South Africa's Restrictions on Interest Deductions and Their Compatibility with the Non-Discrimination Provisions of the 2017 Version of the OECD Model.

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ABSTRACT

This dissertation examines whether South Africa's interest deduction tax laws are compatible with selected aspects of their Double Taxation Treaties that are based on the 2017 OECD Model Tax Convention. This dissertation will outline and examine the innerworkings of three of South Africa's domestic interest deduction legislative provisions namely, sections 23N, 31 and 23M of the Income Tax Act. Thereafter, the relevant Non-Discrimination provisions of the 2017 OECD Model Tax Convention contained in Article 24 will be discussed. The exemptions to Article 24 will also be dealt with before addressing the impact of the recently added 'Savings Clause'. The understandings gained from the above will then be used to test South Africa's interest deduction legislative provisions against the relevant Articles of the OECD Model Tax Convention. This dissertation concludes the following: section 23N does not constitute discrimination; section 31 necessarily does but falls within one of the exemptions to Article 24; and section 23M violates the non-discrimination provision contained in Article 24(4) and as such, is not compatible with any of South Africa's Doubled Taxation Treaties that contain the relevant Articles. This dissertation ends off with recommendations on how South Africa deals with the conflict, the best of which is to amend section 23M to include an arm's length requirement.

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Table of Contents

Chapter 1: Introduction

I. BACKGROUND

The threat posed by Base Erosion and Profit Shifting ("**BEPS**") is not unique to South Africa, but it does tend to disproportionately affect developing countries which has caused it to attract an ever-increasing amount of discourse.[1] It is estimated that South Africa are losing USD $7 billion annually as a result of these harmful practices.[2] One of the main methods employed in order to achieve BEPS is through excessive interest deductions. A typical example of how this type of BEPS occurs is when multinational enterprises ("**MNEs**") finance a local subsidiary in South Africa with incredibly high levels of debt. The local subsidiary then repays this loan over time and is able to claim the interest expense as a deduction against their taxable income.[3]

In response to the BEPS problem caused by excessive interest deductions, South Africa has implemented several provisions geared towards combatting the abuse.[4] For the purposes of this dissertation, only the provisions that focus on the deductibility of interest, of which there are three, will be dealt with.[5] Two of the provisions are fairly similar in that they both make use of a formula that contains several variables that effectively limits the amount of interest repayments that can be claimed as a deduction. The main difference between the two provisions is that one applies to reorganization and intra group transactions as defined in the Income Tax Act 58 of 1962

[1] BEPS is the process whereby profits that accrue in one state are shifted to another without the first mentioned state being able to levy taxes on those profits and as a result, eroding the state's tax base. See Crivelli, E., De Mooij, R.A. and Keen, M.M., 2015. *Base erosion, profit shifting and developing countries* (No. 15-118). International Monetary Fund at page 4 for a discussion on how BEPS hits developing countries harder than developed countries.
[2] L. Donnelley, Giants cost SA billions in lost taxes' 2019 accessible at https://mg.co.za/article/2019-01-11-00-giants-cost-sa-billions-in-lost-taxes/ [accessed on 25/01/2019]
[3] Section 10 of the Income Tax Act allows for the deduction of interest expenses against taxable income.
[4] M. Rudniki, 2015. Interest-deduction limitation-Section 23N. *Business Tax and Company Law Quarterly*, *6*(2) at page 38.
[5] Withholding taxes, while a useful mechanism to combat BEPS, will not be discussed in this dissertation as they do not raise discriminatory concerns which is what this dissertation, for the most part, is concerned with.

