



**THE AVAILABILITY OF TREATY RELIEF FOR SECONDARY TRANSFER PRICING
ADJUSTMENTS TAKING THE FORM OF A DEEMED DISTRIBUTION OF AN ASSET
IN *SPECIE* IN SOUTH AFRICA**

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ABSTRACT

The number of MNEs have increased substantially in recent years, putting a strain on international tax rules which have not developed at the same pace. Many of these MNEs have kept their tax bill at a minimum by shifting profits to low tax jurisdictions by using transfer prices that do not accord with economic reality.

In response hereto, many tax jurisdictions have implemented domestic anti-avoidance legislation to assist tax authorities in curbing tax avoidance resulting from the manipulation of transfer prices. SA is an example of such a country. These anti-avoidance provisions typically involve a primary and secondary adjustment. The primary adjustment requires that an adjustment be made to the transfer price used by the MNE in the event that the said price does not reflect an arm's length price. The secondary adjustment concerns itself with making the actual allocation of funds consistent with the primary adjustment by deeming there to be another transaction, i.e. the secondary transaction. In SA, this secondary adjustment takes the form of a deemed distribution of an asset in *specie* in the case of residents who are companies. As such, this secondary transaction (i.e. the deemed dividend) is subject to Dividends Tax in SA levied at the domestic rate.

This study considered whether such a deemed dividend will qualify for treaty relief in the form of the reduced rate provided for by Article 10 of the OECD MTC and UN MTC.

In making this analysis, three main issues were specifically considered, namely (i) whether the SA company paying the Dividends Tax will have access to treaty relief in cases where Dividends Tax is not listed as a covered tax in the relevant tax treaty, (ii) whether a deemed dividend under a secondary adjustment in terms of SA domestic law falls within the dividend definition contained in Article 10.3 of the OECD and UN MTC, and finally (iii) whether the relevant deemed dividend can be regarded as 'paid' for purposes of Article 10.1 and 10.2 of the OECD MTC and UN MTC.

It was concluded that the SA Company will not qualify for the reduced rate provided for by tax treaties modelled on the OECD MTC and UN MTC as the deemed dividend does not fall within the ambit of the dividend definition contained in these model treaties. However, some of SA's tax treaties currently in force, deviate from the wording used in these model

treaties to such an extent that it brings deemed dividends under a secondary adjustment in SA within the scope of the dividend definition, and in doing so, provides the SA Company with access to the reduced rates provided for in tax treaties. Examples hereof are the tax treaties that SA have concluded with the UK and NZ.

Should SA decide to adopt a more 'forgiving' approach towards the availability of relief for secondary adjustments, it is recommended that SA either amend the domestic relief provisions to allow access to such relief, or amend the dividend definition contained in the tax treaties it currently has in force to include deemed dividends in terms of secondary adjustments in SA. The first approach is preferred as it is not always possible and timely to amend tax treaties currently in force.

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LIST OF ABBREVIATIONS

Abbreviation	Meaning
BEPS	Base erosion and profit shifting
DTA	Double tax agreement
GAAR	General anti-avoidance rule
G20	Group of twenty
ITA	Income Tax Act, No. 58 of 1962
MNE	Multinational enterprise
NZ	New-Zealand
NRST	Non-resident shareholders' tax
OECD	Organisation of Economic Cooperation and Development
OECD MTC	OECD Model Tax Convention on Income and on Capital (2014)
OECD MTC (2010)	OECD Model Tax Convention on Income and on Capital (2010)
OECD MTC (2008)	OECD Model Tax Convention on Income and on Capital (2008)
OECD TPG	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010)
SA	Republic of South Africa
SARS	South African Revenue Services
STC	Secondary Tax on Companies
TP	Transfer pricing
UK	United Kingdom
UN	United Nations
UN MTC	UN Model Tax Convention on Income and on Capital (2011)

CHAPTER 1: INTRODUCTION

1.1 Background: Secondary adjustments and the OECD and UN perspectives

The phenomenon of moving profits to low tax jurisdictions by using transfer prices that do not accord with economic reality has always been of concern to taxing jurisdictions. However, as recently pointed out by the Organisation of Economic Cooperation and Development (OECD), international tax issues have never been as high on the political agenda as they are today.¹ The number of multinational enterprises (MNEs) have increased substantially in recent years, putting a strain on international tax rules which have not developed at the same pace. Although the OECD/G20 base erosion and profit shifting (BEPS) project has mainly focussed on the weaknesses in the current rules which create opportunities for BEPS, one must not lose sight of those areas in want of further development to avoid situations of double taxation without a mechanism for relief. One such area is the so-called secondary transfer pricing (TP) adjustment.

The focus of policies and debates on TP has largely been directed to the question of how to determine an arm's length price (i.e. primary TP adjustment) in order to ensure that profits are taxed where economic activities take place and value is created.² A subject somewhat left in the cold, is the tax consequences of the secondary adjustment that may be triggered by a TP assessment.

After a primary TP adjustment, it is not uncommon to have funds in the hands of one associated enterprise when, if in line with that primary adjustment, they should be in the possession of another associated enterprise.³ To make the actual allocation of funds consistent with that primary adjustment, some countries deem there to be a constructive transaction, i.e. the secondary transaction.⁴ These secondary transactions are based entirely on domestic law, and as such the rules and tax treatment thereof may vary substantially among the tax jurisdictions of the contracting parties. It however typically takes the form of

¹ OECD/G20 BEPS Action 13: 2015 Final Report, 2015:3

² Teixeira, 2009:449. OECD/G20 BEPS Action 13:2015 Final Report, 2015:3

³ Teixeira, 2009:449

⁴ Teixeira, 2009:449

a constructive dividend,⁵ a constructive capital contribution or a constructive loan. Some countries, however, choose not to make provision for a secondary transaction in their domestic TP legislation at all. These disparities in domestic legislation may lead to double taxation.

Tax treaties play a fundamental role in the relief of double taxation in order to reduce the costs of MNEs in their cross-border transactions. Article 9 of the OECD Model Tax Convention on Income and on Capital (2014) (OECD MTC) is one such example and deals specifically with the taxation of associated enterprises (i.e. MNEs). It provides that profits should be allocated between the two contracting states by using an arm's length price; and that should a contracting state make a TP adjustment to achieve such an arm's length price, the other state will be required to make a corresponding adjustment to prevent the potential for double taxation. Such a corresponding adjustment is however only required if the other contracting state considers it justified both in principle and as regards the amount, i.e. in essence, if the other state agrees with the arm's length price determined by the state who made the TP adjustment.

The Commentary on paragraph 2 of Article 9 of the OECD MTC however notes that the article does not deal with secondary adjustments.⁶ Hence it neither forbids nor requires tax administrations to make secondary adjustments⁷. Article 9 therefore does not provide a mechanism for relief for double taxation resulting from secondary adjustments. Vogel however notes that '(a)lthough secondary adjustments are neither required nor prohibited by Article 9, it is appropriate that, once they are imposed under the terms of the country's domestic law, the country still has to take into account other provisions of the treaty' in order to address any potential double taxation.⁸

The question therefore arises whether, and to what extent, secondary transactions, asserted by tax authorities in terms of their domestic law, will qualify for relief under the distributive

⁵ The OECD makes use of the term 'constructive dividend', whereas it is more commonly referred to as a 'deemed dividend' in South Africa. Both terms will be used interchangeably in this study, but will carry the same meaning throughout this study.

⁶ Refer to par. 8 of the said commentary.

⁷ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TPG), 2010:par. 4.69

⁸ Vogel, 1997:557,n.44

rules of the treaty. For example, will secondary adjustments taking the form of constructive dividends (i.e. deemed dividends) enjoy protection under Article 10 of the OECD MTC so as to restrict the taxing rights of the state imposing the dividend withholding tax? The view of the OECD, as will be explained later in this study, is that secondary adjustments in the form of constructive dividends fall within the ambit of Article 10, provided that they are treated as dividends (i.e. constructive dividends) under the domestic law of the country where the 'payer' is a resident. As such, relief is available in the form of a reduced rate for Dividends Tax in terms of Article 10.

The view expressed above is however specific to the OECD and its member states. South Africa (SA), although currently being considered for membership of the OECD, is not a member yet and is therefore not bound by the view of the OECD, although SA courts have shown to be guided by the interpretation of the OECD in the interpretation of treaties modelled on the OECD MTC.⁹

SA is however a member state of the United Nations (UN) and, as will be shown later in this study, the UN seems to share the view of the OECD insofar as it relates to the treatment of secondary adjustments in terms of Article 9 and 10 of the UN Model Tax Convention on Income and Capital (2011) (UN MTC).

1.2 Treatment of Secondary Adjustments in SA: History and recent developments

Exchange controls in SA have historically provided some protection against the more significant manipulation of transfer pricing to transfer profits to lower tax jurisdictions.¹⁰ In anticipation of the relaxation of exchange controls and the envisaged adverse effect on the SA tax base, transfer pricing legislation, in the form of section 31, was introduced into the Income Tax Act, No. 58 of 1962 (ITA) in 1995.¹¹

At the time, the secondary adjustment was included in a separate section of the ITA, namely section 64C(3)(e). The said section deemed any amount adjusted or disallowed in terms of

⁹ Du Plessis, 2012:43

¹⁰ SARS Practice Note No. 7, 199:6

¹¹ Ibid

section 31 of the ITA to be a dividend that has been declared and distributed to a recipient by the South African company. At the time, SA taxed dividends by means of a Secondary Tax on Companies (STC), as part of a two-tier system of levying corporate taxes on income. STC was imposed at the second stage on a resident company on the 'net amount'¹² when a dividend was declared by the company. It was therefore a tax levied at the company level, and not a tax levied on the shareholder as is typically the case with dividends tax.

STC was repealed and replaced with dividends tax effective 1 April 2012. Due to this change, the National Treasury indicated that the automatic deemed dividend rule (i.e. section 64C(3)(e)) stemming from a transfer pricing adjustment would not continue in the new Dividends Tax regime.¹³ Instead, National Treasury opted to include the secondary adjustment in section 31 of the ITA directly and to have it take the form of a deemed loan by the South African taxpayer to the non-resident.¹⁴ The secondary adjustment therefore resulted in the South African taxpayer being taxed on a notional interest amount, calculated by using an arm's length interest rate applied to the loan, until the deemed loan was repaid to the South African taxpayer.¹⁵

However, this legislative change was short-lived as keeping track of secondary adjustments in the form of a deemed loan proved to be a significant administrative burden both for the taxpayer and SARS.¹⁶ Furthermore, the deemed loan was rarely repaid by the foreign entity for a number of reasons, including, that there were no obligations to do so.¹⁷ Exchange control restrictions in the country of the connected person also made it impossible in certain instances to repatriate the funds resulting in an ongoing interest charge for tax purposes.¹⁸

In view of the above, National Treasury revised the form of secondary adjustments with effect from 1 January 2015. As of this date, in the case of residents who are companies, the secondary adjustment is deemed to be a dividend consisting of a distribution of an asset in

¹² The net amount is the amount by which a dividend declared exceeds the sum of incoming dividends accrued during the 'dividend cycle'. A dividend cycle begins and ends each time a dividend is declared.

¹³ Explanatory Memorandum to the Revenue Laws Amendment Bill, 2011:116

¹⁴ Ibid:117

¹⁵ Ibid:117

¹⁶ Joubert & Isaac, 2015

¹⁷ Explanatory Memorandum to the Revenue Laws Amendment Bill, 2014:61

¹⁸ Ibid:62

specie declared and paid by that resident to that other person.¹⁹ Dividends (including deemed dividends) are subject to Dividends Tax in SA at a rate of 15%.²⁰ As the deemed dividend takes on the form of a distribution of an asset '*in specie*', the dividends tax will be levied at the company level in terms of section 64EA of the ITA, and not on the shareholder (i.e. beneficial owner) as is the case with cash dividends.

