A PROPOSED INTERPRETATION OF THE PHRASE 'SUBJECT TO TAX' IN SECTION 23M(2)(i)(aa) OF THE INCOME TAX ACT NO. 58 OF 1962, WHEN READ IN CONTEXT OF THE SOUTH AFRICAN TAX TREATIES.

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Abstract

Following the tax policy recommendation of the Organisation for Economic Co-operation and Development (‘OECD’)/Group of Twenty (‘G20’) member countries, under the OECD/G20 Base Erosion and Profit Shifting Project: Action 4 (‘BEPS Action 4’), the South African legislature recently enacted an internationally focused anti-avoidance provision, in section 23M of the Income Tax Act No.58 of 1962 (‘the Act’). The provision aims to limit interest expenditure incurred by the debtor, provided that the corresponding interest income accrued to non-resident creditor is, among other things, (which is most important,) not ‘subject to tax’ in terms of section 23M(2)(i)(aa) of the Act. However, despite its importance, the phrase ‘subject to tax’ is not defined in section 23M or in the general definition of the Act nor has the matter came before the South African courts for consideration. This has lead to confusion among taxpayers, and fragmented views among South African tax scholars, tax practitioners and the South African Revenue Services (‘SARS’). On the other hand, the phrase ‘subject to tax’ has a long history in international tax law and it appears *inter alia*, in the South Africa-France, South Africa-Sweden and South Africa-Germany interest distributive rules tax treaties.

The objective of this study is, based on the canons of interpretation of fiscal legislation, to propose an interpretation of phrase ‘subject to tax,’ particularly when read in context of South African tax treaties, and thereafter apply it in the context of foreign corporate tax, normal tax and withholding tax on interest.

The author concludes that the phrase ‘subject to tax’ means that non-resident creditors must ‘actually’ be liable to pay tax on interest, subject to deductions, set-offs and foreign tax reliefs. It is the authors view that if foreign corporate tax falls within the ambit of the word ‘tax’ as defined in the applicable tax treaty and/or ‘covered tax’ therein, the word ‘tax’ encompass foreign corporate tax ‘actually’ imposed on a non-resident creditor in its country, as a result of accrued interest from the South African source.

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Abbreviations and Glossary

BEPS	Base Erosion and Profit Shifting Project
FDI	Foreign Direct Investment
IFA	International Fiscal Association
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
OECD MTC	OECD Model Tax Convention on Income and Capital (26 July 2014)
SARS	South African Revenue Service
TAX TREATY	An Agreement for the Avoidance of Double Taxation
THE ACT	The Income Tax Act 58 of 1962, often referred to as the domestic tax law
UN MTC	United Nations Model Double Taxation Convention between Developed and Developing Countries (1 January 2011)
VCLT	Vienna Convention on Law of Treaties

1 CHAPTER 1 - Introduction

1.1 Background

1.1.1 Interest limitation under Base Erosion and Profit Shifting Project: Action 4 (BEPS Action 4)

A country may wish to attract foreign direct investment (FDI) and by doing so, it also attracts debt capital, which may encourage erosion of its corporate tax base by multinational enterprise (MNE) groups.[1] Corporate tax base can be eroded thorough interest expenditure from the tax country with low/zero-corporate tax rate on cross-border intra-group loans by MNE group. Such international tax planning technique is used to reduce the overall effective tax rate of the MNE group,[2] particularly where there is a mismatch between the tax treatment of interest expenditure, which is deductible, and the corresponding interest income which is not taxable in the source country. As a result, the Organisation for Economic Co-operation and Development ('OECD')/Group of Twenty ('G20') member countries, under the OECD/G20 Base Erosion and Profit Shifting Project: Action 4 ('BEPS Action 4'),[3] has identified cross-border interest expenditures and other financial payments that are economically equivalent to interest, as a key risk associated with corporate tax base erosion.

To counter this, the BEPS Action 4[4] recommended tax policy reform (the so-called 'best practice'). This recommendation limits cross-border interest expenditure of the resident entity, to the extent that the entity's net interest expense is, amongst other things, more than its earnings before interest and tax or earnings before interest, tax, depreciation, and amortization (EBITDA). Since this recommendation, several countries,[5] including South Africa, have implemented this best practice.

On the other hand, when International Fiscal Association (IFA) considered cross-border interest expenditures topic in detail for the first time in 1982, it was then concluded that, in line with the principle of taxation in accordance with earning capacity, cross-border interest expenditure should only be refused

[1] P.H. Blessing, *Chapter 3.1: The Debt-Equity Conundrum – A Prequel in Tax Treatment of Interest for Corporations* (O.C.R. Marres & D. (Dennis) Weber eds. (2012), section 3.1.1. Online Books IBFD

[2] D. Piltz, *International aspects of thin capitalization*, International Fiscal Association ('IFA') General Report Cahiers, Volume 81b (1996), p92, Online Books IBFD.

[3] OECD, *Limiting base erosion involving interest deductions and other financial payments, Action 4 – Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project, (2015), p17. Available at: http://dx.doi.org/10.1787/9789264241176-en (accessed 15 May 2019). (Hereinafter cited as 'BEPS Action 4').

[4] Ibid.

[5] Amongst those countries are; India: section 94B of Income Tax Act, 1961; United Kingdom: section 155(6)(a) taxation (International and other Provisions) Act 2010 and all the member states of the European Union that have adopted the anti-avoidance measures that include interest limitation rules based on earnings. See Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, article 4 OJ L 193 (2016), EU Law IBFD.

based on non-compliance with the arm's length[6] principle, to avoid tax burdens that cannot be eliminated through tax treaties.[7] Almost 40 years later, the topic was revisited and it became apparent that the arm's length principle and the avoidance of tax burdens that cannot be eliminated through tax treaties had taken a back seat and the priority had now become anti-based erosion.[8] This priority, however, comes with 'complexity and uncertainty',[9] which BEPS Action 4 might have overlooked.

1.1.2 Interest limitation under section 23M of the Act and other relevant provisions

South Africa, pursuant to best practice, has enacted section 23M of the Income Tax Act No.58 of 1962 (the Act)[10] with effect from 1 January 2015. In essence, it is aimed at limiting cross-border interest expenditure incurred by the debtor,[11] provided the corresponding interest income that accrued to the non-resident creditor[12] was not 'subject to tax'. The limitation is based on the proportion of net interest expense to the EBITDA. This provision applies in addition to the general rule under section 24J (2) of the Act, that allows interest expenditure incurred by the debtor, provided that the debtor is carrying on a trade and the interest expenditure is incurred in the production of income.

The focus of this study is the 'subject to tax' requirement in terms of section 23M(2)(i)(a) of the Act. South Africa, as an emerging economy, relies heavily on FDI from developed countries.[13] Tax policy seeks to attract FDI debt by exempting corresponding interest income accrued to non-resident creditors from normal tax, provided that the non-resident creditor does not carry on a business through a permanent establishment[14] ('PE') in South Africa to which this interest is attributed.[15]

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[6] The words are used in this study to define loan and/or interest not at commercial rate unless otherwise specified.

[7] E. Höhn, *The tax treatment of interest in international economic transactions*, IFA General Report Cahiers, Volume 67a (1982), p168. Online Books IBFD.

[8] J. Gadwood and P. Morton, *Interest deductibility: the implementation of BEPS Action 4*, IFA General Report Cahiers, Volume 104A (2019) p44. Online Books IBFD.

[9] Ibid., p21

[10] Section 23M of the Income Tax Act No.58 of 1962 ('the Act'). Unless otherwise stated, statutory references in study are to the Act and the Act is often referred to as the domestic tax law; For a detailed discussion on this provision, see, for example, D. Kruger, *Interest-deduction limitation - Section 23M.* Business Tax and Company Law Quarterly, Volume 6, Issue 1. (2015), p11-21

[11] The word debtor, for the purpose of this study is used to describe a South African corporation that issued a debt to a non-resident corporation which in a 'controlling relation' ('non-resident creditor') with that debtor.

[12] The word non-resident creditor is used to define a 'person' who is not a 'resident'. Furthermore, for the purpose of this study, it is used in a sense of a non-resident corporation which is in a 'controlling relationship' with its own South African debtor.

[13] See, for example, the President Cyril Ramaphosa launched a US $100 billion FDI drive over the next five years. See statement by the President on launch of new investment drive, 16 April 2018, Available at: http://www.dirco.gov.za/docs/speeches/2018/cram0416.htm (accessed 12 August 2019)

[14] For detailed discussion on the concept of 'PE', see, for example, W. Horak, *Permanent Establishment,* in *Silke on International Tax* (E. Brincker & de Koker, LexisNexis 2010) section 18.2

[15] Section 10(1) (h) of the Act.

This exemption, as mentioned, presents an international tax planning opportunity to MNE groups through intra-group loans. However, 'debt financing only offers a significant tax advantage if the shareholder [non-resident creditor] pays no taxes on the income received (e.g. because it benefits from tax exemption), if it is making losses, or is a resident in a non-tax or low-tax country'.[16] Therefore this could be the case, if the non-resident creditor is resident in territorial tax system countries such as Hong Kong,[17] or in a low-tax country such as Cyprus, at 12.5 per cent corporate tax rate,[18] relative to a higher 28 per cent in South Africa.

To protect South African corporate tax base from base erosion, withholding tax on interest was implemented with effect from 1 March 2015, at 15 per cent tax rate, subject to South African tax treaty relief provisions and/(or) domestic tax law exemptions.[19] This was in addition to already existing transfer pricing rules which deny excessive (i.e. not arm's length price) cross-border interest expenditure incurred by the debtor in relation to a debt from non-resident creditor.[20] Fernande opines that the BEPS Action 4's best practice indirectly rejects the long-standing arm's-length price principle under the transfer pricing rules at a general level. [21] With regard to the interaction between the transfer pricing rules and the interest limitation rules in South Africa, according to Kruger, transfer pricing rules should be applied first.[22]

On the other hand, BEPS Action 4[23] and Arnold[24] opine that the use of withholding tax on interest is considered ineffective, unless the withholding tax rate is aligned to the corporate tax rate. In South Africa, withholding tax on interest is considered ineffective. This is because the withholding tax rate of 15 per cent (which the tax treaty could reduce further to as low as five per cent[25] or effectively zero, if the right to tax interest is waived under an applicable tax treaty[26]) is not aligned to the corporate tax rate of 28 per cent.

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[16] Supra note 2.

[17] Y. Zhang, *Hong Kong - Corporate Investment Income*, (2020) section 2.1.1, Country Tax Guides IBFD

[18] For detail list in respect of the tax treaties that are likely to present tax planning opportunity, see Appendix attached, under column [H].

[19] Section 50A - 50H of the Act.

[20] Section 31 of the Act.

[21] S. Fernandes, *Acknowledgements in International Double Taxation of Interest – Assessing Recent Developments in Thin Capitalization Regimes*: (2019), section 3.2, Online Books IBFD.

[22] See Kruger, supra note 10, p20.

[23] Supra note 3, p22.

[24] 'The reduction of the domestic tax base as a result of the payment of deductible interest to a non-resident is offset fully by domestic tax on the recipient of the interest, only if the tax on the recipient is levied at the same rate as the rate applicable to the payer' See, B.J. Arnold, *Restrictions on Interest Deductions and Tax Treaties*, Bulletin for International Taxation, Volume 73, Number 4, (2019), at footnote 6. Journals IBFD.

[25] For detailed list of the tax treaties that South Africa has limiting right to tax interest see Appendix attached, under column [F]

[26] For detailed list of the tax treaties that South Africa has waived the right to tax interest see Appendix attached, under column [E]

1.2 Problem statement

At first glance, the phrase ‘subject to tax’ under section 23M(2)(i)(aa) of the Act, appears quite simple and self-evident. However, it deserves careful examination, particularly because it is not defined in either section 23M or in the general definition of the Act, has not been brought before the South African courts for consideration and SARS has not made a pronouncement dealing with it. The phrase is also employed in the South African tax treaty interest distributive rule, as a condition that the tax treaty tax relief relating to interest will only be enjoyed in South Africa if the interest is ‘subject to tax’ in the non-resident creditor’s country.

A careful examination of this phrase reveals the following uncertainties:

a) Foreign corporate tax

When the word tax is properly interpreted in the context of an applicable tax treaty, it is not clear if foreign corporate tax imposed on the non-resident creditor as a result of accrued interest from a South African source, falls within the ambit of the word ‘tax’ in the phrase ‘subject to tax’ under section 23M(2)(i)(aa) of the Act.. The rules do not expressly state that the tax in question is the ‘South African tax’ and the word ‘tax’, in addition to general statutory definition in section 1 of the Act, it is defined in 19 tax treaties.[27]

b) Normal tax and withholding tax on interest

It is not clear whether normal tax or withholding tax on interest is not levied on interest accrued to non-resident creditors as a result of tax treaty relief, where it can be argued that the interest was subject to tax for the purpose of section 23M(2)(i)(aa). What is clear and well known is that if tax is not levied on interest accrued to non-resident creditors due to domestic law exemptions, that interest was not ‘subject to tax’ for the purpose of section 23M(2)(i)(aa).

In light of the illustrations above, the following two inter-related research questions were generated:

a) What is the meaning of the phrase ‘subject to tax’ in section 23M(2)(i)(aa) of the Act?
b) Does foreign corporate tax imposed on the non-resident creditor, in respect of interest income, fall within the general statutory definition of the word ‘tax’ for the purpose of section 23M(2)(i)(aa) of the Act?

[27] For detailed list of the tax treaties that South Africa has defined the word ‘tax’ in the tax treaty see Appendix attached, under column [I]

There is confusion and fragmented views on how the rules are to be applied in practice.[28] According to Bingham*,* the law must be accessible and, as far as possible, intelligible and clear.[29] This study attempts to clarify this key provision in the interest of limitation rules, which will contribute to legal certainty and hopefully minimise tax policy impediment, so as to attract FDI debt.

1.3 Research objective

The objective of this study is to interpret the phrase 'subject to tax' in section 23M (2)(i)(aa) of the Act when read in context of the South African tax treaties.

To achieve this aim, the general canon of construction for interpreting fiscal legislation is briefly discussed and applied to interpret the phrase 'subject to tax' in Chapter 2.

Chapter 3 investigates whether foreign corporate tax imposed on the non-resident creditor as a result of the corresponding interest income, does not fall within the definition of tax for the purpose of section 23M (2)(i)(aa) of the Act.

Chapter 4 investigates whether the phrase 'subject to tax' contained in the interest distributive rule articles in the South Africa-Sweden[30], South African-France[31] and South African-Germany[32] tax treaties, are able provide that the context permits and shed light on the meaning of the phrase 'subject to tax' in section

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[28] Tax practitioners, to an extent, have different opinions on how the phrase 'subject to tax' is to be applied, see, for example, L Rood, *The new interest limitation rules – when is the non-resident creditor 'not subject to tax'?*, (2014). Available at: http://www.werksmans.com/virt_e_bulletins/new-interest-limitation-rules-non-resident-creditor-subject-tax/ (accessed 14 July 2019); Kruger, supra note 10, p17; K. Mandy, *The limitation of deductions for untaxed interest*, South African Institute of Tax Professionals, TaxTalk, Volume 2014, Number 44, (2014) p48; E. Mazansky, *Hybrid Debt and Hybrid Equity Instruments and the Interest Limitation Rules in South Africa,* Bulletin for International Taxation, Volume 69, Number 3. (2015), section 7.1. Journals IBFD

[29] T. Bingham, *The rule of law,* University of Cambridge Sir David Williams Lecture (2006). See https://www.cpl.law.cam.ac.uk/sir-david-williams-lectures2006-rule-law/rule-law-text-transcript, (accessed 14 July 2019)

[30] Article 11(1), *Convention between the Government of the Republic of South Africa and the Kingdom of Sweden for the Avoidance of Double Taxation and the prevention of fiscal evasion with respect to taxes on Income and on Capital,* (1995). Treaties IBFD.

[31] Article 11(1), *Convention between the Government of the Republic of South Africa and the Government of the French Republic for the Avoidance of Double Taxation and the prevention of fiscal evasion with respect to taxes on Income and on Capital,* (1995). Treaties IBFD.

[32] Article 8(1), *Agreement between the Republic of South Africa and the Federal Republic of Germany for the avoidance of double. taxation with respect to taxes on income,* (1973). Treaties IBFD. (According to SARS there is new 2008 tax treaty between South Africa and Germany, however at the time of writing this study it was only ratified by South Africa. See https://www.sars.gov.za/AllDocs/LegalDoclib/Agreements/LAPD-IntA-DTA-2013-01%20-%20Status%20Overview%20of%20All%20DTAs%20and%20Protocols.pdf) (accessed 15 November 2019)

23M(2)(i)(aa) of the Act. On the onset, it should be noted that it is not a common tax treaty policy for South Africa to negotiate for 'subject to tax' clauses when negotiating tax treaties.[33]

Chapter 5 aims to establish whether it can be argued that the non-resident creditor is subject to (normal) tax on interest income when the non-resident creditor is entitled tax treaty relief, and as result, no 'actual' tax is paid.

Chapter 6 further probes in light of the tax treaty relief, whether at the end, no withholding tax on interest is levied or 'actually' paid, it can be argued that the non-resident creditor is subject to withholding tax on interest.

Furthermore, due to the influential role that the Organisation for Economic Co-operation and Development Model Tax Convention on Income and Capital (OECD MTC), and to an extent the United Nations Model Double Taxation Convention (UN MTC) between developed and developing countries plays in the development of the South African tax treaties, the different provisions, particularly the interest income distributive rules under Article 11 of both the 2014 OECD MTC'[34] and 2011 UN MTC'[35] will be discussed, in context of South African tax treaties interest income provisions and section 23M of the Act. South African tax treaties are largely based on different versions of the OECD MTC, with more recent tax treaties based on the 1992 to 2003 OECD MTC. As a result, reference will be mainly on the OECD MTC.

Chapter 7 discusses the summary and conclusions of this study.

1.4 Research method

A qualitative approach research method is used in this study. The research strategy used is doctrinal in nature. It entails the study of the relevant provisions of the Act, including South African tax treaties, decided South African and foreign court cases and legal literature relating to the objective of this study. The policy objective aimed at attracting FDI debt and curbing corporate tax base erosion associated with cross-border interest expenditure is reviewed, to ascertain the context and purpose of the interest limitation rules.

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[33] J. Hattingh, South Africa, in *BRICS and the Emergence of International Tax Coordination*, (Y. Brauner & P. Pistone, eds), (2015), section 8.2.1.2. Online Books IBFD.

[34] Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (15 July 2014), Online Models IBFD [Hereinafter cited as OECD MTC]. Unless otherwise stated, OECD MTC references are to the 2014 OECD MTC.

[35] United Nations Model Double Taxation Convention between Developed and Developing Countries, (1 January 2011). Online Models IBFD [Hereinafter cited as UN MTC]. Unless otherwise stated, UN MTC references are to the 2011 UN MTC.

1.5 The scope limitation

For the purpose of this study, only the tax treaty rules relating to interest, to the extent applicable, are discussed. It is assumed that the non-resident creditor is entitled to the tax treaty benefits and taxes referred to in this study are covered in the tax treaties.

While a detailed discussion of the interest definitions as contained in section 24J(1) of the Act[36] (which section 23M of the Act refers to regarding the interest definition) and Article 11(3) of the OECD and UN MTCs[37] is beyond the scope of this study, it is important to highlight the differences between the two definitions. The domestic tax law interest definition is not exhaustive, the opening words of the definition state that 'interest includes…', whilst, the interest definitions in Article 11(3) of the OECD and UN MTCs are generally exhaustive (the words 'interest means ...'). Furthermore, Article 11(3) of the OECD MTC specifically excludes the penalties on late payment from the interest definition. As a result, the tax treaty benefits will generally not be available to non-resident creditors, to the extent that the tax treaty interest definition is not met, because the tax treaty definition is narrow while the domestic tax law is wider. However, some of the tax treaties deviate from the OECD and UN MTCs, such as the South Africa-United States of America treaty,[38] which also refers to the domestic tax law interest definition.[39]Therefore, it is important to refer to the particular tax treaty under consideration.

In terms of the Article 11(2) of the OECD and UN MTCs, South Africa as the source country, will generally have limited taxing rights in respect of interest income accrued to non-resident creditors, provided that the non-resident creditor, as a recipient, satisfies the 'beneficial ownership' requirements.[40] For the purpose of this study, it is assumed that the beneficial ownership requirements are met.

Furthermore, the study does not address the taxation of derivatives, hybrid debt, and interest that is paid to and from banks.

[36] The definition of an 'interest' in section 24(J)(1) of the Act.

[37] Article 11(3), OECD and UN MTCs.

[38] Article 11(2), *Convention between the Republic of South Africa and the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on Income and Capital Gains*, (1997). Treaties IBFD.

[39] Because the tax treaty partly defines interest and also makes reference to the domestic (tax) law definition, therefore, if the context permits, the domestic (tax) law definition might be consulted for the tax treaty purpose. For a discussion as to when the domestic (tax) law may offer assistance regarding undefined terms in the tax treaty see, for example, John F. Avery Jones et al, *The Interpretation of tax treaties with particular reference to article 3(2) – Part 1 and 2 of the OECD Mode*l, British Tax Review (1984), p4-54 & p90-100 respectively.

[40] For a general discussion of the concept of 'beneficial ownership', see, for example, W. Haslehner, in Reimer & Rust (eds), *Klaus Vogel on Double Taxation Conventions,* 4th ed (2015), p910-914; J. David B Oliver, Jerome B. Libin, Stef van Weeghel and Charl du Toit, *Beneficial Ownership*, Bulletin for International Taxation, Volume 54, Number 7, (2000). Journals IBFD.

Lastly, it is important to note that the study only captures the state of the relevant law, including the tax rates, at the time this study was written.

2 CHAPTER 2 – South African interpretation of fiscal legislation

2.1 Interpretation of fiscal legislation

2.1.1 Introduction

In this chapter, the rules of interpretation of fiscal legislation by the South African courts, and the tax policy objective behind section 23M of the Act, are briefly discussed, to form a basis for the interpretation of the phrase 'subject to tax' as contained in section 23M(2)(i)(aa) of the Act.

2.1.2 Different rules of interpretation(s)

According to Devenish,[41] the process of interpretation involves a trilogy of phenomena: first, it is concerned with linguistics, which concerns semantics, syntax and the rule of logic. Secondly, it involves not only statutes but also the common law, which is essentially encapsulated in the presumption of interpretations. Thirdly, it is inextricably intertwined with *jurisprudence* or the philosophy of law.

It follows from the above that the common law techniques of judicial interpretation should be followed, which include the literal rule approach, the modern purposive approach and the relevant presumption - *contra fiscum* rule. These are discussed briefly below.

2.1.3 Literal rule approach

Historically, the South African courts followed the literal interpretation canon of construction to interpret fiscal legislation.[42] According to Devenish, this rule contends that the true meaning of the text is to be sought (virtually) exclusively in the exact words used in the Act.[43] However, this rule of interpretation may be departed from to give effect to the intention of the legislature, if the exact words used give rise to a glaring absurdity.[44] The Appellant Division (now Supreme Court of Appeal ('SCA')), in the *Glen Anil Development Corporation Ltd* case,[45] however, rejected the notion that fiscal legislation (apart from *contra fiscum* rule which is discussed in section 2.1.5), should be interpreted differently to other legislation. In addition, the court went further and held that:

> *'even in the interpretation of fiscal legislation, the true intention of the Legislature is of paramount importance, and, I should say, decisive'* [46]

[41] G. E, Devenish, *Interpretation of Statutes*, 1st ed, (1992), p2 and the sources cited therein.

[42] For authority, see, *Cape Brandy Syndicate v IRC,* 1921(1) KB 64 p71.Thereafter, numerous South African cases such as in *CIR v Simpson* 1949 (4) SA 678 (A) p695 and *CIR v Frankel* 1949 (3) SA 733 (A) p738 quoted the *dictum* therein with approval.

[43] Supra note 41, p26.

[44] Farrar's Estate v *CIR* 1926 TPD 501 at 5

[45] *Glen Anil Development Corporation Ltd v SIR* 1975 (4) SA 715 (A), p727

[46] Ibid.

2.1.4 Purposive rule approach – 'purpose' and 'context'

In 2012 before section 23M of the Act came into effect in 2015, the SCA in the *Natal Joint Municipal Pension Fund* case rejected the literal rule approach of seeking the true intention of the legislature from studying the provision in question as an appropriate rule to interpret all statutes, including fiscal legislation.[47] The court went further and laid down the appropriate modern principle to interpretation. It held that:

> *'The present state of the law can be expressed as follows: 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 it's 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'*[48]

This passage was applied to fiscal legislation by the SCA in the *Bosch* case. The court held:

> *'The words of the section provide the starting point and are considered in the light of their context, the apparent purpose of the provision and any relevant background material'.*[49]

Furthermore, in relation to the literal rule approach, the court went further to state that:

> *There may be rare cases where words used in a statute or contract are only capable of bearing a single meaning, but outside of that situation, it is pointless to speak of a statutory provision or a clause in a contract as having a plain meaning'*[50]

The purposive rule approach in South Africa finds support from the English case of *McGuckian,* delivered in House of Lords in 1997, by Lord Steyn:

> *'During the last 30 years there has been a shift away from literalist to purposive methods of construction.'*[51]

The similarity of the South African and English rules of interpretation is not surprising, as South African courts have traditionally paid due regard to English case law as a persuasive precedent.[52]

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[47] *Natal Joint Municipal Pension Fund v. Endumeni Municipality* 2012 (2) All SA 262 (SCA) p272-279

[48] Ibid.

[49] *CSARS v Bosch and Another* 2015 (2) SA 174 SCA p180

[50] Ibid.

[51] *IRC v McGuckian*, (1997) STC 908 (HL) p915

[52] For example, the literal rule approach was drawn from the English case of *Partington v The Attorney General* which was quoted with approval in the South African domestic tax law case of *George Forest Timber* in 1942.

2.1.5 Contra fiscum rule

Alongside the literal interpretation canon of construction in respect of fiscal legislation, there existed a well-settled rule of interpretation, the contra *fiscum rule*. The Appellant Division held in the *Estate Reynolds* case that:

> *'in a matter of doubt, we are bound to invoke the rule of interpreting contra fiscum.'* [53]

In light of the 1996 South African Constitution[54] and the development of the purposive interpretation canon of construction, it might be doubtful that the presumption that statutory ambiguity has to be resolved in favour of the taxpayer, still has a place in this modern era of interpretation. The existence of the rule was confirmed recently, in a minority judgment in the SCA.[55] Furthermore, according to Goldswain, the rule still remained part of South African common law and was not in conflict with the Constitution[56] - a view shared by renowned tax lawyer, David Meyerowitz.[57]

It is therefore submitted that the rule still exists, regardless of the doubt surrounding it. On the other hand, it was held in the *Glen Anil Development Corporation Ltd* case, in relation to anti-avoidance provision, namely section 103 of the Act, (part of which was repealed and replaced by sections 80A to 80L) that:

> *'Section 103 of the Act is clearly directed at defeating tax avoidance schemes. It does not impose a tax, nor does it relate to the tax imposed by the Act or to the liability therefor or to the incidence thereof, but rather to schemes designed for the avoidance of liability thereof. It should, in my view, therefore, not be construed as a taxing measure but rather in such a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed.'*[58]

Meyerowitz argues that it is apparent that an anti-tax avoidance provision can be viewed in such a way that makes it more effective than its language might suggest.[59] However, even though the rule still exists, it does not apply to every provision of fiscal legislation.

[53] *Estate Reynolds and other v CIR* 1937 (A) 57 p70

[54] In terms of section 39(2) of the Constitution of the Republic of South Africa, 1996, [Hereinafter cited as the Constitution] every court must promote the spirit, purport and objective of the Bill of Rights.

[55] *CSARS v Daikin Air Conditioning South Africa (Pty) Ltd* 2018 JDR 1072 (SCA) p13

[56] G.K Goldswain, *The purposive approach to the interpretation of fiscal legislation – the winds of changes*, Meditari Accounting Research, Volume 16, Issue2, (2008). p116

[57] D Meyerowitz, *Has the Contra Fiscum Rule Vanised?*, Acta Juridica 79, (1995). p86

[58] Supra note 45, p727-728

[59] Supra note 57, p88

2.1.6 Summary of the rules of interpretation

In summation, the SCA categorically rejected the literal rule of interpretation and clearly held that the purposive rule applied. Accordingly, it involves a process, the context and apparent purpose of the provision offers valuable assistance when attributing the most appropriate meaning to the words used in the statutes, including fiscal statutes. The ordinary meaning of the words of the statues is always the starting point. Therefore, it is necessary to examine the Act relating to section 23M. Although the *contra fiscum* rule still exist, in cases of tax avoidance, the rule cannot be invoked. In the context this study, section 23M of the Act is examined below.

2.2 Application of the interpretation rule

2.2.1 Relevant text of section 23M of the Act.

The starting point is the ordinary meaning of the words of the section itself. It is convenient therefore, to quote the relevant part of the Act, specifically Section 23M 'Limitation of interest deductions in respect of debts owed to persons not subject to tax , which reads:

> *…(2) Where an amount of interest is incurred by a debtor during a year of assessment in respect of a debt owed to –*
>
> *(a) a creditor that is in a controlling relationship with that debtor; or*
>
> *(b) a creditor that is not in a controlling relationship with that debtor, if that creditor obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that debtor, and the amount of interest so incurred is not during that year of assessment -*
>
> *(i) (aa) subject to tax in the hands of the person to which the interest accrues; or…*
>
> *the amount of interest allowed to be deducted may not exceed the amount determined in accordance with subsection (3)' (own emphasis)*

2.2.2 Ordinary meaning of the phrase 'subject to tax'

The phrase 'subject to' has an established common law[60] meaning, namely what is dominant and subordinate in the context of a conflict in the provision or clause in a contract. However, it is submitted that in the context of section 23M of the Act, the question is not about conflict, and so the common law meaning does not offer any assistance, thus, an ordinary meaning is explored below.[61]

[60] *S v Marwane* 1982 (3) All SA 405 (AD) p417

[61] Generally the court, in answering the question of what is the meaning of the word/phrase, in the first place it turns to the definition provision of Act, thereafter common law and if it finds no guidance in both, it turns to the ordinary English dictionary. If, however, the word is commonly used among lawyers in a sense different from common speech, the professional meaning is used. See Supra note 41-p288-289 and J. Willis, *Statute Interpretation in a Nutshell,* The Canadian Bar Review, Volume 16, Number 1, (1938) p6. In light of the modern rule of interpretation, this article is somewhat outdated, however it remains a classical in setting out the principle of interpreting the statute.

The Merriam-Webster English dictionary defines the words 'subject to' as - 'likely to do, have, or suffer from (something)'.[62] The synonyms of the word 'subject' are defined as an adjective as, 'liable, open, exposed, prone, susceptible, and sensitive'.[63] Of particular interest are the antonyms of these words, namely: exempt and immune. Therefore, based on the ordinary dictionary meaning, it is submitted that what is key is that there must be a likelihood not necessarily a present certainty that the non-resident creditor will suffer from a tax on accrued interest.

The phrase 'subject to tax' is commonly understood by tax practitioners to mean 'actually' be liable to pay tax.[64] In light of the shift from the literal approach to purposive rule approach, it is doubtful that the ordinary dictionary meaning is the one to the follow; therefore, it is submitted that the ordinary meaning of this phrase, as understood among professionals in the tax arena is to be followed.

Next, it is important to understand it in the 'context[65]' and apparent 'purpose' of section 23M of the Act, discussed below. The word 'tax' is considered in detail in Chapter 3.

2.2.3 'Context' and 'purpose' of section 23M of the Act.

The word 'context' is defined widely by the SCA in the *Hoban* case, as follows[66]:

> *'Context includes the entire enactment in which the word or words in contention appear and in its widest sense would include enactments in pari materia and the situation or mischief, sought to be remedied'*

It is submitted that all the words of section 23M and the entire scheme of the Act, particularity the interest-charging provisions and, because of cross-border setting between the debt and the non-resident creditor, the tax treaty (other statute in *pari materia*), form part of the context to assist in attributing the most appropriate meaning of the phrase 'subject to tax' in section 23M(2)(i)(aa) of the Act. The tax treaty implication is discussed in details in the following chapters.

Turning to the 'purpose' of the interest limitation rules, it was highlighted in Chapter 1 that interest expenditure incurred by the debtor is generally deductible in terms of section 24J(2) of the Act.[67] However,

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[62] 'Subject to' *The Merriam-Webster.com Dictionary*, Merriam-Webster Inc., https://www.merriam-webster.com/dictionary/subject%20to. (Accessed 15 November 2019)

[63] 'Subject.' *The Merriam-Webster.com Dictionary,* Merriam-Webster Inc., https://www.merriam-webster.com/dictionary/subject. (Accessed 15 November 2019)

[64] See, for example, Supra note 10, p11, and W. Horak, *Tax Reform and Practice under the New South Africa Political Dispensation –A Critical Review*, Acta Juridaica 49 (2002), p78.

[65] Word 'take its colour, like a chameleon, from its setting and surrounds in the Act*'. see, De Beers Marine (Pty) Ltd v CSARS* 2002 (5) SA 136 (SCA), p143

[66] *Hoban v Absa Bank Ltd* 1999 (2) SA 1036 (SCA), p1044

[67] Section 24J(2) of the Act.

the words of the heading of section 23M of the Act states 'limitation of interest deductions…'; therefore, the apparent purpose of section 23M of the Act is, read literally, 'limitation of interest deductions…', despite the interest being fully deductible in terms of section 24J(2) of the Act, if the non-resident creditor is not subject to tax.[68] Furthermore, the heading – *'Limitation of interest deductions in respect of debts owed to persons not subject to tax'*- read in the context of section 23M(2)(i)(aa) of the Act, clearly indicates that section 23M of the Act is a specific anti-tax avoidance provision, because it applies in addition to the charging provision, namely section 24(J) of the Act.

2.2.4 Tax policy objective behind section 23M of the Act

The following passage from the South African National Treasury succinctly summaries the tax policy objective for the enactment of section 23M of the Act:[69]

> *'While debt capital is an important tool for investment, debt capital can also create opportunities for base erosion. Deductible interest paid to foreign (and other exempt) persons represents a risk to the fiscus because of the deduction/exemption mismatch… At the end of the day, a balance is required between attracting debt capital and the protection of the tax base against base erosion'*

Furthermore, a descriptive analysis of the South African corporations' corporate tax returns conducted by Van der Zwan,[70] reveals that the proportion of the South African corporations controlled by foreign corporations located in low/zero tax-countries (including Mauritius, the British Virgin Islands, Cyprus and Guernsey) is relatively higher than those of the overall population of foreign-held corporations in relatively high tax-countries. Van der Zwan asserts in support of the National Treasury, that this may be evidence of base erosion. For more details, regarding tax treaties that are likely to cause tax erosion, see column [H] of the Appendix to this thesis. In light of the above, it is submitted that the tax policy objective appears to confirm the apparent purpose found in the text of section 23M, as well clarifies that the Act is targeted at 'foreign (and other exempt) persons'.

2.3 Conclusion

Pursuant to the SCA's dictum in the *Natal Joint Municipal Pension Fund* case upholding that the purposive interpretation rule be followed when interpreting fiscal legislation and as summarised in section 2.1.6, it has been argued in this study that the phrase 'subject to tax' means that non-resident creditors must 'actually'

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[68] Recourse can be had to the heading or preamble of a provision when they is uncertainty in the words of a provision.
See, President of the Republic of South Africa and Another v Hugo 1997 (6) BCLR 708 (CC) at footnote number 13 and the sources cited therein.

[69] South African National Treasury, *Explanatory Memorandum to the Taxation Laws Amendment Bill,* (2013), p37, available at: http://www.treasury.gov.za/legislation/bills/2013/Default.aspx (accessed 15 May 2019).

[70] P van der Zwan*, An evaluation of interest deduction limitations to counter base erosion in South Africa,* South African Journal of Economic and Management Sciences, Volume 21 Number 1, (2018), p8

be liable to pay tax on interest, subject to deductions, set-offs and foreign tax reliefs. Thus, what is required is a likelihood (not necessarily a certainty) that the non-resident creditor will 'actually pay' tax. Furthermore, the text and tax policy behind section 23M of the Act, reveals that this provision is an internationally focused anti-avoidance provision, arguably aimed at non-resident creditors not 'subject to tax'. The chapters that follow investigate the meaning of this phrase when read together with other South African tax treaties, and thereafter applies it in the context of foreign corporate tax, normal tax and withholding tax on interest.

3 CHAPTER 3 – Definition of the word ‘tax’ for the purpose of Section 23M of the Act

3.1 Introduction

This chapter briefly discusses the tax treaty interpretation rules and the relationship between the tax treaty and the domestic tax law, forming a basis to investigate whether the word ‘tax’ in the phrase ‘subject to tax’ in section 23M(2)(i)(aa) of the Act does not encompass foreign corporate tax imposed on non-resident creditors by its country, as a result of accrued interest from the South African source. [71] To achieve this, the definition of the word ‘tax’ as defined in the Act and as defined and/or covered in applicable tax treaties is discussed - in the context of the tax treaty interest related provisions.

3.2 Interpretation of the tax treaties

South Africa has concluded approximately 79 tax treaties with other countries and each tax treaty binds South Africa and its tax treaty partner as a matter of international law. They are concluded in terms of section 108 of the Act the objective of which is the ‘… prevention, mitigation or discontinuance of the levying, under the laws of Republic and of such other country [non-resident creditor’s country], of tax in respect of the same income, profit or gains….’ [72] It further provides that once the tax treaty is approved by the South African legislature and duly gazetted, it becomes part of the Act.[73]

However, despite the tax treaty being part of Act, Avery Jones and his co-authors, assert that ‘treaty interpretation is a subject in itself and not merely an extension of statutory interpretation, as has sometimes been thought in common law countries where treaties normally take their effect by virtue of statute.[74] Similarly, the South African courts, as the final arbiters in the tax treaty interpretation, acknowledge that the interpretation rules[75] codified by Articles 31-32 of the Vienna Convention on Law of Treaties[76] (‘VCLT’) are to be followed when interpreting tax treaties, an autonomous ‘international tax language’.[77] As a result, the

[71] For detailed discussion on the concept of ‘tax’, see, for example, J. Hattingh, *Elimination and Prevention of International Double Taxation*, in *Silk on International Tax* (E. Brincker & de Koker, LexisNexis 2010) section 36.24.1. As valuable as theliterature is, it deals with the general principle regarding the concept of tax and the meaning of tax for the purpose of limiting the tax credits allowed for the tax charged by foreign countries.

[72] Section 108(1) of the Act.

[73] See section 108(2) of the Act, read with 231(4) of the Constitution.

[74] John F. Avery Jones at al, *The Interpretation of tax treaties with particular reference to article 3(2) of the OECD Model – Part 1,* British Tax Review (1984), p4: see, also, K Vogel, *Double Tax Treaties and Their Interpretation*, International Tax & Bus. Lawyer, Volume 4, Number 1, (1986) p31

[75] See, *Krok and Another v CSARS* 2015 (6) SA 317 (SCA) p329-330, in which the SCA settled the issue on how the tax treaties are to be interpreted.

[76] United Nations, Article 31-33, *Vienna Convention on Law of Treaties,* (1969). Online Models IBFD.

[77] See, *Downing v SIR,* 1975 (4) SA 518 (A) p523, where the court expressly noted the existence of ‘international tax language’

tax treaty interpretation rules are briefly discussed below to form a basis for the interpretation of the word 'tax' in the tax treaties, for the purpose of section 23M.

Briefly, Article 31(1) of the VCLT states that the tax treaty must be interpreted in good faith, in accordance with the ordinary meaning of the terms of the tax treaty in their context and in light of the objective and purpose of the tax treaty. The context is narrowly defined in Article 31(2) of the VCLT, and according to international taxation scholar, Klaus Vogel, context refers to the entire text of the actual tax treaty and any related documents made in connection with the tax treaty.[78] The 'object and purpose' of a tax treaty includes the entire tax treaty, and not only the purpose of a single provision.[79] Therefore, it is submitted that related interest provisions form part of context in understanding the definition of tax in the tax treaty, discussed below.

Vogel states further that according to Article 31(4) of the VCLT, the parties to the tax treaty can ascribe a meaning to a term that deviates from the ordinary meaning.[80] Lastly, Article 32 of the VCLT provides that other supplementary means of interpretation can be used, to the extent that they confirm an interpretation already found in light of the context and the objective of the entire tax treaty.

3.3 The relationship between the domestic tax law and the tax treaties

To the extent that there is a conflict between the tax treaty and the domestic tax law, the SCA in the *Tradehold Ltd* case, held[81]

> *'a double tax agreement [tax treaty] thus modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict.'*

In addition, in terms of the Constitution which is the supreme law in South Africa,[82] the courts are bound, when interpreting any legislation (including *fiscus* legislation), to prefer any reasonable interpretation that is consistent with international law over any alternative interpretation that is inconsistent with international law.[83] In the absence of common law in South Africa specifically dealing with the relationship between domestic specific anti-tax-avoidance provisions and the tax treaty, the author is of the view that the common law and Constitution are to be relied on.

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[78] K Vogel/A Rust, *Introduction* in Reimer & Rust (eds), *Klaus Vogel on Double Taxation Conventions,* 4th ed (2015), p39

[79] K. Vogel/R. Prokisch, *Interpretation of Double Taxation Conventions,* IFA General Report Cahiers, Volume 78a, (1993) p72. Online Book IBFD

[80] Supra note 78.

[81] *South African Revenue Service v Tradehold Ltd* 2013 (4) SA 184 (SCA) p191

[82] See, section 1(c) and section 2 of the Constitution.

[83] Ibid, section 233.

Furthermore, South Africa should respect the international character of the tax treaties (i.e. the tax treaties on cross-border taxations of the debtor and the non-resident creditor) by treating them *leges speciales* (special legislation), compared to domestic tax law which is treated as *lex generalis* (general legislation). Under the old rule, 'the special legislation overrides the general legislation' that is effective at the time of implementation of the special legislation. Lastly, under the supplementary rule, later general legislation, unless otherwise specified, does not overrule earlier special legislation.[84] Therefore, the introduction of the interest limitation provisions, do not affect the existing provisions of the tax treaties unless expressly or implicitly intended.

3.4 Definition of the word 'tax' in the Act and applicable tax treaties

This section discusses the word tax in the Act and the tax treaties, including 'covered tax' under the tax treaties, to the extent that the word tax relates to section 23M of the Act.

3.4.1 Definition of the word 'tax' in the Act

As earlier remarked, the word 'tax', in the phrase 'subject to tax' is not defined in section 23M the Act. In the absence of the definition in section 23M of the Act or any judicial guidance, it should be interpreted as prescribed in the definition provision,[85] namely section 1 of the Act which unhelpfully states.[86]

> *'Unless the context otherwise indicates, tax means tax or a penalty imposed in terms of this Act*'.

The definition tells little more than 'tax means tax...,' but the surrounding words - 'tax…imposed in terms of this the Act' - gives a clue that it must be a tax that is levied under the Act. Furthermore, the original version of section 23M of the Act was headed: 'limitation of interest deductions in respect of debts owed to persons not subject to tax <u>under this Chapter</u> (i.e. Chapter II)'[87] (emphasis added). Chapter II of the Act contains a number of charging provisions, the two of which are noticeably applicable to interest income accrued to non-resident creditors. First, normal tax (under Part I of Chapter II), levied on 'taxable income' in terms of section 5(1) of the Act (see Chapter 5) and secondly, withholding tax on interest (under Part IVB of Chapter II), levied in terms of section 50B of the Act (see Chapter 6). The definition specifically refers to a 'penalty' as 'tax'. However, for the purpose of section 23M of the Act, it is doubtful that the definition is to be followed to an extent that it refers to a penalty.

[84] K. Vogel, *The Domestic Law Perspective,* in G Maisto, *Tax Treaties and Domestic Law*, (2006) p3. Online Book IBFD.

[85] Supra note 61.

[86] The definition of 'tax' in section 1 of the Act.

[87] When section 23M of the Act was first enacted by section 61 of the *Taxation Laws Amendment Act 31 of 2013*, the heading contained the words underlined above.

3.4.1.1 'Unless the context otherwise indicates…'

It is convenient at this stage to make three overarching deductions. First, numerous SCA decisions provide a useful point of departure in relation to the definition section of the Act, holding that a defined word does not always, depending on the 'context', carry its defined meaning,[88] and, as mentioned in section 2.2.3, the 'context' is widely defined to include the entire scheme of the Act, including an applicable tax treaty.[89] Secondly, in terms of the *Werner van Kets* case, the provision of the tax treaty and the Act should, if at all possible, be reconciled and read as one coherent whole.[90] The case, admittedly concerned the so-called administrative provision, namely exchange of information upon request. The main question was regarding whether a person who was not a 'taxpayer' for the purpose of the then section 74A and 74B under Chapter III, as defined in section 1 of the Act, was a taxpayer for the purpose of South Africa-Australia tax treaty.[91] The definition of the word taxpayer read as follows:[92]

> '*Unless the context otherwise indicates*, taxpayer means any person chargeable with any tax leviable under this Act'.

The High Court held:

> *'…The definition of taxpayer in section 1 would represent an insurmountable obstacle to compliance. However, if the DTA [tax treaty] is interpreted as part of domestic tax legislation, then it behoves this court to interpret section 74A and 74B so as to render them compatible with this very (sic) provisions of the DTA and, in particular, Article 25 thereof[93]….In my view, once the DTA is read together with the Act, this reading would imply that the word 'taxpayer' should include those taxpayers who do not fall within the scope of the Act but fall within the scope of the DTA…'[94]*

The High Court held further:

> *'The essential dispute therefore hones down further to whether the provisions of the DTA in general and Article 25 thereof in particular broaden the scope of section 74A and section 74B beyond the strict meaning of the definition of taxpayer in section 1.'[95]*

The answer to this question is 'yes'. The court altered the meaning ascribed to the word 'taxpayer' in the definition section of the Act. The author is of the view that the court's decision appears to be in consonance

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[88] *CIR v Simpson*, supra note 42, p692 and also *Investments (Pvt) Ltd v Cot* 1960 (1) SA 59 (SR) p63.

[89] Supra note 66, p1044.

[90] *South African Revenue Service v Werner van Kets* 2012 (3) SA 399 (WCC) paragraph 25.

[91] See, Article 25 read with Article 2, *Agreement between the Government of Australia and the Government of the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to the Taxes on Incomes*. (1999) (as amended through 2008). Treaties IBFD

[92] The definition of a 'taxpayer' in section 1 of the Act

[93] Supra note 90, paragraph 26.

[94] Ibid, paragraph 20.

[95] Ibid, paragraph 23.

with the Constitution,[96] which as remarked, obliges the court to prefer an interpretation that is consistent with the relevant tax treaty, as a source of international law, over any alternative interpretation that is inconsistent with the relevant tax treaty.

Lastly and finally, without 'Chapter II' in the heading throwing light on which tax section 23M(2)(i)(aa) refers to - 'subject to tax in the hands of the person to which the interest accrues' - it is not at all clear, particularly, because that non-resident creditor (person) is likely to be liable to foreign corporate tax in its foreign country as a result of accrued interest income within South African source.[97] One should note that the court is entitled to consider the heading of a section if the word of the provision is unclear, for the light which it might throw on a particular word(s).[98]

3.4.2 Definition of the word 'tax' in the tax treaties

The OECD MTC surprisingly does not define the word 'tax', which could have thrown light on the meaning of the word as employed in a tax treaty that also does not define it.[99] This problem however goes beyond the present investigation.[100]

South African tax scholars [101] and SARS,[102] for the purpose section 23M(2)(i)(aa), follow a fairly narrow literal interpretation that limits the definition to only South African taxes, namely normal tax and withholding tax on interest, more particularly by referring to the use of the words - '…*imposed in terms of this Act*'- in section 1 of the Act. Thus, strictly speaking, the definition governs the meaning of the word 'tax' as imposed in terms of the Act, but not when it is imposed under the domestic tax law of the non-resident creditor. It is submitted that the narrow interpretation is to be followed only in the absence of the tax definition in the applicable tax treaty. The basis of this view is discussed below.

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[96] Section 233 of the Constitution.

[97] Corporate tax is the most widely adopted tax around the world.

[98] Supra note 68.

[99] For a general discussion regarding the concept of 'tax' in a tax treaty, see, K. Raad and M. Lang, *The concept of Tax*, (2005), section 3.1 and 3.2 respectively. Online Books IBFD; W. Cui, *Article 2 – Taxes Covered – Global Tax Treaty Commentaries*, (2019) section 2, Global Topics IBFD; Also see SARSs opinion regarding a comprehensive list of 'covered tax', SARS, Binding General Ruling 9 – Issue 3, *Taxes on Income and Substantially Similar Taxes for Purposes of South Africa's Tax Treaties,* (2017) at https://www.sars.gov.za/AllDocs/LegalDoclib/Rulings/LAPD-IntR-R-BGR201209%20%20Taxes%20income%20RSA%20Tax%20Treaties.pdf (Accessed 15 December 2019)

[100] The aim is to investigate if foreign corporate tax falls within the meaning of 'tax' for the purpose of section 23M of the Act. It is impractical to consider each of South African tax treaties in this study. See appendix for a condensed survey of the tax treaties in relation to interest.

[101] See P. Haupt, *Notes on South African Income Tax*, 13th ed (2020) section 17.6; and M. Stiglingh*, Silke: South African Income Tax*, (2020) p546

[102] This is according to the author's practical experience.

3.4.2.1 Tax covered under Chapter III of the Act and Article 2 of the tax treaties

In 2017, the heading of section 23M of the Act was amended[103] from 'limitation of interest deductions in respect of debts owed to persons not subject to tax under this Chapter' to 'limitation of interest deductions in respect of debts owed to persons not subject to tax' (i.e. the words 'under this Chapter' were deleted). The reason provided in the Explanatory Memorandum[104] was:[105]

> *'The proposed amendment to the heading of section 23M addresses the concern that many taxpayers [non-resident creditor] may not be subject to tax by virtue of treaty protection and treaty relief falling outside Chapter II'.*

What is abundantly clear from the Explanatory Memorandum is that, as opposed to the former heading that was only limited to taxes covered under Chapter II, the amended heading is wide enough to include the operation and objective of the tax treaty by virtue of section 108(1) of the Act[106] under Chapter III, which provides that:

> *'…with a view to the prevention, mitigation or discontinuance of the levying, <u>under the laws of the Republic and of such other country [non-resident creditor's country], of tax</u> in respect of the same income...' (author's emphasis)*

So far as the objective and operation of the tax treaty is concerned, it is, to an extent applicable to this study, to prevent double taxation with respect to taxes on the same income,[107] avoidance of discrimination, and encouraging FDI debt, discussed under section 3.5 below.

The taxes referred are not all the taxes levied by either South Africa or the non-resident creditor's country under its domestic tax law, but only taxes that are within the ambit of the tax treaty for the purpose of distributive rules.[108] On the other hand, for the so-called administrative provision such as non-discrimination rule (see section 3.5.2), it applies beyond the taxes which are covered by the scope of the tax treaty.

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[103] Effective 19 January 2017, see section 41 of the Taxation Laws Amendment Act 15 of 2016.

[104] For example, see, Supra note 53, p184, where an Explanatory Memorandum was used as a permissible aid to interpret the Act.

[105] South Africa National Treasury, *Explanatory Memorandum to the Draft Taxation Laws Amendment Bill* (2016), clause 41, available at:http://www.treasury.gov.za/public%20comments/TLAB%20and%20TALAB%202016%20Draft/2016%20Draft%20Explanatory%20Memorandum%20on%20the%202016%20Draft%20Taxation%20Laws%20Amendment%20Bill.pdf (accessed 15 May 2019)

[106] Section 108(1) of the Act.

[107] See section 108(1) of the Act, read with the respective tax treaty preamble which states the objective of the tax treaty is '…the avoidance of double taxation with respect to taxes on income…' and also see ample literature regarding indisputable purpose and object of the tax treaties, L. Olivier and M. Honiball, *International Tax, A South Africa Perspective*, 5th ed (2011) p276; K.J. Holmes, *Double Tax Treaties in International Tax Policy and Double Tax Treaties – An Introduction to Principles and Application,* (2nd revised ed). (2014), section 3.1. Online Books IBFD; M. Lang, *The problem of double taxation in Introduction to the Law of Double Taxation Conventions* (2nd revised ed) (2013) section 1.3.1. Online Books IBFD

[108] It is a well-established principle that the tax treaty does not impose tax, therefore South African tax treaties do not create a new tax. The taxes referred in South African tax treaties are the taxes levied by South Africa or the tax treaty partner in terms of its domestic tax law.

Article 2(1) of the respective South African tax treaties, modelled after the OECD MTC, covers 'taxes on income or on capital'. Article 2(3) generally contains an exemplary list of taxes on income and on capital, of which virtually all South African tax treaties list the corporate tax levied under domestic tax law of the non-resident creditor's country.

Thus, it can be inferred that because the lawmaker found it necessary not only to make reference to taxes imposed under Chapter II, but in addition, implicitly made reference to taxes imposed under Chapter III, foreign corporate tax levied under the non-resident creditor's domestic tax law should also form part of tax when the 'subject to tax' test is applied, for the purpose of interest income accrued to non-resident creditor. Furthermore, this construction, which prevents economic double taxation on interest, is in consonance with the principle that the non-resident creditor, as a taxpayer, has a right to use international public law provisions that are most advantageous for tax purposes. As Arnold puts it, 'where the provisions of a DTA [tax treaty] and the provisions of the domestic law both apply to a taxpayer, the taxpayer is entitled to the more favourable results'.[109]

3.4.2.2 Autonomous meaning of the word tax in the tax treaties

The word 'tax' is expressly defined in the 19 tax treaties under the definition provision.[110] Article 3(1) and the definitions follows two distinct approaches: first, in the South Africa-Iran[111] and South Africa-Turkey[112] tax treaties, the definition is wider (underlined words below). The South Africa-Iran treaty states that:

> *'for the purposes of this Agreement, unless the context otherwise requires; the term means <u>any tax</u> covered by Article 2 of this Agreement' (author's emphasis)*

A plain reading of the wording of the definition above is wide enough to include foreign corporate tax, to the extent that is covered by Article 2 of the South Africa-Iran tax treaty. The text of the tax treaty is presumed to be the authentic expression of the intention of the tax treaty partners provided,[113] that it is consistent with the purpose of the tax treaty as a whole. It is submitted that there is no evidence that the context overthrows the expression 'any tax covered by Article 2…' which South Africa and Iran have deliberately employed. This view finds support in the *Commerzbank AG* tax treaty case,[114] where the English High Court rejected

[109] B Arnold, *The relationship between Tax Treaties and the Income Tax Act: Cherry Picking,* Canadian Tax Journal, Volume 43, Number 4. (1995), p870

[110] Supra note 26.

[111] Article 3(1)(d), *Agreement between the Republic of South Africa and the Islamic Republic of Iran for the Avoidance of Double Taxation and the Exchange of Information with respect to Taxes on Income,* (1998). Treaties IBFD

[112] Article 3(1)(c), Agreement *between the Republic of South Africa and the Republic of Turkey tor the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, (2006), (*read with amending protocol).* Treaties IBFD

[113] Supra note 79, p73 source cited in footnote 52. The English Court reject an interpretation which ignores the expressed wording in the tax treaty.

[114] *Commissioners of Inland Revenue v Commerzbank AG,* (1990). Case Law IBFD.

the interpretation that ignored the text of the tax treaty. This line of interpretation maybe be applied when interpreting the South Africa-Turkey tax treaty because it contains a similar provision.

Secondly, in the remaining 17 tax treaties, tax is not widely defined. For example Article 3(1)(k) of the South Africa-Australia tax treaty[115] states:

> *'the term 'tax' means Australian tax or South African tax* <u>as the context requires</u>*, but does not include any penalty or interest imposed under the law of either Contracting State relating to its tax' (author's emphasis)*

Based on the literal interpretation, it initially appears that separate meanings must be given to the phrases 'Australian tax' and 'South African tax' because the definition does not couple the words 'Australian tax and South African tax' with 'and,' but are distinguished by the word 'or'. It is submitted that the construction does not give the underlined words above – as the context requires – effect, including the entire objective and purpose of the tax treaty provisions which are- avoidance of economic double taxation, avoidance of discriminations and encouraging foreign investment.

On the other hand, it is argued that when the word tax is properly interpreted to allow the words Australian tax to be within the ambit of the word 'tax' for the purpose of accrued interest to non-resident creditor, in context of the objective of the South Africa-Australian tax treaties, it give effect to the purpose and objective of the South Africa-Australian tax treaty. This is because it results to no economic double taxation, non-discrimination and arguably encourages FDI debt. This construction can be applied to 16 other tax treaties that are similar to the South Africa-Australian tax treaty.

3.5 Tax treaty interest related provisions

In this section, the focus is turned to the tax treaty interest related provisions, wherein the definition of the word 'tax' in these tax treaties ought to be understood in context, to shed light on the entire purpose and objective of the tax treaties, to the extent that they relate to interest. These key provisions relate to cross-border economic double taxation, non-discrimination with respect to the deduction of interest by non-resident creditor and tax treaty saving clause, as discussed below.

3.5.1 Cross-border economic double taxation on interest

The OECD, under BEPS Action 4, cautions that the '…new rules [interest limitations] should not result in double taxation… .'[116] In an attempt to prevent this, some countries such as Austria have implemented

[115] Article 3(1)(k), *Agreement between the Government of the Republic of South Africa and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with* respect to Taxes on Income, (1999) (read with amending protocol of 2008). Treaties IBFD

[116] Supra note 3, at the back of the cover page. It should be noted that is an observer, not a member of the OECD, but a G20 member countries.

rules similar to section 23M of the Act, taking into account the foreign corporate tax imposed in the residence country when applying the 'subject to tax' rule on interest.[117]

In the case of South Africa, if the definition of the word 'tax', for the purpose of section 23M of the Act, does not encapsulate the corporate tax imposed in a foreign country, it will unavoidably result in cross-border economic double taxation.[118] This is because: firstly, the portion of interest expense exceeding the relevant limit[119] is disallowed as interest deduction in determining the tax liability of the debtor, and therefore it is subject to corporate tax in South Africa.[120] According to Fernandes, disallowing interest deduction in that manner is to, albeit in a disguised manner, regain the taxing rights on interest income after having agreed to waive it in the tax treaty[121]or agreed to a reduced withholding tax rate.[122] This aspect is discussed further below (section 3.5.2).

Secondly, in the non-resident creditor's country, the full accrued interest income will be subject to foreign corporate tax.[123] The non-resident creditor's country is unlikely to exclude such portion of interest expense exceeding the limitation from the tax base of the non-resident creditor, because it will independently apply its domestic tax law on the total amount of interest accrued to the non-resident creditor. This means that cross-border interest is not only assessed once as income, except in territorial tax system countries such as Hong Kong, which does not tax non-resident creditors on interest from foreign source .[124]

Furthermore, the non-resident creditor is unlikely to qualify for the foreign tax relief (on additional corporate tax created by disallowing a portion of the interest to be deducted by the debtor) in terms of Article 23 of the South African tax treaty patterned after the OECD MTC, since there is no juridical double taxation.

Lastly, the non-resident creditor is unlikely to qualify for the so-called corresponding adjustment deduction in terms of the provision equivalent to Article 9(2) of the OECD MTC, because the portion of interest expense exceeding the limit is not computed on an arm's length basis but on a fixed formula basis. However, the issue relating to corresponding adjustment has limited practical importance because not all the South African tax treaties contain Article 9(2) of the OECD MTC or its equivalent, partly because South

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[117] E Schaffer & W Siller, *Interest deductibility: the implementation of BEPS Action 4*, IFA Austria Report Cahiers, Volume 104a (2019), p117. Online Books IBFD.

[118] See, supra note 21, section 2.2.3.5 and supra note 78, p12.

[119] The portion of interest expense exceeding the relevant limit is carried forward for a limited period. See, section 23M(3) of the Act

[120] The disallowed interest expenditure portion will result in an increased debtor's corporate tax in South Africa.

[121] Supra note 26.

[122] Supra note 21, section 4.2.1.2.5.

[123] As mentioned earlier, it is common that most countries tax their residents on their worldwide income, including on accrued interest income from South African source.

[124] Supra note 17.

Africa took a position on Article 9(2) of the OECD MTC to reserve the right to optionally apply this provision.[125]

3.5.2 Non-discrimination of the non-resident creditor relating to interest deduction

In terms of the tax treaty, provisions patterned after Article 24(4) of the OECD MTC, essentially requires South Africa, as the source country, to allow cross-border interest (or royalties) expenditure made by the debtor to the non-resident creditor under the same conditions that would have applied if the non-resident creditor was a South African resident. [126] Virtually all the South African tax treaties contain provisions similar to Article 24(4) of the OECD MTC or its equivalent[127]. As an illustration, the South Africa-Iran[128] tax treaty states that:

> *'Except where the provisions of paragraph 1 of Article 9, paragraph 7 of Article 11, or paragraph 6 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State'*

According to Fernandes, the matter relating to non-deductibility of interest in relation to cross-border interest expenditure is not a matter of prohibition of non-discrimination as such, but rather a matter of due respect for the agreed allocation of taxing rights as allocated under interest distributive rule (i.e. it is a matter concerning Article 11 of the OECD MTC). Thus, if Fernandes' argument is followed, South Africa by enacting interest limitation rules that seek to regain taxing rights on interest, after waiving them in some cases,[129] will not mean enforcing the tax treaty 'in good faith'.[130] His view that Article 24(4) of the OECD MTC is entrenched in the interest allocation rule, is supported by historical material about the origins and

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[125] In practice, lack of the provision equivalent to Article 9(2) of the OECD MTC in some of the tax treaty has led to double taxation caused by transfer pricing adjustments.

[126] Article 24(4), *OECD MTC.*

[127] See Appendix attached, under column [G].

[128] Article 23(4), *Agreement between the Republic of South Africa and the Islamic Republic of Iran for the Avoidance of Double Taxation and the Exchange of Information with respect to Taxes on Income,* (1998). Treaties IBFD

[129] Supra note 26.

[130] In terms of VCLT, the tax treaty obligation must be performed in good faith, therefore the tax treaty obligation must survive subsequent restriction by the Act. See Supra note 76, Article 26.

rationale of OECD MTC relating to interest[131] and royalty[132] distributive rules. They reveal that the provisions relating to non-deductibility of interest were addressed by the same Organisation for European Economic Co-operation Committee - Working Party No. 11 - which was responsible for the interest distributive rule. Since the 1977 OECD MTC,[133] this provision has been incorporated as a separate paragraph in Article 24(4) OECD MTC from the interest and royalty distributive rules respectively.

Furthermore, in the absence of local doctrine on the non-discrimination, the Indian court[134] - Income Tax Appellate Tribunal Delhi - in the tax treaty with identical provision[135] to the South Africa-Iran tax treaty quoted above, held in favour of the Indian taxpayer that sought reliance on Article 26(3) of India-United States (patterned after Article 24(4) of the OECD MTC). [136] In summary, the taxpayer leased servers from non-residents based in the United States. The Indian taxpayer claimed the lease payment as revenue business expenditure while no withholding tax in India was paid because the taxpayer was of the view that such services were not of a technical nature on which withholding tax had to be paid. India had a similar specific anti-avoidance provision to section 23M of the Act in that the revenue business expense was disallowed on the basis that no withholding tax was withheld on the payment to non-resident. Such prohibition did not apply if payment was made to Indian residents.

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[131] The Committee tasked to discuss the interest distributive rule stated that '…it is desirable that the deduction in question should also be allowed in cases where the interest is paid by a resident of a Contracting State [South Africa] to a resident of other state [non-resident creditor's country], with of course the provision to prevent fraud: It considers that the deduction should not be forbidden simply because the tax payable by the recipient [non-resident creditor] of such interest is reduced in the State of source in application of the proposed Article [Article 11]. Any other method of procedure might cancel out the beneficial effect of the measure taken to avoid double taxation'. See, Organisation for European Economic Co-operation, *Working Party No. 11 of the Fiscal Committee – Revised Fourth Report on the Taxation of Interest* (1961), page 8 of Part 2. https://www.taxtreatieshistory.org/ (accessed 15 June 2020)

[132] The Committee tasked to discuss the royalty distributive rule stated that '…If, however, after the signature of the Convention, a State, with the object of indirectly countering the effect of its relinquishment of the tax at source, were to introduce into its law a rule prohibiting the deduction for the purpose of the payer's tax of royalties paid to a non-resident, then in the Fiscal Committee's view, such a measure would be incompatible with the objects of paragraph 1 of the Article [i.e. paragraph that allocates the taxing rights]' See, Organisation for European Economic Co-operation, *Working Party No. 8 of the Fiscal Committee – Revised Third Report on the Taxation of Royalties* (1961), page 9 of Part 1. https://www.taxtreatieshistory.org/ (accessed 15 June 2020)

[133] Article 24(4) OECD Model Tax Convention on Income and on Capital (11 April 1977), Online Models IBFD

[134] *Millennium Infocom Technologies v. ACIT*, (2008) 21 SOT 152 (Del) , Case Law IBFD

[135] References to foreign cases in South Africa is common in tax treaty matters. For example, see, Supra note 87. Although they are not binding, nevertheless they are persuasive, particularly when they are dealing with the provisions similar to the South African tax treaties.

[136] 'Except where the provisions of paragraph 1 of Article 9 (Associated enterprises), paragraph 7 of Article 11 (Interest), or paragraph 8 of Article 12 (Royalties and fees for included services) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State' See, Article 26(3) of *Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.* (1989), Treaties IBFD.

Against this backdrop, it is submitted that prohibiting cross-border interest expenditure, and the implicit requirement that withholding tax on interest must be levied on interest income to the non-resident creditor (i.e. 'subject to (South African) tax' requirement in section 23M of the Act) as a condition for the debtor to be able to deduct interest expense is clearly discriminatory. This is because this condition is not applied if the interest is paid to a resident creditor and in the National Treasury's own admission (tax policy objective),[137] this provision is aimed at non-resident creditors.

Mandy is in agreement with this assertion, although without substantiating his view,[138] whilst Kruger disagrees.[139] Kruger disagrees because exempt resident creditors such as local pension funds are also not 'subject to (South African) tax' on accrued interest income, therefore the rules are not only aimed at non-resident creditors . Avery Jones and Bobbett, whilst summarising the panellists' views at the Kyoto IFA Congress that dealt with non-discrimination issues, do not support Kruger's reasoning, on the basis that a non-resident creditor is more comparable to a local business corporation than to a local pension fund.[140] In addition, by its very nature, section 23M is only applicable in cross-border contexts, which makes it clear that it is aimed at non-resident creditors.

Lastly, the wording of section 23M(2)(i)(aa) does not expressly preclude the operation of the provision equivalent to Article 24(4) of the OECD MTC; and neither was, in the author's knowledge, any tax treaty with provision equivalent to Article 24(4) of the OECD MTC modified after the introduction of section 23M of the Act, in order to accommodate the latter. It should be noted that Article 24(4) of the OECD MTC does not apply if interest is denied due to the fact that it is considered to be excessive,[141] or is not computed on an arm's length basis.[142]

3.5.3 Saving clause in the tax treaties

Under Article 1(3) of OECD[143] and UN MTCs of 2017,[144] read with paragraph 3 of the commentary to Article 1, subject to specific exceptions listed in Article 1(3),[145] the tax treaty does not restrict a country from taxing their residents without any limitations imposed by the tax treaty. Currently, however, there is no South

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[137] Supra note 69.

[138] K. Mandy, *The Limitation of Deduction for Untaxed Interest*, Taxtalk , Volume 44, (2015) p48

[139] Kruger, supra note 10, p21.

[140] A panel member of the joint proceedings of the IFA/OECD seminar held during the IFA Congress in Kyoto in October cited by John F. Avery Jones and C. Bobbett, *Interpretation of the Non-Discrimination Article of the OECD Model,* Bulletin for International Taxation, Volume 62, Number 2, (2008) p51

[141] Article 11(6), *OECD MTC*

[142] Article 9(1,) *OECD MTC*

[143] Article 1(3) and paragraph 3 of the commentary to Article 1, *OECD MTC* (2017). Online Models IBFD

[144] Article 1(3) and paragraph 3 of the commentary to Article 1, *UN MTC* (2017). Online Models IBFD

[145] Included under exceptions is the double taxation relief provision, similar to Article 23 of the OECD MTC.

African tax treaty with this saving clause (including those tax treaties that were entered into after 2017). It is, therefore, doubtful that the South African courts will read in this clause into South African tax treaties.

3.6 Conclusion

In this chapter, it was highlighted that in the *Warner van Kets* case (wherein it was argued that it followed the correct interpretation in consonance with section 233 of the Constitution), the definition provision of the Act was expanded by the wider tax treaty definition. To the extent that there is a conflict between the tax treaty and the Act, the tax treaty prevails.

Thus, for the purpose of section 23M(2)(i)(aa) of the Act, it was argued that the word 'tax', as defined in the definition provision of the Act, should be interpreted, following tax treaty interpretation rules, to encompass the word 'tax' as defined in Article 3(1) of the relevant tax treaty, encompassing foreign corporate tax. To the extent applicable to this study, the tax treaty definition is read in the context of intending to prevent cross-border economic double taxation on interest, avoidance of discrimination with respect to the deduction of interest by non-resident creditor and encouraging FDI debt. In other words, the word 'tax' should encompass foreign corporate tax 'actually' imposed on non-resident creditor in its country as a result of accrued interest from the South African source.

In the alternative, it was argued that the amended heading of section 23M(2)(i)(aa) of the Act implicitly covers taxes which are within the ambit of Article 2 of the tax treaties because, by virtue of section 108(1) of Act, they are taxes under Chapter III of the Act. In virtually all the South African tax treaties, foreign corporate tax forms part of 'covered taxes' in Article 2; therefore, it forms part of the tax referred to under Chapter III. Put differently, the fact the law maker found it necessary to state that interest must be 'subject to tax' after taking into account the application of the relevant tax treaty, implies that it sought 'covered taxes' under the tax treaty, which foreign corporate tax forms part of, to be considered when applying the 'subject to tax' phrase in section 23M of the Act. However, because there is no common law regarding this construction, and South African tax scholars and SARS seem not to adopt a wider interpretation, there is doubt what court's view would be; and there is no doubt that SARS would challenge a wider construction. In the author's view, the more conservative approach to follow, is when the particular tax treaty expressly defines the word 'tax' such as in South Africa-Iran tax treaty.

4 CHAPTER 4 –'Subject to tax' in France, Sweden and Germany interest distributive rules tax treaties

4.1 Introduction

In this chapter, the meaning of the phrase 'subject to tax' as it is used in the interest distributive rule of the tax treaty is investigated. The consensus view by international tax scholars, relevant foreign courts decisions and practical application amongst countries is analysed to form a view regarding the meaning of this phrase. Thereafter, that meaning is reconciled with the phrase 'subject to tax' in section 23M(2)(i)(aa) of the Act.

In addition to section 23M(2)(i)(aa) of the Act, the phrase 'subject to tax' is, in deviation from the OECD MTC,[146] employed in the South Africa-Germany,[147] South Africa-France[148] and South Africa-Sweden[149] tax treaties' interest distributive articles. This is a bid to prevent international tax planning that would result in either double non-taxation[150] or a reduction of the South African withholding tax on interest in respect of interest accrued to non-resident creditor. This phrase is not defined in any of the three tax treaties mentioned and recourse (context permitting) cannot be had to the South African domestic tax law because there is no established meaning under the Act. For example, the following text on interest Article 11(1) of the South Africa-Sweden tax treaty (the wording is similar to South Africa-France tax treaty) stipulates that:[151]

> *'Interest arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State, provided such resident is the beneficial owner of the interest and is <u>subject to tax</u> thereon in that other State'. (author's emphasis)*

Notably, a 'resident' definition in Article 4(1)(b) of the same tax treaty uses a different phrase, namely, 'liable to tax', for a definition of who is a resident for the purpose of the tax treaty, which reads:[152]

> *'In the case of Sweden, any person who, under the laws of Sweden, is <u>liable to tax</u> therein…' (author's emphasis)*

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[146] The OECD MTC does advocate for the use of 'subject to tax' clause. See, paragraph 15 of the commentary to Article 1, *OECD MTC.*

[147] 'However, such interest may be taxed in the Contracting State in which it arises, and according to the law of that State; but the tax so charged shall not exceed 10% of the amount of the interest if such interest is <u>subject to tax</u> in the other Contracting State'. See supra note 32.

[148] Supra note 31.

[149] Supra note 30.

[150] See paragraph 35 of the commentary to Article 23A and B of the OECD MTC.

[151] Supra note 30.

[152] Ibid, Article 4(1)(b).

4.2 Consensus view amongst international tax scholars

The English dictionary, as mentioned, defines the meaning of the two phrases as the same. [153] On the other hand, in the context of the tax treaty, there is consensus that the phrase 'subject to tax' has a different meaning to the phrase 'liable to tax' (used to determine the personal scope of the tax treaty pattern after Article 4(1) of the OECD MTC), and that they are not synonymous. 'Subject to tax' requires an 'actual' accrual of an obligation to pay tax and 'liable to tax' describes the legal situation of a taxpayer.[154] Furthermore, Avery Jones asserts that the two concepts are used consistently in this particular way[155] in the context of tax treaties, as opposed to the context of the ordinary English dictionary meaning,[156] where a distinction is not made between the two concepts.

4.3 Practical application amongst countries

Lang,[157] in the IFA 2004 General Report convincingly revealed, based on a summary analysis,[158] that there is divergence on how these 'subject to tax' related provisions in the tax treaties are conceptually understood amongst international tax scholars and practitioners, and how they are applied in practice by different countries. For example, he points out that in some countries what is required is that income must 'taxed' (i.e. an inclusion of the tax base is enough), and in other countries, income must be 'effectively taxed' (i.e. requires proof that income was taxed and the tax was paid). He further argues (contrary to the consensus), that, in the context of the tax treaty, 'in some languages, the term 'subject to tax' means the same as 'liable to tax'. Therefore, the consideration relating to the term 'liable to tax' will also apply to those states in which the language does not make a distinction.[159] Lastly, 'these provisions are a reaction to a certain legal system valid at the time of the conclusion of the convention. Several DTCs [tax treaties] previously concluded with South Africa, for instance, contain 'subject-to-tax' clauses which become understandable against the backdrop of the fact that, in certain areas, South Africa based its taxation on the principle of territoriality,[160] explains Lang. It follows that there can be no generally accepted meaning of the phrase 'subject to tax' in practice.

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[153] Supra note 62.

[154] R. Ismer/K. Riemer, in Reimer & Rust (eds), *Klaus Vogel on Double Taxation Conventions,* 4th ed (2015) , p248; Also Avery Jones and other authors agrees, see: John F. Avery Jones, *Weiser v HMRC: Why do we need 'Liable to Tax' and 'Subject to Tax' clauses?,* British Tax Review, Volume 1 (2013); D Ward et al, *A Resident of a Contracting State for Tax Treaty Purpose: A Case Comment on Crown Forest Industries*, Canadian Tax Journal, Volume 44, Number 2,(1996) p408; W. Horak, *Tax Reform and Practice under the New South Africa Political Dispensation –A Critical Review*, Acta Juridaica 49 (2002), p78.

[155] See Avery Jones, supra note 154, p11.

[156] Supra note 62.

[157] M Lang, *Double non-taxation*, IFA General Report Cahiers, Volume 89a (2004) p11. Online Books IBFD

[158] Unfortunately, it appears that South Africa was not part of the reporting country as the South African report could not be found.

[159] Supra note 157.

[160] Ibid. p105.

4.4 Overview of the relevant foreign court rulings

In the absence of tax treaty case law and tax treaty policy and practice in South Africa regarding concept of 'subject to tax,'[161] the English decision of the First-tier Tribunal English court, though not determinative, is relevant and persuasive. The case dealt with the United Kingdom-Israel tax treaty pension distributive rule article,[162] which contained a similar clause on which the judge accepted the principle submitted by counsel for Her Majesty's Revenue and Customs, ruling as follows:

> *''Subject to tax', on the other hand, requires income actually to be within the charge to tax in the sense that a contracting state must include the income in question in the computation of the individual's taxable income with the result that tax will ordinarily be payable subject to deductions for allowances or reliefs…a person is not regarded as 'subject to tax' if the income in question is exempted from tax…'*[163]

The court followed the correct interpretation process prescribed in the VCLT, by seeking an autonomous meaning.[164] Furthermore, Hattingh and his co-authors[165] also opine, in light of the German Federal Tax Court ruling concerning the 'subject to tax' clause in the South Africa-Germany tax treaty pension distributive rule article,[166] that the ruling in that case is relevant in South Africa particularly if the matter concerns the South Africa-Germany tax treaty. The German court followed the country's settled case law in finding that the 'subject to tax' clause, entitled the source country to tax the income, in the absence of 'actual' taxation by the residence country if it fails to exercise its right to tax.

The South African decision in the *Downing*[167] case expressly acknowledged the existence of an 'international tax language'. It is unclear whether the South African courts would regard the phrase as having a consensus meaning shared by international tax scholars because the OECD MTC does not advocate the use this phrase and as Lang has revealed, it is not uniformly applied amongst countries. On the basis of 'common interpretation' of tax treaties however, the ruling(s) concerning this phrase made by

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[161] The author is of the view that there is no tax treaty policy objective in South Africa behind the use of this phrase and it is mainly used in a pursuit of demand of the tax treaty partner country. For example with regard to Germany, which is well known to pursue tax treaty policy and practice of preventing non-double tax by using, amongst other, 'subject to tax' and 'switch-over' clauses, it appears that it demanded this phrase as it is present in the following South Africa-Germany tax treaty articles: Interest, Independent Personal Services, Income from Employment, Pensions, Other Income and Royalties. See supra note 34 and for a recent evidence see, R Resch, *The New German Unilateral Switch-Over and Subject-to-Tax Rule,* Bulletin for International Taxation, Volume 47, Number 10, (2007), p480, Journals IBFD. As a results, it is challenging to interpret this special clause in the context of South Africa.

[162] Article XI(2),*Convention Between the Government of United Kingdom of Great Britain and Northern Ireland and The Government of Israel the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, (1963) (as amended through a protocol in 2019), Treaties IBFD

[163] *Paul Weiser v. Commissioners for Her Majesty's Revenue and Customs,* (2012) paragraph 37. Case Law IBFD

[164] See Avery Jones, supra note 154, at 9.

[165] T. Hagemann, J. Hattingh and C. Kahlenberg, *Recent Developments Regarding the Taxation of Pensions under Tax Treaties from a German and a South African Perspective.* Bulletin for International Taxation, Volume 71, Number 1, (2016) p7. Journal IBFD

[166] Supra note 32, Article 16(1).

[167] Supra note 77. p523.

foreign courts, such as the German court, can be applied (as submitted by Hattingh and his co-authors') if the courts find them plausible. The First-tier Tribunal English court case is also helpful on the basis that, as remarked in Chapter 1, the two countries follow the same legal system and South African courts regularly borrow from the English courts.

4.5 Conclusion

The views of international tax scholars, German Federal Tax Court and the First-tier Tribunal English court regarding the meaning of the phrase subject to tax, in the context of tax treaties, appears to be in consonance. The phrase, however, is not applied uniformly in practice amongst countries; perhaps over time there will be convergence. It follows, therefore, that South Africa, as the source country, can only waive its interest taxing rights (or with regard to South Africa-Germany tax treaty, grant the tax treaty benefit of withholding tax reduction) on condition that, interest is 'actually' subjected to Swedish (or French or Germany) tax. In other words, the non-resident creditor either in Sweden or France or Germany, can only enjoy the tax treaty benefits, namely, exemption from the South African withholding tax on interest (or reduced tax rate in case of Germany) in respect to interest, if that interest is included in the computation of the taxable income of the non-resident creditor, with the result that tax will be payable subject to deductions for allowance and reliefs. What is clear, however, is that the word 'tax' in the phrase 'subject to tax', for the purpose of these three tax treaties, refers to a 'foreign corporate tax', not South African tax. Therefore, the three tax treaties expand the word tax in 'subject to tax' test in section 23M(2)(i)(aa) to include foreign tax, and that construction is consistent with obligations of the tax treaties as discussed in Chapter 3.

5 CHAPTER 5 – Interest 'subject to (normal) tax'

5.1 Introduction

This chapter discusses the interest-charging provisions and the effect of applicable tax treaty relief provisions on them, to establish when is interest accrued to the non-resident creditor, 'subject to normal tax' in terms of section 23M(2)(i)(aa) of the Act.

5.2 Overview of the normal tax rules in respect of interest

In terms of the Act, a series of predetermined steps have to be taken to determine the non-resident creditor's 'taxable income' i.e. the tax base on which normal tax is levied, which includes the determination of 'gross income', defined in section 1 of the Act, as far as is relevant, as follows:

> *'in relation to any year or period of assessment means - (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 the Republic during such year or period of assessment, excluding receipts or accruals of capital nature…' (author's emphasis)*

Accordingly, interest 'accrued' to non-resident creditor falls within the definition only if it is from a 'source' within South African.[168] Where it does, there is a need to determine whether it constitutes 'income', discussed under sections 5.3 and section 5.4.

5.3 'Source' of interest

In this section the focus is on the interest source rules contained in section 9(2)(b), read with section 9(4)(b) of the Act, as well as the effect of the interest source rule on applicable tax treaty which is generally modelled after Article 11(5) of the OECD MTC.

5.3.1 Source of interest under the domestic tax law

The concept of 'source' in relation to interest accrued to non-resident creditors is codified in the Act since 2011.[169] Section 9(2)(b) of the Act deems the source to be in South Africa on either of the following bases: (i) the debtor paying the interest is a South African residence('hereinafter the debtor source principle')[170] and such interest is not attributed to a PE[171] outside South Africa, or; (ii) the debt is utilised or applied in

[168] 'Interest' as defined in section 24J(1) of the Act, is deemed, in terms of section 24J(3) of the Act to have accrued to non-resident creditor, provided it is from a source within South Africa, regardless 'whether or not the amount constitutes a receipt or accrual of a capital nature'

[169] Before the interest source rule principle was codified in 2011, the courts had developed the source principle in relation to interest. See two leading cases: *CIR v Lever Bros and Another* 1946 (AD) 441 and *First National Bank of Southern Africa Limited v CIR* 2002 (3) SA 375 (SCA).

[170] Section 9(2)(b)(i) of the Act.

[171] Neither the Act nor South African tax treaties contain proper steps to determine taxable income of a PE. This problem, however, is beyond to scope of this study. For general principle on how PE is taxed, see, for example, J. Hattingh and B. Newton, *The attribution*

South Africa even if the debtor is outside South Africa('hereinafter the utilisation source principle').[172] Any interest that does not meet the debtor or utilisation source principle is deemed to be from a source outside South Africa in terms of section 9(4)(b) of the Act. Therefore, it is submitted that post the introduction of the statutory source rule, there is no room to apply common law source principle because the statutory source rule provides for complete legal consequences in determining the source of interest. Accordingly, in the absence of a tax treaty, interest constitutes the non-resident creditor's gross income if the debtor is a South African resident or the debt is utilised in South Africa.

5.3.2 Source of interest under the tax treaties

A detailed discussion regarding the tax treaty source rule, particularly where a third country is involved, is beyond the scope of this study.[173] The tax treaty, in addition to the statutory source rule discussed above, introduces 'international source rule' which, in terms of Article 11(5) of the OECD MTC, deems interest to arise in the debtor's residence country i.e. the OECD MTC only follows the debtor source principle.[174] Virtually all the South African tax treaties contain the provision similar to Article 11(5) of the OECD MTC or its equivalent.

Article 22 of the South Africa-Australia tax treaty ,[175] at Australia's request,[176] contains deemed source rule which provides that income derived by an Australian resident which the tax treaty allocates the taxing right to South Africa shall, for the purpose of the South African domestic tax law, be deemed to arise from South African source. This deemed source rule is, in terms of the Australian case law capable of creating a new tax liability that will otherwise not have existed if the tax treaty was not applicable.[177] Therefore, on the basis of common interpretation of the deemed source rule, it is possible that an Australian non-resident creditor, might be liable to South African tax that would otherwise not have existed if there was no tax treaty between

of profits to permanent establishments, IFA South Africa Report Cahiers, Volume 91B, (2006). Online Books IBFD and A. Oguttu, *The Challenges of Taxing Profits Attributed to Permanent Establishments: A South African Perspective,* Bulletin for International Taxation, Volume 64, Number 3, (2010), Journals IBFD.

[172] Section 9(2)(b)(ii) of the Act.

[173] For a detailed discussion relating to source in a tax treaty, see, for example, John F. Avery Jones, *Tax treaty Problems relating to Source*, British Tax Review, Volume 3 (1998) p222 – 250.

[174] Vogel, supra note 74, p22.

[175] Supra note 115, Article 22.

[176] It is Australia's practice to include general deemed source in the tax treaty. See C. Taylor, *Some Distinctive Feature of Australian Tax Treaty Practice: An Examination of their Origins and Interpretation*, eJournal of Tax Research, Volume 9 (2011), p309 - 315

[177] See *Satyam Computer Service Ltd v Commissioner of Taxation*, (2018), Case Law IBFD. The case involved Article 23(1), Agreement between the Government of Australia and Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (July 1991), which has identical provision to South Africa-Australia tax treaty deemed source rule provision.

the two countries. This is a challenge to the well-known tax treaty principle that tax treaty is a shield not a sword.[178]

South Africa has waived its interest taxing right to the non-resident creditor's country in 19 of the 79 South African tax treaties.[179] As a result, there was no value to have international source rule in such tax treaties and the statutory source rule does not have an effect, since the right to tax interest is waived.

5.3.3 The effect of applicable tax treaty source rule on the statutory source rule

Evidently there is a conflict between the wider statutory source rule, which concerns the debtor or utilisation source principle, and the narrow (or non-existence due to waived interest taxing right) tax treaty source rule which only focus on the debtor source principle. Koole asserts that the statutory utilisation source principle is more accurate as a proxy to locate economic activity than a mere debtor-payment rule i.e. the debtor source principle under the tax treaty.[180] However, because the tax treaty becomes part of the Act,[181] of which provisions are read together with the Act, to the extent that the conflict exists, the tax treaty debtor source principle shall overrides the statutory utilisation of source principle, and such formulation is methodically correct.[182]

It can be argued that the statutory source rule ought to independently examine absent applicable tax treaty source rule, to firstly establish the non-resident creditor's gross income, and thereafter apply the tax treaty to relieve the normal tax liability.[183] It is submitted that this argument is not plausible. The tax treaty should apply along the domestic tax law intermediate steps, establishing the normal tax liability. This view is shared by Vogel, who asserts that the tax treaty acts like a stencil that is placed over the pattern of the domestic tax law and covers certain parts [intermediate steps], otherwise the tax treaty source rule is rendered ineffective.[184]

With regard to the South Africa-Australia tax treaty deemed source rule which is, as argued above, capable of creating a new tax liability that will otherwise not exists absent the tax treaty, it is submitted that, so far

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[178] See, supra note 76, paragraph 26 and Ibid, where the taxpayer sought reliance on the principle that the tax treaties are 'shields not swords'.

[179] Supra note 26.

[180] T Koole, *Withholding Tax in the era of BEPS, CIVs and Digital Economy,* IFA South Africa Report Cahiers, Volume 103B, (2018) p17

[181] Supra note 81, p191.

[182] See supra note 90, paragraph 25.

[183] Particularly by those who believe that for a tax treaty to apply, there must firstly be a tax in the source country, and similarly, a tax in the residence country. Whether tax will actually become due after allocation in terms of the tax treaty is not required. For example, see, Rood, supra note 28.

[184] Vogel, supra note 74, p26.

as interest income is concerned, it is unlikely to do so because the interest statutory source rule are wider than the South Africa-Australia source rule.

5.4 Interest 'income'

Only interest which is from the 'source' within South Africa as discussed above is included in the non-resident creditor's gross income. However, pursuant to section 10(1)(h) of the Act, the same interest is deducted from gross income to arrive at the non-resident creditor's interest 'income', as it is generally exempt from normal tax.[185] The word 'exempt' as employed in the Act means immune from tax [normal tax].[186] The exemption is subject to certain exceptions, amongst others, is when interest accrues to a PE of the non-resident creditor in South Africa. According to Roeleveld and West, the tax treaties which allocate exclusive rights to tax the interest to the non-resident creditor's country, appear to be aligned to the domestic interest exemption and the two provisions are in harmony.[187]

It follows that due to interest exemption and waived interest taxing right in applicable tax treaties, no interest 'income' is to be included in the computation of the non-resident creditor's taxable income.

5.5 Conclusion

It was argued that the non-resident creditor is liable to normal tax on interest only if, first, interest is from the 'source' within South Africa in terms of the statutory source rule read together with applicable tax treaty source rule, and, secondly, it is not exempt from normal tax and/or the right to tax it is not waived under applicable tax treaty. The wider statutory source rule concerns the debtor or utilisation source principle. It is cut by an applicable narrow tax treaty source rule (or non-existence), which only focuses on the debtor source principle, so that the latter will limit the former down to the extent that it is narrow.

With regard to interest 'income', it was highlighted that interest does not form part of the non-resident creditor's interest income. This is due to interest exemption rules, which are aligned to some of the tax treaties, despite the fact that it might have passed the source test to be included in gross income. However, even though it might fall within the gross income definition, it cannot be argued that is 'actually' taxed because it is immune from normal tax due to exemption. Therefore, for the purpose of section 23M(2)(i)(aa) of the Act, it is not subject to normal tax– an opinion shared by Mandy.[188]

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[185] The definition of an 'income' in section 1 of the Act,

[186] I. Isaacs, W. Fielding and L. Lazar, *Law and Practice of South African Income Tax*, 1963, p441; Also de Koker and Williams submit that, with regard to subject to tax in section 23M(2)(i)(aa), 'notwithstanding that an amount of interest may, for example, constitute gross income, it will not be regarded as being subject to tax if it is exempted'. See AP de Koker and R.C. Williams, *Silk on South African Income Tax*, Last updated October 2020. Section 13.39A. Lexis Nexis Online.

[187] J. Roeleveld and C. West, *New tendencies in tax treatment of cross-border interest of corporations*, IFA South Africa Report Cahiers, Volume 93B, (2008), p671

[188] Mandy, supra note 28, p48.

6 CHAPTER 6 – Interest 'subject to (withholding) tax'

6.1 Introduction

This chapter discusses the interest-charging provisions and the effect of applicable tax treaty relief provisions on them, to establish when interest is paid to the non-resident creditor, 'subject withholding tax on interest' for the purpose of section 23M(2)(i)(aa) of the Act.

6.2 Overview of withholding tax rules in respect of interest

Withholding tax on interest was enacted effective of 2015, however it is not new in South Africa *per se*.[189] The Act had 'non-resident tax on interest' up until 1997, which had a similar effect to withholding tax on interest.[190] The charging provision, as far as is relevant, provides as follow:[191]

> *Levy of withholding tax on interest -*
>
> *(1) (a) There must be levied for the benefit of the National Revenue Fund a tax, to be known as the withholding tax on interest, calculated -*
>
> *(i) at the rate of 15 per cent; or*
>
> *(ii) at such rate as the Minister may announce in the national annual budget contemplated in section 27(1) of the Public Finance Management Act, with effect from a date mentioned in that Announcement, of the amount of any interest that is <u>paid by any person</u> to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from <u>a source within the Republic in terms of section 9(2)(b)</u>.* (Author's emphasis)

Accordingly, similar to the normal tax charging provisions discussed in the previous chapter, the 'source' test is central in determining whether 'interest'[192] paid by any person[193] (the debtor included), to or for the

[189] The author is doubtful that withholding tax on interest is effective in addressing cross-border corporate tax leakage given the small percentage of withholding tax on interest to corporate tax collected thus far, namely, 0.22% (2017), 031% (2018) and 0.29% (2019). In addition, as compared to withholding tax on dividends (WTD), the withholding tax on interest is relatively insignificant i.e. 1.43% (2017), 2.83 %(2018), 2.09% (percentage of withholding tax on interest compared to WTD).

[190] Section 64A -64F of the Act, which was repealed in 1988.

[191] Section 50B of the Act.

[192] For the purpose of withholding tax on interest, with effect from 1 March 2016, interest is defined under section 24J (1) of the Act, but the definition refers to paragraphs (a) and (b). Therefore, interest as a result of sales and leaseback arrangements (i.e. paragraph (c) of the definition of interest in section 24J(1)) is excluded for from interest definition for the purpose of withholding tax on interest. Before the definition was codified in 1 March 2016, it bore the interest common law meaning. The word 'interest' has been defined as compensation for the use of money (see ITC 1496 53 SATC 229 at 249, ITC 1587 57 SATC 97 at 105, ITC 1588 57 SATC 148 at 152). In *Cactus Investments (Pty) Ltd v CIR* 1999 (1) JTLR 1, p5, the SCA held that this definition cannot always be applicable, but that in some instances interest can be regarded as the return an investor expects for his or her investment.

[193] 'The person who makes payment' in terms of section 50E(1) of the Act, might not be the debtor/issuer of a capital debt, for example it might be 'withholding agent' (in terms of the section 156 of the Tax Administration Act no. 28 of 2011, withholding agent is defined as a person who must under the Act, withhold an amount of tax and pay it to SARS). However, for the purpose of this study, the person who makes payment is the debtor. For detailed discussion of 'the person who makes payment', see, M. Bornman, C. Horn

benefit,[194] of the non-resident creditor is liable to withholding tax of 15 per cent, subject to local exemptions,[195] and applicable tax treaty relief discussed below.

6.3 'Source' of interest

The interest source rule(s) discussion in section 5.3 in relation to normal tax is equally applicable to withholding tax on interest, therefore there is no need to reiterate discussion in this chapter.

6.4 The effect of relief provisions of tax treaties

Once it has been established that the non-resident creditor paid interest from a source within South Africa, the next step is to determine whether the applicable tax treaty prevents or limits the interest-charging provisions. The right to tax interest is generally shared between South Africa and the non-resident creditor's country in terms of the tax treaties modelled on Article 11(2) of the OECD MTC. [196] However there are deviations in 19 tax treaties in which, as mentioned, the rights to tax are exclusively allocated to the non-resident creditor's country.

Where such right is shared, the South African 15 per cent tax rate is limited under applicable tax treaty as *lex specialis,* [197] as discussed below. Majority of the tax treaties limit the rate to ten per cent, as set out in the OECD MTC.[198] The South Africa-Germany treaty states that interest must be 'subject to tax' in the non-resident creditor's country for such treaty to limit the rate.[199]

The rest of the tax treaties where the rate is agreed through negotiations as suggested in terms of the UN Model, ranges from five to 25 per cent, of which only four set the rate at 15 per cent.[200] Notably, the one which sets the rate at 25 per cent is an old South Africa-Israel tax treaty. However, such rate is in essence ineffective because South Africa can only tax up to the 15 per cent rate set in the domestic tax law.

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and L. Bernard, *Withholding Tax on Interest: who has the Withholding Obligation*, Journal of Economics and Financial Sciences, Volume 12 Number 1 (2019), page 1-7 available at https://hdl.handle.net/10520/EJC-1d072e32b8 (accessed 10 September 2020)

[194] The phrase 'the benefit' is not defined for the purpose of withholding tax on interest, accordingly Kruger submits that for the context of passive incomes (interest included), it should be interpreted by applying the test of 'beneficial ownership' postulated by the Canadian Federal Court of Appeal, in *Prevost Car Inc. v Her Majesty the Queen*. In light of that case, Kruger submits that the essence of the beneficial ownership traits is of 'being in possession, use, risk and control'. See D. Kruger, *Who is a Beneficial Owner?* Volume 3, Issue 1, Business Tax and Company Law Quarterly, (2012), p8 -17 and the source cited therein.

[195] In terms of section 50D of the Act, various exemptions exist which SARS has concisely categorised in three, namely the debtor, instrument (debt) and the foreign person (non-resident creditor). See https://www.sars.gov.za/TaxTypes/WTI/Pages/default.aspx (accessed 15 September 2020)

[196] Article 11(2), *OECD MTC*

[197] Supra note 81, p191.

[198] See Appendix attached, under column [F]

[199] Supra note 32.

[200] Supra note 211.

6.5 Conclusion

The interest source rules as discussed in the previous chapter regarding normal tax applies equally to withholding tax on interest. Therefore, only once the interest has passed the source test can it form part of the non-resident creditor's tax base, which 15 per cent withholding tax rate is applied to, subject to a reduced rate in pursuant of the applicable tax treaty provisions, is levied.

Accordingly, it is submitted that the non-resident creditor is 'actually' taxed on interest even if the rate is reduced by an applicable tax treaty to a lower rate than 15 per cent. Similarly, Mazansky, states that, 'If the withholding tax is payable, even at a reduced rate under a tax treaty, but not zero, the interest limitation rules will not apply'.[201] One can argue that to an extent, interest income is not subject to a full 15 per cent of withholding tax on interest because the rate is reduced by an applicable tax treaty, it should be treated as 'proportionally' not subject to withholding tax on interest.

In the author's view, however, such argument is not convincing, firstly; the wording of section 23M(2)(i)(aa) of the Act, does not require quantification of either the rate nor the tax amount, the test only requires actual taxation. Secondly, as discussed, the heading of section 23M of the Act was amended to specifically cover the operation of the tax treaty which includes the rate reduction as a result of the tax treaty. However, where a nil tax rate applies, it is submitted that, it cannot be argued that a non-resident was actually taxed on interest, because factually there is no withholding tax on interest. It should be noted that a nil tax rate on the tax treaty is largely reserved for foreign portfolio investment and foreign government debt, not for FDI debt.

In conclusion, 'subject to withholding tax on interest' test is passed for the purpose of section 23M(2)(i)(aa) of the Act, if interest income accrued to non-resident creditor is included in the tax base, as a result of passing the source test- a mere symbolic tax amount will suffice. On the other hand, if interest is exempted from withholding tax on interest, either in terms of the domestic tax law or in terms of the tax treaty, it cannot be argued that withholding tax on interest was 'actually' levied.

[201] Mazansky, supra note 28, p181. E.

7 CHAPTER 7 – Summary and conclusions

In the absence a definition of the phrase 'subject to tax' in the Act, and uncertainty around it, the aim of this study was to propose an interpretation of this phrase for the purpose of section 23M(2)(i)(aa) of the Act. This is particularly important when it is read in the context of tax treaties and applied in the context of foreign corporate tax, normal tax and withholding tax on interest. It should be noted that it has a long history in international tax law, as such, it is employed in the South Africa-France, South Africa-Sweden and South Africa-Germany interest distributive rules tax treaties.

In the course of the detailed discussion in each chapter the findings have been summarized, with a general summary provided here.

Broadly, this study highlighted the following: firstly, in light of the pronouncement of the SCA in the *Natal Joint Municipal Pension Fund* case, the purposive interpretation rule ought to be followed to interpret the phrase 'subject to tax' in section 23M(2)(i)(aa) of the Act. This involves a process, the context and apparent purpose of Section 23M of the Act. As a result, the entire scheme of the Act, including the provisions of the applicable tax treaty relating to interest income and the definition of the word 'tax' and/or 'covered tax' thereof, forms part of context under which the phrase 'subject to tax' in section 23M(2)(i)(aa) of the Act is to be understood.

Secondly, while the *contra fiscum* rule still exists, the rule cannot be invoked when interpreting section 23M of the Act because it is a specific anti-tax avoidance provision. A better provision to invoke in an attempt to try and resolve uncertainty around this phrase, from the non-resident creditors' perspective, is the tax treaty rights.

Thirdly, the tax treaty is independently interpreted in accordance with the VCLT rules, in light of the entire object of an applicable tax treaty, which includes, to the extent applicable to this study, preventing cross-border economic double taxation on interest, non-discrimination with respect to the deduction of interest by non-resident creditor and encouraging FDI debt. Upon a conflict the between the Act and the tax treaty, the tax treaty prevails, and this includes when interpreting the specific anti-tax avoidance provision.

Lastly, the 'source' on interest, in terms of statutory source rule, read together with the applicable tax treaty source rule, and the right to tax interest in terms of applicable tax treaty, are key determinants of whether the non-resident creditor is liable to a normal tax or withholding tax.

Accordingly, following purposive interpretation rule, it was argued that the phrase 'subject to tax' means that the non-resident creditor must 'actually' be liable to pay tax on interest, subject to deductions, set-offs and foreign tax reliefs. With regard to the word 'tax' in the phrase 'subject to tax' in section 23M(2)(i)(aa) of the Act, it must be read together with the tax definition and/or 'covered tax' in the tax treaties. The word

‘tax’ and/or ‘covered tax’ under the tax treaty is interpreted autonomous to the word ‘tax’ under the Act. Therefore, if the non-resident creditor is liable to foreign corporate tax in respect of interest accrued from South African source, and foreign corporate tax falls within the ‘tax’ definition under the relevant tax treaty, foreign corporate tax falls within the definition of the word ‘tax’ in the phrase ‘subject to tax’ under section 23M(2)(i)(aa) of the Act, because the tax treaty widens the tax definition.

In the alternative, the mere fact that foreign corporate tax falls within virtually all the South African tax treaties ‘covered taxes’ and that implicit reference of the amended heading of section 23M(2)(i)(aa) of the Act to taxes under Chapter III, (which including covered taxes), therefore foreign corporate tax falls within the word ‘tax’. In addition, the South Africa-Sweden, South African-France, and South African-Germany tax treaties, where the phrase ‘subject to tax’ is employed in the interest distributive rule shield light that, for the purpose of these tax treaties, the tax in question is foreign corporate tax.

It was further argued that interest accrued to the non-resident creditor will not qualify as being ‘subject to tax’ in terms section 23M(2)(i)(aa) of the Act. This applies if wider statutory source rule concerns the debtor or utilisation source principle is cut by an applicable narrow tax treaty source rule (or non-existence), which only focuses on the debtor source principle, so that the latter will limit the former down to an to the extent that it is narrow.

Similarly, in respect of foreign corporate tax, if interest is included in the commutation of the foreign taxable income of the non-resident creditor with the result that foreign corporate tax will be payable subject to deductions for allowance and reliefs, it can be argued that the non-resident creditor was subject to tax in terms section 23M(2)(i)(aa) of the Act.

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APPENDIX

Condensed survey of South African tax treaty in relation to interest accrued to non-resident creditor*

[A]: No	[B]:Countries	[C]:Entry into force	[D]:Qualifying companies holding (%)	[E]:Allocation of taxing right	[F]:tax treaty limitation tax rate (%)	[G]:non-resident creditor's Foreign corporate tax rate (%) #	[H]:Opportunity to erode tax base ~	[I]:Definition of Tax	[G]:Interest deductibility provision
1	Algeria	12-Jun-00	10	Shared	10	26	Unlikely	-	Art24(4)
2	Australia	21-Dec-99	5	Shared	10	30	Unlikely	Art3(1)(i)	Art23A(3)
3	Austria	01-May-97	5	Waived	-	25	Likely	-	Art24(3)
4	Belarus	01-Jan-04	5	Shared	10	18	Unlikely	-	Art23(3)
5	Belgium	01-Jan-99	5	Shared	10	25	Unlikely	-	Art23(3)
6	Botswana	01-Jan-05	10	Shared	10	22	Unlikely	-	Art23(4)
7	Brazil	01-Jan-07	10	Shared	15	25	Unlikely	-	Art24(3)
8	Bulgaria	01-Jan-05	5	Shared	5	10	Likely	-	Art23(3)
9	Cameroon	01-Jan-18	10	Shared	10	33	Unlikely	Art3(1)(j)	Art25(3)
10	Canada	01-Jul-97	5	Shared	10	28	Unlikely	-	Art23(4)
11	Chile	01-Jan-17	5	Shared	15	27	Unlikely	-	Art23(4)

[A]: No	[B]:Countries	[C]:Entry into force	[D]:Qualifying companies holding (%)	[E]:Allocation of taxing right	[F]:tax treaty limitation tax rate (%)	[G]:non-resident creditor's Foreign corporate tax rate (%) #	[H]:Opportunity to erode tax base ~	[I]:Definition of Tax	[G]:Interest deductibility provision
12	China (People's Rep.)	01-Jan-02	5	Shared	10	25	Unlikely	Art3(1)(d)	Art24(3)
13	Congo (Democratic Republic)	01-Jan-13	5	Shared	10	30	Unlikely	-	Art22(4)
14	Croatia	01-Jan-98	5	Waived	-	18	Likely	Art3(1)(d)	Art23(4)
15	Cyprus	01-Jan-99	5	Waived	-	12.5	Likely	-	Art23(4)
16	Czech Republic	01-Mar-98	5	Waived	-	19	Likely	-	Art23(3)
17	Denmark	01-Jan-96	5	Waived	-	22	Likely	-	Art24(4)
18	Egypt	01-Feb-99	15	Shared	12	40.55	Unlikely	Art3(1)(j)	Art23(4)
19	Eswatini (formerly Swaziland)	01-Mar-05	10	Shared	10	27.5	Unlikely	-	Art23(4)
20	Ethiopia	01-Jan-07	10	Shared	8	30	Unlikely	Art3(1)(i)	Art23(4)
21	Finland	01-Jan-96	5	Waived	-	20	Likely	-	Art23(3)
22	France	01-Jan-96	5	Waived; only when ‘subject to (foreign)tax’	-	31	Unlikely	-	Art24(3)
23	Germany - old	01-Jan-65	7.5	Shared	10; only when ‘subject to (foreign)tax’	15	Unlikely	Art3(1)(d)	Art23(3)
24	Ghana	01-Jan-08	5	Shared	10	25	Unlikely	-	Art25(3)
25	Greece	01-Jan-04	5	Shared	8	29	Unlikely	-	Art24(3)

[A]: No	[B]:Countries	[C]:Entry into force	[D]:Qualifying companies holding (%)	[E]:Allocation of taxing right	[F]:tax treaty limitation tax rate (%)	[G]:non-resident creditor's Foreign corporate tax rate (%) #	[H]:Opportunity to erode tax base ~	[I]:Definition of Tax	[G]:Interest deductibility provision
26	Grenada - old	01-Jul-51	N/A	N/A	N/A	28	N/A	Art3(2)	
27	Hong Kong	30-Sep-14	5	Shared	10	16.5	Likely ^	Art3(1)(i)	Art22(3)
28	Hungary	05-May-96	5	Waived	-	9	Likely	-	Art24(3)
29	India	01-Jan-98	10	Shared	10	30	Unlikely	Art3(1)(k)	Art23(5)
30	Indonesia	01-Jan-99	10	Shared	10	25	Unlikely	-	Art23(4)
31	Iran	01-Jan-99	10	Shared	5	25	Unlikely	Art3(1)(d)	Art23(4)
32	Ireland (Iceland)	01-Jan-98	5	Waived	-	25	Likely	-	Art24(4)
33	Israel - old	01-Mar-78	25	Shared	25	23	Unlikely	Art3(1)(f)	Art24(4)
34	Italy	01-Jan-00	5	Shared	10	24	Unlikely	-	Art24(3)
35	Japan	01-Jan-98	5	Shared	10	23	Unlikely	Art3(1)(j)	Art23(3)
36	Kenya	01-Jan-16	10	Shared	10	30	Unlikely	-	Art24(3)
37	Korea (Rep.)	01-Jan-97	5	Shared	10	25	Unlikely	-	Art24(4)
38	Kuwait	01-Jun-06	0	Waived	-	15	Likely	-	Art24(4)
39	Lesotho	01-Mar-17	10	Shared	10	25	Unlikely	-	Art24(3)
40	Luxembourg	01-Jan-01	5	Waived	-	24.9	Likely	-	Art24(3)
41	Malawi - old	01-Jul-68	N/A	N/A	N/A	30	Unlikely	ArtII(1)(d)	-
42	Malaysia	01-Jan-07	5	Shared	10	24	Likely ^	-	Art24(4)

[A]: No	[B]:Countries	[C]:Entry into force	[D]:Qualifying companies holding (%)	[E]:Allocation of taxing right	[F]:tax treaty limitation tax rate (%)	[G]:non-resident creditor's Foreign corporate tax rate (%) #	[H]:Opportunity to erode tax base ~	[I]:Definition of Tax	[G]:Interest deductibility provision
43	Malta	01-Jan-98	5	Shared	10	35	Unlikely	-	Art23(3)
44	Mauritius	01-Jan-16	5	Shared	10	15	Unlikely	Art3(1)(i)	Art23(3)
45	Mexico	01-Jan-11	5	Shared	10	30	Unlikely	-	Art23(3)
46	Mozambique	01-Jan-10	8	Shared	8	32	Unlikely	-	Art23(4)
47	Namibia	01-Jan-00	5	Shared	10	32	Unlikely	-	Art24(3)
48	Netherlands	01-Jan-09	5	Waived	-	25	Likely	-	Art25(3)
49	New Zealand	01-Jan-05	5	Shared	10	28	Unlikely	-	Art22(3)
50	Nigeria	01-Jan-09	7.5	Shared	7.5	30	Unlikely	-	Art23(3)
51	Norway	01-Jan-97	5	Waived	-	25	Likely	-	Art24(3)
52	Oman	01-Jan-04	5	Waived	-	15	Likely	-	Art22(3)
53	Pakistan	01-Jan-00	10	Shared	10	29	Unlikely	-	Art23(4)
54	Poland	01-Jan-96	5	Shared	10	19	Unlikely	-	Art23(4)
55	Portugal	01-Jan-09	10	Shared	10	17	Unlikely	-	Art24(3)
56	Qatar	01-Jan-16	5	Shared	10	10	Likely	Art3(1)(i)	Art22(3)
57	Romania	01-Jan-96	15	Shared	15	16	Unlikely	-	Art24(4)
58	Russia	01-Sep-00	10	Shared	10	20	Unlikely	-	Art23(4)
59	Rwanda	01-Jan-11	10	Shared	10	30	Unlikely	-	Art23(3)

[A]: No	[B]:Countries	[C]:Entry into force	[D]:Qualifying companies holding (%)	[E]:Allocation of taxing right	[F]:tax treaty limitation tax rate (%)	[G]:non-resident creditor's Foreign corporate tax rate (%) #	[H]:Opportunity to erode tax base ~	[I]:Definition of Tax	[G]:Interest deductibility provision
60	Saudi Arabia	01-Jan-09	5	Shared	5	20	Unlikely	-	-
61	Seychelles	01-Jan-03	5	Waived	-	30	Unlikely	-	Art24(4)
62	Sierra Leone - old	01-Jul-51	0	N/A	N/A	30	Unlikely	ArtII(2)	-
63	Singapore	01-Jan-17	5	Shared	7.5	17	Unlikely	-	Art22(3)
64	Slovak Republic	01-Sep-99	5	Waived	-	21	Likely	-	Art23(3)
65	Spain	01-Jan-08	5	Shared	5	25	Unlikely	-	Art23(3)
66	Sweden	01-Jan-96	5	Waived; only when 'subject to (foreign)tax'	-	22	Unlikely	-	Art23(3)
67	Switzerland	01-Jan-10	5	Shared	5	8.5	Likely	-	Art23(3)
68	Taiwan	01-Nov-96	5	Shared	10	20	Unlikely	-	Art23(3)
69	Tanzania	01-Aug-07	10	Shared	10	30	Unlikely	-	Art22(4)
70	Thailand	01-Jan-97	10	Shared	15	20	Unlikely	-	Art23(3)
71	Tunisia	01-Jan-00	10	Shared	12	25	Unlikely	-	Art23(4)
72	Turkey	01-Jan-07	10	Shared	10	22	Unlikely	Art3(1)(c)	Art23(5)
73	Uganda	01-Jan-02	10	Shared	10	30	Unlikely	-	Art24(4)
74	Ukraine	01-Jan-05	5	Shared	10	18	Unlikely	-	Art22(4)
75	United Arab Emirates	01-Jan-17	5	Shared	10	20	Unlikely	ArtII(1)(d)	Art23(3)

[A]: No	[B]:Countries	[C]:Entry into force	[D]:Qualifying companies holding (%)	[E]:Allocation of taxing right	[F]:tax treaty limitation tax rate (%)	[G]:non-resident creditor's Foreign corporate tax rate (%) #	[H]:Opportunity to erode tax base ~	[I]:Definition of Tax	[G]:Interest deductibility provision
76	United Kingdom	01-Jan-03	5	Waived	-	19	Likely	-	Art23(3)
77	United States	01-Jan-98	5	Waived	-	21	Likely	-	Art24(5)
78	Zambia - old	01-Jul-53	N/A	N/A	N/A	35	Unlikely	-	-
79	Zimbabwe	01-Mar-17	5	Shared	5	24.7	Unlikely	-	Art23(3)

Explanation of the Tick marks.

*	Adopted from IBFD withholding tax table rate for South Africa. Table IBFD (Last reviewed: 19 February 2020)
#	See Country Tax Guides IBFD (accessed 01 March 2020)
^	Foreign source interest exempt see; https://taxsummaries.pwc.com/malaysia/corporate/income-determination (accessed 01 March 2020)
~	Likely is when interest is exempt (or taxed at less 15%) from South African withholding tax on interest and tax at a lower foreign corporate tax