(**“ITA”**), while the other applies only to transactions where there exists the possibility of BEPS.[6] The third provision contains South Africa’s transfer pricing rules and applies only to transactions that are deemed to not have been concluded at arm’s length.[7]

While addressing the aforementioned problem through domestic legislation is a necessary step, there exists the possibility that these domestic laws could conflict with tax treaties that are based on the OECD Model Tax Convention (“**OECD MTC**”). The reason for this is that the OECD MTC contains an Article whose express purpose it is to prevent discrimination based on various grounds.[8] Two of the grounds on which this Article prevents discrimination, are residency and foreign ownership.[9] Therefore, if any of the abovementioned domestic laws discriminate based on either of these grounds, they could be in conflict with the OECD MTC. This, however, is not where the enquiry would end. This is because the OECD MTC contains exemptions to the non-discrimination Article, where if certain requirements are met, despite being discriminatory, the relevant domestic laws would not be incompatible with the OECD MTC.

The reason that this issue has become topical, despite the conflict potentially existing for years, is due to the recent addition of Article 1(3), known as the “Saving Clause”, in the 2017 version of the OECD MTC. The Savings Clause provides that Double Taxation Treaties do not limit a State’s right to tax its own residents unless the relevant treaty explicitly states so. This has caused debate to form around whether the non-discrimination clause contained in the OECD MTC can prevent a State from applying certain of its domestic provisions.

[6] Section 23N of the Income Tax Act applies to reorganization and intra group transactions while section 23M applies only to in situations where BEPS is a concern.
[7] Section 31 of the Income Tax Act.
[8] Article 24 of the OECD Model.
[9] Article 24(4) and (5) of the OECD Model.

II. RESEARCH QUESTION AND SCOPE

The aim of this Minor-dissertation is to assess the compatibility of South Africa's domestic legislation dealing with excessive interest deductions with the non-discrimination provisions contained in South Africa's Double Taxation Treaties. I will focus on South Africa's response, through its domestic legislation, to the base erosion and profit shifting ("**BEPS**") caused by excessive interest deductions. I test these domestic laws against the OECD MTC, on which South Africa bases most of its Double Taxation Treaties and determine whether or not a conflict exists. Should a conflict between South Africa's domestic law and its Double Taxation Treaties be found to exist, solutions as to how to resolve the conflict will be put forward. As a precursor to this discussion, the impact of the addition of Article 1(3) into the 2017 version of the OECD MTC will be examined.

This dissertation will hinge on whether any of South Africa's domestic laws on interest deductibility, first, constitute discrimination in terms of the non-discrimination Article of the OECD MTC. And second, if discrimination is found to exist, whether the domestic laws fall within one of the exemptions that the OECD MTC provides for. There will also be a brief discussion on the impact of the Savings Clause should South Africa to choose to adopt it before concluding with recommendations on how to resolve the potential conflict.

It is important to keep in mind that while South Africa's laws on interest deductibility will be looked at in depth, the purpose of this dissertation is not to determine whether or not South Africa's domestic legislation does enough to prevent profit shifting.

III. RESEARCH METHOD

This dissertation follows a qualitative doctrinal approach in that various bodies and models of law, both domestic and international will be examined, namely, the Income Tax Act ("**ITA**") and the OECD MTC with accompanying commentary. Issues of interpretation with the aforementioned bodies of law will require additional texts to be examined such as the Vienna Convention, OECD publications, and various opinions of prominent South African and International academics.

IV. STRUCTURE OF THIS PAPER

This dissertation is divided into six chapters. *Chapter 2* of this paper will take an in-depth look at the ITA and South Africa's response to limiting the deductibility of interest. This will involve unpacking which scenarios section 23N, 23M and 31 apply to, before using diagrammatic examples to illustrate how each section limits the amount of interest expense that can be claimed as a deduction.

Chapter 3 will begin by examining the relevant paragraphs contained in the non-discrimination Article will be dealt with before looking at the arm's length and special relationship exemptions respectively.[10] Penultimately, the type of comparability analysis required by Articles 24(4) and (5) will be looked at before looking at, when multiple provisions of the OECD MTC are applicable, the hierarchy and interaction of the various provisions[11]. Lastly, the potential impact of the introduction of the Savings Clause will be looked at, with particular focus on its effect on Article 9(1).

Chapter 4 determines whether or not South Africa's domestic interest deduction laws are compatible with the 2017 OECD Model. As a preliminary matter, the distinction between direct,

[10] Article 9(1) and 11(6) of the OECD MTC.
[11] It should be noted that unless otherwise stated, all references to Articles will be to Articles of the 2017 OECD Model. The reason the OECD Model is preferred over the UN Model, is not because the respective Articles differ significantly, but rather because a strong majority of South Africa's treaties are based on the OECD Model and not the UN model. The reason that the 2017 version of the OECD model is opted for will be discussed in depth in Chapter 3.

indirect and disguised discrimination will be discussed, as well as which types of discrimination are covered by Article 24. After which the chapter will look at whether each of the three domestic interest deduction rules constitute prima facie discrimination. Thereafter, the rules that are found to be discriminatory will be tested against the relevant OECD MTC Articles discussed in Chapter 3, whereas the rules that do not constitute prima facie discrimination will automatically not be incompatible with the OECD MTC and the enquiry into those specific rules will end there. This chapter will conclude the following: section 23N does not constitute prima facie discrimination; section 31 necessarily entails discrimination but only through incorrect application can be in conflict with the OECD MTC; and section 23M constitutes disguised discrimination and is in direct conflict with the OECD MTC.

Chapter 5 of this paper will examine the consequences of the clash been South Africa's section 23M and Article 24(4) of the 2017 OECD Model. This will require an in depth look at the status of provisions of treaty provisions in South African law. In order to do this, South African case law as well as academic view points on the matter will be discussed before international commentary is turned to. *Chapter 5* will conclude by listing the options available to South Africa that would allow a resolution of the conflict before recommending the most suitable option based on various factors such as policy considerations and ease of implementation.

Chapter 2: South Africa's Interest Deduction Rules

I. INTRODUCTION

In this chapter, I will explain South Africa's response to excessive interest deductions. This chapter will be separated into two sections, each section dealing with a different type of transaction. The first section will deal with reorganization and acquisition transactions to which section 23N applies. The second section will deal with all the other types of transactions to which section 31 and 23M apply.

South Africa's response to excessive interest deductions began in 1995 when the South African Treasury introduced a debt to equity ratio.[12] Then, the debt to equity ratio was 3:1 which effectively means that a company's capital could consist of a maximum of 75% debt. If any interest payments were made in lieu of debt in excess of that 75%, the interest would not be deductible.[13] A debt to equity rule in isolation has easy work arounds and so the legislature has, over the years, made several adjustments and enacted various provisions to combat the evolving tactics of MNEs.[14] Twenty-three years later, and South Africa has a robust legal regime to combat BEPS caused by excessive interest deductibility, consisting of three 3 key provisions of the ITA: Section 23N; Section 31; and Section 23M.

Section 23N deals with excessive interest deductions that are directly a result of reorganisation or acquisition transactions.[15] Section 31 and section 23M are broader than section

[12] A. Readhead, 'Preventing Base Erosion: South Africa's Interest Limitation Rules', *Natural Resource Charter Case Study* (2017) at page 1.
[13] Ibid.
[14] For an example of how debt to equity rules have easy work arounds, please see A. Beesley,"*Engie tax arrangements broke European tax law – EU Commission*," Financial Times, 5 January 2017, https://www.ft.com/content/38779574-35a8-3b00-86ef-f6498186a3fa
[15] Section 23N(2) states the following: "Where an amount of interest is incurred by an acquiring company in terms of a debt-

(a) directly or indirectly assumed or applied for the purpose of procuring, enabling, facilitating or funding the acquisition by that acquiring company of any asset in terms of a reorganisation transaction;

23N and deal with excessive interest deductions that are caused by transactions other than reorganisation or acquisition transactions.[16] These three sections will be discussed specifically within the context of MNEs for two reasons. Firstly, there are certain consequences that only arise when interest payments are made to an entity that is located outside of South Africa, and it is these consequences that we are interested in. And secondly, because this thesis is concerned with discrimination it is necessary to discuss MNEs where at least one entity is located outside of South Africa.

II. SECTION 23N OF THE INCOME TAX ACT

In 2011, section 45 was suspended in order to give the South African Treasury an opportunity to address BEPS caused by companies abusing the aforementioned section.[17] When Treasury lifted the suspension on section 45, they enacted the temporary section 23K. Section 23K's purpose was to prevent the deductibility of interest that was the result of debt incurred in respect of group reorganisations or liquidation transactions. This blanket prevention on the deductibility was subject to the proviso that the Commissioner of SARS could allow the deductibility of interest incurred as a result of certain transactions provided he or she was satisfied that the transactions were not going to result in base erosion or profit shifting.

The introduction of section 23K placed a huge burden on SARS and the Commissioner as they had to determine whether every section 45 and 47[18] transaction posed a threat to the tax base

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(b) used directly or indirectly for the purpose of redeeming, refinancing or settling the debt contemplated in paragraph (a);

(c) issued, assumed or used in terms of an acquisition transaction; or

(d) used directly or indirectly for the purpose of redeeming, refinancing or settling the debt contemplated in paragraph (c),

the amount of interest allowed to be deducted must not exceed the amount determined in terms of subsection (3)."

[16] See section 31 and 23M of the Income Tax.

[17] Section 45 of the Income Tax Act contains the special rules relating to intra-group transactions.

[18] Section 47 of the Income Tax Act contains the special rules relating to liquidation, winding up and deregistrations.

of the country and, after consulting several factors, decide if the interest would be deductible.[19] This section was always intended to be a temporary solution and, although it was in place longer that initially planned, was replaced by section 23N which came into effect on 1 April 2014.[20]

Section 23N limits the amount of interest that can be deducted in accordance with an equation that is a function of the particular interest accrued or received by the acquiring company and a tax proxy for interest-adjusted earnings before interest, taxes, depreciation, and amortisation (which will referred to as "Tax EBITDA").[21] Before getting into how section 23N operates, it is crucial to understand to which situations s23N applies.

Broadly speaking, section 23N applies to interest incurred in respect of debts that are used to fund two categories of transactions.[22] The first type are reorganisation transactions – reorganisation transactions comprise section 45 intra group transactions and section 47 liquidation transactions. And the second type are acquisition transactions.[23]

An "acquisition transaction" is defined as a transaction whereby the acquiring company acquires equity shares in an operating company or in a controlling company in relation to that operating company. In order to qualify as an "acquisition transaction", the acquiring company must, at the end of the day, be in a controlling position over the acquired company.

Now that it is understood which transactions fall within the scope section 23N, the workings of the formula located in section 23N(4) can be unpacked. The formula is as follows:

Maximum interest allowed as a deduction = X + (A% x Y) - Z

[19] Supra note 4 at page 39.
[20] Ibid
[21] P. Van der Zwan, D.P. Schutte & W. Krugell, 2018, 'An evaluation of interest deduction limitations to counter base erosion in South Africa', *South African Journal of Economic and Management Sciences* page 2
[22] The interest that section 23N applies to is interest as defined in section 24J of the Income Tax Act.
[23] P. Van der Zwan, 'Investment and funding instruments' in SILKE: *South African Income Tax* 21 ed (2018) page 538

Where —

'X' = interest accrued to or received by the acquiring company;

'A' = a percentage calculated by using the following formula:

40 x [(average repo rate + 400 basis points)/10];

'Y' = the highest amount of adjusted taxable income of the acquiring for the following years:

Year in which the acquisition or reorganisation transaction took place;

Year preceding the year in which the acquisition or reorganisation agreement was entered into;

Year in which the interest is incurred by the acquiring company;

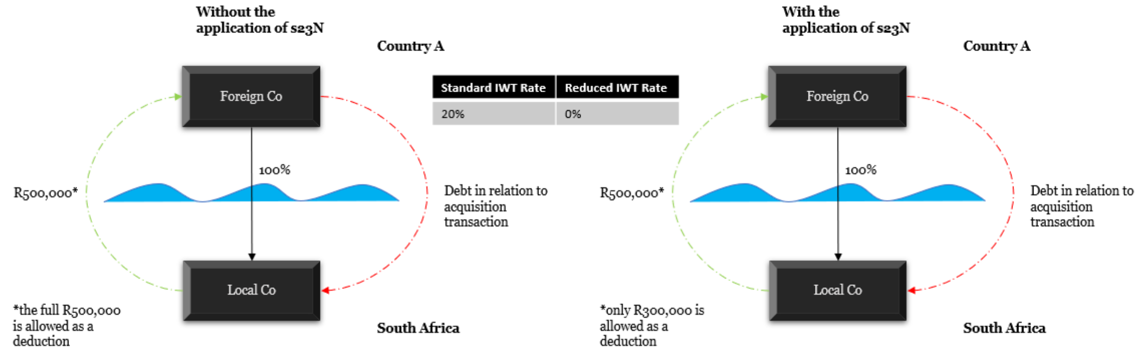
And;

'Z' = interest incurred by the acquiring company in respect of debts to which s23N does not apply.[24]

While the formula itself is convoluted, the inner workings of the formula do not need to be grappled with for the purposes of this Paper. What is important, however, is to understand the basic effect of the formula and the individual variables. Effectively, the larger the company's taxable income and the lower their interest received as a result of debts that section 23N is not applicable to, then the larger the interest deduction that will be allowed in respect of the acquisition or reorganisation transaction. Therefore, the amount of interest expense that will be allowed as deductible is directly proportional to adjusted income and inversely proportional to other interest.

The effect of Article 23N is more easily depicted by use of example.

[24] Section 23N(4) of the Income Tax Act 58 of 1962.



Profit before tax	R1,652,000
Unrelated interest	R100,000
Interest paid	R500,000
Adjusted Taxable Income	R1,052,000

Profit before tax	R1,652,000
Unrelated s23M interest	R100,000
Interest paid	R500,000
Adjusted Taxable Income	R1,052,000

A. Outcome of the transaction without applying s23N:

Local Co has a profit before tax of R1,652,000. They have interest unrelated to the loan for the acquisition transaction of R100,000 and the interest they are paying to Foreign Co is R500,000. If section 23N did not apply to this transaction, the result would be the following: Firstly, Local Co could claim the full R500,000 in interest expense that it is paying over to Foreign Co as a deduction as per section 24J(2) of the Act.[25] In relation to Foreign Co, the interest that they are receiving will be exempt in terms of section 10(1)(h) and withholding tax can only be levied in terms of the relevant Double Taxation Agreement.[26] Double Taxation Agreements based on the OECD MTC usually set out the rules for interest withholding tax in Article 11 and state a certain level which withholding tax needs to be withheld at. A further issue arises in that South Africa has concluded Double Taxation Treaties with certain countries that effectively reduces the rate at which South Africa can tax the interest to 0%.[27] The result of this is that South Africa cannot tax Local Co on its interest payments, nor can it tax Foreign Co on the interest it is receiving. In terms of the above

[25] Section 24J(2) of the Income Tax Act 58 of 1962
[26] Section 10(1)(h) of the Income Tax Act 58 of 1962
[27] For example, Article 11(1) of the Netherlands South Africa DTAA, interest that arises in a Contracting State and paid over to the beneficial owner who is a resident of the other Contracting State is taxable only in that other state.

example, R500,000 is effectively being shifted out of South Africa and into Country A simply through the use of interest deductions.

B. The effect of section 23N

In order to determine the effect of section 23N, one has to apply the formula to the above amounts. The first step is to work out Local Co's adjusted taxable income, which is done by subtracting all interest incurred from the profit before tax amount. Doing so leaves Local Co with an adjusted taxable income of R1,052,000. The next step in this scenario is to multiply the adjusted taxable income by 40%, which yields R400,000.[28] The final step is to subtract from the R400,000, any unrelated interest incurred which is R100,000. This leaves us with a total of R300,000 which represents the maximum deduction that Local Co is allowed in respect of its interest payments to Foreign Co. The overall effect is to reduce the amount of profit that is being shifted out of South Africa and into Country A by R200,000.

Despite this chapter focusing on the domestic provisions in place to prevent excessive interest deductions, it is important to keep in mind the international effects, if any, of these provisions. While section 23N caps the amount of interest expense that is deductible and thus increases the local entity's taxable income, it has no effect on the foreign entity receiving the payments. The reason for this is that the provisions of section 23N do not change the character of the payments made to the foreign entity. Only a certain portion of the interest expense is allowed to be deducted for South African income tax purposes, but Foreign Co's tax is still dealt with in terms of the relevant Double Taxation Treaty. And if the relevant Double Taxation Treaty reduces the withholding tax rate to 0%, then the taxation of Foreign Co remains the same as if section 23N

[28] The average repurchase rate is 5.5% and therefore A = 40 x [5.5+4/10] = 38%

had not been applied. The overall tax liability of the MNE will be increased by section 23N, but the individual welfare of the foreign entity receiving the interest payments is unchanged.

III. SECTION 31 OF THE INCOME TAX ACT

The next interest deductibility law that will be dealt with in this Chapter is section 31 of the ITA which contains South Africa's transfer pricing and thin capitalisation rules.[29] The transfer pricing and thin capitalisation rules were not always contained in the same section and only in 2012 did the legislature decide that combining the set of rules would be more in line with international trends.[30] The type of interest abuse that section 31 wants to prevent is situations where a foreign entity loans money to a connected local entity, let's say for the purchase of certain machinery, but the loan is in excess of what is required for the local entity to purchase said machinery and the interest rate is in excess of what would be considered arm's length. This situation would allow the local entity to claim far larger interest expense deductions than would ordinarily be the case.

The current section 31 has a wide reach and applies to all "affected transactions". A transaction will be an affected transaction if it is one that is entered into directly or indirectly between a resident and a non-resident for the benefit of either or both of the parties involved.[31] Crucially, the resident and non-resident must be connected persons. Additionally, there must be a term or condition in the agreement that differs from a similar agreement between two unrelated entities. Lastly, the transaction must result in a tax benefit for one of the parties to the agreement.[32] A tax benefit will be deemed to have arisen in one of the following two circumstances:

[29] W. Horak & A.J. Bakker, South Africa - Transfer Pricing, Country Tax Guides IBFD at page 1.
[30] A.W. Oguttu, Curbing Thin Capitalization: A Comparative Overview with Reference to South Africa's Approach – Challenges Posed by the Amended Section 31 of the Income Tax Act 1962, 67 Bull. Intl. Taxn. 6 (2013), Journals IBFD page 321
[31] In addition, a transaction will be affected if it entered into between: a non-resident and another non-resident's PE located in South Africa; a resident and another resident's PE located outside of South Africa; and a non-resident anf any CFC in relation to any resident – section 31(1) of the Income Tax Act 58 of 1962
[32] Section 31(2) of the Income Tax Act 58 of 1962

1) The taxpayer is able to deduct an amount greater than what would have been the case had the transaction been concluded between two unrelated entities.
2) The taxpayer's receipts or accruals are reduced by an amount greater than would have been the case had the transaction been concluded between two unrelated entities.[33]

If a transaction is considered an affected transaction, two adjustments need to be made in terms of section 31(2) and section 31(3).

The primary adjustment is focused on correcting the taxable profits of the enterprises involved in the transaction. To do this, it puts the taxable income of both parties at the level it would have been at had the transaction been at arm's length. As such, any interest payments that are deemed excessive or not at arm's length will not be deductible and therefore increase the taxable income of the enterprise to an arm's length level.[34]

Once the primary adjustment has been made and an arm's length amount of interest determined, any "interest" over and above that will, not only be treated as fully taxable, but be reclassified as a dividend in specie.[35] The reasoning behind this is that any value flowing out of South Africa could be a disguised distribution of profits and as such, should be treated as a dividend. While it might not always be the case that a company is trying to disguise a dividend in the shape of interest repayments, it is a legitimate enough concern for the Legislature that it warrants being applied in blanket fashion to all excessive interest payments.

Once the amount is reclassified as a dividend, it will be subject to a dividends tax of 20%. Ordinarily, a dividend could be taxed at a reduced rate depending on which country the dividend

[33] Ibid
[34] Supra note 29 page 6.
[35] Ibid

is flowing out of South Africa into.[36] But because this is a dividend in specie it is argued that it falls outside the scope of the scope of the applicable treaty Article – usually Article 10 in South Africa's Double Taxation Treaties - and is therefore not taxed at a lower rate. This position was confirmed in Volkswagen of South Africa v SARS where it was held that a dividend in specie or a deemed dividend in specie shares characteristics with STC and therefore falls outside the scope of the dividends tax Article of the relevant Double Taxation Treaty.[37]

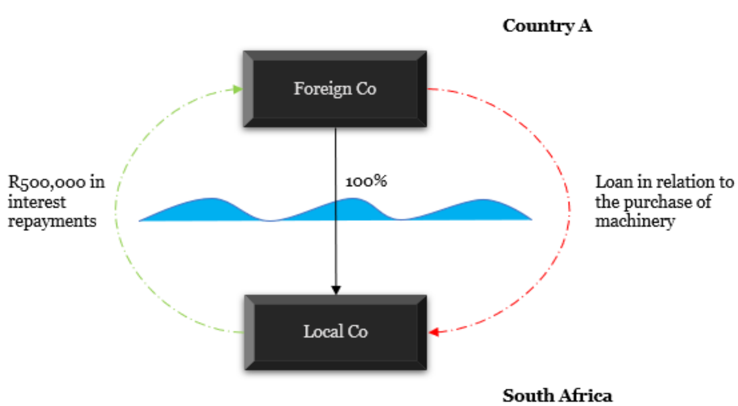
Like with section 23N, the effect of section 31 is best illustrated through the use of an example.

A. Outcome of the transaction without applying s31

In the diagram below, Foreign Co loans money to its related company Local Co, to the value of R500,00 for the purchase of certain machinery. Imagine that the machinery is only going to cost Local Co R200,000 to purchase. Without the application of section 31, the consequences of this transaction are identical to the ones described above in relation to section 23N where that section

Standard IWT Rate	Reduced IWT Rate
20%	0%

Standard DWT Rate	Reduced DWT Rate
20%	0%



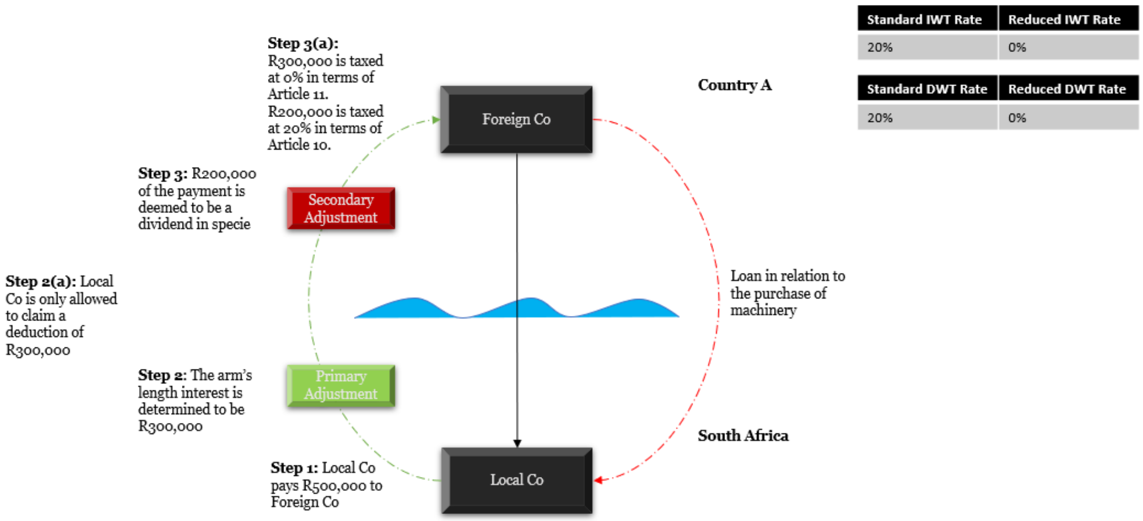
[36] For example, in terms of Article 10(3) of the South Africa Netherlands Income and Capital Tax Treaty, if the beneficial owner of the dividends is a company the capital of which is wholly or partly divided into shares and which is a resident of the other Contracting State and holds directly at least 10 per cent of the capital of the company paying the dividends, the Contracting State of the company paying the dividend may not levy tax on that dividends.

[37] Volkswagen of South Africa (Pty) Ltd v C: SARS 70 SATC 195

not applicable either. The Local Co will be allowed to claim the full interest expense of R500,000 as deductible and the tax consequences of Foreign Co will be dealt with in terms of relevant Double Taxation Treaty where they will either have tax withheld at the standard or reduced rate.

B. The effect of section 31

As seen at step 2 in the diagram below, the primary adjustment limits the deduction that the local entity may claim as a deduction. In this instance Local Co pays R500,000 in interest payments to Foreign Co. However, upon application of the transfer pricing rules, it is determined that had the two entities been unrelated, the interest payments would have equated to R300,000. As such, the primary adjustment contained in section 31(2) of the ITA reduces the amount of the payment classified as interest to R300,000. At this stage, the overall effects of section 31 and section 23N are identical. It is the secondary adjustment that represents the biggest departure from South Africa's other interest deduction rules. At step 3 of the below diagram, the R200,000 that was considered not at arm's length in terms of section 31(2) is recharacterized as a dividend in specie in terms of section 31(3). The consequence of this recharacterization is that the R200,000 would not qualify for any reduced withholding rate on interest in as provided for in the relevant Double Taxation Treaty. Furthermore, and as discussed above, because the dividend is a deemed dividend in specie, it would also not qualify for any reduced dividend withholding tax rate in terms of the relevant Double Taxation Treaty.[38] The remaining dividend is therefore taxed at the full withholding dividends tax rate as per the relevant Double Taxation Treaty.[39].



Thus, the overall effect of section 31 is to increase the tax liability of both the resident and the foreign entity. While the resident entity's interest deduction is limited to the arm's length amount of interest, the foreign entity has to pay the full withholding tax rate on the amount of interest deemed to be excessive. While section 23N targets the local entity only, section 31 targets both the payor and receiver of the interest payments.[40]

It must be noted that the application of section 31 does not preclude the application of sections 23M and 23N which will be discussed at the end of this Chapter.

[38] Supra note 30 at page 324.
[39] In respect of the Netherlands South Africa Double Taxation Agreement, the dividend would be taxed at 20% as per Article 10.
[40] SARS Draft Interpretation Note on section 31 of the Income Tax Act 58 of 1962 page 4

IV. SECTION 23M OF THE INCOME TAX ACT

The last section that will be dealt with in this chapter is section 23M. Section 23M was implemented shortly after section 23N and took effect from 1 January 2015.[41] Like section 23N, 23M applies an interest limit based on the ratio between the particular interest and Tax EBITDA.[42] