess amount of foreign taxes is forfeited and will not qualify for a deduction in terms of any other section of the ITA[134]. In addition, any excess may not be carried forward to the following year of assessment and be taken into account as a deduction in that following year (SARS, 2015:78).

Example 5.2 Deduction Method
R, a resident of South Africa, earns 100 of mining income from Venezuela who uses the contract legal design to allocate the right to mine Oil and Gas on which it pays 50 of tax that qualifies for the deduction for foreign taxes under section 6*quat*. Under the deduction method, R will pay tax to South Africa on the net of income of 50 (100-50). As R is taxable in South Africa at a rate of 28%, it will pay a tax of 14 to South Africa and a total tax of 64 on its income of 100, for a combined foreign and domestic rate of 64%.

5.2.3 Qualifying amounts

Olivier & Honiball (2008:320) state that amounts qualifying for the rebate that is deducted from the normal tax payable of a resident Oil and Gas company are the following specific categories of income:

1. Any income received by or accrued to a resident, from a source outside the Republic, which is not deemed to be a from a source within the Republic (section 6*quat* (1)(*a*)(i));
2. Any portion of net income of a CFC as contemplated in section 9D of the ITA which is attributed to a resident Oil and Gas company (section 6*quat* (1)(*b*));
3. Any taxable capital gain as contemplated in section 26A of the ITA from a foreign source which is not deemed to be from in the Republic (section 6*quat* (1)(*e*));

[134] Section 23B

4. Any amount (income or capital gain) which is received by or accrued to any other person but is deemed to have been received or accrued by the resident Oil and Gas company in terms of section 7 or paragraphs 68, 69, 70, 71, 72 or 80 of the Eighth Schedule (section 6*quat* (1)(*f*)(i) and (ii)).

5.2.4 Qualifying taxes

Section 6*quat* (1A) limits the rebate to foreign taxes on income and capital gains from a source outside the Republic. According to SARS (2015:20), in determining whether or not a particular foreign tax qualifies as a tax on income, that basic scheme of application of the foreign tax must be compared to that of the ITA. Only if the basis of taxation is substantially similar, will the foreign tax be accepted as a tax on income. In *Mary D Biddle v Commissioner* [1938][135] it was held that for taxes paid to a foreign country to qualify as an income tax, it must be shown that the tax imposed by the foreign country is a tax on income within the United States' concept thereof. Similarly, in a South African context, the foreign tax liability must be a tax on income within the South African concept thereof.

The mere fact that it is regarded as a tax on income by the country levying the tax is not sufficient. The precise nature of the foreign tax or duty must be determined. A similar term may have a different connotation in another tax jurisdiction. It is immaterial that the foreign tax law differs from the domestic tax law to a certain extent. For example, the foreign tax law may include certain items of income or may allow certain exclusions or deductions not included or allowed under domestic tax law (SARS, 2015:20).

Taxes payable on capital gains are regarded as taxes on income. Thus, any reference to taxes payable on income includes taxes payable on capital gains. Any withholding tax on income such as dividends[136], service fees (effective 1 January 2016)[137], interest (effective from 1 March 2015)[138] and royalties[139], are also regarded as a tax on income if they were imposed as a final withholding tax (SARS, 2015:20).

To qualify for the section 6*quat* rebate, a tax must be a tax on income within the South African concept thereof. According to SARS (2015:22 and 2020:2), taxes that are not taxes on income for purpose of the section 6*quat* rebate include:

[135] [1938] 302 US 573.
[136] Section 64E(1) of the ITA
[137] Section 51(B)(1) of the ITA
[138] Section 50(B)(1) of the ITA
[139] Section 49A-G

1. Turnover such as Alternative Minimum Tax (AMT) in Equatorial Guinea[140], commodity or consumption taxes;
2. Value-added tax;
3. Sales tax;
4. Customs and excise duties;
5. Import and export duties;
6. Environmental-affecting taxes such as a greenhouse gas tax, carbon tax or flaring taxes;
7. Resource royalties
8. Company duties
9. Business license and other trade taxes
10. Stamp duties or security transfer taxes
11. Transfer duties
12. Registration duties
13. Property or real estate taxes, such as surface rental fees
14. Gift or donation taxes
15. Capital transfer taxes; and
16. Capital taxes such as those in Venezuela levied on the incremental increase in the value of capital assets owned by Oil and Gas companies.

A resident Oil and Gas company carrying on mining operations abroad may incur certain of the above taxes in the ordinary course of such operations, for example, excise taxes or duties that are payable regardless of whether or not the company makes a profit. Under section 23(d) of the ITA, any tax imposed under the Act may not be deducted in determining taxable income. According to SARS (2015:43), the fact that a deduction of foreign taxes on income is not specifically denied under section 23(d) does not mean that foreign taxes that do not qualify for the section 6*quat* relief automatically qualify for a deduction. To qualify for a deduction the foreign taxes charged against profits must meet the requirements for deductibility under section 11(a) read with section 23(g) (see chapter 3, 3.5.3 – Allowable deductions).

Foreign taxes charged on profits already earned are not deductible under section 11(a). This is because a foreign tax on profits is not an expense incurred in the production of income but is instead an appropriation of profits already earned (SARS, 2015:43). In *Port Elizabeth Electric*

[140] The minimum corporate tax is based on 1% of the oil and gas companies previous year's turnover. The AMT operates when the operations of the company result in a taxable loss or when the minimum tax is more than 35% of the taxable profits.

Tramway Company Ltd v Commissioner of Inland Revenue [1936] CPD 241, which is supportive of the principle, Watermeyer AJP and Davis J held that:

> "There is certainly one type of expenditure which must be excluded, and that is expenditure payable out of income after it has been earned. An example is a tax upon profits. In a sense, such expenditure might be said to be attendant upon business operations, but there is a real distinction between "charge against profits and an appropriation of profits after they have been earned." See *Van Ryn Deep Ltd. v Commissioner for Inland Revenue* [1922], WLD 22." (SARS, 2015:43)

In *Van Ryn Deep Ltd v CIR* [1922] WLD 22 the South African court held that provincial tax, which had been imposed on the profits after the profits had been earned, could in no way be said to have been an expense incurred in earning the profits or connected in any way with the production of the profits and consequently was not deductible for income tax, the liability for which was not affected by what was done either voluntarily or involuntarily with profits after they had been earned (SARS, 2015:43).

In the context of a resident Oil and Gas company, the allocation of production from profit oil to the State under a PSC will not qualify under the domestic tax legislation for a rebate under section 6*quat* (1) as a "tax on income" and also will not qualify for a deduction under section 11(a) as such tax is suffered after the profit oil has been earned. Furthermore, the allocation of production from profit oil to the State under a PSC will not qualify as a deduction under section 6*quat* (1C).

5.2.5 Proved to be payable

Foreign tax will only qualify to be dealt with under section 6*quat* if it is "proved to be payable" ***and*** the resident Oil and Gas company does not have "any right of recovery" of the tax (SARS, 2015:24). A tax will be "proved to be payable" if the resident Oil and Gas company has an unconditional legal liability to pay the tax. An unconditional liability to pay the foreign tax means the foreign tax must be levied legitimately under the foreign jurisdiction's tax law and tax treaty (if applicable) before it can qualify for rebate under section 6*quat*. Where a foreign jurisdiction imposes a tax that is not following the foreign jurisdiction's tax law or tax treaty (if applicable), but it is paid, by the resident Oil and Gas company, that foreign tax will not be regarded as "proved to be payable".

Practically this situation tends to arise in the context of withholding taxes when the tax treaty provides for a rate of tax that is lower than the domestic rate provided for in the tax legislation. Under section 6*quat* (1) the amount of foreign tax qualifying for a rebate is

limited to the tax which may be levied under the tax treaty. The resident Oil and Gas company would need to seek a refund of the excess withholding tax from the foreign tax authorities and if that fails can follow the mutual agreement procedure (MAP) under the tax treaty (if a tax treaty exists between South Africa and the foreign country). The excess withholding tax will not qualify for a deduction under section 6*quat* (1C), section 11(*a*) or any other section.

Example 5.3 – Foreign country imposing withholding tax at domestic rate instead of the lower rate specified in the tax treaty.

Facts:
South Africa has concluded a tax treaty with Ghana which latter may levy a withholding tax of 5% of the gross amount of interest being remitted from Ghana. However, Ghana insists on levying its domestic tax rate of 8% on the interest income remitted to a resident of South Africa.
The source of the interest is located in Ghana as the funds are made available in Ghana to pursue oil and gas mining activities.

Result:
The resident Oil and Gas company only has an unconditional legal obligation to pay 5%, even though 8% was withheld. Accordingly, the resident Oil and Gas company may only claim a rebate to the extent of 5% as specified in the tax treaty under section 6*quat*(1). The remaining 3% may not be claimed as a rebate under section 6*quat* (1) it should be claimed from the Ghanaian Revenue Authority (GRA).

5.2.6 Right of recovery by any person

The term “right to recovery by any person” is interpreted by SARS (2015:29) very broadly and includes any form of relief against a foreign tax liability. For example, a refund, credit, rebate, remission, or deduction, is considered to be a right of recovery. Any other form of economic benefit to which a person becomes entitled is also considered to be a “right of recovery by any person”.

To the extent that the resident Oil and Gas company receives a refund of foreign taxes or is the recipient of a benefit resulting in the removal (or reduction) of double taxation the obligation to provide relief from double tax diminishes. The right of recovery *by any person* covers those jurisdictions where a shareholder of a company receives a refund for the tax paid by the company (SARS, 2015:29).

The resident Oil and Gas company or any other person must not be able to recover the taxes proved to be payable. Should the resident exercise a right of recovery, for example, by contesting a foreign tax liability, the amount of the foreign tax liability will not be allowed as a credit while the tax is in dispute and not yet finally determined (SARS, 2015:26). The amount of the foreign tax liability under dispute and not paid will only be taken into account

for purposes of determining the foreign tax rebate as and when all legal remedies have been exhausted or a decision in the matter is no longer open to such remedies (SARS, 2015:26). However, should the resident have settled whole or a part of any disputed tax liability while continuing to exercise a right of recovery, SARS will allow the amount so paid to be taken into account in calculating the credit relief (SARS, 2015:26).

5.2.7 Assessed loss position

In terms of section 6*quat* (1A), the foreign tax must be payable on amounts included in the resident Oil and Gas company's taxable income. The term "taxable income" is defined[141] in terms of the ITA to mean the aggregate of "income" (included or deemed to be included in taxable income) less allowable "deductions". Should the result of a resident Oil and Gas company's tax calculation for a particular year of assessment represent a tax assessed loss (whether by expenditure in the current year or a tax assessed loss brought forward from the previous year), no foreign tax credit will be allowed in that year of assessment because there is no normal tax payable (SARS, 2015:30). However, it will still be possible for the taxpayer to carry forward the qualifying foreign taxes to the succeeding year of assessment under section 6*quat* (1B)(*a*)(ii).

5.2.8 Limitation on the amount of the rebate

Section 6*quat* (1B) provides that the section 6*quat* (1) rebate shall not in aggregate exceed an amount which bears to the total normal tax payable the same ratio as the total taxable income attributable to the specific category of income in respect of which the rebate may be claimed, bears to the total taxable income.

In determining the amount of taxable income that is attributable to the relevant category of income, any allowable deductions must be deemed to have been incurred proportionally, subject to certain limitations (Olivier & Honiball, 2011:323). This *pro-rata* ratio may be expressed in terms of the following formula (SARS, 2015:36):

$$\frac{A}{B} \times C = D$$

Where:
A= taxable income derived from all foreign sources
B= total taxable income derived from all sources
C = normal tax payable on B
D = section 6*quat* rebate

[141] Section 1 of the ITA

The SARS (2015:37) offers guidance on the application of the formula.

"Before applying the formula, one must in the first instance determine –

a. What is income sourced within and deemed to be within South Africa; and
b. What income is sourced outside South Africa?

Secondly, a tax computation must be performed to determine the taxable income resulting from-

i. The income derived from sources within South Africa and deemed to be within South Africa; and
ii. The income is derived from foreign sources.

In determining the taxable income derived from a foreign source-

- Any expenditure incurred which is directly attributable to such income must be deducted from such income (irrespective of whether such expenditure is incurred in or outside South Africa); and
- A portion of any general expenses incurred which are not directly attributable to income derived either domestically or abroad, for example, head office expenses, must be apportioned between taxable income from-
    - A source within South Africa or deemed to be within South Africa; and
    - A foreign source,

  based on any method which gives a fair and reasonable apportionment appropriate to the circumstances of the particular case (for example, turnover, gross profit or value of fixed assets).

Failure to allocate expenses to foreign activities could result in an inflated foreign tax credit".

This is illustrated in example 5.4 below.

Example 5.4 Classification of expenses relating to income from a source within South Africa and income from a foreign source

A resident oil and gas company with local oil and gas mining activities and foreign mining activities in Australia derives the following results in year 1:
Taxable income derived from a South African source R1000
Taxable income derived from a foreign permanent establishment in Australia R110

In Australia where the permanent establishment is located the petroleum resource rent tax (PRRT) is 40% while the tax rate in South Africa is 28%. As a result, excess foreign tax credits of R12 are created. In South Africa, a bank guarantee is raised to secure the issue of the mining right in Australia. The bank charges guarantee to raise fees of R10. The Oil and Gas company claims these expenses as a deduction against South African sourced income, as the expense has been incurred by the South African Oil and Gas company.

Result:

	Taxable income (SA source)	**Taxable income (Australia)**	**Taxable income (All sources)**
Taxable income excl. guarantee raising fees	1000	110	1110

Guarantee raising fees	(10)	0	(10)
Taxable income	990	110	1100
Tax payable		40	308

Application of the credit limitation: (R110/R1100) x R308 = R30.8

If the guarantee raising fees of R10 were correctly taken into account in determining foreign-sourced taxable income (namely recognised as a deduction from the Australian taxable income) the application of the credit limit will provide the following result:
(100/1100) x R308 = R28

Adapted from SARS (2009:23-24)

The above formula effectively creates a so-called "pooled basis" of double tax relief, in other words, all foreign income derived from different foreign sources for a particular year is calculated together and all related foreign taxes are also calculated together. It is therefore not necessary to link the foreign tax to the related foreign income. Furthermore, it is not necessary to subdivide between the different foreign countries from which the amounts are derived (SARS, 2009:22). The weakness of the "pooled basis" is that it allows taxpayers to manipulate their foreign tax burdens between high and low tax jurisdictions to maximise the credit against the South African tax. Another problem is that it allows them to mix highly "mobile" forms of income with the less mobile forms, which leads to the manipulation of different kinds of income merely to maximise the foreign tax credit from one type of income against another. The Katz Commission (1997:45) however recommended the retention of the "pooled basis" in their report. The Commission considered that providing for separate pools by country would introduce disproportionate complexity without materially enhancing revenue collection.

Excess credits arise where the sum of the foreign taxes proved to be payable exceeds the allowable rebate determined by applying the formula and limitation provisions contained therein. Under section 6*quat*(1B)(iii), the excess amount may not be carried forward for more than seven years calculated from the year of assessment when such excess amount was for the first time carried forward. This is referred to internationally as the "indirect foreign credit method" (Oliver (ed), 2006:12).

The exception to the "pooled basis" is foreign tax credits that are attributable to any proportional amount, which is taken into account in the determination of the taxable income of the resident by an election made in terms of section 9D(12) or section 9D(13) or relates to any amounts contemplated in section 9D(9) proviso (*b*) which is not excluded from the application of section 9D(2), which will in aggregate be limited to the amount of the normal tax which is attributable to those proportional amounts. The purpose of these exceptions is to prevent residents from generating excess foreign tax credits from foreign-sourced income in

the form of "diversionary income", passive income, where the resident elects a foreign company to be treated as a CFC and where the resident elects that the exclusions provided for in section 9D(9) do not apply. The reason for this limitation is that the foreign tax credit provisions should only serve to avoid economic double taxation of these sources of foreign income (Olivier & Honiball, 2008:324). In these exceptional situations in respect of CFC proportional amounts, the excess foreign tax credit may not be carried forward to the subsequent tax year.

Example 5.5 Income from more than one foreign country

A resident oil and gas company during its year of assessment ended 31 December 20X2 has the following taxable income:

SA source	R1000
Ugandan source (pre-tax)	R300
Argentinian source (pre-tax)	R200
CFC in the United States of America	R500
	R2000

The resident oil and gas company has chosen to make the section 9D (12) election to include the US CFC's income in its SA tax computation.
The tax rates in the foreign countries are as follows:

Uganda	30%
Argentina	35%
United States federal tax rate	35%

The SA tax computation is as follows:

Taxable income			R2000
SA tax at 28% =			R560
Section 6*quat* rebate			
Foreign taxes			
Uganda (30% x R300)	R90		
Argentina (35% x R200)	R70		
	R160		
Limited to 28% x R500		(R140)	
US CFC (35% x R500)	R175		
Limited to 28% x R500		(R140)	(R280)
SA normal tax			R280

Note: The excess of R20 foreign taxes in Uganda and Australia may be carried forward to the following year. The excess foreign tax of R35 in respect of the CFC income may not be carried forward.

Adapted from Huxham & Haupt (2011:422)

5.2.9 Conversion of foreign taxes

Section 6*quat*(4) of the ITA provides that taxes incurred in a foreign currency must be converted to South African Rand (ZAR) on the last day of the year of assessment by applying the average exchange rate for that year of assessment. Accordingly, income and expenses converted following section 24I of the ITA are accounted for at a different exchange rate to the taxes levied thereon. The difference between the exchange rate between the date that the foreign tax liability was incurred, the end of the year of assessment and the date the foreign

tax liability is settled must be determined under section 24I and does not impact section 6*quat* rebate determination (SARS, 2015:81). If the amount of foreign taxes translated includes cents that is less than one rand, that amount must be rounded off to the nearest rand[142].

5.2.10 Carryback of losses

According to the Katz Commission (1997:46), there is little consistency around the world on the carry-forward or carry-back of unutilised foreign tax credits. At the one extreme the United States and Canada, for example, allow a 7-year carry-forward plus a 3-year carry-back. The United Kingdom and New Zealand, on the other hand, allow no carry-forward or carry-back.

The carry-forward of unutilised foreign tax credits under section 6*quat* is limited to 7 years, but there is no allowance for the carry-back of excess tax credits to previous years (SARS, 2015:62). When foreign tax credits related to foreign income derived from a jurisdiction that allows for carry-back (for example the Netherlands), section 6*quat*(5) provides for an adjustment if the rebate is too high or too low compared with the amount of foreign tax payable using an additional or reduced assessment mechanism. SARS will issue a reduced assessment under section 93 of the Tax Administration Act (TAA). The SARS notwithstanding the three-year prescription period at section 99 of the TAA will issue a reduced or additional assessment made within six years from the date of the assessment in terms of which the rebate or deduction of the amount of tax proved to be payable was allowed.

5.3 Introduction to FARI modelling

An adaptation of the IMF's FARI model was used to perform an analysis of the economic impact of the South African taxation of foreign mining income derived from Egypt, Equatorial Guinea, Ghana and Nigeria. The same inputs were used in Chapter 5 as those applied in Chapter 2 with regards to macro-economic assumptions such as oil price and inflation rate and micro-economic assumptions such as Weighted Average Cost of Capital (WACC) discount rate, hypothetical capital and operating expenditure, hypothetical P50 recoverable reserves estimation of an oil and gas field and hypothetical production profile. The hypothetical inputs were based on a proposed South African field development with geology analogous to the petroleum provinces and hydrocarbon basins in the selected countries. The inputs are documented in an Assumptions Book (Annexure A) to allow reproduction of the economic results.

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[142] Section 6*quat* (4A).

The aim of the financial analysis of the domestic tax relief for the selected countries is to illustrate both the South African taxation of the foreign-sourced income together with the limitations in the domestic tax relief. Below is a repeat synopsis of the fiscal terms applied in the source State and a brief description of the section 6*quat* treatment of the foreign taxes paid:

1. Egypt makes use of a PSC in terms of which, the oil produced is divided between the recovery of production costs (40% maximum), and the remainder is labelled as profit oil. The Egyptian General Petroleum Corporation (EGPC) pays the corporate income tax on behalf of the contractor (Oil and Gas company) out of its share of profit oil. According to the SARS (2015:24) interpretation, to qualify for the rebate under section 6*quat* the foreign tax needs to be paid *by* the South African resident on foreign-sourced income *to* the foreign government (see 5.2.4 above).
2. Equatorial Guinea makes use of a PSC. The recovery of costs for purposes of determining Cost Oil is limited to a maximum of 70%. The government's share of Profit Oil from production is determined based on the contractor's pre-tax rate of return (ROR). The allocation of production from profit oil to the State under a PSC will not qualify under the domestic tax legislation for a rebate under section 6*quat* (1) as a "tax on income" (see 5.2.4 above).

   AMT is based on 1% of the Oil and Gas companies previous year's turnover. The AMT operates when the operations of the company result in a taxable loss or when the minimum tax is more than 35% of the taxable profits. AMT is not recognised as a "tax on income" for purposes of a section 6*quat* (1) rebate but will qualify as a deduction under section 11(a) of the ITA.
3. In Ghana, Additional Oil Entitlement (AOE) is determined following a sliding scale based on the contractor (Oil and Gas company)'s after-tax inflation-adjusted rate of return (ROR). AOE is not recognised as a qualifying tax (see 5.2.4 above) for purposes of the rebate under section 6*quat*.
4. In Nigeria, Oil and Gas companies are subject to both Petroleum Profits Tax and Tertiary Education Tax. These taxes are both levied upon income and qualify for a rebate under section 6*quat.*

5.4 Summary of the economic modelling results

The Snapshot Results of the FARI Economic Modelling is documented in Annexure B. What follows is guidance in the interpretation of the Snapshot Results for taxation of foreign mining income in South Africa.

5.4.1 Structural differences

In Chapter 3, the taxation of foreign mining operations in South Africa was examined. It was observed in Chapter 3 that the amount determined as taxable income in South Africa will differ from the amount subject to taxation in the source country as determined under the domestic tax legislation of that country. As a result of these structural differences in the manner in which taxable income is derived in South Africa in comparison to the calculation of taxable income in the source country, there are systemic differences that cannot be resolved through amendment of the domestic tax provisions as pertain to relief from double taxation.

Most of the structural differences are timing differences the impact of which are unwound over the life of the Oil and Gas mine. Examples of timing differences are depreciation of capital expenditure in source countries that follow the concession legal design *versus* an immediate deduction in South Africa, or spread of the deduction of operational expenditure imposed by cost recovery caps applied in source countries that follow the contract legal design *versus* the deferment of a tax deduction for pre-production operational expenditure in South Africa until the mine enters production. But certain structural differences are permanent and accordingly would require a legislative amendment to the South African domestic tax legislation to remedy. One such permanent structural difference that should be addressed would be to allow a tax deduction in South Africa for foreign prospecting expenditure by amendment to section 15(b) of the ITA.

It is discriminatory to disallow the deduction of prospecting expenditure (otherwise deductible for South African mining rights) based upon the location of the mine outside of the Republic of South Africa. The introduction of an amendment to the domestic legislation does not create an advantage in respect to foreign mining activities but instead provides for equity in the treatment of foreign mining and domestic mining activities.

The fact that such deductions are allowed in respect to domestic mining activities is indicative of a policy position in the design of the domestic tax legislation to allow for the deduction of prospecting expenditure. Furthermore, the domestic tax legislation already encompasses anti-

avoidance provisions that protect against the risk of erosion of the tax base. Foreign tax assessed losses (created from the deduction of prospecting expenditure) are ring-fenced from local taxable income in terms of section 20 of the ITA.

	South Africa – s6*quat*	**South Africa – Structural amendment**
EGYPT		
Contractor NPV in $mm	-162	-159
AETR % (combined)	127%	127%
Foreign AETR %	104%	104%
Foreign AEIT %	80%	80%
Foreign Income Tax in $mm	558	558
SA Income Tax in $mm	219	216
SA AEIT%	31.5%	31.11%
EQUATORIAL GUINEA		
Contractor NPV in $mm	241	243
AETR % (combined)	69%	69%
Foreign AETR %	66%	66%
Foreign AEIT %	57%	57%
Foreign Income Tax in $mm	398	398
SA Income Tax in $mm	202	200
SA AEIT%	29.11%	28.73%
GHANA		
Contractor NPV in $mm	173	176
AETR % (combined)	79%	79%
Foreign AETR %	68%	68%
Foreign AEIT %	36%	36%
Foreign Income Tax in $mm	248	248
SA Income Tax in $mm	226	223
SA AEIT%	32.5%	32.12%
NIGERIA		
Contractor NPV in $mm	44	47
AETR % (combined)	98%	97%
Foreign AETR %	97%	97%
Foreign AEIT %	67%	67%
Foreign Income Tax in $mm	465	465
SA Income Tax in $mm	196	193
SA AEIT%	28.18%	27.79%

Table 5.1 Summary of results of FARI economic modelling in respect to a structural difference in the taxation of foreign mining by South Africa

5.4.2 SARS practise

There is an asymmetry in the domestic tax legislation that provides explicitly for the inclusion of amounts (in cash or otherwise) in "gross income" yet it would deny the deduction of foreign taxes on income where such an expense is paid by the Oil and Gas company in the form of offtake from production in barrels of oil. The purpose of section 6*quat* is to allow for a rebate in respect of qualifying foreign taxes and a deduction for foreign taxes on income at section 6*quat* (1C) that do not satisfy the criteria for section 6*quat* rebate. In the absence of the tax deduction for non-qualifying foreign taxes under section 6*quat* (1C), such taxes cannot be deducted in terms of section 11(a) as they are paid after the foreign mining income is earned. It is SARS practice to limit the tax deduction under section 6*quat* (1C) to foreign taxes on income (incurred) paid in cash.

An amendment to the domestic tax provisions as for relief from double taxation would make abundantly clear an allowable tax deduction and remove ambiguity in the interpretation of the legislation for the deductibility of foreign taxes paid under a PSC.

The FARI economic modelling results of the proposed amendment to the domestic tax legislation (excluding the structural amendment) is contrasted with the economic modelling results of the existing domestic tax relief ("South Africa – s6*quat*") and taxation at source in the table below:

	South Africa – s6*quat*	**A proposed amendment to s6*quat* (Excluding Structural)**	**Taxation at source**
EGYPT			
Contractor NPV in $mm	-162	-5	-2
AETR % (combined)	127%	105%	
Foreign AETR %	104%	104%	104%
Foreign AEIT %	80%	80%	80%
Foreign Income Tax in $mm	558	558	558
SA Income Tax in $mm	219	46	
SA AEIT%	31.5%	7%	
EQUATORIAL GUINEA			
Contractor NPV in $mm	241	260	266
AETR % (combined)	69%	67%	
Foreign AETR %	66%	66%	66%
Foreign AEIT %	57%	57%	57%
Foreign Income Tax in	398	398	398

$mm			
SA Income Tax in $mm	202	196	
SA AEIT%	29.11%	28.2%	
GHANA			
Contractor NPV in $mm	173	247	250
AETR % (combined)	79%	69%	
Foreign AETR %	68%	68%	68%
Foreign AEIT %	36%	36%	36%
Foreign Income Tax in $mm	248	248	248
SA Income Tax in $mm	226	223	
SA AEIT%	32.5%	32.14%	
NIGERIA			
Contractor NPV in $mm	44	44	47
AETR % (combined)	98%	98%	
Foreign AETR %	97%	97%	97%
Foreign AEIT %	67%	67%	67%
Foreign Income Tax in $mm	465	465	465
SA Income Tax in $mm	196	190	
SA AEIT%	28.18%	27.31%	

Table 5.2 Summary of results of FARI economic modelling in respect to a proposed amendment to s6*quat*

In respect to those countries that apply the contract legal design such as Egypt and Equatorial Guinea, there is no section 6*quat* rebate for PSCs and accordingly, the Oil and Gas company will not achieve full double taxation relief as evidenced by the increase in AETR and decrease in the Oil and Gas company's NPV (of "South Africa- s6*quat*" economic modelling results in comparison with "Taxation at source" economic modelling results). Furthermore, in respect to those countries that apply the concession legal design, but include tax instruments in the design of their tax regime that do not qualify as "taxes on income" for purposes of section 6*quat,* such as Ghana's AOE, the Oil and Gas company will not achieve full double taxation relief as in evidenced by the increase in AETR and decrease in the Oil and Gas company's NPV (of "South Africa- s6*quat*" economic modelling results in comparison with "Taxation at source" economic modelling results). Where a country applies the concession fundamental legal design, and its taxes on income qualify for purposes of the section 6*quat* rebate, such as Nigeria, the Oil and Gas company will achieve full double taxation relief under the domestic tax relief.

The proposed amendment to the domestic tax legislation, namely to allow the deduction of foreign taxes in the form of barrels of oil, reflects substantive achievement of full double

taxation relief. The results of the economic modelling reflect similar Contractor NPVs and AETRs where the "Proposed amendment to s6*quat (Excluding Structural)*" economic modelling results are compared with the "Taxation at source" economic modelling results for Egypt, Equatorial Guinea and Ghana in the case study. The difference in the NPV and AETR for the Nigerian case study are ascribed to how taxable income is calculated in South Africa in comparison to the computation of taxable income for Nigerian tax purposes (discussed in 5.4.1 above).

5.5 Conclusion

The interpretation of the meaning of "taxes" in terms of section 6*quat* is limited to foreign taxes on income and capital gains. The SARS interpretation of qualifying "taxes" excludes taxes paid in the form of the offtake from production in barrels of oil. Such non-qualifying foreign taxes on foreign source income would also not be allowed as a deduction under section 6*quat* (1C). It is recommended that section 6*quat* (1C) should be amended to allow for the deduction for foreign taxes on foreign source income taxable in South Africa. It is proposed that section 6*quat* (1C) is amended as follows:

(1C) For the purpose of determining the taxable income derived by any resident from carrying on any trade <u>outside the Republic</u>, there may at the election of the resident be allowed as a deduction from the income of such resident so derived the sum of any taxes on income <u>including the appropriation of profits in cash or otherwise</u> (other than taxes contemplated in subsection (1A)) proved to be payable by that resident to any sphere of government of any country other than the Republic, without any right of recovery by any person other than a right of recovery in terms of any entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment.

Should a tax treaty exist, in the absence of a tax rebate or deduction under the domestic tax legislation, the South African Oil and Gas company might seek relief from tax in South Africa that was levied by the source jurisdiction under the tax treaty? But they will only be able to make use of the treaty provisions if they qualify as a resident of one of the Contracting States for treaty purposes. In Chapter 4, the thesis examined the relief available under the tax treaties specifically in the context of oil and gas mining.

In Chapter 7, the thesis will contrast the double tax relief available under the domestic tax legislation discussed in this chapter with the relief available under the DTAs as discussed in Chapter 4 to assist Oil and Gas companies in their choice of which double tax relief to apply.

CHAPTER 6
THE CAUSE OF INADEQUATE DOUBLE TAX RELIEF

6.1 Introduction

When more than one country asserts its right to tax the same income, this gives rise to double taxation. Arnold & McIntyre (1995:33-34) identify three types of double taxation that arise from conflicts over tax jurisdiction, namely source-source, residence-residence and residence-source conflicts

Of these three types of double taxation, residence-source conflicts are the most likely to occur absent of measures to relieve double taxation. Residence-source conflicts are very difficult for a taxpayer to avoid through tax planning. To some degree, taxpayers can minimize their exposure to the other types of double taxation through careful tax planning (Arnold & McIntyre, 1995:34).

In addition to the types listed above, double taxation can occur due to differences in the way countries define income, the classification of the income and the timing and tax accounting rules they adopt. Double taxation may also occur due to disputes among countries over how to set a proper arm's length price on transfers between related parties (Arnold & McIntyre, 1995:34).

This thesis aims to determine whether or not the unilateral relief from double taxation under the South African domestic tax legislation and/or bilateral relief under DTAs serve to provide full relief from double taxation to a South African resident company engaged in the exploration for and production of oil and gas outside of South Africa. In chapter 6, the thesis examines the possible causes of inadequate relief from double taxation under either/both the domestic tax legislation and the double taxation agreements.

6.2 Conflicts in interpretation

The foreign tax relief available under the domestic law is interpreted following the ITA (as amended) and South African legal precedence prevailing as at the tax year of assessment in which the taxable income is received or accrued in respect of which the double tax relief is sought (see Chapter 3, 3.4 – Interpretation of domestic legislation). This may lead to conflicts in the interpretation of the application of a DTA in three ways when there is a change in domestic law (Vogel, 2005:64):

1. If the treaty refers to terms or rules of the domestic law, and these terms were changed,
2. If the new law still corresponds to the wording of the treaty, though no longer to its goal or objective,
3. If the new law contradicts the treaty.

Article 3(2) of the 2017 OECD MTC provides that in the interpretation of a term not defined in the treaty, the definition of a term in the domestic law (as amended) applies. When the interpretation of a term transitions corresponding to changes to the domestic law or a progression in the court precedent this is an ambulatory approach to interpretation. But in the context of terms defined in the treaty, Avery Jones (1984:90) supports a static interpretation, namely an interpretation referenced to the law of the contracting States at the time when the treaty was concluded[143]. An ambulatory interpretation would give the contracting States, through changes in their domestic law, the opportunity to alter the scope of an international obligation (Vogel, 2005:64).

6.2.1 Residence-residence conflict

Where a term is not defined in either the domestic law or the DTA, such as the term "place of effective management", which is used to determine residence (see Chapter 3, 3.2 -Resident and 3.3 - Place of effective management), and the domestic interpretation of the term differs from the interpretation used in the DTAs the potential for a residence-residence conflict exists. The term POEM is not defined in the domestic tax legislation or the DTA, yet it is applied as the tie-breaker to both the domestic law and the majority of South Africa's DTA[144]. In this scenario, where the concept of POEM from a DTA perspective differs from its domestic interpretation in the definition of "resident" in the ITA, Vogel (2005:39) states that Article 31(1) of the VCLT provides the mandate to interpret a tax treaty "in light of its object and purpose" which leads to the requirement that States should seek the treaty interpretation which is most likely to be accepted in both Contracting States. Residence-residence conflicts can be resolved by approaching the tax officials of the two treaty countries (the "competent authorities") to a DTA, through the Mutual Agreement Process (MAP) at Article 24 of the SA /Egypt DTA, Article 26 of the SA /Ghana DTA and Article 24 of the SA /Nigeria DTA.

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[143] *The Queen v. Melford Developments Inc*., Court of Appeals, [1981] 35 DTC 5020; Supreme Court, [1982] 36 DTC 6281.

[144] In the circumstance that the country is a signatory to the MLI, their DTA with South Africa at Article 4(3) replaces the POEM tiebreaker with an obligation that the competent authorities should mutually agree the residence state.

6.2.2 Source-source conflict

The term “source” is not defined in the tax treaties. The meaning of “source” is derived from its meaning under the domestic laws of the Contracting States to the treaty (see Chapter 2, 2.2 – Source). Double taxation resulting from source-source conflicts may be addressed by specific provisions of a treaty. The 2017 OECD MTC provides the source State has the primary right to tax income earned within its borders without regard to the residence of the taxpayer. For example, the 2017 OECD MTC provides that income derived from immovable property including income arising from the operation of a mine or well, has its source in the country where the immovable property is located (Article 6)). These “source” rules in the 2017 OECD MTC are important not only to authorize taxation of income in the source State but also to require the residence State to give credit for the taxes levied by the source State.

In terms of Article 6 of the SA /Ghana DTA income derived from the direct use, letting or use in any other form of immovable property by a resident of a Contracting State from immovable property situated in the other Contracting State may be taxed in that other State. The definition of immovable property in Article 6 of the SA/Ghana DTA specifically includes rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Furthermore, per the Ghanaian domestic tax legislation, the source of the mining income is the location of the mine. The source State however is not conclusive in the circumstance that Oil and Gas fields straddle the border of neighbouring States.

On the 29th of November 2011, the Government of Cote d'Ivoire led by President Alassane Ouattara mapped out a new maritime border covering some of Ghana's Jubilee oilfields. The Cote d’Ivoire maritime border dispute with Ghana created uncertainty as to whether the Deep Water Tano (DWT) production area of the producing Jubilee field should fall within the borders of Ghana or Cote d’Ivoire. Contractors to the DWT Petroleum Agreement (PA) also had to suspend drilling activities in the Tweneboa-Enyenra-Ntomme (TEN) Fields which formed part of the DWT production area until resolution of the border dispute in an International Tribunal for the Law of the Sea (ITLOS) ruling on 21 September 2017.

The Tribunal ruled in favour of Ghana but had it ruled in favour of Cote d’Ivoire it would have led to the development of a mechanism to differentiate the oil production from the Jubilee field ascribed to the DWT production area from the West Cape Three Points (WCTP) production area located in Ghana. The existing Jubilee Unitization Agreement used to allocate the percentage of Jubilee production ascribed to each production area, would in all

likelihood have proven to be inadequate as it was negotiated by the oil and gas right holders (inclusive of GNPC as representative of the Ghanaian Government) to the exclusion of the Government of Cote d'Ivoire. Cote d'Ivoire might have argued that there is a perverse incentive to skew the allocation of Jubilee production in favour of Ghana, as Ghana has lower taxes on Oil and Gas income.

No DTA exists between Ghana and Cote d'Ivoire, but if a DTA were in place it is unlikely to have resolved the source-source conflict as most tax treaties do not have extensive source rules. Instances of the source-source type of double taxation that are not resolved by specific provisions of a treaty, may be resolved through consultation of the competent authority in each of the Contracting States under the treaty's mutual agreement procedures (MAP) (Arnold & McIntyre, 1995:34). The 2019 ATAF MTC, 2016 US MTC, 2017 UN MTC and 2017 OECD MTC all provide for a MAP clause at Article 25.

6.3 The impact of the fundamental legal design

Double tax burdens can become onerous and interfere substantially with international commerce. The necessity for double tax relief is clear on grounds of equity and economic policy (Arnold & McIntyre, 1995:33). But legislating or contracting for double tax relief is not a simple task due to the domestic (South African) interpretation of the foreign fiscal terms and a lack of familiarity with the fundamental legal designs used to tax Oil and Gas companies in foreign jurisdictions (see Chapter 2, 2.3 - Fundamental legal designs). The result is that there may be difficulty in securing double taxation relief under the domestic tax legislation.

Examples, discussed below, of problematic areas in securing double tax relief in respect of foreign taxes on income is the meaning of terms such as "period of assessment" for concession regimes (for example Nigeria); "tax" in the scenario that the National Oil Company pays the taxes from its share of Profit Oil under a production sharing contract (PSC) (for example Egypt); "amount" in the scenario that the PSC provides for oil off-take by the host government instead of cash payments (for example Democratic Republic of Congo's PSC); and, "joint venture" in the scenario of economic double taxation.

6.3.1 Period of assessment

"Year of assessment" as defined in Section 1 of the Income Tax Act (ITA), means in the context of a company a reference to any financial year of that company. In terms of section 27 (2) (b) of the Companies Act, in the first year of trading, a financial year may be extended up

to 15 months. Accordingly, it is common that in the year of commencement, the financial year of a company and the year of assessment for tax purposes may be greater or shorter than a period of 12 months.

It is to be expected that the year of assessment of an Oil and Gas company for South African tax purposes may differ from the year of assessment in a foreign jurisdiction. Particularly where the foreign jurisdiction has legislated a fiscal year-end that is different from the company's financial year-end.

Double tax relief is provided under the domestic tax legislation in Section 6*quat* of the ITA. Implicitly double tax relief provided under the domestic tax legislation accommodates the differences in tax years of assessment. Entitlement to a foreign tax credit under section 6*quat* arises for a resident in the year of assessment in which a foreign-sourced amount on which foreign taxes are payable is included in the resident's taxable income (SARS, 2015:74). The foreign tax liability doesn't have to be incurred in the same tax year that the amount is included in the taxpayer's taxable income.

Section 6*quat* (1) of the ITA provides that:

> "Subject to the provisions of subsection (2), a rebate determined in accordance with this section shall be deducted from the normal tax payable by any resident in whose taxable income there is included –
>
> *(a)* Any income received by or accrued to such resident from any source outside the Republic (other than any foreign dividend contemplated in paragraph (d)) which is not deemed to be from a source within the Republic; or […]"

Section 6*quat* (1) of the ITA requires that the income that is included in the Oil and Gas company's taxable income be derived from a source outside of South Africa. Subsection (1) does not require that the foreign income tax liability is calculated for the same income as which the South African tax liability is calculated.

Section 6*quat* (1A) of the ITA provides that:

> "[…] the rebate shall be an amount equal to the sum of any taxes on income proved to be payable to any sphere of government of any country other than the Republic, without any right of recovery by any person […] by –
>
> *(b)* Such resident in respect of-
>
> (i) Any income contemplated in subsection (1) (a); […]"

Subsection (1A) provides that the rebate is the sum of all taxes which are legally payable to the foreign government in respect of the income which has been derived from a source outside South Africa.

The reference to the income contemplated in subsection (1A) refers to income that has been derived from a source outside of South Africa. Subsection (1A) does not require that the income which is subject to tax in the host country should tie-up with the income which is subject to tax in South Africa.

Section 6*quat* (1B) of the ITA addresses the fact that the host country may calculate the tax liability attributable to the foreign-sourced income differently to that of South Africa by stipulating that the foreign taxes paid (irrespective that they may be determined on a different basis than that of the South African legislation) will be limited to the South African tax payable. This serves to protect the South African tax base by only allowing a foreign tax rebate up to the South African tax liability attributable to the foreign income.

But section 6*quat* is inapt in dealing with multiple foreign tax years when they fall within one South African tax period of assessment, expressly because the foreign income upon which such foreign taxes are paid is only taxed once in South Africa, as is illustrated by the Nigerian example below.

Under the Nigerian Companies Income Tax Act, Cap C21, Laws of the Federation of Nigeria 2004 (CITA), following the commencement rules stipulated in section 29(3), a new business is taxed in its first tax year on a basis that recognizes three periods of assessment within the first year:

Period 1: The tax liabilities for the first period are based on the taxable profits of the tax year in which the company commenced business operations, namely the taxable profits of the period beginning from the business commencement date to 31 December of that calendar year[145].

Period 2: The tax liabilities for the second period are based on the taxable profits of the first 12 months of business operations from the commencement date.

Period 3: The assessable profit for the third period is based on the operating results of the preceding financial year.

From the second tax year, the company transits to the preceding year basis of taxation. This will be the basis of taxation for subsequent years.

[145] Section 29(3a) of CITA

This rule was introduced by the Nigerian authorities to combat the poor level of compliance amongst newly registered taxpayers in Nigeria, by collecting 3 periods-worth of tax in the first actual tax year of assessment in Nigeria.

The impact of the Nigerian commencement rule can be illustrated by an example.

A company with a financial year ending 28 February commences business on 1 November 2XX1 in Nigeria. In the year of commencement, it will be subject to tax in Nigeria on its profits for the period 1 November 2XX1 to 31 December 2XX1; 1 November 2XX1 to 31 October 2XX2 and 1 January 2XX2 to 31 December 2XX2. In Nigeria, the Company pays tax in respect of each of these tax periods that fall in the year of commencement. Namely, it will pay tax three times in its first year of commencement.

In South Africa, in the year of commencement, the company may have a financial year of assessment longer (up to 15 months) or shorter than 12 months (minimum 3 months). In this example, the first financial year of the company is 14 months, namely 1 November 2XX1 to 31 December 2XX2. In South Africa, the company will be assessed for tax for this period of assessment and will be liable for tax based on the foreign profits earned in this tax period of assessment.

Even though the Nigerian tax periods of assessment all fall within the South African tax period of assessment, and accordingly should qualify for the section 6*quat* rebate, it is the SARS practice to only recognize one of the Nigerian tax years, and the SARS will allow for the offset of the tax paid for one of the tax periods in the commencement year of assessment in Nigeria against the South African tax liability for the year of assessment, 1 November 2XX1 to 31 December 2XX2.

While SARS interpretation and practice may be disputed this leaves little comfort to the Oil and Gas company in our Nigerian example. Given the life cycle of oil and gas projects, there is a risk that where a foreign tax is being disputed that, at the time the dispute is resolved, there will be insufficient foreign income included in taxable income against which the foreign tax limitation will be calculated – resulting in a loss of foreign tax credits. Furthermore, if left undisputed, the resident Oil and Gas company with Nigerian mining activities may suffer South African tax above the foreign tax paid in the first two tax years that it enters production (as the foreign taxes paid in Nigeria were determined for foreign income from the two years preceding production), similarly upon abandonment and decommissioning of the field - two

years of foreign tax credits would be lost in the absence of foreign income to include in taxable income.

6.3.2 Definition of tax

Tax as defined[146]means any levy, a tax levied under the ITA or any previous Income Tax Act. This is an extremely narrow definition of "Tax", confined to taxes on income and capital gains from a South African income tax perspective (see Chapter 5, 5.2.4 – Qualifying taxes). In the context of giving effect to provisions in the Act that provides for relief from double taxation such as section *6quat* a more liberal and extended interpretation of the meaning of "Tax" should be applied (Passos, 1986:69).

A narrow interpretation by the SARS (2015:24) of section 6*quat* as to the meaning of "Tax" particularly for PSCs and Joint Ventures results in disallowed claims for a rebate for foreign income taxes paid. According to the SARS interpretation, to qualify for the rebate under section 6*quat* the foreign tax needs to be paid *by* the South African resident on foreign-sourced income *to* the foreign government.

Under the Egyptian PSC, the contractor is subject to Egyptian income taxes. EGPC (the Egyptian NOC) assumes, pays and discharges on behalf of each contractor, the contractor's Egyptian income tax out of EGPC's share of the oil and gas produced. EGPC furnishes the contractor with the proper official receipts evidencing the payment. The SARS in this example is reluctant to allow relief under section 6*quat* in respect of Egyptian taxes paid because the South African resident Oil and Gas company (contractor) has not borne the foreign tax on income, the foreign NOC has paid the contractor's tax from the foreign NOC's share of profits.

In contrast, a tax rebate is allowed for withholding tax deducted from payments to an Oil and Gas company by the foreign recipient of a good or service, even though such taxes are deducted on behalf of the taxpayer. This is on the basis that the withholding tax is recognized as a profits tax paid by the company and not the recipient (*Volkswagen of South Africa (Pty) Ltd v C SARS* [2008]). The SARS (2015:35) deems a resident to have incurred a foreign tax liability in circumstances where the foreign taxes are withheld on behalf of the resident Oil and Gas company by the person paying the foreign-sourced amount. A rebate is also allowed for foreign tax paid by a non-resident where attribution applies. The same principle applies to partnerships or Joint Ventures see 6.3.4 below. Section 6*quat* (1C) allows a resident to claim

[146] Section 1 of the ITA, definition of "Tax".

a deduction for foreign taxes on levied income derived from foreign trade operations that do not qualify for a rebate under section 6*quat* (1).

6.3.3 Amount

In the context of levying tax on income in South Africa, there must be an "amount", in cash or otherwise, received or accrued before gross income arises (see Chapter 3, 3.5.1.1 – Amount).

In *CIR v People Stores (Walvis Bay) (Pty) Ltd* [1990] AD one of the judges, Hefer J, accepted the following statement made by Watermeyer J in *Lategan v CIR* [1926] CPD:

> "In my opinion, the word "amount" must be given a wider meaning and must include not only money but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value"

When an asset other than money is received, it will have to be valued. The principle has been established, in the South African Appellate Division *Lace Proprietary Mines v CIR* [1938][147], that this value will normally be the market value on the date the asset was received (*CIR v Lydenburg Platinum* [1938][148]*)*.

The South African Appellate Division case *CIR v Butcher Brothers (Pty) Ltd* [1945] [149] is authority for the principle that an asset that does not have money's worth or cannot be turned into money cannot be included in income. As long as the amount (being a tangible or an intangible right) has an ascertainable money value and can be converted into money it will fall into gross income (*CIR v Delfos* [1933]).

It is the author's view that in the context of providing credit in South Africa for foreign taxes paid, there should similarly be a wider meaning of "amount". Therefore, whether foreign taxes are paid in cash or otherwise, the SARS should recognize an "amount" of foreign tax paid.

The term "taxes on income" is defined in section 6*quat* (3) of the ITA to specifically exclude any compulsory payment to the government of any other country constituting consideration for the right to extract any mineral or natural oil. It is submitted that the purpose of this subsection is to exclude those tax instruments such as royalties, surface fees and production

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[147] *Lace Proprietary Mines Ltd v CIR* [1938] AD 267 (9 SATC 349)
[148] 4 SATC 8
[149] *CIR v Butcher Brothers (Pty) Ltd* [1945] AD 301 (13 SATC 21)

bonuses that are based on the value or volume of production. Namely, the subsection seeks to exclude taxes that are levied at the wellhead instead of at the profit line or on net income from oil and gas activities. The basis for these payments is the exercise of property rights by the government, which is different from the obligation of taxpayers to contribute to public expenses, as is the case of taxes. Section 6*quat* (1A) limits the rebate (credit) to foreign taxes on income and capital gains from a source outside the Republic. “Taxes on income” are described by the SARS (2009:15) as an appropriation of the profits of a taxpayer and accordingly tax instruments such as royalties, surface fees and production bonuses are not “qualifying taxes” for purposes of the domestic tax credit. Section 6*quat* (1C) of the ITA allows for a deduction of foreign taxes that do not qualify for the domestic tax credit under section 6 *quat*(1), but as stated these tax instruments are not recognised as taxes on income and as such do not qualify for deduction from taxable income within the ambit of section 6 *quat* (1C). These tax instruments will qualify for deduction under section 11(a) read with section 23(g) (see chapter 3, 3.5.3 – Allowable deductions) as an operational expense of the mining activities.

Regrettably, the SARS have interpreted section 6*quat* (3) to exclude in the context of Oil and Gas companies <u>all</u> tax payments otherwise than in cash (see Chapter 5, 5.2.4 – Qualifying taxes). The SARS (2015:24) gives the following example as an explanation:

> “Production sharing agreements, involve ownership by a foreign government of oil and gas reserves, with a private oil company acting as contractor furnishing capital, services and technical knowledge. The contractor is compensated in the form of a share of production. Foreign taxes paid by or on behalf of the contractor to the foreign government are also in the form of a share of production. Since the foreign government already owns the oil and gas reserves, no payment is actually made by the contractor to the government and even if such a payment could be identified, it is more akin to royalty than to an income tax”.

The difficulty in securing a 6*quat* relief for foreign taxes paid in the context of Production Sharing Contracts (PSCs) is illustrated by the Democratic Republic of Congo (DRC). Under the DRC PSC, the government has a fixed participating interest in the PSC, namely 15%. The oil and gas company (contractor) pays royalties on the production at either 9% or 12.5% depending on the level of cumulative production. Furthermore, instead of DRC corporate income taxes, the PSC provides that profit oil should be split between the contractor and the government of the DRC in a ratio based on the cumulative production, namely 45% for the DRC; and 55% for the contractor where the cumulative production is less than 12 million barrels and 40% for the DRC and 60% for the contractor with cumulative production that exceeds 12 million barrels. This profit oil is collected by the government of the DRC (by its

ministry) instead of being paid to the Revenue Authority of the DRC. The SARS in this example treats the profit oil allocation to the government of the DRC in the same way as a royalty for the extraction of minerals and will not allow relief under section 6*quat* in respect of profit oil paid because the term "taxes on income" is defined in section 6*quat* to specifically exclude any compulsory payment to government constituting consideration for the right to extract any mineral or natural oil (SARS, 2015:23).

6.3.4 Joint Ventures

Section 6*quat* (1A) of the ITA, deems a resident to have incurred a foreign tax liability notwithstanding that it has been paid by someone else from a partnership established in a foreign country that treats a partnership as a person for tax purposes.

Subsection (1A) accordingly makes provision for unincorporated joint ventures (such as those used in most oil and gas countries operating under the concession legal design). Ghana is such a country, where GNPC will enter into a Joint Operating Agreement (JOA) with an Oil and Gas company or group of Oil and Gas companies.

In countries that have adopted the contractual legal design, joint operating activities are primarily conducted by a joint venture company. For example, in Venezuela, joint venture companies (Empresas Mixtas) are established. Oil and Gas companies are recognized as investors in terms of the shareholder agreement, whilst PDVSA (the Venezuelan NOC) is the operator and majority shareholder (by law) with equity participation above 50%.

In an attempt to allow Oil and Gas companies the benefit of incorporation without suffering the consequential fiscal results, some countries have introduced legislation to eliminate one layer of taxation. In the United States, for example, certain companies have the choice to be taxed as "Sub- Chapter S" corporations, resulting in their being taxed as if they were tax transparent partnerships.

6.4 Legislated limitations in the domestic legislation

6.4.1 Foreign source

The section *6quat* rebate does not apply to the foreign tax paid on income from a South African source or deemed source. It is submitted that "source" and "deemed source" in the

context of section 6*quat,* bear the ordinary meaning which it has for purposes of the "gross income" definition in section 1 of the ITA[150] (IBFD, 2001:324) (See Chapter 2, 2.2 – Source).

Section 6*quat* is arguably too restrictive with South African sources in that there are often circumstances where income, like management fees, is sourced in South Africa because, for example, the relevant management services are performed in South Africa. Interestingly, where a DTA (for example Ghana/South Africa DTA) contains a deemed source rule with regards to technical, managerial and consultancy fees in terms of which such fees are deemed to be sourced in the country of the PE irrespective of where they are physically rendered, SARS has taken the stance that the treaty provisions will override and deem the income to be from a foreign source (SARS 2015:14). A claim under section 6*quat* (1) may be allowed in respect of such fees.

An example of deemed source income in respect of which a section 6*quat* rebate cannot be claimed is foreign recoupment. Paragraph *(n)* of the definition of "gross income" in section 1 of the ITA provides that any amount which is required to be included in a taxpayer's income in terms of section 8(4) (recoupments), is deemed to have been received or accrued from a source within the Republic notwithstanding that such amounts were recovered or recouped outside South Africa. Should such recoupment also be subject to foreign tax, no section 6*quat* rebate will be available due to the application of section 6*quat*(1A)(a)(i). It is submitted that section 6*quat*(1A)(a)(i) needs legislative amendment to enable resident Oil and Gas companies to claim tax credits in these circumstances. It is proposed that section 6*quat* is amended with the addition of a new subsection (*d*) to section 6*quat* (1):

6*quat*. Rebate or deduction in respect of foreign taxes on income – (1) Subject to subsection (2), where the taxable income of any resident during a year of assessment includes –

(a) Any income received by or accrued to such resident from any source outside the Republic; or

(b) Any proportional amount contemplated in section 9D; or

(c) ……

(d) Any foreign source amount specifically required to be included in the taxpayer's income in terms of section 8(4) deemed to have been received or accrued from a source within the Republic; or…

[150] *CIR v Lever Brothers & Unilever Ltd* [1946] 14 SATC 1.

Section 6*quat* (1C) allows for the deduction of foreign taxes levied in respect of South African-source income derived from foreign trade operations.

The DTAs makes no reference to "source" as a requirement for a foreign tax credit. The requirements for foreign tax relief under a double taxation agreement are mere that the income upon which the foreign tax was paid is taxed in both Contracting States.

6.4.2 Income

Vogel (2005: 147) states "there is at the international level a basic common understanding of what "income" means". He adds that the "positive definitions of the term "income" in national income tax legislation usually are much narrower than this widest of all definitions of the term". This is true of South Africa's domestic tax legislation.

"Income" is defined in section 1 of the ITA as "the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax" (see Chapter 3, 3.4 - Income). But South Africa does not levy tax on "income" as defined. It is levied upon "taxable income". "Taxable income" means:

> "the aggregate of (a) the amount after deducting from income of any person all the amounts allowed […] to be deducted from or set off against such income; and (b) all amounts to be included or deemed to be included in taxable income of any person in terms of this Act".

The meaning of "income" appears to vary in the 2017 OECD MTC between contextual meanings of a "net income" and a "gross income" (Bramo, 2007: 73-82). According to SARS (2015:73), the word "income", as is used in the Article dealing with the elimination of double taxation in a DTA, must be interpreted to mean "net income" or "taxable income". It does not mean "income" as defined in section 1(1) of the ITA. In this regard Vogel (2005:1217) states the following:

> "63. The maximum deduction is normally computed as the tax on net income, i.e. on the income from State E (or S) less allowable deductions (specified or proportional) connected with such income".

This is the same as paragraph 63 of the 2017 OECD MTC on Article 23B[151]. Furthermore, in paragraph 62 of the 2017 OECD MTC on Article 23B[152], the credit for foreign taxes is subject to a maximum for "income" that provides-

[151] At page 343
[152] At page 342

> "[T]he deduction which the State of residence (R) allows is restricted to that part of the income tax which is appropriate to the income derived from the State S, or E (so-called "maximum deduction"). Such maximum deductions may be computed […] by apportioning the total tax on total income according to the ratio between the income for which the credit is to be given and the total income".

Under the domestic tax legislation (see Chapter 5, 5.2.3 – Qualifying amounts), relief from double taxation is limited to the extent that foreign source income has been included in the resident Oil and Gas company's taxable income. This narrow interpretation of income poses a difficulty in the context of transactions between the resident Oil and Gas company and its foreign PE. For example, a resident Oil and Gas company may "transact" with its PE (a branch in Mozambique) and for accounting purposes charge a fee including a mark-up on those "transactions" (for example, accounting services in the form of the relevant portion of the related employees' salaries plus consumables plus a mark-up) (SARS, 2015:34). However, from a South African tax perspective when calculating taxable income and attributing profits to the South African presence and the foreign PE, transactions within one legal entity are not recognised. Accordingly, the fee payable by the foreign branch to the head office is not recognised in the resident's hands (that is, there is no gross income) and the foreign branch may only be allocated a relevant portion of the external costs excluding any internal mark-up. Mozambique levies a withholding tax at 20% on all remittances in a foreign currency, which would apply to payments by the foreign branch to the South African head office. The resident Oil and Gas company will not qualify for a section 6*quat* (1) rebate for the Mozambique withholding tax paid. The reason is that the accounting fee "charged" by the head office to the foreign branch is not recognised for tax purposes and there is no foreign-source income that has been included in the resident's taxable income. This applies irrespective of whether the withholding tax was levied on the cost portion of the "fee" or the full "fee" including the mark-up and irrespective of whether or not the withholding tax was permitted under the SA /Mozambique DTA.

6.5 Conflicts in classification

It often happens that income is classified differently for domestic purposes than for treaty purposes (Kirchoff, 2002:9). According to Vogel (1997:54), there are three possible classifications (otherwise known as qualifications):

1. Each State applying the treaty qualifies the treaty terms according to the requirement of its domestic law: *lex fori* qualification.
2. Both States qualify treaty terms consistently according to the law of the State in which the income arises: source State qualification.

3. Both States seek to establish a consistent qualification from the context of the treaty: autonomous qualification.

In theory double taxation which arises due to the different classification should be eliminated by the residence State giving a credit for the foreign taxes paid or payable. However, the residence State may refuse to give a credit on the basis that in their opinion the source State did not levy tax following the treaty. This argument was addressed by the OECD in Article 23A (4) of the 2017 OECD MTC (Avery-Jones, 2003:184).

Article 23A(4) is primarily intended to address conflicts of classification, namely cases where the two States consider that the same item of income falls within different articles of the treaty because of differences in the domestic laws of the two States, but where the residence State agrees that the other State has applied the treaty correctly. An example of this is the classification of income derived from the exploration for and production of oil and gas as "business profits" of a "permanent establishment" by one Contracting State (see Chapter 4, 4.7.2 – Permanent establishment and 4.7.3 – Business profits) and as income from "immovable property" (see Chapter 4, 4.7.4 – Immovable property) by the other. Both of these classifications under the 2017 OECD MTC provide that the oil and gas income may be taxed in the State of the source without any limitation. In this example, if the residence State does not follow a scheduler system of taxation[153], the residence State would agree with the "effect" of the other State's application of the treaty. Accordingly, based on the Commentary to Article 23 of the OECD MTC (paragraph 32.1-32.7) the residence State must accept the classification by the source State and provide relief to eliminate double taxation.

6.6 The allocation of income

Article 6 of a DTA based on the 2017 OECD MTC provides that "income derived by a resident of a Contracting State from immovable property, including income from agriculture or forestry, situated in the other Contracting State *may only be taxed* in that other State". And Article 7(1) provides that "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" (see Chapter 4, 4.7.1 – Enterprise and 4.7.2 – Permanent Establishment).

[153] Under a scheduler system, different kinds of income are measured by different rules and the total income is then taxed (Olivier & Honiball, 2011:16).

The use of the word "*may*" as opposed to "*shall*" is significant. According to Clegg & Stretch (2012:2), the word "shall" is normally used as being the equivalent to "must", while the word "may" is usually used in a permissive sense. In the context of the use of the wording "may be taxed" in Article 7, both Contracting States are given the right to tax the income. In this circumstance, the taxpayer would need to refer to another Article, namely Article 23 in the DTA which then requires one of the States (usually the state of residence) to provide relief in terms of its domestic law or terms of the treaty by either exempting the income from tax or by granting credit in respect of tax paid in the other State.

However, the word "may" can be equivalent to "must". In *CIR v King* [1947][154] it was held that the word "may" was equivalent to "must" and a similar conclusion was reached in *Stroud, Riley & Co. Ltd v SIR* [1974][155]. The context of the use of the wording "may only be taxed" in Article 6, is an obligatory use of the term and the country of source is given the primary right to tax. Article 6 accordingly provides for an exemption in the State of residence for income from immovable property, such as income from the right to extract natural resources.

According to Arnold (2006:6), Article 7 provides rules for computing the business profits attributable to a PE and requires the net income basis of taxation, whereas Article 6 leaves the taxation of income from immovable property to the provisions of the domestic law. If an amount is covered by both Article 7 and another article of the DTA, Article 7(7) of a DTA based on the 2017 OECD MTC indicates that the other article takes precedence over Article 7 (Arnold, 2006:5). Accordingly, Article 6 will take precedence over Article 7 where the right to extract oil and gas is recognised as immovable property in terms of the domestic tax legislation of the source State. But in the context of jurisdictions, where income from the exploration and production of oil and gas is distinguished as "business profits" and not considered to be a passive investment to derive income from "immovable property" under the domestic law of that contracting State, Article 7 is preferred. Where Article 7 is preferred both countries have the right to tax business profits attributed to a PE in the host country.

The allocation of income to a PE under Article 7(2) of a DTA modelled on the 2017 OCED MTC requires that those profits are to be calculated as if the PE were an independent enterprise carrying on its business at arm's length with the enterprise of which it is a PE. This provision is aimed at preventing the manipulation of profits between the two jurisdictions.

[154] [1947] (2) SA 196 (A), 14 SATC 184

[155] [1974] SA 534 (EPD), 36 SATC 143

Article 7(4) provides that no profits are to be attributed to a PE as a result of the mere purchase by that PE of goods or merchandise for the enterprise. When determining the profits of the PE, expenses incurred for that PE, including executive and general administrative expenses, must be deducted, irrespective of where incurred (Article 7(5)). In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the PE's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that expenses to be taken into account as incurred for the PE should be the actual amount so incurred. The deduction allowable to the PE does not depend on the actual reimbursement of such expenses by the PE (2017 OECD Commentary, 2017:134). The profits to be attributed to the PE must be determined by the same method year by year, unless there is good and sufficient reason for a change in methodology (Article 7(5)).

6.7 Conflicts of qualification

Vogel (2003:41) in an article entitled *Conflicts of Qualification: The Discussion is not finished*, wrote:

> "This article analyses why the OECD (*Article 23*) - does not cover all cases of different qualifications and when and why, as a consequence of such conflicts, double taxation or double non-taxation may still arise."

Vogel's article premises that, Article 23A (4) does not require the residence State to eliminate double taxation where there is a conflict regarding the interpretation of facts or the interpretation of the treaty provisions (see Chapter 4, 4.3 – Interpretation of double taxation agreements). If the residence State does not agree with the interpretation given by the source State, it should not be bound to apply the treaty based on that interpretation (Sasseville, 2009:46).

The extent that Article 23 of the 2017 OECD MTC applies is unclear in the case that both States agree that their interpretation of the treaty is different but equally correct. Consider the case of "associated enterprises" and attribution to a "permanent establishment" where a "range" of prices can all satisfy the arm's length standard (see Chapter 4, 4.7.6 – Associated enterprise). The arm's length principle is binding on both the State where the PE is situated and the State of residence (Rohatgi, 2002:83). Is the residence State of an enterprise that has a PE in the other State required to apply Article 23 based on the arm's length transfer price or method used by the source State even though that price or method differs from the arm's length transfer price or method used by the residence State?

Example 6.1

R a company resident in South Africa has oil and gas mining operations in Ghana. The oil and gas production is sold to other independent oil companies with refineries in South Africa. For a given taxable period, the actual cost of producing the oil & gas, taking into account all direct and indirect costs is 1000, and the oil & gas is sold at 1500. In selling the oil & gas, R incurs marketing and shipping costs of 200, leaving profits of 300.

Article 7 (Business Profits) of the double taxation agreement between South Africa and Ghana allocates the taxing rights on these profits. Following Article 7, Ghana will be allowed to tax the profits that the PE would have made if it has been a separate and independent enterprise. Quite clearly, the PE, if it had been a separate and independent enterprise would not have sold the oil & gas to R for 1000 or less since this represents R's direct and indirect production costs in Ghana. It is also clear that R would not have paid more than 1200 if it had acquired the oil & gas from an independent enterprise since that amount represents the maximum amount that it could pay to break even when it sells the oil and gas to the IOCs.

To determine the profits that are attributable to the PE under Article 7, it will be necessary to determine the arm's length price at which the oil and gas would have been sold by the PE, and acquired by the rest of R, if the PE had not been part of R but, instead, a separate and independent enterprise. The arm's length price, which will be somewhere between 1200 and 1500, will determine, for purposes of the double taxation agreement between South Africa and Ghana, which part of the profits is considered to arise in each State.

In determining the transfer price of the oil and gas from the PE in Ghana to the rest of the enterprise in South Africa, R may have an interest in choosing either a higher transfer price that will maximise the share of profits allocated to Ghana or a low transfer price that will maximize the share of profits allocated to South Africa. This will depend on the tax rates and various other tax factors (for example loss utilisation) in each State and, if all the tax factors are relatively equal, R may have no interest at all in determining the transfer price of the oil and gas. South Africa and Ghana, however, will both be interested in what the transfer price is, but their interests will go in opposite directions: Ghana would want to make sure that the price is not too low to deprive it of tax revenues; conversely, South Africa will want to make sure that the price is not too high to reduce the profits on which Ghana has exclusive taxing rights.

It will therefore not be surprising if all three parties who are required to determine the transfer price of the oil and gas (namely the taxpayer R, the revenue authority of South Africa and the revenue authority of Ghana) end up with different amounts.

In such a situation, the MAP under Article 25 of the 2017 OECD MTC is available to address these cases, but the MAP found in most of the South African DTAs only requires the competent authorities to "endeavour to resolve" the cases that are presented to them, without any obligation to reach an agreement. This is the reason for the addition to the 2017 OECD MTC of Article 25(5) providing for the mandatory arbitration of unresolved issues arising in MAPs (Sasseville, 2009:47). None of the DTAs in the case study provide for the mandatory arbitration (as these DTAs were based upon the 2014 OECD MTC and its predecessors) and this dispensation is unlikely to change as South Africa chose to opt-out of the Action 14 article on Mandatory Binding Arbitration within the context of the MLI.

6.8 Multilateral instrument

While one of the purposes of DTAs is to minimise taxation of the same income in both contracting States to the DTA, the complex structures available to companies engaged in the exploration for and production of oil and gas across different jurisdictions can lead to potential abuse of DTAs. To mitigate against this, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, known as the Multilateral Instrument (MLI) was agreed upon by OECD and G20 member countries to offer concrete solutions for governments to close loopholes in DTAs and allow signatory governments to modify existing DTAs to implement the tax treaty measures developed during the OECD's BEPS Project (Action 15), without the need to expend resources renegotiating each existing DTA bilaterally. It transposes the results of the BEPS Project onto the existing DTAs between signatory governments, allowing governments to implement agreed minimum standards to counter treaty abuse and improve dispute resolution mechanisms while providing flexibility to accommodate specific tax treaty policies.

As of 29 June 2021, 95 countries are signatories to the MLI. South Africa became a signatory to the MLI on 7 June 2017 and has elected certain provisions of the articles that apply in 76 of the DTAs to which South Africa is a party[156]. SCOF (2017:6) outlines the BEPS Project Actions incorporated into the MLI:

> *"Action 2- Hybrid Mismatch Arrangements*
>
> Part II of Action 2 addresses income earned through transparent entities that are not treated as a taxpayer, such as partnerships. It recommends the inclusion of a provision that ensures that the benefits of tax treaties are granted in appropriate cases to the income of these entities; and these benefits are granted where neither State treats, under its domestic law, the income of such entities as the income of one of its residents. South Africa elected to apply this provision.
>
> *Action 6-Treaty Abuse*
>
> To deal with increased concerns that dual resident entities are involved in tax avoidance, Action 6 recommends that cases of dual residence under DTAs be resolved on a case-by-case basis. This tie-breaker rule replaces the current rule based on the place of effective management; over 20 of South Africa's 78 DTAs include the new tie-breaker clause. South Africa adopted this provision.

[156] Egypt, Ghana and Nigeria are included in the list of countries that have notified that their DTA(s) are covered by the MLI.

> *Article 8 of the MLI- Dividend Transfer Transactions*
>
> Action 6 proposes a minimum holding period of 365 days before entities can benefit from a preferential rate of dividends, and the purpose is to avoid the manipulation of the preferential rate of dividends. South Africa opted to apply this provision.
>
> *Action 7- Artificial Avoidance of Permanent Establishment Status*
>
> Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies deals with an arrangement through which a person sells products in a country in its name but on behalf of a foreign enterprise that is the owner of the products. South Africa entered a reservation on this Article."

An example of the impact of the MLI on the SA DTAs is South Africa has elected option A of Article 13 of the MLI to apply in respect to deeming exceptions of certain physical activities from the term "permanent establishment" at Article 5(4) of the DTA. Option A in substance limits the exceptions from applying unless each of the activities undertaken or the combination of activities is of a preparatory or auxiliary nature.

Article 13(4) of the MLI states that a PE may be created in the following circumstances

a) Where a non-resident carries on activities from a single place in a host jurisdiction and one of the activities qualifies as a PE but the other does not;
b) Where a non-resident carries on activities in a host jurisdiction from two different places and one of the places is a PE and the other is not;
c) Where two closely related non-residents carry on activities from a single place in a host jurisdiction and one of the activities qualifies as a PE but the other does not; or
d) Where two closely related non-residents carry on activities in a host jurisdiction from two different places and one of the places is a PE and the other is not.

In any of these circumstances, the combined activities may be treated as creating a PE in respect of each location or activity if the activities constitute complementary functions that are part of a cohesive business operation.

Article 5(3) of the SA /Nigeria DTA provides that a building site or construction or installation project constitutes a PE only if it lasts more than six months. The impact of the MLI on the SA/Nigeria DTA would be to obviate the time measurement at Article 5(3) used to determine whether or not the Oil and Gas exploration activities undertaken by a South African resident Oil and Gas company in Nigeria constitutes a PE where the considerations a) to d) above predicate that there is an existing PE in Nigeria.

The table below sets out the notifications and reservations that South Africa has elected which would replace the existing articles of its DTAs for the selected sample countries:

	Egypt	Ghana	Nigeria
Article 4 of MLI – Dual resident entities	Article 4(3) of DTA	Article 4(3) of DTA	Article 4(3) of DTA
Article 5(8) of MLI – Elimination of double taxation	Does not apply to SA/Egypt DTA	Does not apply to SA/Ghana DTA	Does not apply to SA/Nigeria DTA
Article 6(6) of MLI - Preamble	Does not apply to SA/Egypt DTA	Does not apply to SA/Ghana DTA	Does not apply to SA/Nigeria DTA
Article 7 of MLI- Prevention of treaty abuse	Does not apply to SA/Egypt DTA	Does not apply to SA/Ghana DTA	Articles 10(6), 11(8) and 12(7) of DTA
Article 8 of MLI – Dividend transfer transactions	Does not apply to SA/Egypt DTA	Article 10(2)(a) of DTA	Article 10(2)(a) of DTA
Article 9 (6) (a) of MLI – Capital Gains	Does not apply to SA/Egypt DTA	Does not apply to SA/Ghana DTA	Does not apply to SA/Nigeria DTA
Article 10(5)(a) of MLI – PE in 3rd State	Does not apply to SA/Egypt DTA	Does not apply to SA/Ghana DTA	Does not apply to SA/Nigeria DTA
Article 11 (3)(a) of MLI – saving clause	Does not apply to SA/Egypt DTA	Does not apply to SA/Ghana DTA	Does not apply to SA/Nigeria DTA
Article 12 (4), 13(7)(Option A) and 14 (3)(a) of MLI – Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions (Option A)	Article 5(4) of DTA	Article 5(4) of DTA	Article 5(4) of DTA
Article 16 (5)(a) of MLI – Mutual Agreement Procedure	Article 24(1) of DTA	Article 26(1) of DTA	Article 24(1) of DTA
Article 17 (3) of MLI – Corresponding Adjustments	Article 9(2) of DTA	Article 9(2) of DTA	Article 9(2) of DTA

Table 6.1 – South Africa's MLI notifications and reservations

6.9 Conclusion

The SARS interpretation of "tax" is limited to "taxes on profit" which was examined in further detail in Chapter 5, "period of assessment" is limited to the tax year that the foreign income is included to be taxed in South Africa, "amount" is limited to cash only and an unincorporated "joint venture" is equated to a partnership while a reduced withholding tax rate through a DTA may provide relief from dividend withholding tax for an incorporated JV.

The SARS interpretation restricts the meaning of "tax" to a foreign tax on income paid by the South African resident on foreign-sourced income to the foreign government. This narrow SARS interpretation particularly for PSCs and Joint Ventures results in disallowed claims for a rebate for foreign taxes paid because the resident Oil and Gas company has not directly borne the foreign tax on income, as the foreign State's national oil company (NOC) has paid

the tax from the NOCs share of profits or the tax is treated by SARS as constituting consideration for the right to extract any mineral or natural oil.

With "period of assessment" the domestic tax relief is inapt in dealing with multiple foreign tax years when they fall within one South African tax period of assessment, expressly because the foreign income upon which such foreign taxes are paid is only taxed once in South Africa.

SARS have interpreted the definition of "tax on income" to exclude in the context of Oil and Gas companies all tax payments otherwise than in cash, accordingly taxes taken from production as barrels of oil do not constitute an "amount" of qualifying foreign tax.

It is recommended that the domestic tax legislation should be amended to also accommodate contractual legal designs, and to recognize the payment of taxes on income in the form of off-take from production (namely barrels of oil). It is proposed that section 6 *quat* (1A) is amended as follows:

(1A) For the purpose of sub-section (1) the rebate shall be an amount equal to the sum of any taxes on income, including the appropriation of profits in cash or otherwise proved to be payable to any sphere of government of any country other than the Republic, without any right of recovery by any person (other than a right of recovery in terms of entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment) by –

Profits derived from the exploration for and production of oil and gas may be classified either as "business profits" of a "permanent establishment" or as income from "immovable property". This classification is generally made following the domestic legislation of the source State.

Relief under the DTA may be complicated where the Contracting States do not agree on the classification of income or the allocation of profits and expenses as provided for in the "business profits" Article or "associated enterprises" Article. This is problematic where an arm's length price adjustment of an expense or profits results in additional tax paid in one State without a reciprocal adjustment for economic double taxation relief in the other State. An Oil and Gas company may under Article 9(2) of a double taxation agreement seek such a reciprocal adjustment by engaging the competent authority in the circumstance that this article is not replaced or altered by South Africa becoming a signatory to the MLI.

CHAPTER 7
CONCLUSION AND RECOMMENDATIONS

7.1 Introduction

In a climate of diminishing local oil and gas reserves, South African Oil and Gas companies are forced to seek oil and gas reserves outside of the country's borders. Cross border investment and trading in an international arena had the inherent risk of international double taxation (Olivier & Honiball, 2008:4).

Countries often provide their residents with relief from juridical double taxation unilaterally through their domestic income tax law. The tax credit method is the means adopted by South Africa as a unilateral legislative tax relief mechanism. In addition, if a tax treaty exists between South Africa and the host country, resident Oil and Gas companies can utilize the articles of the DTA to eliminate double taxation for income tax levied in the host country on mining activities in that country. Therefore, *prima facie* a taxpayer has two avenues through which to obtain double tax relief in respect of income tax in a host country with which its residence country is a DTA partner (Holmes, 2007: 99).

The relief via a DTA may be more generous than that in domestic law. For example, the domestic law may allow for limited relief by way of a tax deduction in the taxpayer's country of residence for the tax paid in a foreign jurisdiction, whereas a DTA will allow for either a full exemption or a tax credit, either of which confers a greater tax benefit on the taxpayer than a deduction from assessable income (Holmes, 2007:100).

In Chapter 7, the thesis will contrast the double tax relief under the tax treaties with that of the domestic tax relief to ascertain whether the tax treaties provide the same, if not more favourable tax relief than that available under the domestic tax legislation. The chapter aims to offer guidance to Oil and Gas companies in their selection of the option that will provide full relief (where possible) from double taxation by contrasting the FARI economic modelling results detailed in Chapter 2 with that detailed in Chapter 5.

7.2 The choice in South Africa

In terms of section 6*quat* (2) of the ITA, the rebate and the deduction available under the domestic tax legislation shall not be granted in addition to any relief that the resident Oil and Gas company is entitled to under any DTA. According to SARS (2015:66), a resident Oil and Gas company may elect not to apply the terms of section 6*quat* but rather to claim the relief provided for foreign taxes paid via a DTA. This choice of relief must be exercised annually

and the resident is not bound by a choice made in previous years of assessment. The taxpayer will prefer the more beneficial relief[157] , namely, the taxpayer is likely to select the option that provides for full double tax relief. If no option is elected by the resident, or where the relevant DTA specifically requires that South Africa provide a tax credit, the choice will lie with SARS (Olivier (ed), 2003:12).

7.3 The interaction between double taxation agreements and section 6*quat*

Section 6*quat* provides for either a rebate or a deduction in respect of foreign taxes. South African DTAs provide for the exemption method and credit methods of relief from double taxation (Olivier & Honiball, 2011:328). None of South Africa's DTAs allows for the deduction method of relief (Olivier & Honiball, 2011:325).

The wording of the relevant article of the DTA will determine how the DTA relief must be applied in a specific case (SARS, 2015:66). The DTA articles can be divided into (a) those that are "subject to" section 6*quat;* and (b) those that do not refer to section *6quat.*

South Africa's DTA with Ghana is an example of a treaty with the "subject to" stipulation. Article 24(b) of the DTA reads as follows:

> "Double taxation shall be eliminated as follows:
>
> […]
>
> *(c)* In South Africa, *subject to* the provisions of the law of South Africa regarding the deduction from tax payable in South Africa of tax payable in any country other than South Africa, Ghana tax paid by residents of South Africa in respect of income taxable in Ghana, in accordance with the provisions of this Convention, shall be deducted from the taxes due according to South African fiscal law. Such deduction shall not, however, exceed an amount which bears to the total South African tax payable the same ratio as the income concerned bears to the total income."

The words "subject to" make it clear that the credit must be determined under section 6*quat* since this is the only section of the domestic law that provides for the set-off of foreign taxes against normal tax payable. In these circumstances, the whole of section 6*quat* will be applicable and not merely certain elements of it such as the carry-forward of excess tax credits (SARS, 2015:69).

[157] Hefer JA in *Cactus Investments v CIR* [1999] (1) SA 315 (SCA) at 322 states:

> "It is often said that there is no equity in tax legislation (nor, I would add, complete rationality) […]. The taxpayer's remedy is to arrange his affairs, so far as he is able, so as not to attract these results."

The limitation provided in section 6*quat* (1B)(*a*) is an overall limitation that takes into account all of the foreign taxes attributable to the aggregate of the foreign-sourced amounts included in a resident's taxable income (SARS, 2015:36).

As a result, any foreign taxes payable on amounts derived from a country with which South Africa has concluded a DTA that is subject to section 6*quat* must be aggregated in terms of the domestic provision rather than the DTA with all the other foreign taxes payable in other countries that also qualify for the section 6*quat* rebate notwithstanding that the DTA article dealing with the elimination of double taxation specifically provides for a "per country" limitation (SARS, 2015:70).

Vogel (2005:1174) states the following on the implications when an article of a DTA dealing with the elimination of double taxation expressly refers to the domestic law for its implementation:

> "Treaties quite frequently do expressly refer to domestic law in regard to implementation- particularly of the credit method".

On the question of whether the DTA relief provisions are complete or require further reliance on domestic law, Vogel (2005:1131) says the following:

> "The details of both the exemption method and the credit method must be shaped by reference to domestic law, *viz.* in regard to the reference figures- what positive and what negative elements should be included in the "foreign items of income" and what in the "domestic" ones, etc. – and in regard to procedures. In this connection, the credit method is, however, by far the more complicated of the two, and that is why it is normally shaped and supplemented to a much greater extent by domestic law."

Vogel (2005:1216) expands on the above statement:

> "60. [Operation of the credit] Article 23B sets out the main rules of the credit method, but does not give detailed rules on the computation and operation of the credit. This is consistent with the general pattern of the Convention. Experience has shown that many problems arise. Some of them are dealt with within the following paragraphs. In many States, detailed rules on credit for foreign tax already exist in their domestic laws. A number of conventions, therefore, contain a reference to the domestic laws of the Contracting States and further provide that such domestic rules shall not affect the principle laid down in Article 23B."

Arnold (2002:47) supports this principle:

> "Treaty provisions establish the general principle of exemption or credit. Each country is left to establish detailed rules for the implementation of the general principle."

Thus section 6*quat* does not merely expand on the article of a DTA dealing with the elimination of double taxation. It provides for the detailed rules on the computation and operation of the credit which are not provided for in the DTA (SARS, 2009:35).

South Africa's DTA with Egypt is an example of a treaty that is not expressly "subject to" section 6*quat*. Article 22(1) of South Africa/Egypt DTA reads as follows:

> "(b) in South Africa, Egyptian tax paid by residents of South Africa in respect of income taxable in Egypt, in accordance with the provisions of this Agreement, shall be deducted from the South African tax due according to South African fiscal law. Such deduction shall not, however, exceed an amount which bears to the total South African tax payable the same ratio as the income concerned bears to the total income."

When a resident Oil and Gas company elects a DTA credit method of relief that is not subject to section 6*quat,* the question arises as to how the foreign tax rebate in respect of taxable income derived from the relevant country must be determined. The resident Oil and Gas company must refer to the wording of the particular DTA, or, if applicable, a separate agreement with the particular country, to determine how to calculate the tax relief under the DTA (SARS, 2015:67).

If the resident Oil and Gas company elects the relief provided under the DTA, none of the additional relief measures granted under section 6*quat*[158] will be available, and the relief is applied on a "taxable income per country" basis rather than on a "per income item" basis.

When a resident Oil and Gas company derives foreign-sourced amounts from both (a) a foreign country with which South Africa has concluded a DTA which provides for a credit method of relief that is subject to section 6*quat,* and (b) a foreign country with which South Africa has concluded a DTA which provides for a credit method of relief that is not subject to section 6*quat w*ithin the same year of assessment, two separate credit limitation calculations must be performed for that year if the resident elects to follow the DTA credit method of relief in respect of the DTA that is not subject to section 6*quat* (SARS, 2015:72).

Example 7.1 – Determination of section 6quat rebate and a DTA credit within the same year of assessment.
Facts:
A resident company conducts oil and gas mining operations in South Africa. It also has branches in Mozambique and Namibia. South Africa has a DTA with each of these two

[158] For example, a person electing to use a tax treaty credit method will not be entitled to carry forward any excess foreign taxes under paragraph(ii) of the proviso to section 6*quat*(1B)(*a*).

countries. The DTA with Mozambique provides for the credit method of relief and is expressly subject to section 6*quat* while the DTA with Namibia provides for the credit method of relief without any express reference to section 6*quat*. The corporate tax rate in Mozambique is 32%. Corporate tax in Namibia is levied at 35% under the Petroleum Tax Act and Additional Profits Tax is paid based on the rate of return. The company elects the DTA credit method of relief in respect of income derived from Namibia.

For its 2020 year of assessment the following results are relevant:

Description	**Total**	**South Africa**	**Mozambique**	**Namibia**
Taxable income	1500	1000	200	300
Foreign taxes proved to be payable	244		64	105+75
Normal tax payable at 28%	420			

Result:

Description	**Total**	**South Africa**	**Mozambique**	**Namibia**
Section 6*quat* credit [200/1500 x420]	56		56	
The balance R8 (64-56) is carried forward to the following year of assessment				
Calculation of the DTA credit [300/1500 x 420]	84			84
The balance R96 (180-84) is forfeited and may not be carried forward				
Calculation of final normal tax payable				
Normal tax payable before rebates	420	420		
Less: DTA credit rebate		(84)		
Section 6*quat* rebate		(56)		
Final normal tax payable		280		

Adapted from SARS (2009:37)

7.4 Jurisdiction to tax

DTAs do not levy taxes and there are no restrictions under international law to a legislative jurisdiction to impose and collect taxes. In most countries, the jurisdiction to tax is based on the domestic legislative process, which is an expression of national sovereignty. States apply their jurisdiction to tax, based on varying combinations of income source and residence principles (Sauvant & Roffe, 2000:11). In South Africa, residents are subject to tax on their worldwide income and non-residents are subject to tax on their South African source income.

A DTA will apply to residents of one or both of the Contracting States. Accordingly, the taxpayer does not need to be a resident of South Africa to secure treaty relief provided that it is a resident in the other Contracting State. Relief for double taxation under the domestic legislation in South Africa is limited to residents only. Under both a DTA and the domestic tax legislation the country of residence provides relief from double taxation, whilst the country of source is given preference as the jurisdiction with the right to tax.

7.5 Types of taxes

The section 6*quat* rebate is limited to tax on the types of income and capital referred to in section 6*quat*(1), namely foreign taxes on income, dividends and capital gains from a source outside the Republic, while the DTA credit is limited to the taxes covered by the relevant treaty (Schwarz, 2001:171).

In chapter 5 of the thesis, numerous taxes were listed as not being taxes on income and accordingly are not taxes qualifying for relief under section 6*quat*, although such taxes may qualify as a deduction from income under the general deduction formula. The scope of taxes covered under the DTAs is a tax on income or similar taxes and tax on capital gains and may offer tax credit relief in circumstances where there would be no deduction or relief available for income tax paid under the domestic law based on a SARS narrow interpretation of income tax.

7.6 Payment of foreign tax

Under the DTAs, a foreign tax must be paid before relief can be granted. By contrast, section *6quat* merely provides that the foreign taxes must be proved to be *payable*, that is, a legal obligation to pay exists. An absolute and unconditional legal liability to pay the foreign taxes must exist irrespective of the fact that payment may only be made in the future. The foreign jurisdiction must have a legitimate right to tax the foreign-sourced amount under its domestic tax law.

In referring to the United Kingdom case of *Sportman v IRC* [1998] STC SCD 289, Schwarz (2011:174) discussed the meaning of “tax payable”, the court found in the *Sportman case* that a tax credit should not be allowed because not only was no tax paid but there was no basis on which it might be paid. In practice, however, SARS only allows the rebate in respect of taxes shown to be paid as evidenced by a foreign income tax assessment and proof of payment of such as receipts (SARS, 2009:42-43). Receipts alone are not accepted by SARS as evidencing taxes that qualify for a rebate because they may be provisional tax payments that were not based on actual income.

Many countries impose some form of advance payment or provisional tax system for example Ghana and the Netherlands. The specific terms of these systems vary but are generally based upon the taxpayer’s liability for the preceding year of assessment or an estimate of its liability imposed by a foreign tax jurisdiction (SARS, 2015:27). This is similar to South Africa’s

provisional tax payments which are made in respect of estimated tax liability rather than an ascertained or fixed tax liability (see chapter 6, "period of assessment" in this regard).

If and to the extent that the resident taxpayer can prove that these advance or provisional payments correspond to (and do not exceed) the final foreign tax liability such payments should be regarded for purposes of section 6*quat* as being "proved to be payable".

7.7 The tax credit mechanism

The tax credit mechanism provided for under the domestic tax legislation is the same as that provided under the DTAs. Section 6*quat* (1B) provides that:

> "the rebate or rebates for any tax proved to be payable […] shall not in aggregate exceed an amount which bears to the total normal tax payable to the total taxable income attributable to the income […]".

A double taxation agreement modelled on the 2017 OECD MTC provides at Article 23B:

> "1. Where a resident of a Contracting State derives income […] which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:
>
> a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
> b) […]
>
> Such deduction […] shall not, however, exceed that part of the income tax […] as computed before the deduction is given, which is attributable, as the case may be, to the income […] which may be taxed in that other State."

Example 7.2- Determination of the tax credit rebate under the domestic tax legislation and DTA

A resident oil and gas company conducts oil and gas mining operations in South Africa and the United Kingdom (UK) via a branch. In the United Kingdom, Corporate Income Tax is levied at 30% on oil and gas exploration and production. A supplementary additional tax charge of 32% is also levied on UK exploration and production activities. The taxable profits for the supplementary charge are calculated in the same way as for corporate tax purposes but without any deduction for finance costs. The supplementary charge is not deductible for corporate tax purposes in the UK.

For its 2021 year of assessment the following results are relevant:

Description	**South Africa**	**United Kingdom**	**Total**
Taxable income	2000	500	2500
Foreign taxes proved to be payable		150 +160	310
Normal tax payable at 28%			700

Result:

Description	**South Africa**	**United Kingdom**	**Total**
1. Section 6*quat* credit		140	140

[500/2500 x700]
The balance R170 (310-140) is carried forward to the following year of assessment

2. Calculation of the DTA credit

[500/2500 x 700]	140	140

The balance R170 (310-140) is forfeited and may not be carried forward

3. Calculation of final normal tax payable

Normal tax payable before rebates	700
Choice of DTA credit rebate or Section 6*quat* rebate	(140)
Final normal tax payable	560

Note: The Section 6*quat* credit rebate is more beneficial as the excess foreign tax credit may be carried forward.

The distinction between the credit mechanism under the domestic tax relief and that under a DTA is when part of the income derived is exempt from tax in South Africa, under a DTA, in calculating the amount of tax on the remaining income, South Africa may take into account the exempted income. For example, included in the income from the foreign oil and gas activities are foreign dividends received by the Oil and Gas company that is exempt under the participation exemption (section 10B(2)(a) of the ITA), such dividends may be used in the calculation of the tax credit available under a DTA.

7.8 Excess foreign tax credits

When the sum of foreign taxes payable exceeds the amount of the rebate calculated in terms of section 6*quat,* the excess may be carried forward to the immediately succeeding year of assessment in which it will rank as a foreign tax credit available for set-off against the normal tax payable in respect of taxable income derived from foreign sources in that year of assessment[159].

A carryover mechanism is pivotal to any foreign tax credit system. Without it, double taxation might occur because tax jurisdictions used different (a) taxing principles; (b) definitions of the term "income"; and (c) timing rules.

In terms of section *6quat,* any excess may not be carried forward for more than seven years. If a determination of an excess amount of foreign taxes is made for more than one year of assessment, the excess amount determined for each year of assessment must be recorded separately and applied on a first-in-first-out basis against the normal tax payable in future years of assessment.

[159] Paragraph (ii) of the proviso to section 6*quat*(1B)(a).

Double taxation agreements provide exemption or credit only in principle while failing to arrange for their implementation (Vogel, 2005:1174). It is left to the domestic legislation to provide the detailed rules for the implementation of the general principle set up by the DTA (Rohatgi, 2005:141). These detailed rules will generally cover (a) the use of either the overall limitation method or the country-by-country limitation method in calculating foreign tax credits;(b) carry-back or carry-forward of excess tax credits; (c) revision of previous assessments to allow for the rebate or deduction of the correct amount of foreign taxes payable; and (d) persons entitled to a foreign tax credit. In South Africa, section 6*quat* provides the domestic rules for implementation.

Those DTAs that do not contain Article 23B of the 2017 OECD MTC or its predecessors (for example the SA/Egypt DTA) make it impossible to carry forward a tax treaty credit, and any tax treaty credit not utilised will be lost. This is because there is no reference to the use of domestic law provisions which specifically allow a tax treaty credit to be carried forward. Accordingly, it is preferable to claim a foreign tax credit under section 6*quat* if the foreign tax paid exceeds the South African tax liability on the foreign source income.

7.9 Ring-fencing per country

Section 6*quat* (1) provides for the "overall" rebate of foreign taxes. All foreign-sourced amounts derived from different foreign countries are added together and likewise, foreign taxes are paid in applying the section 6*quat* formula. This is in contrast to the "per country" limitation imposed by the tax relief available under the DTAs, which deals only with bi-lateral tax relief between the two contracting States. Accordingly, section 6*quat* allows for the cross-subsidization of foreign tax relief in respect of activities carried out in a low tax jurisdiction through taxes paid in respect of activities carried out in a high tax jurisdiction.

Example 7.3 – Cross subsidisation under section 6quat.

During the year ended 31 December 2018, a resident Oil and Gas company has a South African source income of R700. It has foreign income from Kuwait of R200 on which tax of R30 (15% Corporate Income Tax) was paid. It also has an income of R100 from Nigeria on which tax of R85 (85% Petroleum Profits Tax). The tax computation is as follows:

SA income			R700
Foreign income	Kuwait	R200	
	Nigeria	R100	R300
			R1000
SA tax at 28%			R280
Less: section 6*quat* rebate			
Foreign tax	Kuwait	R30	
	Nigeria	R85	
		R115	
Limited to:			

R300/R1000 x R280	(R84)
SA tax payable	R196

Note that the rebate of R84 of the R115 is claimed even though in isolation it exceeds the South African tax on the income from Nigeria. There is no "per country" limitation. The excess of R31 foreign tax in the pool is carried forward to the next year.

Adapted from Huxham & Haupt (2011: 421)

7.10 Assessed loss

A rebate under the domestic tax legislation is only available when normal tax becomes payable (section 6*quat* (1B)(a)). When read with section 20, this effectively means that a resident Oil and Gas company in an assessed loss position cannot claim a section 6*quat* rebate in the tax year in which the assessed loss applies, as no normal tax will become payable in that year (Olivier & Honiball, 2008:321).

A DTA does not impose liabilities for a tax it merely provides relief for taxes levied under the domestic law. Some countries charge an Alternative Minimum Tax (AMT) when a branch or company is in a tax assessed loss position. For example, in Tanzania when a branch or company has incurred perpetual tax losses for three consecutive years, the branch or company is required to pay AMT at a rate of 0.3% on turnover. South Africa has a DTA with Tanzania, and accordingly, it may be possible by electing tax relief under the DTA to claim a tax credit in South Africa for this tax paid in Tanzania. The tax credit however cannot exceed an amount that bears to the total South African tax payable the same ratio as the income concerned bears to the total income (SARS, 2015:67). Given that the Tanzanian oil and gas mining activities have generated a loss, there is no taxable income derived in Tanzania for domestic tax purposes and the allowable tax credit is therefore NIL.

In the scenario of a tax assessed loss position as determined under the domestic tax legislation, whilst both section 6*quat* and the DTA do not allow for the offset of foreign taxes paid, section 6*quat* at least allows for the carry forward of tax credits.

Example 7.4- Effect of foreign mining activities on the determination of rebate
Facts:
A resident Oil and Gas company conducts its primary mining activities in South Africa. It also holds a concession right in Gabon that commenced exploration activities in Year 1-3 and entered into production in Year 4.

Years 1-3
The company derives taxable income from a South African source amounting to R1000 each year. Corporate tax is levied in South Africa at a rate of 28%. Its branch in Gabon incurred exploration costs resulting in R100, R300 and R800 in years 1-3 respectively and operating costs of R50 each year.

Year 4
The company derives taxable income from a South African source amounting to R1000. Its branch in Gabon derived taxable income of R2000. Foreign tax is levied in Gabon at the rate of 73%.

Result:
Years 1-3
In Gabon, the branch of the Oil and Gas company has assessed losses in years 1-3, which are carried forward to year 4 under the domestic tax legislation.

For South African tax purposes the exploration costs of R100, R300 and R800 are not deductible under section 15(b) of the ITA. A foreign assessed loss is created when the R50 operating costs are deducted under section 11A, but these losses are ring-fenced in terms of section 20(1) and are carried forward to year 4. The local taxable income of R1000 each year is subject to normal tax in South Africa at the rate of 28%.

The assessed loss is regarded as a foreign loss for purposes of the section 6 *quat* rebate.
Year 4

Tax position in Gabon	
Taxable income for year 4	R2000
Less: Assessed loss brought forward from years 1-3	(R1350)
Taxable income	R650
Tax levied at 73%	R474.50

Tax position in South Africa		
(1)Taxable income from a foreign source	R650	
Taxable income for year 4	R2000	
Less: Cumulative assessed loss	(R150)	
Less: section 36(11) deduction upon commencing production	(R1200)	
Taxable income from a South African source	R1000	
Taxable income (all sources)	R1650	
Normal tax payable at 28%	R462	
Section 6*quat* rebate:		
Taxable income derived from all foreign sources / Taxable income derived from all sources	x	Normal tax payable
= R650 / R1650 x R462		
= R182		

Thus only R182 of the foreign taxes paid qualify for the foreign tax rebate. The difference of R292.5 will be carried forward as an excess foreign tax credit.

7.11 Period of assessment

Entitlement to a foreign tax credit under section 6*quat* arises for a resident in the year of assessment in which a foreign-sourced amount on which foreign taxes are payable is included in the resident's taxable income and the foreign tax liability doesn't have to be incurred in the same tax year that the amount is included in the taxpayer's taxable income (SARS, 2015:74). Thus foreign taxes payable must be taken into account in the year of assessment in which the foreign-sourced amount is included in taxable income and not the year of assessment in which the foreign taxes are incurred.

Entitlement to a foreign tax credit under a DTA arises when both Contracting States may tax the same income. It stems from the principle, the country of residence provides the tax credit in terms of a DTA, the foreign tax credit is allowed for foreign taxes paid in the country of source in the year of assessment that the country of residence sought to tax the foreign income.

7.12 Summary

7.12.1 The context for double taxation

Governments assert their right to tax, known as the jurisdiction to tax, based either on the source of the income (in the context of Oil and Gas companies, the physical location of the mine) or the residence of the taxpayer (in the context of Oil and Gas companies, their POEM). When more than one country asserts the right to tax, the same Oil and Gas mining income this gives rise to double taxation.

The computation of taxable income is determined per the domestic legislation of the country exercising its right to tax the income, whether this is the host country (source country) or the country of residence. Inclusions in the determination of income, allowable tax deduction and exemptions from taxation under the domestic legislation create inherent structural differences in the computation of taxable income, as the base upon which the tax is levied in each country. Chapters 2 and 3 of the thesis provide context for the rationale and determination of the tax liability in the source jurisdiction and South Africa, respectively.

In Chapter 2, the thesis examines the concept "source". The source jurisdiction enjoys the primary right to tax income under the tax treaties. Chapter 2 analyses the fundamental legal designs (namely Concession or Contract Legal Design) used by host governments to allocate the right to mine Oil and Gas and the possible tax instruments that are applied in the source jurisdiction. SARS lack of familiarity with the fundamental legal designs used to tax Oil and Gas companies in foreign jurisdictions (see Chapter 2, 2.3 - Fundamental legal designs) may result in practical difficulty in securing double taxation relief under the domestic tax legislation due to timing and interpretation differences (see Chapter 6, 6.3 - The impact of the fundamental legal design).

In Chapter 3, the thesis examines the concept of "residence". A corporate person is a resident in South Africa where it is incorporation in South Africa or its POEM is located in South Africa. A corporate person is not resident in South Africa where in terms of a double taxation agreement (DTA) the corporate person is a resident of another country. The term, POEM is

not defined in the tax treaties nor the domestic tax legislation. Chapter 3, analyses the SARS interpretation of the POEM as a tie-breaker for dual residency under most of South Africa's DTAs and the meaning ascribed to POEM by the courts of law. The MLI (Article 4(1) of the MLI) replaces the POEM tie-breaker with a MAP tie-breaker for dual residence, but in the absence of mandatory arbitration where the competent authorities are unable to decide, Oil and Gas companies may be unable to access tax treaty benefits (See Chapter 6, 6.8 - Multilateral instrument). Chapter 3 outlines the basis for the inclusion of foreign mining income into "gross income" as defined and the allowable tax deductions over the life cycle of an Oil and Gas well in the calculation of taxable income. Chapter 3 recommends an amendment to the domestic tax legislation to allow for a tax deduction for foreign prospecting expenditure (see Chapter 3, 3.6.2 Exploration and appraisal capital expenditure).

Oil and Gas companies have the choice of whether they wish to apply the double taxation relief available under the domestic tax legislation or the DTAs. Chapters 4 and 5 of the thesis, outline the double taxation relief available under the DTAs and domestic tax legislation, respectively.

In Chapter 4, the thesis describes the purpose of double taxation agreements, examines their legal standing together with the pattern of the MTCs that shape the South African DTAs and analyses the Articles specific to Oil and Gas mining operations. Chapter 4 evaluates the interpretation of the double taxation agreements with the guidance offered by the VCLT (see Chapter 4, 4.3 - Interpretation of double taxation agreements) and considers the reliance that South African courts will place on the OECD MTC and the commentary to the OECD MTC in the interpretation of double taxation agreements. Relief under a DTA can be hampered where there are disputes over the right to tax the business profits of permanent establishments following transfer pricing (TP) principles in the circumstance that contracting states do not agree on the TP principle to be applied (see Chapter 6, 6.7 - Conflicts of qualification). Relief under a DTA is at threat where there are conflicts over the classification and allocation of income in terms of the DTA Articles (see Chapter 6, 6.5 - Conflicts in classification and 6.6 - The allocation of income).

In Chapter 5, the thesis dissects the unilateral double tax relief offered under the domestic tax legislation at section 6 *quat* of the Income Tax Act (ITA). Legislative limitations erode the efficacy of the domestic tax relief. Legislative limitations include the definition of "qualifying taxes" (see Chapter 5, 5.2.4 - Qualifying taxes), the source of the foreign taxes paid (see Chapter 6, 6.4.1 - Foreign source) and the SARS' refusal in practice to allow a credit or deduction for taxes paid in the form of barrels of oil (see Chapter 6, 6.3.3 -Amount). Chapter

5, recommends an amendment to the domestic tax legislation to allow either a credit or a tax deduction for foreign taxes taken from production.

7.12.2 Outcome of contrasting the quality of double tax relief offered

The credit relief under a DTA is the same as the credit relief available under the domestic tax legislation. But the domestic tax legislation allows for the carry-forward of excess tax credits which the DTAs do not allow in the circumstance that the DTA is not "subject to" the domestic tax legislation, such as the SA/Egypt DTA.

The credit relief for foreign tax under the domestic tax legislation is provided in the year of assessment that the income is subject to normal tax in South Africa. The credit relief under a DTA for foreign tax paid in the source jurisdiction is provided in the same year that the country of residence has sought to tax the income. The arm's length principle is applied in determining the attribution of income under both the domestic tax legislation and the DTAs.

Qualifying to access relief under a DTA is easier than under the domestic tax legislation. The domestic tax legislation offers relief from double taxation only to tax residents, while the DTAs offer relief from double taxation to any person provided they are a resident of one of the Contracting States. The domestic tax legislation limits credit relief from foreign taxes to taxes levied on foreign source income. The DTAs provide for relief from foreign taxes irrespective of their source.

The domestic tax legislation seeks to tax a resident Oil and Gas company on its worldwide income irrespective of the source. Exemption from tax under the domestic tax legislation is limited to income categories as specified under sections 10, 10B, 10C and section 64F of the ITA. In contrast, the exemption from tax as granted under a DTA would be inclusive of all income categories where one country is granted the exclusive right to tax.

In respect to evidencing foreign taxes in terms of which relief is sought the domestic tax legislation is less onerous. Under the DTAs, a foreign tax must be paid before relief can be granted. By contrast, section *6quat* merely provides that the foreign taxes must be proved to be *payable*, namely, a legal obligation to pay exists.

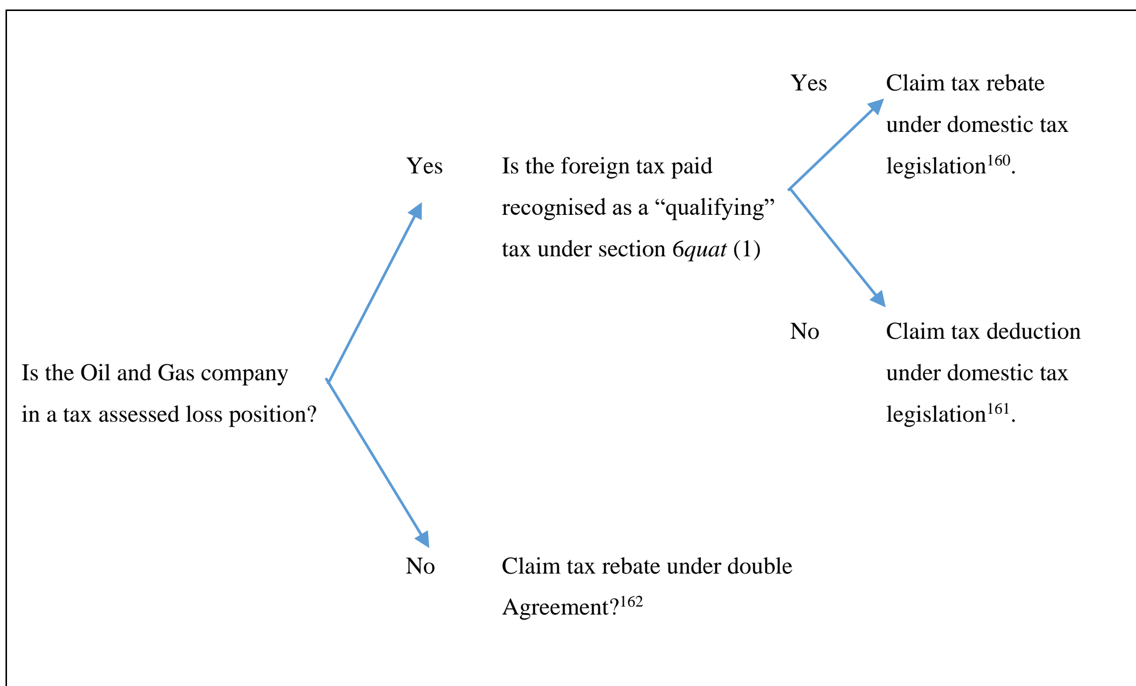
The domestic tax relief under the "pooled basis" is more generous than the per country relief offered by the DTAs. In the circumstance that the DTA tax relief is "subject to" the domestic

tax legislation, the "pooled basis" and carry forward of excess foreign tax credits become available as part of the DTA tax relief.

Resident Oil and Gas companies on an annual basis have the choice of claiming relief from double taxation either in terms of the domestic tax legislation or if a tax treaty exists with the source State, in terms of a DTA entered into between South Africa and the source State. The Oil and Gas company is likely to choose the double tax relief that is the most beneficial.

The type of Legal Design, the form of taxes paid and the assessed tax status of an Oil and Gas company are all determinants in the choice of tax relief, whether this is domestic tax relief or relief under a DTA.

The decision tree below based upon the quality of the double tax relief offered may serve as a guide in this regard:



__7.12.3 Outcome of contrasting the quantum of double tax relief offered.__

The IMF's FARI model is an analytical tool that allows economic and financial analysis of Extractive Industries (EI) projects. Four countries, namely Egypt, Equatorial Guinea, Ghana and Nigeria were selected for the economic evaluation on the basis that 1) both the Concession Legal Design and Contract Legal Design are represented by the chosen countries,

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[160] Excess foreign tax credits can be carried forward for 7 years.
[161] Tax assessed losses can be carried forward (and under limited conditions backward)
[162] No carry forward of excess foreign tax credits or tax assessed losses under DTA relief.

2) the extent of double taxation relief under the domestic tax legislation (in terms of qualifying taxes, non-qualifying taxes and excess tax credits) is illustrated and 3) Egypt, Ghana and Nigeria have a DTA with South Africa to accommodate comparison with the double taxation relief under the domestic tax legislation.

The fiscal terms for Egypt, Equatorial Guinea, Ghana and Nigeria were used as inputs to the FARI model in chapter 2 to assess the outcome of taxation in the source country. The results of the FARI economic modelling in chapter 2 (repeated in Table 7.1 below) serve as the baseline for the measurement of the efficacy of relief from double taxation under the double taxation agreements (chapter 4) and the domestic tax relief (chapter 5). The same macro-economic assumptions (namely oil price and inflation rate) and microeconomic assumptions such as Weighted Average Cost of Capital (WACC) discount rate, operating expenditure, capital expenditure and production profile were used as inputs for all four of the country scenarios (see Annexure A).

To interrogate the veracity of the results multiple scenarios were examined, "oil" (this is the base case), "significant oil", "gas" and "oil and gas". The choice of fundamental legal design did not appear to have an impact on the observations for each of the scenarios considered. The outcomes of the source country economic modelling for Egypt and Nigeria reflected the highest AETRs of the sample countries consistently even when changes in the dominant form of hydrocarbon extracted and the volume of the reserve are incorporated into the economic modelling.

	Oil Base Case (AETR)	**Significant Oil (AETR)**	**Gas (AETR)**	**Oil & Gas (AETR)**
Egypt	104%	92%	103%	99%
Equatorial Guinea	66%	60%	96%	77%
Ghana	68%	48%	68%	60%
Nigeria	97%	91%	96%	96%

Table 7.1 Summary of results of FARI economic modelling in respect to taxation at source (AETR)

The South African corporate tax calculations for mining operations conducted in Egypt, Equatorial Guinea, Ghana and Nigeria were performed based upon the determination of taxable income following the domestic tax legislation in Chapter 3 and relief from double taxation under the domestic tax legislation as examined in Chapter 5. The same macro-economic assumptions (namely oil price and inflation rate) and microeconomic assumptions such as Weighted Average Cost of Capital (WACC) discount rate, operating expenditure,

capital expenditure and production profile were used as inputs for all four of the country scenarios (see Annexure A).

Double tax relief as available in terms of section 6*quat* of the ITA *versus* double taxation relief available under the DTAs is applied as a switch in the model for purpose of this chapter. This analysis allows an illustrative contrast of the economic impact of the choice of double taxation relief (see Annexure B). The output of the FARI economic modelling is presented in terms of Contractor Net Present Values (NPVs), Average Effective Tax Rate (AETRs) combined and foreign and Average Effective Income Tax Rate (AEIT) in South Africa for mining activities located in each of the countries in the case study.

For ease of reference the definition of each of the measures used in the economic modelling results is repeated below:

a) The AETR is defined as the "ratio of the present value of government receipts (the "basket of taxes" levied) over the lifetime of a project to the present value of pre-tax cash flows, both calculated at a WACC of 12%";
b) The AEIT is defined as the "ratio of the present value of Corporate Income Taxes on income levied over the lifetime of a project to the present value of pre-tax cash flows, both calculated at a WACC of 12%". The AEIT will differ from the official corporate tax rate as it is measured against pre-tax cash flows and is not measured against taxable income; and
c) The NPV is defined as "the difference between the present value of the cash-flows (inflows nett of outflows) at a WACC of 12% (for the project) and the initial capital invested by the Oil and Gas company". The Oil and Gas company will not make an investment where NPV is negative. In the countries examined, the economic modelling results for Egypt "Oil base case" reflects a negative NPV, this is indicative that the crude oil price macro-economic assumption at $56/bbl is below the breakeven price of $68/bbl required to meet the hurdle investment rate or WACC of the project.

Measure	South Africa – s6*quat*	Double Taxation Agreement
EGYPT		
Contractor NPV in $mm	-162	-5
AETR % (combined)	127%	105%
Foreign AETR %	104%	104%
SA Income Tax in $mm	219	46
SA AEIT%	31.5%	6.64%

EQUATORIAL GUINEA		
Contractor NPV in $mm	241	No DTA
AETR % (combined)	69%	No DTA
Foreign AETR %	66%	66%
SA Income Tax in $mm	202	No DTA
SA AEIT%	29.11%	No DTA
GHANA		
Contractor NPV in $mm	173	247
AETR % (combined)	79%	69%
Foreign AETR %	68%	68%
SA Income Tax in $mm	226	223
SA AEIT%	32.5%	32.14%
NIGERIA		
Contractor NPV in $mm	44	44
AETR % (combined)	98%	98%
Foreign AETR %	97%	97%
SA Income Tax in $mm	196	190
SA AEIT%	28.18%	27.31%

Table 7.2 – FARI Model contrasting domestic tax relief with DTA outputs

Where the case study source country has adopted the Contract Legal Design, namely PSC's, no tax rebate is available in terms of section 6*quat*. The results of the economic modelling, therefore reflect a higher NPV for double taxation relief claimed under the tax treaty for Egypt than for tax relief claimed under the existing domestic tax legislation ("South Africa – s6*quat*").

Where the case study source country has adopted the Concession Legal Design the results of the economic modelling differ under the South African domestic tax recognition of the tax instruments levied in the source country. In respect to Ghanaian mining operations, there is no section 6*quat* tax rebate available for AOE which is taken from production (as barrels of oil). Accordingly, the results reflect a higher NPV for double taxation relief claimed under the Ghana/South Africa DTA than tax relief claimed under the existing domestic tax legislation ("South Africa – s6*quat*"). Tax instruments used in Nigeria, namely PPT and education tax are recognised as "qualifying taxes" for purposes of section 6*quat*. The outputs of the FARI economic model for Nigeria reflects no substantial difference between the NPV of double tax relief under the domestic tax legislation ("South Africa - s6*quat*") in comparison to the double taxation relief claimed under the Nigeria/South Africa DTA.

7.13 Recommendations

In Chapter 3, the thesis identified structural differences in the manner in which taxable income is computed in South Africa in contrast to how taxable income is computed in the source country under the domestic tax legislation of that country. This is an inherent systemic difference that is not affected by the choice of double taxation relief. Temporary differences are ascribed to the timing of tax deductions, while permanent differences are ascribed to specific limitations in the domestic tax legislation. To address tax discrimination in the deduction of prospecting expenditure based on the location of the mining activity it was proposed that section 15(b) of the ITA is amended by the deletion of the reference to mining activities within the Republic, as follows:

> **15. Deductions from income derived from mining operations.** - There shall be allowed to be deducted from the income derived from mining operations –
>
> (*a*) an amount to be ascertained under the provisions of section 36, in lieu of allowances in section 11(*e*), (*f*), (*g*A), (*o*), 12D, 12DA, 12F and 13quin;
>
> (*b*) any expenditure incurred by the taxpayer during the year of assessment on prospecting operations (including surveys, boreholes, trenches, pits and other prospecting work preliminary to the establishment of a mine) in respect of any mining area ~~within the Republic~~ together with any other expenditure which is incidental to such operations to the extent that income from such operations will become taxable when the mine commences production…

This tax amendment will not result in the erosion of the South African tax base as existing anti-avoidance provisions in the domestic tax legislation provide that foreign losses arising from the deduction of capital expenditure against income derived from foreign mining operations will be ring-fenced by section 20, for offset against foreign taxable income in prospective years of assessment.

In Chapter 5 and Chapter 6, the thesis proposes an amendment to tax provisions in the domestic tax legislation for relief from double taxation to better align the efficacy of the domestic tax relief from double taxation to the relief from double taxation available under the DTAs. The primary cause for this misalignment is the limitation of domestic tax relief to foreign taxes paid (incurred) in cash.

To recognise foreign taxes on income that are paid in the form of off-take from production in barrels of oil, as qualifying taxes for purpose of the section 6 *quat* rebate, it is recommended that section 6*quat* (1A) is amended as follows:

(1A) For the purpose of sub-section (1) the rebate shall be an amount equal to the sum of any taxes on income, <u>including the appropriation of profits in cash or otherwise</u> proved to be payable to any sphere of government of any country other than the Republic, without any right of recovery by any person (other than a right of recovery in terms of entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment) by –

Alternatively, to accommodate the tax deduction of foreign taxes on income that is paid in the form of off-take from production in barrels of oil, it is recommended that section 6*quat* (1C) is amended as follows:

(1C) For the purpose of determining the taxable income derived by any resident from carrying on any trade <u>outside the Republic</u>, there may at the election of the resident be allowed as a deduction from the income of such resident so derived the sum of any taxes on income <u>including the appropriation of profits in cash or otherwise</u> (other than taxes contemplated in subsection (1A)) proved to be payable by that resident to any sphere of government of any country other than the Republic, without any right of recovery by any person other than a right of recovery in terms of any entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment.

The outcomes of the FARI economic modelling when the proposed domestic tax legislation amendments (both structural and section 6*quat*) are inputted as changes to the FARI economic modelling reflect attainment of the ideal for full double taxation relief as envisaged by the thesis, namely the "Proposed amendments to domestic tax legislation" economic modelling results correspond with the envisaged "Full double tax relief" economic modelling results.

Measure	**Double Taxation Agreement**	**Proposed amendments to domestic tax legislation**	**Full Double Tax Relief**
EGYPT			
Contractor NPV in $mm	-5	-2	-2
AETR % (combined)	105%	104%	104%
Foreign AETR %	104%	104%	104%
SA Income Tax in $mm	46	43	43
SA AEIT%	6.64%	6%	6%
EQUATORIAL GUINEA			
Contractor NPV in $mm	No DTA	266	266

AETR % (combined)	No DTA	66%	66%
Foreign AETR %	66%	66%	66%
SA Income Tax in $mm	No DTA	194	194
SA AEIT%	No DTA	28%	28%
GHANA			
Contractor NPV in $mm	247	250	250
AETR % (combined)	69%	68%	68%
Foreign AETR %	68%	68%	68%
SA Income Tax in $mm	223	221	221
SA AEIT%	32.14%	32%	32%
NIGERIA			
Contractor NPV in $mm	44	47	47
AETR % (combined)	98%	97%	97%
Foreign AETR %	97%	97%	97%
SA Income Tax in $mm	190	187	187
SA AEIT%	27.31%	26.9%	27%

Table 7.3 – FARI Model proposed tax amendments and achieving full double tax relief

7.14 Conclusion

This Thesis evaluates whether or not the unilateral relief from double taxation under the South African domestic tax legislation and/or bilateral relief under DTAs serve to provide full relief from double taxation to a South African resident company engaged in the exploration for and production of oil and gas outside of South Africa.

This Thesis does not promote or propose suggestions aimed at achieving no taxation in both the source and residence states (Gil Garcia, 2019:312). Appropriate relief from double taxation, following the international tax single tax principle, premises that the same income is subject to tax once. Application of the single tax principle ensures tax neutrality in the choice of operating jurisdiction thereby facilitating the South African head-quartering of global investments, necessary to satisfy the country's energy demand for oil and gas reserves. The Thesis furthermore does not open the discussion as to whether the allocation of taxing rights is appropriate under a tax treaty, it merely analyses whether full relief can be achieved based on the current allocation of taxing rights under a DTA.

The qualitative contrast of double taxation relief offered indicates that the unilateral domestic tax relief in South Africa provides the same (if not) better quality of double tax relief than the tax treaty relief.

The quantitative contrast of double taxation relief offered indicates that where the source State uses the concession legal design and the foreign "qualifying" taxes paid to exceed the South African tax liability on such foreign oil and gas mining income, the double taxation relief available under the domestic tax legislation is substantially the same, if not more favourable than the double taxation relief under the tax treaty. This was demonstrated in the tax relief as modelled for Nigerian mining activities. In the circumstance that the source State uses the contract legal design or the foreign taxes paid are not recognised as "qualifying" taxes for purposes of the tax rebate under section 6*quat* (1), the economic impact of double taxation reflects that the double tax relief under the domestic tax legislation is inadequate in comparison to the double tax relief under the tax treaties. This was demonstrated in the tax relief as modelled for Egypt and Ghana.

The deficiency in the SARS interpretation of "qualifying taxes" and part of the structural difference highlighted in the qualitative and quantitative examination of double taxation relief (in Chapters 3 and 5) can be solved by amendment to the domestic tax legislation. The incorporation of the recommended structural amendments (namely to permit the deduction of foreign prospecting expenditure) and amendments to section 6*quat* (namely to recognise foreign taxes paid otherwise than in cash) makes it possible to achieve a form of full double tax relief as close as possible to the single tax principle without an extensive overhaul of the domestic tax legislation.

Certain ambiguities such as those examined in Chapter 6, demonstrate that there are circumstances where South African resident Oil and Gas companies may continue to struggle to achieve full double tax relief. These ambiguities (namely conflicts in classification, conflicts in allocation, conflicts in qualification and conflicts in interpretation) are systemic and cannot be resolved through amendment of the domestic tax legislation alone. These ambiguities may serve as the foundation for further academic research to be conducted with regards to double taxation relief in South Africa.

ANNEXURE A

ASSUMPTIONS BOOK FOR USE WITH FARI MODEL

PETROLEUM MODEL

Double Taxation Relief available to South African residents engaged in the exploration for and production of oil and gas outside of South Africa

27 September 2020

Data status		
	Thesis	Economics
Data rev.	Rev 4	3
Data date	27-Sep-20	27-Sep-20

Purpose

The purpose of this economic evaluation is to supplement the Thesis

ASSUMPTIONS

The presented economics were evaluated at PROJECT level unless otherwise stated.
All financials presented are in NOMINAL terms.

The following primary assumptions have been used in the evaluation of different jurisdictions

Commercial & Fiscal assumptions

Common Corporate macro-economic and fiscal assumptions were used, valid from 1 September 2020
NPV's were calculated using 2020 as a start date with the following discount rate:

USD Discount rate	12.0%	IOC

Financing assumptions

Percent of development costs borrowed	%	70%
Repayment period (beginning production)	years	5
Real interest rate	%	5.0%

US CPI was used to inflate all costs. The average annual US CPI over the next 10 years is estimated to be 1.88%

Year	US CPI	SA CPI
2,020	1.30%	2.3%
2,021	1.60%	4.5%
2,022	1.70%	4.8%
2,023	1.70%	4.5%
2,024	1.70%	4.4%
2,025	1.70%	4.5%
2,026	2.20%	5.0%
2,027	2.20%	5.0%
2,028	2.20%	5.0%
2,029	2.20%	5.0%
2,030	2.20%	5.0%
Average	**1.88%**	

Pricing

The Corporate Brent price assumptions associated with pricing start with a $35/bbl in 2020. The average through to 2032 is $56/bbl.

	Year	Brent	FX rate
		$/bbl	R/$
1	2,020	$35	18.20
2	2,021	$43	16.66
3	2,022	$46	17.06
4	2,023	$55	17.20
5	2,024	$59	17.47
6	2,025	$56	17.66
7	2,026	$58	17.10
8	2,027	$59	16.80
9	2,028	$60	16.25
10	2,029	$61	16.42
11	2,030	$62	16.35
12	2,031	$64	16.20
13	2,032	$65	16.60

The Gas price assumptions associated with pricing start with a $2.78/mmscf in 2020. The average through to 2032 is $4.44/mmscf

	Year	Brent	FX rate
		$/bbl	R/$
1	2,020	$2.78	18.20
2	2,021	$3.43	16.66
3	2,022	$3.72	17.06
4	2,023	$4.40	17.20
5	2,024	$4.69	17.47
6	2,025	$4.51	17.66
7	2,026	$4.60	17.10
8	2,027	$4.70	16.80
9	2,028	$4.79	16.25
10	2,029	$4.88	16.42
11	2,030	$4.98	16.35
12	2,031	$5.08	16.20
13	2,032	$5.18	16.60

W.r.t. fiscal terms for Oil Production, see below for Ghana, Egypt, Equatorial Guinea and Nigeria

		Egypt	Equatorial Guinea	Ghana	Nigeria
Bonus					
Production bonus (start of production)	$mm	20	3	10	0
Royalty rate	%	10%	13%	7.5%	13%
Royalty base (net/gross)	switch	gross	gross	gross	gross
Decommissioning provision (yes/no)	switch	no	yes	yes	yes
Commencement of decommissioning provision	% depletion	0%	0%	60%	50%
Cost Recovery					
Cost recovery ceiling	%	35%	70%	100%	100%
Development and replacement capital cost depreciation period	years	5	5	5	5
Investment uplift (yes/no)	switch	no	no	no	no
Investment uplift	%				
Uplift limit	years				
Profit petroleum sharing	switch	DROP	PSC ROR	AOEcalc	Tax/Royalty
DROP tiers					
Profit petroleum tier 1	Mbpd	10			
Profit petroleum tier 2	Mbpd	25			
Profit petroleum tier 3	Mbpd	50			
Profit petroleum tier 4	Mbpd	100			
AOE tiers					
AOE tier 1	ROR %		18%	17.5%	
AOE tier 2	ROR %		25%	23%	
AOE tier 3	ROR %		40%	28%	
AOE tier 4	ROR %			33%	
Govt. share profit petroleum					
Govt. share tier 1	%	75%	10%	8%	
Govt. share tier 2	%	77%	35%	15%	
Govt. share tier 3	%	78%	55%	20%	
Govt. share tier 4	%	80%		25%	
Govt. share tier 5	%	82%			
Corporate Income Tax rate	%	40.55%	35%	35%	87%
Exploration costs (expensing)	switch	deferred	deferred	deferred	deferred
Development costs (depreciation)	switch	deferred	deferred	deferred	deferred
Development costs and replacement capital depreciation (years)	years	5	5	5	5
Dividend Withholding Tax	%	20%	25%	0%	10%
State owned company (SOC) participation in joint venture	%			10%	
Participation from development or production	switch			production	

W.r.t. fiscal terms for Gas Production, see below for Ghana, Egypt, Equatorial Guinea and Nigeria

		Egypt	Equatorial Guinea	Ghana	Nigeria
Bonus					
Production bonus (start of production)	$mm	12	3	10	0
Royalty rate	%	10%	13%	5%	7%
Royalty base (net/gross)	switch	gross	gross	gross	gross
Decommissioning provision (yes/no)	switch	no	yes	yes	yes
Commencement of decommissioning provision	% depletion	0%	0%	60%	50%
Cost Recovery					
Cost recovery ceiling	%	35%	70%	100%	100%
Development and replacement capital cost depreciation period	years	5	5	5	5
Investment uplift (yes/no)	switch	no	no	no	no
Investment uplift	%				
Uplift limit	years				
Profit petroleum sharing	switch	DROP	PSC ROR	AOEcalc	Tax/Royalty
DROP tiers					
Profit petroleum tier 1	MMscf/day	0			
Profit petroleum tier 2	MMscf/day	125			
Profit petroleum tier 3	MMscf/day	250			
Profit petroleum tier 4	MMscf/day				
AOE tiers					
AOE tier 1	ROR %		18%	17.5%	
AOE tier 2	ROR %		25%	23%	
AOE tier 3	ROR %		40%	28%	
AOE tier 4	ROR %			33%	
Govt. share profit petroleum					
Govt. share tier 1	%	75%	10%	8%	
Govt. share tier 2	%	78%	35%	15%	
Govt. share tier 3	%	80%	55%	20%	
Govt. share tier 4	%	80%		25%	
Govt. share tier 5	%	80%			
Corporate Income Tax rate	%	40.00%	35%	35%	87%
Exploration costs (expensing)	switch	deferred	deferred	deferred	deferred
Development costs (depreciation)	switch	deferred	deferred	deferred	deferred
Development costs and replacement capital depreciation (years)	years	5	5	5	5
Dividend Withholding Tax	%	20%	25%	0%	10%
State owned company (SOC) participation in joint venture	%		20%	10%	
Participation from development or production	switch		production	production	

W.r.t. the South African fiscal terms , see below South African tax treatment of mining operations in Ghana, Egypt, Equatorial Guinea and Nigeria

		Egypt	Equatorial Guinea	Ghana	Nigeria
Production bonus (start of production)					
Tax deductible	switch	no	no	no	no
Royalty rate					
Tax deductible	switch	yes	yes	yes	yes
Decommissioning provision (yes/no)					
Tax deductible	switch	no	no	no	no
Capital Expenditure					
Tax deductible	switch	yes	yes	yes	yes
Pre-Production/Start of Production	switch	Start of Production	Start of Production	Start of Production	Start of Production
Investment uplift (yes/no)	switch	no	no	no	no
Investment uplift	%	0%	0%	0%	0%
Uplift limit	years	0	0	0	0
Opex Expenditure					
Tax deductible	switch	yes	yes	yes	yes
Pre-Production/ Start of Production	switch	Pre-production	Pre-production	Pre-production	Pre-production
Govt. share profit petroleum					
Tax deductible	switch	yes	yes	no	no
Corporate Income Tax rate					
Foreign tax rebate	switch	no	yes	yes	yes
Carried forward limit	years	7.00	7.00	7.00	7.00
Dividend Withholding Tax - rebate	switch	no	no	no	no
Tax Assessed Loss					
Offset from SA tax/carried forward	switch	carried forward	carried forward	carried forward	carried forward

Technical assumptions

The following production profile was derived in order to calculate revenues:

Scenario 1 — **Base Case Oil Scenario**

	OIL Production profile			*mdpd*
		P10	**P50**	**P90**
	Year			
6	**2025**		50	
7	**2026**		23	
8	**2027**		13	
9	**2028**		6	
10	**2029**		2	
11	**2030**		1	

Scenario 2 — **Significant Find Oil Scenario**

	OIL Production profile			*mdpd*
		P10	**P50**	**P90**
	Year			
5	**2024**		85	
6	**2025**		98	
7	**2026**		76	
8	**2027**		60	
9	**2028**		48	
10	**2029**		38	
11	**2030**		24	
12	**2031**		10	
13	**2032**		7	

Scenario 3 — **Gas Scenario**

	GAS Production profile			*MMscf/day*
		P10	**P50**	**P90**
	Year			
5	**2024**		280	
6	**2025**		704	
7	**2026**		1,120	
8	**2027**		1,120	
9	**2028**		1,120	
10	**2029**		1,120	
11	**2030**		1,120	
12	**2031**		640	
13	**2032**		336	

	Scenario 4	Oil and Gas Scenario		
		GAS Production profile		*MMscf/day*
			P10	**P50**	**P90**
		Year			
	5	**2024**		35	
	6	**2025**		88	
	7	**2026**		140	
	8	**2027**		140	
	9	**2028**		140	
	10	**2029**		98	
	11	**2030**		60	
	12	**2031**		42	

	OIL Production profile			*mdpd*
		P10	**P50**	**P90**
	Year			
6	**2025**		0	
7	**2026**		52	
8	**2027**		33	
9	**2028**		23	
10	**2029**		18	
11	**2030**		7	
12	**2031**		5	
13	**2032**		0	

COSTS

Capex

FEED at a cost of 16 m$ was assumed. (in 2020 terms)

Development capex amounts to 193 m$, bringing Total Capex to 209 m$. (in 2020 terms)

The range of wells and associated capex used to calculate P10 to P90 economics are shown below:

Capex: Expl, Appr & Development	P10	P50	P90
G&G, Studies, Expl & Appr			
G&G, Studies, Owners cost		$16	
No of Expl. wells			
No of Appr. wells			
G&G, E&A Capex		**$16**	
Development			
No of E&A wells conv to Prod			
No of Pilot wells			
No of add. Prod. wells		1	
No of Inject. wells			
Capex: Prod. Wells		$83	
Capex: Facilities/Infrastr		$110	
Dev Capex		**$193**	
TOTAL CAPEX		**$209**	

The assumed capex spend profile to produce P50 volumes is as follows (escalated with CPI to be in nominal terms):

P50 CAPEX SPEND PROFILE

		Expl & Appr	FEED	Devel.	TOTAL
1	2020	$0	-$8	$0	**-$8**
2	2021	$0	-$9	$0	**-$9**
3	2022	$0	$0	-$36	**-$36**
4	2023	$0	$0	-$142	**-$142**
5	2024	$0	$0	-$27	**-$27**
6	2025	$0	$0	$0	**$0**
7	2026	$0	$0	$0	**$0**
8	2027	$0	$0	$0	**$0**

Opex

Opex is of the FIXED type and estimated to be 14.8 m$/yr (2020 terms).

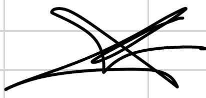
Opex FIXED			
	P10	P50	P90
Opex Selection (annual avg)		**$15**	
Opex (annual avg)	$14	$15	$16

Abandonment

Abandonment is estimated to cost 28 m$ (in 2017 terms; 13.2% of total capex.)
This is treated in economics as annual provisions equally spread over the productive life of the field (not as a once-off expense.)

	P10	P50	P90		
Abandonm. (once-off)	**$28**	**$28**	**$28**	*m$*	13%

Compiled by:



Alison Futter

ANNEXURE B

FARI Economic Modelling results for Taxation at Source (Egypt)

SNAPSHOT RESULTS For Egypt					
NPV results					
		Oil Base Case	Significant Oil	Gas	Oil and Gas
Project pre-tax cash flow	$mm cons	695	3,961	916	1,063
Total benefits	$mm cons	858	4,124	1,079	1,226
Contractor NPV	$mm cons	-2	335	-9	33
Government NPV	$mm cons	725	3,643	942	1,047
Average Effective Tax Rate (AETR)	%	104%	92%	103%	99%
Govt. share of total benefits	%	84%	88%	87%	85%
Other significant analysis					
Oil price used in Modelling $/bbl	56				
Average Effective Corporate Tax Rate	%	14%	14%	7%	14%
Legal Design		Contract	Contract	Contract	Contract
Double Taxation Agreement	Yes/No	Yes	Yes	Yes	Yes

FARI Economic Modelling results for Taxation in South Africa of Egyptian Mining income

SNAPSHOT RESULTS For Egypt						
NPV results						
		South Africa - s6*quat*	South Africa- structural	DTA	Proposed amendments	Full DT Relief
Project pre-tax cash flow	$mm cons	695	695	695	695	695
Total benefits	$mm cons	858	858	858	858	858
Contractor NPV	$mm cons	-162	-159	-5	-2	-2
Government NPV	$mm cons	885	882	728	725	725
Average Effective Tax Rate (AETR)	%	127%	127%	105%	104%	104%
Govt. share of total benefits	%	103%	103%	85%	84%	84%
Foreign Effective Tax Rate	%	104%	104%	104%	104%	104%
Foreign Effective Income Tax	%	14%	14%	14%	14%	14%
Foreign Income Tax	$mm cons	98	98	98	98	98
SA Income Tax	$mm cons	219	216	46	43	43
SA Effective Income Tax Rate	%	31.50%	31.11%	7%	6%	6%

FARI Economic Modelling results for Taxation at Source (Equatorial Guinea)

SNAPSHOT RESULTS For Equatorial Guinea					
NPV results					
		Oil Base Case	Significant Oil	Gas	Oil and Gas
Project pre-tax cash flow	$mm cons	695	3,961	916	1,063
Total benefits	$mm cons	858	4,124	1,079	1,226
Contractor NPV	$mm cons	266	1,593	42	247
Government NPV	$mm cons	457	2,365	877	819
Average Effective Tax Rate (AETR)	%	66%	60%	96%	77%
Govt. share of total benefits	%	53%	57%	81%	67%
Other significant analysis					
Oil price used in Modelling $/bbl	56				
Average Effective Corporate Tax Rate	%	49%	53%	14%	40%
Legal Design		Contract	Contract	Contract	Contract
Double Taxation Agreement	Yes/No	No	No	No	No

FARI Economic Modelling results for Taxation in South Africa of Equatorial Guinean Mining income

SNAPSHOT RESULTS For Equatorial Guinea						
NPV results						
		South Africa - s6*quat*	South Africa- structural	DTA	Proposed amendments	Full DT Relief
Project pre-tax cash flow	$mm cons	695	695	No DTA	695	695
Total benefits	$mm cons	858	858	No DTA	858	858
Contractor NPV	$mm cons	241	243	No DTA	266	266
Government NPV	$mm cons	482	480	No DTA	457	457
Average Effective Tax Rate (AETR)	%	69%	69%	No DTA	66%	66%
Govt. share of total benefits	%	56%	56%	No DTA	53%	53%
Foreign Effective Tax Rate	%	66%	66%	66%	66%	66%
Foreign Effective Income Tax	%	49%	49%	49%	49%	49%
Foreign Income Tax	$mm cons	339	339	339	339	339
SA Income Tax	$mm cons	202	200	No DTA	194	194
SA Effective Income Tax Rate	%	29.11%	28.73%	No DTA	28%	28%

FARI Economic Modelling results for Taxation at Source (Ghana)

SNAPSHOT RESULTS For Ghana					
NPV results					
		Oil Base Case	Significant Oil	Gas	Oil and Gas
Project pre-tax cash flow	$mm cons	695	3,961	916	1,063
Total benefits	$mm cons	858	4,124	1,079	1,226
Contractor NPV	$mm cons	250	2,057	304	429
Government NPV	$mm cons	473	1,909	622	642
Average Effective Tax Rate (AETR)	%	68%	48%	68%	60%
Govt. share of total benefits	%	55%	46%	58%	52%
Other significant analysis					
Oil price used in Modelling $/bbl	56				
Average Effective Corporate Tax Rate	%	36%	51%	43%	50%
Legal Design		Concession	Concession	Concession	Concession
Double Taxation Agreement	Yes/No	Yes	Yes	Yes	Yes

FARI Economic Modelling results for Taxation in South Africa of Ghana Mining income

SNAPSHOT RESULTS For Ghana						
NPV results						
		South Africa - s6*quat*	South Africa- structural	DTA	Proposed amendments	Full DT Relief
Project pre-tax cash flow	$mm cons	695	695	695	695	695
Total benefits	$mm cons	858	858	858	858	858
Contractor NPV	$mm cons	173	176	247	250	250
Government NPV	$mm cons	550	547	476	473	473
Average Effective Tax Rate (AETR)	%	79%	79%	69%	68%	68%
Govt. share of total benefits	%	64%	64%	56%	55%	55%
Foreign Effective Tax Rate	%	68%	68%	68%	68%	68%
Foreign Effective Income Tax	%	36%	36%	36%	36%	36%
Foreign Income Tax	$mm cons	248	248	248	248	248
SA Income Tax	$mm cons	226	223	223	221	221
SA Effective Income Tax Rate	%	32.50%	32.12%	32%	32%	32%

FARI Economic Modelling results for Taxation at Source (Nigeria)

NPV results						
		Oil Base Case	Significant Oil	Gas	Oil and Gas
Project pre-tax cash flow	$mm cons	695	3,961	916	1,063
Total benefits	$mm cons	858	4,124	1,079	1,226
Contractor NPV	$mm cons	47	349	41	53
Government NPV	$mm cons	676	3,614	883	1,017
Average Effective Tax Rate (AETR)	%	97%	91%	96%	96%
Govt. share of total benefits	%	79%	88%	82%	83%
Other significant analysis					
Oil price used in Modelling $/bbl	56				
Average Effective Corporate Tax Rate	%	67%	83%	51%	62%
Legal Design		Concession	Concession	Concession	Concession
Double Taxation Agreement	Yes/No	Yes	Yes	Yes	Yes

FARI Economic Modelling results for Taxation in South Africa of Nigerian Mining income

SNAPSHOT RESULTS For Nigeria						
NPV results						
		South Africa - s6*quat*	South Africa- structural	DTA	Proposed amendments	Full DT Relief
Project pre-tax cash flow	$mm cons	695	695	695	695	695
Total benefits	$mm cons	858	858	858	858	858
Contractor NPV	$mm cons	44	47	44	47	47
Government NPV	$mm cons	679	676	679	676	676
Average Effective Tax Rate (AETR)	%	98%	97%	98%	97%	97%
Govt. share of total benefits	%	79%	79%	79%	79%	79%
Foreign Effective Tax Rate	%	97%	97%	97%	97%	97%
Foreign Effective Income Tax	%	67%	67%	67%	67%	67%
Foreign Income Tax	$mm cons	465	465	465	465	465
SA Income Tax	$mm cons	196	193	190	187	187
SA Effective Income Tax Rate	%	28.18%	27.79%	27%	27%	27%

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