In the case of residents other than a company, the secondary adjustment takes the form of a deemed donation subject to 20% donations tax. This study will however focus only on residents who are companies, and therefore only on secondary adjustments that take the form of a deemed dividend.

1.3 Research question

Given that the latest legislative change regarding the form of the secondary adjustment has only been in effect since 1 January 2015, the tax consequences thereof and the potential for double taxation is still relatively unexplored and uncertain.

Following the change, the question has arisen whether the secondary adjustment in the form of a deemed distribution of an asset in *specie* will qualify for relief from potential double taxation, albeit in terms of domestic legislation or in terms of the relevant treaty provisions.

The present uncertainty is especially due to the remarks made by the Davis Tax Committee²¹ in its First Interim Report on Action 13 of BEPS, which read:

It is suggested that the secondary adjustment should take into account the fact that, regardless of the relationship between the South African taxpayer and the counterparty, a transfer pricing adjustment is triggered as a result of economic value being transferred from South Africa for no, or inadequate, consideration. This transfer of economic value results in depletion in the asset base of the South African taxpayer; and a resultant potential loss of future taxable income for the Fiscus. For this reason it

¹⁹ Refer section 31(3)(i) of the Income Tax Act, No. 58 of 1962, as amended [ITA].

²⁰ Refer section 64E of the ITA.

²¹ The Davis Tax Committee has been mandated by SA's Minister of Finance to assess SA's tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability in SA. The Committee only makes recommendations to the Minister of Finance in this regard, and it is left to the hands of National Treasury to decide whether to implement the recommendations or not.

is suggested that transfer pricing adjustments are economically similar to outbound payments of dividends to foreign related parties since they represent a distribution of value from South Africa to the foreign company. Therefore the secondary adjustment mechanism should result in a tax equivalent to the proposed 15% withholding tax. For example, a tax similar to the old secondary tax on companies (STC) would be appropriate. Because it would be a tax levied on the South African company rather than on the foreign related party, *no DTA relief would be available* (Davis, 2014:22). (emphasis added)

This report was released on 30 September 2014, three months prior to the effective date of the legislative change in regards to secondary adjustments. From the above extract from the report, it is clear that the Davis Tax Committee was in favour of treating the secondary transaction as a deemed dividend, and that the deemed dividend should be taxed similar to the repealed STC so that it would not qualify for relief in terms of a treaty. This suggestion is presumably based on the argument that the relevant double tax agreement (DTA) only provides relief from double taxation in the hands of the beneficial owner (i.e. the shareholder) of the dividend, and not the company paying the dividend.²² The Taxation Laws Amendment Act of 2014, which contained the relevant legislative change in regards to secondary adjustments, was promulgated on 20 January 2015. From the timing and the fact that the deemed dividend takes the form of a distribution of an asset in *specie* (thereby resulting in the Dividends Tax being levied at the company level), it appears as though the view expressed by the Davis Tax Committee played a strong part in the promulgation of the legislative change. The report of the Davis Tax Committee only makes recommendations, and therefore is not binding in law but it may be indicative of how the South African Revenue Services (SARS) will interpret and apply the amendment, leaving resident taxpayers in the dark as to whether such secondary transactions will qualify for relief or not.

It is furthermore interesting to note that most of the DTA's that SA currently has in force, only covers non-resident shareholders' tax (NRST) and/or STC in regards to dividend income. Dividends Tax is not specifically listed as one of the 'taxes covered' in nearly all of SA's treaties. This is the case even for some treaties concluded after the introduction of Dividends Tax in SA in 2012, an example hereof being the recent DTA concluded between SA and the Republic of Chile.

²² This issue will be addressed in detail in Chapter 2 of this study.

This results in further uncertainty as to whether any relief is available in SA for Dividends Tax under treaties which only list NRST and/or STC as the existing taxes covered under Article 2 of the relevant treaty.

This study will therefore aim to provide more clarity by answering the question as to whether the secondary adjustment, in the form of a deemed distribution of an asset in *specie*, will qualify for treaty relief, and especially the relief provided for in Article 10 of the OECD MTC and UN MTC. This article makes provision for relief in the form of a reduced rate at which Dividends Tax may be levied on the dividend in the source state.

1.4 Research method

A qualitative approach based on a literature study of purely theoretical aspects and documentary analysis is used as the research method. The research strategy followed is doctrinal in nature, i.e. research which “provides a systematic exposition of the rules governing a particular legal category, analyses the relationships between rules, explains areas of difficulty and, perhaps, predicts future developments”²³. The doctrinal research method adopted will entail the following steps:

- Identification of the applicable legal requirements;
- Analysis of the issue(s) from a legislative viewpoint;
- Studying of sources such as commentaries on the OECD and UN MTC, explanatory memorandums, textbooks, journal articles *etcetera* as background;
- Use of primary sources such as case law and legislation;
- Synthesising of all issues within the appropriate context; and
- The drawing of an effective and meaningful conclusion.

The research method will be conducted by considering the following:

- Whether the SA company paying the Dividends Tax on the secondary adjustment will have access to treaty relief especially given the fact that Dividends Tax is not listed as a covered tax in most of SA’s current treaties in force;

²³ Hutchinson & Duncan, 2012:101

- Whether a deemed dividend under a secondary adjustment falls within the dividend definition as contained in Article 10.3 of the OECD MTC and UN MTC;
- Whether a deemed dividend under a secondary adjustment can be regarded as 'paid' within the meaning of Articles 10.1 and 10.2 of the OECD MTC and UN MTC.

The OECD MTC and UN MTC have been selected for the purpose of this study for the following reasons:

- The OECD MTC is generally considered as the most influential of the model tax conventions and used widely, not only by OECD members, but also by non-OECD members.²⁴ SA is party to about 75 bilateral treaties²⁵ for the prevention of double taxation on different types of income and capital gains, and most of these treaties are based on the OECD MTC²⁶. As mentioned above, South African courts, have in the past referred to the commentaries on the OECD MTC for purposes of interpreting treaty provisions.
- The UN Model has been specifically designed to assist developing countries in tax treaty negotiations. It allows for greater taxing rights to be retained by developing countries over income and capital arising from transactions within their borders.²⁷ SA is viewed as a developing country and is a member of the UN.

1.5 Limitations

This study will not consider other forms of relief provided for in accordance with the following articles of the OECD MTC and UN MTC:

- Methods for elimination of double taxation - Article 23;
- Mutual Agreement Procedure and Arbitration – Article 25.

²⁴ Du Plessis, 2012:31

²⁵ SARS website. Available: <http://www.sars.gov.za/Legal/International-Treaties-Agreements/Pages/default.aspx?country=> [2016, September 6]

²⁶ Du Plessis, 2012:31

²⁷ Bland, 2013:5

This study will also not consider any forms of domestic relief available for deemed dividends under a secondary adjustment in SA. Furthermore, as referred to above, this study will not consider secondary transactions in the form of deemed donations.

1.6 Chapter outline

Chapter 2 considers whether the SA company paying the Dividends Tax on the secondary adjustment will have access to treaty relief especially given the fact that Dividends Tax is not listed as a covered tax in most of SA's current treaties in force. In answering this question, the chapter analyses the judgement made in *Volkswagen of South Africa (Pty) Ltd v C: SARS*²⁸ (*Volkswagen case*) and the ruling made by SARS in Binding General Ruling No. 9 (Issue 2) (BGR 9), issued on 19 February 2013. The Volkswagen case involved a South African-resident wholly owned subsidiary of a German holding company that sought to obtain a rate of STC of 7,5% under Article 7 (Dividend article) of the tax treaty with Germany. BGR 9, was issued subsequent to the judgement in the Volkswagen case and dealt with the question whether the now repealed STC and dividends tax can be regarded as 'substantially similar taxes' for purposes of SA's tax treaties.

Chapter 3 considers whether a deemed dividend under a secondary adjustment in SA falls within the dividend definition contained in Article 10.3 of the OECD MTC and UN MTC. The latest commentaries on the OECD MTC and UN MTC are considered as well as the European Union's Final Report on Secondary Adjustments and relevant articles written on the matter. This Chapter also analyses the current treaty that SA has in force with New Zealand (NZ) and the United Kingdom (UK), as these treaties deviate from the wording used in the dividend definition in the OECD MTC and UN MTC. The effect of the deviation is also considered.

Chapter 4 considers whether the deemed dividend under a secondary adjustment in SA can be regarded as 'paid' for purposes of Article 10.1 and 10.2 of the OECD MTC and UN MTC. Again the latest commentaries on the OECD MTC and UN MTC are considered, as well as relevant articles on the matter and the current treaties that SA has in force with the UK and NZ.

²⁸ [2008] JOL 21746 (T), 70 SATC 195

Chapter 5 concludes with a summary of the main findings as to whether deemed dividends under a secondary adjustment in SA will qualify for a reduced rate in terms of Article 10 of the OECD MTC and UN MTC. This chapter will also consider any recommendations or areas that may require further research.

CHAPTER 2: DIVIDENDS TAX – A COVERED TAX FOR SA TREATY PURPOSES?

2.1 Introduction

Chapter 1 outlined that the secondary adjustment in SA, in so far as it relates to residents who are companies, takes the form of a deemed dividend and is subject to Dividends Tax at a rate of 15%. Given the potential for double taxation, as outlined in Chapter 1, SA companies may wish to seek the relief provided for by Article 10 of the OECD MTC and UN MTC²⁹ in the form of a reduced rate of Dividends Tax.

However, before one endeavours to establish whether the relief provided for by Article 10 of the OECD MTC applies, one first needs to consider whether the SA company will have access to treaty relief given the fact that Dividends Tax is not listed as a covered tax in most of SA's current treaties in force.

Should this question be answered in the negative, the SA company will not have access to the relief provided for by SA's treaty network and will have to look at domestic legislation for potential relief.

Should this question be answered in the affirmative the SA company will have access to the relief provided for by SA's treaty network, but it does, however, not follow automatically that the SA company will qualify for the relief provided for in Article 10 of the OECD MTC specifically. The further requirements of Article 10 will need to be considered before one can conclude on this point.³⁰

For purposes of this study it will be assumed that the SA company will have access to the treaty benefits provided for by SA's treaty network by virtue of the fact that it qualifies as a 'person' for treaty purposes and is subject to unlimited tax liability in SA.

This chapter will now proceed to consider whether Dividends Tax can be regarded as a covered tax for SA tax treaty purposes.

²⁹ Unless specifically stated otherwise, hereinafter all references to 'OECD MTC' will also include a reference to the UN MTC. Where the UN MTC significantly deviates from the OECD MTC, it will be stated specifically in this study. Refer to Appendix A for a comparison between the two mentioned models as support for the contention that the models are substantially similar to one another for purposes of this study.

³⁰ Refer to Chapter 3 for a consideration of the further requirements of Article 10 of the OECD MTC.

2.2 Is Dividends Tax covered by SA's treaty network?

2.2.1 Introduction

Dividends Tax only came into effect in SA on 1 April 2012. It is therefore not listed as a 'covered tax' in almost all of the treaties that SA currently has in force. This is due to the fact that most of these treaties were concluded prior to 1 April 2012. Furthermore, the subsequent protocols concluded to amend the existing treaties on the back of the introduction of Dividends Tax in SA, in most cases, only revised Article 10 of the treaty with no subsequent change being made to the 'taxes covered' under Article 2 of the treaty. As such, these treaties typically only cover non-resident shareholders' tax (NRST)³¹ and/or STC in regards to dividend income. This begs the question whether any relief is available in SA for Dividends Tax under treaties which only list NRST and/or STC as the existing taxes covered under Article 2 of the relevant treaty.

Article 2 of the OECD MTC, in addition to providing a list of taxes to be covered by the treaty, clearly states that the treaty will also apply to any subsequent taxes that are *identical or substantially similar taxes* to those specifically listed in Article 2. In the context of this study, the above question can therefore be further distilled by asking whether Dividends Tax can be seen as an identical or substantially similar tax to STC and/or NRST for SA tax treaty purposes.

This Chapter will seek to provide more clarity on the above question by analysing the judgement in the Volkswagen case handed down during April 2008 and the subsequent ruling made by SARS in Binding General Ruling No. 9 (Issue 2) (BGR 9), issued on 19 February 2013.

2.2.2 The Volkswagen case

One of the questions brought before the High Court in the Volkswagen case, was whether STC can be seen as a tax substantially similar to a withholding tax on dividends such as NRST.

³¹ NRST was a tax levied on dividends paid by SA resident companies to foreign company shareholders. It was repealed on 1 October 1995 as it was found to be discriminatory since the sole criterion for the imposition of the NRST was the nationality of the company receiving the dividend (Lovely, 2011:12).

The facts of the case dealt with a SA resident company, namely Volkswagen of South Africa (Pty) Ltd ('VW SA') that paid and declared dividends to its holding company, namely Volkswagen AG ('VW AG') during 2004 and 2005. VW AG was a German tax resident company. VW SA initially paid over the STC to SARS at the domestic rate of 12.5%. However, subsequently VW SA instituted the action in the High Court to seek a refund of the STC paid on the basis that it had paid over too much STC to SARS. This claim was based on the grounds that the provisions of Article 7 of the DTA concluded between SA and the Federal Republic of Germany ('Germany') on 25 January 1973 (Germany-SA 1973 DTA) was applicable and that the tax should be reduced from 12.5% to a rate of 7.5%.

Article 7 of the Germany-SA 1973 DTA dealt with dividends and provided that the source state's right to tax is limited to a reduced rate of 7.5% of the gross amount of the dividend if the recipient is a company which owns directly at least 25% of the voting rights of the company paying the dividend.³² The requisite shareholding percentage was present between VW SA and VW AG.

SARS however rejected the claim on the grounds that STC does not constitute a tax on dividends as envisaged by Article 7 of the said DTA.

What further complicated the matter was that STC was not listed as a tax covered under Article 2 of the Germany-SA DTA. In this regard, only normal tax and NRST were listed as taxes covered by the treaty in regards to dividends. As mentioned above, NRST was a tax levied on dividends paid by SA resident companies to foreign company shareholders but had been repealed in SA subsequent to the conclusion of the Germany-SA 1973 DTA.

In order to determine whether VW SA qualified for the reduced rate in terms of Article 7 of the German-SA 1973 DTA, the High Court had to consider, amongst other questions, whether STC can be viewed as a substantially similar tax to NRST. The court found that there is a difference between taxation on dividends and STC³³, based on the following grounds:

³² Available: <http://www.sars.gov.za/AllDocs/LegalDoclib/Agreements/LAPD-IntA-DTA-2012-39%20-%20DTA%20Germany%20GG%203898.pdf>. [2016, October 4].

³³ *Volkswagen of South Africa (Pty) Ltd v C: SARS* [2008] JOL 21746 (T), 70 SATC 195:202

- STC is a tax on the company declaring the dividend and is not paid by the recipient of the dividend.³⁴ Tax on dividends, on the other hand, will be payable by the recipient of the dividend.³⁵
- STC is a tax on the profits of a company, whereas tax on dividends is a tax on the dividends declared by the company.³⁶

Johann Hattingh eloquently summarised the court's finding by stating that it held that 'the secondary tax on companies was a tax on the distributed profits of a resident company and not on the income of shareholders'³⁷.

The court therefore concluded that the above-mentioned differences between STC and a withholding tax on dividends negate the submission that STC is substantially similar to a withholding tax on dividends such as NRST.³⁸

This judgement cemented the practice already prevailing at the time, namely that STC had been applied uniformly on all SA resident companies and that no DTA had ever been applied to reduce the rate at which STC was levied.³⁹

The treaty between SA and Germany has been renegotiated since its application in the Volkswagen case. The renegotiated treaty was concluded on 9 September 2008 but is still awaiting ratification as at the date of this study. It is interesting to note that Article 2 of the renegotiated treaty was amended to specifically include STC as one of the taxes covered under the treaty. The writer submits that this amendment reinforces the notion that STC cannot be viewed as a tax substantially similar to dividends tax (or NRST). Another interesting amendment is the addition of the proviso to the paragraph limiting the source state's right to tax the dividends by way of a reduced rate of Dividends Tax. This proviso stipulates that the said paragraph shall not affect the *taxation of the company* in respect of the profits out of which the dividends are paid. As STC is a tax levied on the distributed profits of a company, this proviso makes it clear that the rate at which STC is levied domestically shall not be influenced by the reduced rates provided for in this paragraph. As

³⁴ Ibid:203

³⁵ Ibid

³⁶ Ibid

³⁷ Hattingh, 2009:509

³⁸ *Volkswagen of South Africa (Pty) Ltd v C: SARS* [2008] JOL 21746 (T), 70 SATC 195:204

³⁹ Ibid:200

such, the said paragraph cannot be applied to limit SA's right to levy STC. This addition to the renegotiated treaty, furthermore reinforces the judgement reached in the Volkswagen case.

2.2.3 SARS BGR 9

With the introduction of Dividends Tax in SA on 1 April 2012, the question arose whether Dividends Tax is covered by SA's tax treaties even though it may not be specifically named as a covered tax.⁴⁰

Non-resident shareholders receiving SA dividends were unsure whether they would qualify for the reduced rate provided for by SA's treaty network, given that SA's treaties in force at the time did not list Dividends Tax as a covered tax and especially given the judgement made in the Volkswagen case that STC is not substantially similar to Dividends Tax.

In an attempt to remove all uncertainty, SARS issued Binding General Ruling No. 9 to specifically deal with this question.

Binding General Ruling No. 9 (Issue 2) (BGR 9)⁴¹ made reference to the judgement made in the Volkswagen case, but nonetheless came to the conclusion that Dividends Tax will be viewed by SARS to be a tax substantially similar to the taxes covered under Article 2 of SA's tax treaties.⁴² SARS's view and ruling was based on the following line of argument:

- The commentary on Article 2 of the OECD MTC in force at the date of the ruling stated that paragraph 2 of the said article gives a definition⁴³ of taxes on income and on capital and that such taxes comprise taxes on total income and on *elements of income*, on total capital and on elements of capital.⁴⁴

⁴⁰ SARS BGR 9, 2013:par.3.3

⁴¹ SARS issued a third issue of Binding Private Ruling No. 9 on 3 February 2017. Issue 3 (refer footnote 2 on page 1) however refers the reader back to Issue 2 for SARS's view on the recognition of STC and dividends tax as covered taxes under South Africa's tax treaties.

⁴² Ibid

⁴³ Paragraph 2 of Article 2 reads as follows: "There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital..." It is preceded by paragraph 1 of Article 2 which reads as follows: "This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied."

⁴⁴ SARS BGR 9, 2013:par.3.3

- Dividends tax is a tax on an *element of income*.⁴⁵ Therefore it is a covered tax by virtue of paragraphs 1 and 2 of Article 2 of the OECD MTC.⁴⁶
- Some tax treaties however do not contain paragraphs 1 and 2 of the OECD MTC. They nevertheless contain a similar provision to paragraph 4 of the OECD MTC.⁴⁷ Paragraph 4 provides that the Convention shall also apply to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in the place of, the existing taxes specifically listed under paragraph 3 of Article 2.⁴⁸
- SARS is of the view that Dividends Tax is similar to STC since it is also a tax on income. Consequently, SARS also considers Dividends Tax to be a covered tax in these cases by virtue of paragraph 4 of Article 2.⁴⁹
- As such, SARS has informed the competent authorities of all its treaty partners that Dividends Tax is to be viewed as a covered tax under SA's tax treaties.⁵⁰

SARS's contention that Dividends Tax is a tax similar to STC is contrary to the judgement made in the Volkswagen case. Whether the basis for their contention, i.e. that Dividends Tax is also a tax on income, is technically sound, is not part of the scope of this study. The fact of the matter is that the ruling made in BGR 9 is binding on SARS and is valid from the publication date for an indefinite period. As such it is the practice prevailing in SA at the present time. Dividends Tax is therefore a covered tax for purposes of SA's tax treaties.

⁴⁵ Ibid

⁴⁶ Although not specifically stated in SARS BGR 9, the writer assumes that this point is based on the commentary on paragraphs 1 and 3 of Article 2 of the OECD MTC (2010). The commentary on paragraph 1 states that the said paragraph defines the scope of the application of the Convention, i.e. taxes on income and on capital. The commentary on paragraph 3 states that this paragraph lists the taxes in force at the time of signature of the Convention, but that the list is not exhaustive. It serves to illustrate the preceding paragraphs of the Article. Hence, the fact that Dividends Tax is not specifically mentioned under the existing taxes, is of no consequence as it falls within the scope of paragraphs 1 and 2 of Article 2 as a tax on an element of income.

⁴⁷ An example hereof being the DTA concluded between SA and the United States of America.

⁴⁸ SARS BGR 9, 2013:par.3.3

⁴⁹ Ibid

⁵⁰ Ibid

2.3 Conclusion

Before one endeavours to establish whether the relief provided for by Article 10 of the OECD MTC applies to the Dividends Tax levied in SA on secondary adjustments in the form of a deemed dividend, it first needs to be established whether Dividends Tax is a covered tax for SA tax treaty purposes given that it is not specifically listed as a covered tax under paragraph 3 of Article 2 of most of the tax treaties that SA currently has in force. It therefore needed to be considered whether Dividends Tax can be seen as a tax substantially similar to STC or NRST, seeing as these taxes are mainly listed as covered taxes in SA's tax treaties.

In the Volkswagen case, the court found that a withholding tax on dividends (such as NRST) differs substantially from STC as, firstly, it is a tax on the shareholder, whereas STC is a tax on the company, and secondly, as it is a tax on dividends, whereas STC is a tax on the company's distributed profits. The court therefore held that a withholding tax on dividends and STC cannot be viewed as substantially similar taxes.

SARS however ruled in BGR 9 that Dividends Tax is a covered tax for SA tax treaty purposes. SARS based its ruling on the argument that Dividends Tax is a tax on an element of income and therefore a covered tax by virtue of paragraphs 1 and 2 of Article 2 of the OECD MTC, or in the absence of the said paragraphs in a treaty, it is a tax similar to STC since it is also a tax on income, and therefore a covered tax by virtue of paragraph 4 of Article 2 of the OECD MTC.

Whether the above arguments raised by SARS are technically sound is uncertain especially given the judgement made in the Volkswagen case. However, as BGR 9 is binding on SARS for an indefinite period, it is the practice prevailing at the time. As such Dividends Tax levied in terms of SA domestic law will be a covered tax for SA tax treaty purposes by virtue of BGR 9.

As mentioned above, it however does not automatically follow that the SA Company will be entitled to the reduced rate in terms of Article 10 of OECD MTC. These benefits will only be available to the SA Company if the specific requirements of Article 10 are also adhered to. These requirements will further be considered in Chapters 3 and 4 of this study.

CHAPTER 3: THE DIVIDEND DEFINITION – ARTICLE 10.3 OF THE OECD MTC

3.1 Introduction

Chapter 2 established an important point, namely that Dividends Tax levied in terms of SA domestic law will be a covered tax for SA tax treaty purposes by virtue of BGR 9. The SA company will therefore have access to SA's tax treaty network for potential relief on the Dividends Tax it pays on the secondary adjustment.

The next step is to determine whether the SA company will qualify for the specific relief provided for by Article 10 of the OECD MTC. Article 10 awards taxing rights to both the country of source and the country of residence, but limits the country of source's (i.e. SA in this case) taxing rights in certain instances by virtue of a reduced rate of tax to be levied on the dividends.

The question to be answered, therefore, is whether the SA company will qualify for the reduced rate provided for in Article 10.2 of the OECD MTC in regards to the Dividends Tax it bears in SA on the secondary adjustment. This can be answered by considering the following two main questions:

- Does a deemed dividend under a secondary adjustment for SA domestic tax purposes fall within the dividend definition as contained in Article 10.3 of the OECD MTC? (Chapter 3)
- Will the said deemed dividend be regarded as 'paid' as envisaged by Articles 10.1 and 10.2 of the OECD MTC? (Chapter 4)

Chapter 3 will deal with the first question and Chapter 4 will concern itself with the second question.

In answering the first question, this chapter will include a brief analysis of some of SA's current tax treaties which deviate from the OECD MTC in regards to the wording used in the dividend definition. The purpose of this analysis is to evaluate the effect of such a deviation on the findings made in this Chapter.

3.2 Does a deemed dividend under a secondary adjustment qualify as a ‘dividend’ for purposes of Article 10 of the OECD MTC?

3.2.1 Introductory remarks

The term ‘dividends’, as used throughout Article 10 of the OECD MTC, is defined in Article 10.3 to mean:

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

On first reading of the above definition it is not immediately apparent whether a deemed dividend under a secondary adjustment in SA will fall within the scope of this definition. In order to obtain a better understanding of the definition, Teixeira divided the definition into three parts in performing a similar investigation to the one at issue in this study.⁵¹

The three parts identified were as follows:⁵²

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

Teixeira further goes on to state that the following relationship can be established among the three parts of the definition:

- the use of the expression “other rights not being debt-claims, participating in profits” in part (ii) implies that the items mentioned in part (i) cannot be debt claims, but that such a restriction is not applicable to part (iii);

⁵¹ Teixeira, 2009:460

⁵² The analysis done by Teixeira was based on the OECD Model Tax Convention on Income and on Capital (2008) (OECD MTC (2008)), whereas the present study is based on the OECD MTC. The definition of ‘dividends’ as contained in the OECD MTC 2008 has, however, remained unchanged in the OECD MTC.

- The expression “other corporate rights” used in part (iii) indicate that the rights contained in parts (i) and (ii) are also of a ‘corporate’ nature; and
- That recourse to domestic law should apply only to part (iii).⁵³

From the above division, it is clear that a deemed dividend under a secondary adjustment in SA does not fall within the ambit of the above mentioned parts (i) and (ii) of the definition. The said deemed dividend is a notional amount of income triggered by a primary TP adjustment made in terms of SA domestic law, *for SA tax purposes only*. It does not represent a true or real amount of income accrued or received on a share as required by part (i) of the definition. It also does not represent income received or earned due to some other corporate right to participate in the profits of a company, as required by part (ii) of the definition. It is a pure notional dividend for tax purposes only, there being no real dividend for company law, or any other purposes.

Part (iii) of the dividend definition therefore remains as a last resort to bring the secondary adjustment within the scope of the dividend definition. The requirements of part (iii) can be divided into two parts, being:

- income from other corporate rights;
- that is *subjected to the same taxation treatment as income from shares* by the laws of the State of which the company making the distribution is a resident.

In order to determine whether a deemed dividend under a secondary adjustment in SA will fall within part (iii) of the dividend definition, the above two requirements will be considered in further detail below.

3.2.2 *Income from other corporate rights (first requirement)*

Hattingh, in studying the significance of dividends being “income” from “corporate rights” notes that the use of the word “income” in Article 10.3 of the OECD MTC suggests that it ought to be earned by reason of some relationship.⁵⁴ He contrasts the use of the word ‘income’ with the word ‘amount’ which generally denotes something wider and unrelated to

⁵³ Teixeira, 2009:460

⁵⁴ Hattingh, 2009:518

a particular relationship.⁵⁵ He is of the opinion that “income” in a general sense suggests that a person must have done something to earn the income.⁵⁶ The fact that the word is coupled with the phrase “from shares” and “from other [corporate] rights ... participating in profits” suggests that it should be income that is yielded under investment of capital risked as a shareholder, as it is the investment that enables the profit participation.⁵⁷ He further distils the concept by submitting that it excludes any income earned by reason of any *other* relationship, such as active income earned from services provided by a contractor of a company or capital advanced on loan.⁵⁸ As support for his contention, he makes reference to Vogel’s explanation of the concept, i.e. that ‘only income that flows to the recipient because of his position as shareholder comes “from” a “corporate right.”’⁵⁹

In specifically dealing with part (iii) of the dividend definition, i.e. “income from other corporate rights”, Hattingh is of the opinion that deemed dividends under a share buyback transaction will most likely not fall within the scope of “income from other corporate rights”. He is of the opinion that the value realised by a shareholder from the sale of shares are primarily in a legal sense (mostly) a “gain” “from” a *contractual right* (the sale agreement) and not “income from [a] corporate right”.⁶⁰ The corporate right (the share) is merely the object of the sale. This begs the question, following a similar line of argument as Hattingh, whether the benefit obtained under a primary TP adjustment, and forming the object of the secondary adjustment, is not due to a contractual right (i.e. the inter-group pricing agreement) rather than a corporate right (i.e. the direct or indirect shareholding relationship)? This question will enjoy further consideration later in this part of the chapter.

Teixeira specifically considered the question whether secondary adjustments taking the form of deemed dividends will fall within the dividend definition in Article 10.3 of the OECD MTC. In her consideration she however placed less emphasis on whether the deemed dividend will qualify as “income from other corporate rights”. Her submission is that, given that recourse to domestic law is allowed for in this part of the definition, one can argue that whichever payments are deemed a dividend under a country’s domestic law, even constructive

⁵⁵ Ibid

⁵⁶ Ibid

⁵⁷ Ibid

⁵⁸ Ibid

⁵⁹ Ibid, Vogel, 1997:650

⁶⁰ Ibid

payments, are covered by the definition of Article 10.3 of the OECD MTC (2008).⁶¹ Teixeira motivates this remark by referring to the Commentary on Article 10.3 of the then OECD MTC (2008).⁶² It stated that the dividend definition may comprise ‘not only distribution of profits decided by annual general meetings of shareholders, but also other benefits in money or money’s worth, such as bonus shares, bonuses, profits on a liquidation and *disguised distributions of profits*’ (emphasis added).⁶³

To illustrate the concept of ‘disguised distributions of profits’, Teixeira makes reference to a ruling made by the German Federal Tax Court⁶⁴ and submits that the court found that ‘constructive dividends may be assumed if a corporation suffers a decrease in assets by granting a pecuniary benefit to its shareholders or related persons that a diligent businessman would not have granted to an unrelated party.’⁶⁵ The point that Teixeira makes is that transactions where goods or services are rendered by a company to a shareholder, or other related person in relation to that shareholder, for a consideration which is less than an arm’s length consideration,⁶⁶ will amount to a disguised distribution of profits as referred to by the Commentary quoted above. Larking agrees with Teixeira on this point in that he describes a “hidden profit distribution” as the equivalent of a “constructive” or “deemed” dividend, i.e. “[b]enefits (in cash or in kind) derived from companies by shareholders, while not formally distributed as dividends, may nevertheless be treated for tax purposes as profit distributions and taxed as dividends.”⁶⁷ He explains that constructive dividends can include amounts paid to a shareholder in excess of an arm’s length price for goods or services.⁶⁸

⁶¹ Teixeira, 2009:460

⁶² As mentioned above, the dividend definition in Article 10.3 of the OECD MTC (2008) has remained unchanged in the OECD MTC.

⁶³ Teixeira, 2009:460. This interpretation is maintained in the Commentary on Article 10.3 of the current OECD MTC - refer to par. 28 of the said commentary.

⁶⁴ Federal Tax Court (Bundesfinanzhof) Decision No. I R 27/03 of 9 November 2005

⁶⁵ Teixeira, 2009:460

⁶⁶ i.e. typically transactions which lay at the heart of primary and secondary TP adjustments.

⁶⁷ Larking, 2001:76

⁶⁸ Ibid

Teixeira concludes her argument by submitting that, should such a disguised distribution of profits further be treated and taxed as a dividend for domestic tax purposes, it will fall within part (iii) of the definition of a dividend as contained in Article 10.3 of the OECD MTC (2008).⁶⁹

The Final Report on Secondary Adjustments issued by the European Union (EU) Joint Transfer Pricing Forum during 2012 confirms the view of Teixeira that constructive dividends are covered by Article 10 of the OECD MTC (2010). The report however provides no motivation for this contention, but states it rather as a matter of fact.⁷⁰ Given that the report is EU specific, and given that SA is currently not an OECD member state, like many of the EU countries, the report carries little persuasion for purposes of this study.

Hattingh is however doubtful whether submissions similar to that of Teixeira and Larking will survive scrutiny in all cases. In commenting on the OECD MTC's definition of dividends, he traces the origins and development of the definition by having a look at the work performed by Working Parties Nos. 11 and 12 of the Organisation for European Economic Co-operation (OEEC/OECD) in this regard.⁷¹ In specific reference to deemed dividends under domestic legislation, he states that it was not within the spirit of their work that the link to domestic law should provide *carte blanche* to deem anything to be a dividend for treaty purposes.⁷² He goes on to state that there has to be a corporate profit sharing right which entitled and lead to the receipt of the item of income, as prerequisite, to include such deemed dividend within the dividend definition of the OECD MTC.⁷³ He refers to this as the 'essential or central condition'.

Hattingh further states that although part (iii) of the dividend definition contains a reference to domestic law, the yardstick to evaluate when something is a "corporate right" for treaty purposes should probably operate independently and should not vary according to which state is party to the tax treaty. From the above it is evident that Hattingh places greater emphasis on the requirement that the deemed dividend must be seen as "income from [other] corporate rights" than Teixeira.

⁶⁹ Teixeira, 2009:460-461, Par. 28 of the Commentary on Article 10.3 of the OECD MTC (2008). As the interpretation expressed in the Commentary referred to by Teixeira has remained unchanged in the OECD MTC, the submission made by Teixeira should still apply in light of the OECD MTC.

⁷⁰ Refer to par. 4 of the report.

⁷¹ Hattingh, 2009:510

⁷² Ibid:514

⁷³ Ibid

Hattingh is furthermore of the opinion that such a broad conception of a “hidden profit distribution” as envisaged by Larking, was arguably not intended to be applicable under the OECD Model dividend clause.⁷⁴ He admits that it is difficult to conceptually disengage the concept of “hidden profit distributions” from the spectre of applying domestic anti-abuse or legal substance doctrines or general anti-avoidance tax rules in a tax treaty.⁷⁵ He goes on to state that it is only under the respective domestic legal notions of treaty partners that a legal basis may exist to consider the legal substance of a transaction so as to unmask a disguised profit distribution.⁷⁶ He points out that the Commentary on Article 10.3 of the OECD MTC⁷⁷ in this instance ‘has no legal basis itself to import a substance-based notion of the concept of a dividend into the treaty definition’.⁷⁸

In his consideration of the matter, he refers to the Canadian case of *RMM Enterprises Inc. and Equilease Corporation v. Her Majesty the Queen* (1997) 97 D.T.C. 302 (RMM Enterprises case) that dealt with a scheme that fell foul of the general anti-avoidance rule (GAAR) of Canadian domestic tax law. In this case it was found that a sale of shares to an accommodating party attempted to disguise a distribution of surplus profits to the seller and/or shareholder. The Canadian Court held that the treaty’s definition of a dividend (based on the OECD Model), as supported by par. 28 of the Commentary thereon, was wide enough in this case to cover the deemed dividend. As pointed out by Hattingh, the Canadian Tax Court gave primacy to a state’s right to re-characterise tax-abusive transactions, and allowed such a re-characterisation to be followed through in the dividend definition of an OECD Model-based tax treaty.⁷⁹ He remarks that the case makes the general point about the primacy of domestic GAAR rules as legal basis to re-characterise transactions for treaty purposes, but that this case does not provide support for the contention that the treaty definition of a dividend itself provides a legal basis to re-characterise any non-dividend as a dividend in all circumstances.⁸⁰ This must first be achieved under domestic law.

⁷⁴ Ibid:520

⁷⁵ Ibid

⁷⁶ Ibid

⁷⁷ Refer par. 28 of Commentary.

⁷⁸ Hattingh, 2009:520

⁷⁹ Ibid

⁸⁰ Ibid

In the case of this specific study one could argue that the requisite domestic legal basis⁸¹ is present, as the amount is reclassified as a dividend under SA domestic law, and therefore such a domestic reclassification will carry through for treaty purposes so as to bring it within the ambit of the dividend definition⁸². Hattingh is however of the opinion that the judgement in the RMM Enterprises case does not extend to the presumptive re-characterisation rules under domestic tax laws, such as where objective criteria trigger a re-characterisation of a transaction regardless of whether avoidance motivations or an abusive intent is present or not. Section 31(3) of the ITA which re-characterises the secondary adjustment as a deemed dividend in *specie* can be described as such a presumptive re-characterisation rule. It contains objective criteria⁸³, which if present, treats the difference between the transaction amount and an arm's length price (i.e. the so-called excess) as a deemed dividend and presumes that it is from a profit participating corporate right, i.e. hidden profit distribution. This may however not always be the case, but domestic law has sought to presume this and herein lies the crux of Hattingh's contention. The difference between the facts in the Canadian case and a deemed dividend under a secondary adjustment, is that the actual substance of the transaction was investigated under the GAAR in the Canadian case. The re-characterisation was therefore based on the *actual* substance of the transaction being a disguised distribution of profits, and not a *presumption* that it is so. Therefore, if one were to follow Hattingh's line of argument, the presumptive re-characterisation rule found in section 31(3) of the ITA is, by itself, not sufficient to render the 'excess' a hidden profit distribution for purposes of the OECD's dividend definition.

Hattingh raises, but does not answer, another interesting question in this regard, namely whether "hidden profit distributions" must, like an ordinary dividend declaration, be made proportionally to all shareholders before it ranks on the same footing as "income from shares".⁸⁴ The writer does not wish to deal extensively with this question, but is of the opinion that "corporate rights" also include rights which give the holder thereof preference in regards to profit participation (like preference shares). As such, the 'essential condition'

⁸¹ The Transfer Pricing legislation, i.e. specific anti-avoidance provisions found in Section 31 of the ITA.

⁸² As per Article 10.3 of the OECD MTC.

⁸³ Refer section 31(1)-(2) of the ITA.

⁸⁴ Hattingh, 2009:520

that the income must be from a corporate right does not necessarily require proportional profit sharing in all circumstances.

Although Hattingh wrote about deemed dividends in general, his submissions can be applied to deemed dividends under a secondary adjustment in SA as follows:

- Firstly, it does not follow automatically that a deemed dividend under a secondary adjustment in SA fulfils the essential requirement (i.e. income from other corporate rights) merely because it is a deemed dividend in terms of domestic law. Each case will need to be assessed on its own facts and merits to establish whether the essential requirement is being adhered to;
- Secondly, it is doubtful whether the presumptive rule in section 31(3) of the ITA (the provision deeming the excess to be a dividend) will, in itself, be sufficient to render the 'excess' a hidden profit distribution for purposes of the OECD's dividend definition. The necessary legal basis will only be present if in terms of domestic law, it is found that the *actual* substance (and not the *presumed* substance) of the transaction is that of a hidden profit distribution. This will however only be achieved under the SA GAAR as found in sections 80A-L of the ITA, or SA's common law substance-over-form doctrines, which, in the writer's opinion, will normally not be employed in scenarios where the transfer pricing provisions in section 31 of the ITA were already applied.

As is evident from the above discussion, it is already uncertain whether the 'essential requirement' is being adhered to in scenarios where the secondary TP adjustment is made between a company and its shareholder. It presumably becomes even more uncertain in scenarios where the secondary TP adjustment is made between a company and another person who is not a direct shareholder of the company, but forms part of the same group of companies for instance.

In this regard, the Commentary on Article 10.3 of the OECD MTC states that '(t)he benefits to which a holding in a company confer entitlement are, as a general rule, available solely to the shareholders themselves'.⁸⁵ The Commentary however goes on to state that should certain of such benefits be made available to persons who are not shareholders within the

⁸⁵ Refer to par. 29 of the said Commentary.

meaning of company law, it may constitute dividends if the persons receiving such benefits are closely connected with a shareholder.⁸⁶ To illustrate the concept of such ‘closely connected’ persons, the Commentary provides as examples a relative of a shareholder or a company belonging to the same group as the company owning the shares.⁸⁷ As SA’s TP legislation will only apply in cases where the so-called ‘affected transaction’ is entered into between connected persons⁸⁸, the writer submits that the requisite ‘connected party’ relationship should always be present for deemed dividends under a secondary adjustment.

However, the type of ‘benefits’ envisaged by the said commentary above, again denotes some kind of informal dividend (like a hidden profit distribution), as formal dividends can only be made to direct shareholders. This brings the argument back to Hattingh’s point regarding the requisite legal basis to re-characterise a non-dividend (or informal dividend) to a (formal) dividend. Furthermore, even though the Commentary broadens the scope of Article 10 to benefits received by persons who are not direct shareholders themselves, but are closely connected to the shareholder, the question remains whether such benefits can be said to be from a corporate right.

This brings the writer back to a question posed earlier in this section, namely whether the benefit obtained under a primary TP adjustment, and forming the object of the secondary adjustment, is not due to a contractual right (i.e. the inter-group pricing agreement) rather than a corporate right (i.e. the direct or indirect shareholding relationship). Given the above discussion, the writer is in agreement with the line of argument followed by Hattingh and would like to extend his argument by submitting that even though the primary cause of the non-arm’s length nature of the transaction is the shareholder relationship (whether direct or indirect), the ‘excess’ rather represents income from some sort of contractual right (like an intercompany transfer pricing agreement) rather than a corporate right.

Before concluding on whether the first requirement (income from other corporate rights) is being adhered to, it is also interesting to take note of the tax treaties within SA’s existing tax treaty network which contain a dividend definition that deviates from the OECD MTC, in order to shed further light on the above discussion.

⁸⁶ Refer to par. 29 of the said Commentary.

⁸⁷ Refer to par. 29 of the said Commentary.

⁸⁸ As that term is defined for SA tax purposes in Section 1 of the ITA.

The recent protocol (2012) concluded between SA and the UK, defines a dividend for purposes of Article 10 of the said DTA as follows:

The term “dividends” as used in this Article means income from shares, or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident *and also includes any other item which, under the laws of the Contracting State of which the company paying the dividend is a resident, is treated as a dividend or distribution of a company.* (emphasis added)

As evidenced by the emphasised part of the definition, it extends the scope of the dividend definition to include ‘any other item that is deemed a dividend or distribution under the domestic law of the company paying the dividend’. On first sight one might be inclined to think that the said extension of the definition merely duplicates what is already to be included under part (iii) of the OECD dividend definition. However, on closer scrutiny of the words used, one finds that the essential condition that the deemed dividend should amount to “income from any other corporate right participating in profits” is not present in the extension of the definition. In fact no reference to any [corporate] right is made at all. Aside from this, the choice of words used in the inclusion is interesting. The word “income” is replaced with a reference to “any other item”, which, in the same vein as the argument raised by Hattingh above, generally denotes something wider and unrelated to a particular relationship. In fact, no causal relationship is required at all for purposes of this part of the definition. It merely requires that the item must be deemed a dividend or distribution in terms of the domestic law of the country of the company paying the dividend.

The writer therefore submits that Teixeira’s contention that all deemed dividends under domestic legislation is covered by the dividend definition of the OECD MTC will ring true if the said definition would have been similar to the one used in the SA-UK DTA. The choice of words used by the treaty negotiators in the case of the SA-UK DTA is testimony to the fact that Hattingh’s argument as outlined above carries merit.

The DTA between SA and the Government of New Zealand (NZ) defines a ‘dividend’ for purposes of Article 10 of the DTA as follows:

The term “dividends” as used in this Article means income from shares and other income *treated as income from shares* by the laws, relating to tax, of the Contracting State of which the company making the payment is a resident for the purposes of its tax. (emphasis added)

Although the wording used in the SA-NZ DTA differs from the wording used in the SA-UK DTA, it ultimately also removes the ‘essential condition’ that the deemed dividend must amount to “income from any other corporate right sharing in profits”. The effect of the words “treated as income from shares” in the above definition is that it specifically imports into the SA-NZ DTA the presumption made under domestic legislation that certain amounts are income from shares, i.e. hidden profit distributions. This, again, supports Hattingh’s contention that presumptive re-characterisation rules under domestic legislation are, in itself, not sufficient to provide a legal basis to re-characterise a non-dividend amount into a dividend amount for purposes of the OECD MTC. The SA-NZ DTA contains a special feature importing this presumption into the DTA which, in the writer’s opinion, would not have been necessary had Hattingh’s contention not been correct.

To conclude, the writer is in agreement with the submissions made by Hattingh as outlined above, especially given the choice of words used in the SA-UK DTA and the SA-NZ DTA. As such, before a deemed dividend under a secondary adjustment can be viewed as “income from any other corporate right’, a causal relationship between the deemed dividend and some or other corporate right sharing in profits needs to be present. As outlined above, it is doubtful whether this is indeed the case with deemed dividends under secondary adjustments in SA. The writer is rather of the opinion that in more cases than not, the ‘excess’ would rather be attributable to a contractual right (like an inter-company transfer pricing agreement) than a corporate right. Furthermore, the fact that section 31(3) of the ITA presumes the deemed dividend to be from a corporate right is not sufficient to provide a legal basis to render the excess a ‘hidden profit distribution’ and therefore re-characterise it as a dividend for purposes of the OECD MTC.

Further support for the writer’s conclusion can also be found in the latest amendments made to sections 8F and 8FA of the ITA. These anti-avoidance provisions deems the interest on hybrid debt instruments to be deemed dividends in certain instances. The 2016 Draft Taxation Laws Amendment Act now defines a deemed dividend for purposes of sections 8F

and 8FA to be *deemed to be in respect of a share*. This was arguably done in an apparent attempt to remove the obstacle to the domestic dividends tax exemptions and treaty relief for purposes of Article 10. No similar clarification has however been included for purposes of the secondary adjustment in article 31(3) of the ITA which may bear testimony of Treasury's intention not to extend treaty benefits to secondary adjustments.

DTA's that deviate from the wording used in the dividend definition as per the OECD MTC, like the SA-NZ DTA and the SA-UK DTA, show greater prospects of success in this regard as it has removed the 'essential condition' that the deemed dividend must amount to 'income from other corporate rights' thereby widening the scope to potentially include deemed dividends under secondary adjustments in SA.

The next part of the study will consider the second requirement of part (iii) of the dividend definition of the OECD MTC, namely that the amount must be subject to the same taxation treatment as income from shares in the country of which the company paying the dividend is a resident (the second requirement).

3.2.3 *Subject to the same taxation treatment as income from shares (second requirement)*

On first blush it appears as though the second requirement is being adhered to as the secondary adjustment is treated as a deemed dividend *in specie* and is thereby subject to tax in terms of Part VIII of the ITA which deals with Dividends Tax.

However, although the tax levied on dividends *in specie* is dealt with under Part VIII of the ITA (Dividends Tax) and although it is levied at the same rate at which Dividends Tax is levied on cash dividends in SA, the person on whom the tax is levied differs for dividends *in specie* as opposed to cash dividends. In the case of cash dividends, the tax is levied on shareholder level. In the case of dividends *in specie*, the tax is levied on company level. Whether this difference will result in the second requirement not being adhered to will need to be considered further.

Article 10.2 of the OECD MTC lays down nothing about the mode of taxation in the State of source, i.e. SA for purposes of this study.⁸⁹ The Commentary on Article 10 is also silent in this regard. As such, on first glance, it may appear as though the fact that the Dividends Tax is

⁸⁹ Par. 18 of the Commentary on Article 10.2 of the OECD MTC.

levied on the SA company, and not the shareholder, should bear no relevance as to the question whether the relief provided for in Article 10 is available or not.

Dividends Tax is, however, a tax levied on the shareholder, and not the company paying the dividend as pointed out in the *Volkswagen* case.⁹⁰ With dividends taking the form of a distribution of an asset in *specie*, the precarious scenario arises in SA whereby the Dividends Tax is levied on the company paying the dividend, and not the shareholder receiving the dividend.⁹¹ This is presumably so because no cash flows to the shareholder from which the Dividends Tax can be withheld. As such, one reason for the reverse charge of the Dividends Tax may be that it is presumably easier for SARS to collect the tax from the SA company, than from the shareholder who resides outside of SARS' sovereign reach. One therefore needs to consider whether the manner in which the tax is collected, alters the nature of the tax to such an extent that it may not be viewed as the "same taxation treatment" as income from shares, and as a result will prevent the SA company from qualifying for the reduced rate provided for in Article 10.2 of the OECD MTC.

The Davis Tax Committee (DTC) has recommended that access to the reduced rate should indeed be denied on this basis. Their recommendation is based on the policy consideration that relief should not be provided in cases where SA's asset base has been depleted due to a transfer of economic value out of the country.⁹² However, until such time that their recommendation transpires into law, the question must be considered against the legal framework prevailing at the date of this study.

In the *Volkswagen* case, discussed in detail in Chapter 2 of this study, the court found that the taxpayer was not entitled to the reduced rate in terms of the Dividends Article of the treaty between SA and Germany on the grounds that there is a fundamental difference between taxation on dividends and STC. The Court ascribed the difference to the following factors:

- STC is a tax on the company declaring the dividend, whereas Dividends Tax will be payable by the recipient of the dividend; and

⁹⁰ As per judgement made in *Volkswagen Case*.

⁹¹ Refer section 64EA(b) of the ITA.

⁹² DTC First Interim Report-Action 13: Re-examine TP documentation. 2014:19

- STC is a tax on the profits of a company, whereas Dividends Tax is a tax on the dividends declared by the company.⁹³

The Dividends Tax payable by the SA Company on the deemed dividend under the secondary adjustment is similar to STC in the sense that it is also a tax levied on the company declaring the dividend. However, it also differs substantially from STC in the sense that it is labelled as a tax on dividends and not a tax on the distributed profits of the company. It would therefore appear to be somewhat of a hybrid tax between STC and Dividends Tax in its purest form. Given the difference between the Dividends Tax levied on deemed dividends under secondary adjustments, and STC, the writer is doubtful whether the judgement in the Volkswagen case can solely be applied to prevent access by the SA company to the reduced rate provided for in Article 10.2 of the OECD MTC.

SARS aimed to provide more clarity on the matter by issuing BGR 9.⁹⁴ The ruling draws a specific distinction between cash dividends and dividends *in specie*. It states that for *cash* dividends ‘the tax falls on the person entitled to the benefit of the dividend attaching to a share (usually shareholder) even though the tax is withheld by the company paying the dividend’.⁹⁵ As such, the cash dividend ‘falls within the dividends article of South Africa’s tax treaties thus enabling a non-resident shareholder to secure a lower rate of dividends tax when applicable’.⁹⁶ The ruling however states that as the liability for Dividends Tax on dividends *in specie* falls on the company paying the dividend, the tax is not a tax on the shareholder but a form of corporate tax similar to STC.⁹⁷ The ruling does not explicitly state that access to the reduced rate in terms of SA’s treaty network is denied on this basis, but conveys it in more tacit terms, i.e.

- The Ruling makes no reference to any treaty relief being available for dividends in *specie*, as it did with cash dividends.⁹⁸
- The Ruling states that Dividends Tax on dividends in *specie* is a form of corporate tax similar to STC and refers earlier in the Ruling to the finding made in the Volkswagen

⁹³ Refer page 203 of 70 SATC 195.

⁹⁴ SARS BGR 9 was discussed in detail in Chapter 2 of this study.

⁹⁵ SARS BGR 9, 2013:par.3.3

⁹⁶ Ibid

⁹⁷ Ibid

⁹⁸ Ibid

case that STC, since it is not a tax on shareholders, will not be affected by any limitation imposed on the source state under the dividends article of South Africa's tax treaties.⁹⁹

- The Ruling only makes an express reference to the availability of domestic relief for dividends *in specie*.¹⁰⁰ In this regard, the Ruling provides that 'whether a non-resident shareholder will be able to secure a tax credit for dividends tax in these circumstances will depend on the system of taxing dividends in the non-resident's country of residence'.¹⁰¹ In regards to the SA company paying the dividend, the Ruling states that the SA company should look to section 64FA(2)(a) of the ITA¹⁰² for potential domestic relief.¹⁰³

The writer submits that this tacit denial of benefits conveyed by BGR 9 is further confirmed by the wording used by the legislature in section 64FA(2)(a) of the ITA. This section falls outside the scope of this study, but it essentially entitles the company (that distributes the dividend *in specie*) to the lower rate specified in a tax treaty provided that the person to whom the distribution is made, submits a declaration to the Company stating that the dividend would have qualified for the reduced rate had it been a cash dividend. The inference to be drawn from the wording used in this section is that dividends *in specie*, as a rule, do not qualify for treaty relief presumably because the incidence of tax falls on the company and not the shareholder. The analysis to determine whether the reduced rate will apply is therefore required to be performed as if the dividend in question was a cash dividend, thereby removing the hurdle to treaty relief posed by the dividend *in specie*.¹⁰⁴

⁹⁹ SARS BGR 9, 2013:par.3.3 read with par. 3.2

¹⁰⁰ SARS BGR 9, 2013:par.3.3

¹⁰¹ *Ibid*

¹⁰² This section will form the object of Chapter 4 of this study.

¹⁰³ SARS BGR 9, 2013:par.3.3

¹⁰⁴ Although it falls outside the scope of this study, the writer is doubtful whether the domestic relief provision found in section 64FA(2)(a) of the ITA will go much further in providing relief for the SA company paying the Dividends Tax. It refers the taxpayer back to the requirements set in the treaty and asks of the taxpayer to do an analysis to determine whether the reduced rate under the relevant treaty would have applied had the dividend in question been a cash dividend. Respectfully, the writer is of the opinion that the taxpayer (i.e. the SA company) will run into the same difficulties as discussed in this chapter. The fact the dividend is in the form of cash, rather than in some other form, does not automatically bring the dividend within the requirement that it must amount to 'income from a [corporate] right. Furthermore, it is required that the declaration must be made by the 'beneficial owner', a term which has resulted in exceptional controversy in the OECD arena. For domestic purposes the term is defined in section 64D of the ITA to mean 'the person entitled to the benefit of

This contention finds support in the proviso at the end of Article 10.2 of the OECD, i.e. the paragraph in the article containing the reduced rates. The proviso states that paragraph 2 of Article 10 shall not affect the taxation of the company in respect of the profits out of which the dividends are paid. It is submitted that if one considers that SARS equates the taxation of dividends in *specie* to be a form of corporate tax similar to STC, then it is clear from the proviso to Article 10.2 that the treaty cannot be applied to reduce the rate at which the SA company pays Dividends Tax on the secondary adjustment. It is further interesting to note that the OECD, in general, defines ‘dividends’ as ‘(a) payment by a corporation to shareholders, which is taxable income of shareholders.’¹⁰⁵ (*emphasis added*) This definition also denotes that the tax on the dividends should be levied on the shareholder as the dividends present taxable income of the shareholder and not the company declaring it. When the company bears the tax, it cannot be said to be a tax on the income from shares, and subsequently appears to fall foul of the second requirement.

Hattingh, when discussing the concept “income from corporate rights” contrasts the notion of “distribution” with the notion of “income” from shares/corporate rights. He states that “distribution” implies something that is given to a shareholder by a company regardless of its legal form, but for which the primary cause is the shareholder relationship.¹⁰⁶ He draws a distinction between taxation of the company and taxation of the shareholder by stating that ‘distribution’ is arguably the correct concept to use when the taxation of a company is at issue, as it focusses on the action of the company, i.e. distributing profits.¹⁰⁷ He however finds the concept unusual to employ when the taxation of a shareholder is at issue.¹⁰⁸ To his mind a shareholder cannot be said to have earned a *distribution*, but rather to have earned *income* from shares. In this regard it is also interesting to note that section 31(3) of the ITA deems the excess to be a dividend consisting of a *distribution* of an asset in *specie*, and that the second requirement of par (iii) of the dividend definition of the OECD MTC requires the

the dividend attaching to a share’. In relation to a company, this typically refers to the shareholder which may be a different person from the one with which the SA company concluded the ‘affected transaction’ with. If this is indeed the case, it is doubtful whether the shareholder will take the risk of making such a declaration in regards to a transaction it was not a part of or privy to.

¹⁰⁵ OECD Glossary of Tax Terms, available at: <http://www.oecd.org/fr/ctp/glossaryoftaxterms.htm> [2016, October 24]

¹⁰⁶ Hattingh, 2009:518

¹⁰⁷ Ibid

¹⁰⁸ Ibid

same taxation treatment as *income* from shares. In the writer's opinion, the two words denote different underlying actions, i.e. the distribution of profits by a company and the earning of income on shares by a shareholder. Coupled together with the fact that the incidence of tax also varies between the two actions, the writer is of the opinion that the view taken in BGR 9 is correct and that the manner in which tax is levied on dividends *in specie* cannot be seen as the same as the taxation treatment of income from shares.

This might be seen as unfortunate result, especially if one agrees that this mechanism (i.e. to collect the tax from the SA company rather than from the non-resident shareholder) is only used to make it easier for SARS to collect the tax on dividends *in specie*. An administrative provision is therefore resulting in a denial of access to treaty benefits. However, if viewed in the light that the primary and secondary adjustments are penal in nature, one could raise the counter argument that in order to prevent the mischief which the TP provisions seek to address, the secondary adjustment should not qualify for any treaty relief as it may render the penal provision less effective.

It is again interesting to consider the wording used in the DTA's concluded by SA with NZ and the UK. As was the case with the first requirement above, the second requirement (i.e. "the same taxation treatment as income from shares") is not present in the part added to the dividend definition in the SA-UK DTA or the dividend definition included in the SA-NZ treaty. This significantly widens the ambit of the definition to potentially include a deemed dividend *in specie* under a secondary adjustment in SA. However, if one considers the fact that the SA-NZ treaty still contains the proviso at the end of Article 10.2¹⁰⁹, it may be that the proviso still prohibits access to the reduced rates, despite the more lenient dividend definition included in Article 10.3 of the said treaty. The SA-UK treaty, on the other hand, does not include the proviso at all which, in the writer's opinion, removes the last potential barrier to treaty relief for the SA company seeking to claim relief on the Dividends Tax paid on the secondary adjustment.

¹⁰⁹ i.e. which provides that the reduced rates may not apply to affect the taxation of the company in respect of the profits out of which the dividend is paid.

3.3 Conclusion

Chapter 3 proceeded with answering the question whether a SA company will have access to the reduced rates in Article 10.2 of the OECD MTC by investigating whether the deemed dividend under a secondary adjustment qualify as a dividend for purposes of Article 10 of the OECD MTC.

It was concluded that the dividend definition in Article 10.3 of the OECD MTC can be divided into three parts, of which the first two parts only apply to actual dividends and therefore excludes deemed dividends. The third part of the definition deals with deemed dividends and requires that the amount must be ‘income from other corporate rights (first requirement) and must be subjected to the same taxation treatment as income from shares in the source state (second requirement).

First requirement:

In order to adhere to this requirement, it was found that a causal relationship between the income amount and a corporate right had to be present. Some authors contended that such a causal relationship was present by virtue of paragraph 28 of the Commentary on Article 10.3 of the OECD MTC which provides that the dividend definition does not only include a distribution of profits decided by annual general meetings of shareholders, but also other benefits in money or money’s worth, such as a *disguised distribution of profits*. These authors describe a “hidden profit distribution” as the equivalent of a constructive dividend and are of the view that it includes amounts paid to a shareholder in excess of an arm’s length price for goods or services rendered (as is the case with TP adjustments).

It was however concluded that Hattingh’s narrow interpretation of a “hidden profit distributions” appears to be correct. He contends that the relevant commentary has no legal basis itself to import a *substance-based* notion of the concept of a dividend into a treaty. Only in cases where the *actual substance* of the transaction was found to be that of a dividend under *domestic substance-over-form doctrines or the GAAR*, can the necessarily legal basis be present to re-characterise the amount as a hidden profit distribution, and therefore a dividend, for purposes of Article 10 of the OECD MTC. Primacy to a domestic re-characterisation can therefore only be given where the *true* substance of the transaction

was found to be a dividend under domestic law, and not in scenarios where the substance is *presumed* to be that of a dividend, as is the case with deemed dividends under a secondary adjustment in terms of article 31(3) of the ITA.

The Chapter therefore concluded that, in the absence of the application of domestic substance-over-form doctrines or the GAAR proving otherwise, deemed dividends under a secondary adjustment do not amount to income from other corporate rights as envisaged by article 10.3 of the OECD MTC.

Second requirement:

This requirement states that the secondary adjustment must be subjected to the same taxation treatment as income from shares in SA. A deemed dividend under a secondary adjustment is treated as a dividend in *specie* in SA, and as such Dividends Tax is levied on company level, as opposed to on shareholder level as with cash dividends.

Chapter 3 therefore considered whether this disparity may result in a denial of treaty benefits on the basis that the secondary adjustment is not subject to the same taxation as income from shares, i.e. cash dividends. Several factors were considered in this regard. Firstly, the Volkswagen case ruled that Dividends Tax is a tax levied on the income of shareholders, and not the distributed profits of a company. Secondly, BGR 9 states that although Dividends Tax is a covered tax for treaty purposes, dividends in *specie* will nonetheless not qualify for treaty relief as it is levied on company level, rather than on shareholder level. Thirdly, it is clear from the wording used in 64FA(2)(a) of the ITA (domestic relief provisions) that dividends in *specie* will never qualify for treaty relief because the tax is levied on company level as opposed to on shareholder level as is the case with cash dividends. Fourthly, the OECD generally defines dividends as *taxable income of shareholders* which further suggests that the tax must be levied on shareholder level, as is the case with cash dividends in SA. Finally, the wording used in SA's DTA's with NZ and the UK does not contain the requirement that the amount must be subject to the same taxation treatment as income from shares. Such an omission would not have been necessary if it was irrelevant for treaty relief purposes, whether the tax was levied on company level or on shareholder level.

Given the above arguments, Chapter 3 concluded that a deemed dividend under a secondary adjustment cannot be regarded as being subject to the same taxation as income from shares in South Africa.

From the above conclusions, it becomes apparent that a deemed dividend under a secondary TP adjustment will most likely not fall within the dividend definition of the OECD MTC and will therefore not qualify for the reduced rates provided for in Article 10.2 of the OECD MTC. Treaties which however deviate from the OECD MTC in that it has removed the first and second requirement in its dividend definition, show greater prospects of success in this regard. For example, the SA-UK DTA and the NZ-SA DTA, where the first and second requirement has been removed from the dividend definition, may indeed be wide enough to include within its ambit deemed dividends under a secondary adjustment.

Chapter 4 will now proceed to establish whether a deemed dividend under a secondary adjustment in SA can be regarded as 'paid' for purposes of Article 10.1 and 10.2 of the OECD MTC.

CHAPTER 4: THE 'PAID' REQUIREMENT - ARTICLES 10.1 AND 2 OF THE OECD MTC

4.1 Introduction

It was established in Chapter 3 that the SA company will have access to the reduced rates provided for in Article 10.2 of the OECD MTC, if it can be shown that:

- The deemed dividend under the secondary adjustment falls within the dividend definition of Article 10.3 of the OECD MTC; and
- The said deemed dividend can be regarded as 'paid' as envisaged by Articles 10.1 and 10.2 of the OECD MTC.

Chapter 3 investigated the first question and established that this requirement will not be met as deemed dividends under a secondary adjustment do not represent income from a corporate right and is also not subject to the same taxation treatment as income from shares. Treaties that deviate from the wording used in the dividend definition of the OECD MTC may potentially include such deemed dividends within its ambit especially if it does not contain the requirements that the amount must be income from a corporate right and taxed in the same manner as income from shares, as is the case with the SA-NZ DTA and the SA-UK DTA.

Chapter 4 will now consider the second question, i.e. whether deemed dividends under a secondary adjustment can be regarded as 'paid' for purposes of Article 10 of the OECD MTC.

4.2 Can deemed dividends be regarded as 'paid' for purposes of Article 10

Article 10.1 of the OECD MTC provides that dividends *paid* may be taxed by the State of which the shareholder receiving the dividend, is a resident. Article 10.2 of the OECD MTC provides that the State in which the company *paying* the dividend is a resident, may also tax the dividends *paid* but limits the right to tax in the form of a reduced rate of tax. From the above it is clear that both distributive rules require that the dividend has been *paid* in order for the relevant distributive rule to apply.

It therefore needs to be considered whether a deemed dividend under a secondary adjustment can be regarded as 'paid' for purposes of Article 10.2 of the OECD MTC, especially as no payment has occurred in the typical sense.

The terms 'paid', 'paying' and payment are however not defined in Article 10 of the OECD MTC.¹¹⁰ The Commentary on Article 10.1 of the OECD MTC provides more guidance in this regard and attributes a very wide meaning to these terms.¹¹¹ It states that 'the concept of payment means the fulfilment of the obligation *to put funds at the disposal of the shareholder* in the manner required by contract or by custom'.¹¹² (*emphasis added*)

Commentators on the OECD MTC are also of the opinion that the term 'payment' and its derivatives should be interpreted in a broader sense.¹¹³ In the context of Article 10, Vogel describes payment as 'the provision of any advantage qualifying as a dividend under Art. 10.3'.¹¹⁴ Peter Wattel is also of the opinion that the terms 'paid' and 'payment' should be interpreted broadly, but in any case should include a fulfilment of an obligation, or at least a real shift of assets or value from one taxpayer to another.¹¹⁵ Marjaana Helminen also remarked that the term 'paid' 'must be interpreted to include any form of satisfying the shareholder's claim to receiving the dividend'.¹¹⁶ She concludes by stating that the term 'payment' includes the provision of *any advantage* from a company to a shareholder provided the dividend would otherwise qualify as a dividend.¹¹⁷ Her view is in line with that of Vogel in that they both agree that 'paid' should mean any advantage qualifying as a 'dividend' under Art. 10.3 of the OECD MTC. Hattingh puts it somewhat differently and remarks that as 'the use of the word "paid" in Article 10.1 of the OECD MTC has as its function the identification of the person entitled to the benefits of the specific treaty provision, the word should probably not be read so as to restrict the treaty application when an item falls within the definition of a dividend'.¹¹⁸ In the same vein, Teixeira is of the opinion that deemed distributions treated by domestic law as dividends could be considered as

¹¹⁰ Teixeira, 2009:462

¹¹¹ Refer par. 7 of the said Commentary

¹¹² Refer par. 7 of the said Commentary

¹¹³ Teixeira, 2009:462

¹¹⁴ Vogel, 1997:587,n.44

¹¹⁵ Wattel & Marres, 2003:68

¹¹⁶ Helminen, 1999:248

¹¹⁷ Helminen, 1999:248

¹¹⁸ Hattingh, 2009:521

'paid' for treaty purposes, as they constitute real asset shifting from a company to a shareholder.¹¹⁹The writer is in agreement with these views.

On another note, the Commentary on Art. 10(1) of the OECD MTC, as outlined above, explains that the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or by *custom*. The reference to the word 'custom', as used in the commentary, accords with the 'renvoi' as per the interpretation rule found in Article 3(2) of the OECD MTC. This rule applies when a term is undefined in a treaty, and refers us back to the domestic laws of the country applying the treaty in order to attribute meaning to the term, unless the context otherwise requires. As the SA company is looking to the treaty for relief in regards to the Dividends Tax paid in SA, the 'renvoi' is to be made to the domestic laws of SA, and more specifically the tax laws of SA in the first instance.¹²⁰In this regard section 31(3) of the ITA, being the section in terms of which the secondary adjustment is triggered, regards the deemed dividend to be declared and *paid* on the last day of the period of six months following the end of the year of assessment in respect of which that adjustment is made. This sentiment is echoed by section 64E(2)(b) of the ITA which provides for a deemed *payment* date for dividends taking the form of a distribution of an asset *in specie*, like the secondary adjustment made in regards to companies. From the above, it is therefore clear that it is SA's custom and current tax law to regard the deemed dividend under the secondary adjustment as 'paid'. As such, based on the 'renvoi rule', the deemed dividend under the secondary adjustment in SA can be regarded as 'paid' for purposes of Article 10 of the OECD MTC.

4.3 Conclusion

To conclude, based on the Commentaries on Article 10.1 of the OECD MTC and the learned authors' interpretation thereof, as well as SA's domestic tax law and customs by virtue of the 'renvoi rule' in Article 3(2) of the OECD MTC, the deemed dividend under the secondary adjustment for SA tax purposes can be regarded as 'paid' for purposes of Article 10 of the OECD MTC.

¹¹⁹ Teixeira, 2009:462

¹²⁰ In terms of Art. 3(2) of the OECD MTC any meaning under the applicable tax laws of the State applying the treaty will prevail over a meaning given to a term under other laws of that State.

CHAPTER 5: CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

The purpose of this dissertation has been to establish whether a deemed dividend under a secondary adjustment in SA will qualify for the treaty relief provided for by Article 10 of the OECD MTC.

This determination was made by answering the questions outlined below.

Chapter 2 considered whether the SA company paying the Dividends Tax on the deemed dividend will have access to treaty relief, especially given the fact that Dividends Tax is not listed as a covered tax in most of SA's current DTA's in force.

Chapter 3 considered whether a deemed dividend under a secondary adjustment in SA will fall within the ambit of the dividend definition contained in Article 10.3 of the OECD MTC.

Chapter 4 considered whether a deemed dividend under a secondary adjustment in SA can be regarded as 'paid' for purposes of Article 10.1 and 10.2 of the OECD MTC.

Within and around each of these core issues, further questions were examined. The issues, conclusions and recommendations arising from the preceding chapters are outlined below.

5.2 Chapter 2 – Dividends Tax as a 'covered tax' for SA tax treaty purposes

Dividends Tax is not specifically listed as a 'covered tax' in almost all of SA's tax treaties currently in force. This is so because most of these treaties were concluded prior to the introduction of Dividends Tax in SA on 1 April 2012. Chapter 2 however found that it is the current practice in SA to regard Dividends Tax as a 'covered tax' for SA tax treaty purposes. This practice stems from BGR 9 issued by SARS on 19 February 2013. BGR 9 provides that Dividends Tax is a covered tax for SA tax treaty purposes as it is a tax on an element of income as envisaged by paragraphs 1 and 2 of Article 2 of the OECD MTC, or alternatively, in the absence of paragraphs 1 and 2 in a treaty, it is a tax similar to STC since it is a tax on income and therefore a covered tax by virtue of paragraph 4 of Article 2 of the OECD MTC.

The view taken by SARS in BGR 9 appears contrary to the ruling made in the Volkswagen case, i.e. that Dividends Tax cannot be regarded as a tax substantially similar to STC. However,

as BGR 9 is binding on SARS for an indefinite period it is the practice prevailing at the time. As such, Dividends Tax is a covered tax for SA tax treaty purposes.

5.3 Chapter 3 – Scope of the OECD MTC dividend definition

Building on the findings in Chapter 2, Chapter 3 proceeded to investigate whether a deemed dividend under a secondary adjustment will qualify for the specific relief provided for in Article 10 of the OECD MTC. In order to determine whether the SA Company will have access to the reduced rate provided for by Article 10, it was submitted that two questions must be considered. Firstly, whether the deemed dividend will fall within the ambit of the dividend definition in Article 10.3 of the OECD MTC, and secondly, whether it can be regarded as 'paid' as envisaged by Article 10. Chapter 3 concerned itself with answering the first question.

Chapter 3 found that a deemed dividend under a secondary adjustment in SA will qualify as dividend for purposes of the OECD MTD if, firstly, it represents income from other corporate rights, and secondly, it is subjected to the same taxation treatment as income from shares in SA.

First requirement:

In investigating the first requirement, Chapter 3 considered the views of various writers. Teixeira, although placing less emphasis on this requirement, contends that this requirement will be met in light of the Commentary on Article 10.3 of the OECD MTC and based on the ruling made in the German Federal Tax Court. The commentary that Teixeira refers to, states that the dividend definition does not only include a distribution of profits decided by annual general meetings of shareholders, but also other benefits in money or money's worth, such as a disguised distribution of profits. The German Federal Tax Court ruled that constructive dividends may be assumed if a corporation suffers a decrease in assets by granting a pecuniary benefit to its shareholders or a related person that a diligent businessman would not have granted to an unrelated party. Teixeira therefor submits that the secondary adjustment amounts to a disguised distribution of profits and can therefore be seen as income from a corporate right. She is of the view that such a secondary adjustment will

qualify as a dividend for purposes of Article 10 provided it is also regarded and taxed as such under domestic law.

Larking's views are in alignment with that of Teixeira. He explains that constructive dividends can include amounts paid to a shareholder in excess of an arm's length price for goods or services rendered.

Hattingh conducted a study of the history of the dividend definition as developed by Working Parties Nos. 11 and 12 of the OEEC/OECD. Based on his review, he is of the view that it was not within the spirit of their work that the link to domestic law should provide *carte blanche* to deem anything to be a dividend for treaty purposes. Even though an amount is treated as a dividend under domestic law, it will only qualify as a dividend for treaty purposes in his view, if it adheres to what he calls the 'essential condition, i.e. that there must be a causal relationship between the income and a corporate profit sharing right. On the point of a hidden profit distribution, Hattingh contends that the Commentary on Article 10.3 of the OECD MTC has no legal basis itself to import a substance-based notion of the concept of a dividend into a treaty definition. He is of the view that only in cases where the actual substance of the transaction was found to be that of a dividend under domestic substance-over-form doctrines, can the necessarily legal basis be present to re-characterise the amount as a dividend for purposes of Article 10 of the OECD MTC. He bases his opinion on the judgement in the RMM Enterprises case where it was found under the Canadian GAAR that a sale of shares to a tax accommodating party attempted to disguise a distribution of profits. The Canadian Court held that the treaty's definition of a dividend (based on the OECD Model) was wide enough to cover the deemed dividend. Hattingh however is of the view that the judgement in this case does not extend to presumptive re-characterisation rules under domestic legislation. It only gives primacy to a domestic re-characterisation where the *true* substance of the transaction was found to be a dividend under domestic law, and not the *presumed* substance under domestic rules like the secondary adjustment in article 31(3) of the ITA.

To shed further light on the varying views, this study consulted treaties which SA currently has in force and that contain a dividend definition that varies from the one found in Article 10.3 of the OECD MTC. The treaties consulted were the treaty that SA currently has in force

with the UK and NZ. In both treaties the requirement that the income must be from a corporate right is not present. Both treaties merely require that the income must be treated as income from shares under domestic legislation. The effect of the words 'treated as income from shares' specifically imports into the relevant treaty the presumption made under domestic legislation thereby providing the necessary legal basis to re-characterise the amount as a dividend for treaty purposes. There would be no reason to deviate from the wording used in the model definition in Article 10.3 of the OECD MTC if it already provided the necessary legal basis to import the assumption made under domestic law.

As such, it was found that Hattingh's view appears to be correct and that a deemed dividend under a secondary adjustment in SA will most likely not constitute income from a corporate right, but rather income from a contractual right (i.e. the TP agreement). Only in cases where the actual substance of the secondary adjustment is found to be that of a dividend under domestic substance-over-form doctrines or the GAAR, may it be re-characterised as a hidden profit distribution, and therefore a dividend for purposes of the OECD MTC.

Second requirement:

This requirement asks that the secondary adjustment must be subjected to the same taxation treatment as income from shares in SA. On first glance it appears as though this requirement is easily met, as the secondary adjustment is deemed to be a dividend in *specie* and is subjected to Dividends Tax in SA. On closer scrutiny however, Chapter 3 found that the manner in which dividends in *specie* are taxed, differs from the manner in which cash dividends are taxed. With dividends in *specie*, the tax is levied on company level, whereas with cash dividends the tax is levied on shareholder level. Chapter 3 found that this disparity results in a denial of treaty benefits on the basis that the secondary adjustment is not subjected to the same taxation as income from shares.

The basis for this conclusion was found to be as follows:

- Firstly, the Volkswagen case ruled that Dividends Tax is a tax levied on the income of shareholders, and not the distributed profits of a company.
- Secondly, BGR 9 issued by SARS states that although Dividends Tax is deemed to be a tax similar to STC and therefore a covered tax for treaty purposes, dividends in *specie*

will nonetheless not qualify for treaty relief as it is levied on company level, rather than on shareholder level.

- Thirdly, 64FA(2)(a) of the ITA acknowledges the reduced rates in the treaty for purposes of providing domestic relief, but only on the basis that the dividend in *specie* would have qualified for treaty relief had it been a cash dividend. This formulation of the test for domestic relief suggests that dividends in *specie* would otherwise not qualify for treaty relief. As the only difference between dividends in *specie* and cash dividends, in regards to the way in which Dividends Tax is levied, is the person on whom it is levied, the only inference to be drawn is that access to treaty relief is prevented in scenarios where the Dividends Tax is levied on company level rather than on shareholder level. This inference is supported by the proviso to Article 10.2 of the OECD MTC which states that the reduced rates cannot be applied to affect the taxation of the company in respect of the profits out of which the dividends are paid.
- Fourthly, the OECD generally defines dividends as *taxable income of shareholders* which further suggests that the tax must be levied on shareholder level, as is the case with cash dividends in SA.
- Finally, the wording used in SA's DTA's with NZ and the UK does not contain the requirement that the amount must be subject to the same taxation treatment as income from shares. Such an omission would not have been necessary if it was irrelevant for treaty relief purposes, whether the tax was levied on company level or on shareholder level.

Chapter 3 therefore concluded that a deemed dividend under a secondary TP adjustment will, in most cases, not adhere to the first and second requirement and therefore not qualify as a dividend for purposes of the OECD MTC. As such, the SA Company will not have access to the reduced rates provided for in Article 10.2 of the OECD MTC.

Treaties which however deviate from the OECD MTC in that it has removed the first and second requirement in its dividend definition, show greater prospects of success. The SA-UK DTA and the NZ-SA DTA, for example, does not contain the first and second requirement in

its dividend definition, and may therefore indeed be wide enough to include within its ambit deemed dividends under a secondary adjustment.

5.4 Chapter 4 – The ‘paid’ requirement

Article 10 of the OECD MTC only applies to dividends which are regarded as ‘paid’. Chapter 4 therefore considered whether a deemed dividend under a secondary adjustment can be regarded as ‘paid’ especially as no payment has occurred in the typical sense of the word. It was found that the term should enjoy a wide meaning and entails the fulfilment of the obligation to put funds available at the disposal of the shareholder in the manner provided for by contract or *custom*. This includes a real shift of assets or value from one taxpayer to another as is the case with a primary TP adjustment. Furthermore, it was found that the reference to the word ‘custom’ above, accords with the *renvoi* rule in Article 3.2 of the OECD MTC which deals with the interpretation of terms not defined in the treaty and which provides that the term shall adopt the meaning it has under the tax laws of the state applying the treaty. In this regard, both sections 31(3) and section 64E(2)(b) of the ITA regard the deemed dividend under a secondary adjustment in SA as ‘paid’ for domestic purposes. It was therefore found that it is SA’s custom and current tax law to regard the deemed dividend under a secondary adjustment as ‘paid’ for purposes of Article 10 of the OECD MTC.

5.5 Final remarks and recommendations

Although deemed dividends under a secondary adjustment in SA will be regarded as ‘paid’ for purposes of the OECD MTC, it does not qualify as a dividend for purposes of Article 10 of the OECD MTC as it does not present income from other corporate rights and is not taxed in the same manner as income from shares in SA. As such, the SA Company paying the Dividends Tax will not have access to the reduced rates provided for in Article 10.2 of the OECD MTC.

Treaties that SA currently have in force and that are based on the OECD MTC will therefore deny the SA company access to the reduced rates provided for in Article 10 of the OECD MTC. This treatment is in line with the report issued by the DTC and is based on the policy consideration that TP adjustments are anti-avoidance provisions and therefore penal in

nature. Any relief for the tax paid in terms of these penal provisions will render them less effective in addressing the mischief sought to be addressed, i.e. BEPS.

However, should Treasury decide to rather adopt a more 'forgiving' (and more competitive) policy, they may wish to grant the SA company paying the Dividends Tax on the secondary adjustment access to the reduced rates provided for in Article 10 of the OECD MTC. Should this be the case, it is recommended that the future tax treaties to be concluded with the various treaty partners should deviate from the OECD MTC, as follows:

- Remove the requirement in the dividend definition in Article 10.3 that the amount should represent income from other corporate rights;
- Remove the requirement in the dividend definition that the amount should be subjected to the same taxation as income from shares in the source state;
- Remove the proviso at the end of the distributive rule which provides for the reduced rates (Article 10.2 of the OECD MTC) which provides that the reduced rates may not be applied to affect the taxation of the company in regards to the profits out of which the dividend is paid.

Given that it is not always possible and timely to amend treaties currently in force, it is recommended that the provisions for domestic relief be revised and amended so as to ensure that domestic relief is indeed available for deemed dividends under a secondary adjustment in SA, should Treasury decide to adopt a more lenient policy consideration in this regard.

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APPENDIX A

ARTICLE 10(1)-(3): COMPARISON BETWEEN THE OECD MTC AND THE UN MTC

Article	OECD MTC	UN MTC
10(1)	Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.	Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
10(2)	<p>However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:</p> <p>a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;</p> <p>b) 15 per cent of the gross amount of the dividends in all other cases.</p> <p>The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.</p> <p>This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.</p>	<p>However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State*, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:</p> <p>a) ___ per cent (the percentage is to be established through bilateral negotiations)** of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent*** of the capital of the company paying the dividends;</p> <p>b) ___ per cent (the percentage is to be established through bilateral negotiations)** of the gross amount of the dividends in all other cases.</p> <p>The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.</p> <p>This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.</p>
10(3)	The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.	The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

Notes:

In the above table, the wording of Articles 10(1) to 10(3) has been compared between the OECD MTC and the UN MTC, and differences have been highlighted in bold text. The identified differences have been analysed in the notes below to ascertain whether there is any difference in meaning between the two mentioned model conventions for purposes of this study:

- * The order of the words used in the UN MTC differs from the order used in the OECD MTC, but the meaning remains the same between the two models.
- ** The OECD MTC contains preselected reduced rates for Dividends Withholding Tax, whereas the UN MTC leaves the reduced rates open for negotiation between the Contracting States. This, however, does not detract from the meaning of the words used in Article 10(2) in any manner.
- *** The minimum required percentage shareholding in the company paying the dividend for the lower reduced rate in (a) to apply is much lower under the UN MTC than under the OECD MTC. This only represents a difference in the threshold requirement, and does not represent a difference in meaning between the two mentioned model conventions.

On a further note, the Commentary on the UN MTC in regards to Article 3(1)-(3) refers to the Commentary on the said articles in the OECD MTC. For purposes of this study, the two mentioned models and their respective commentaries can be treated as substantially similar to one another.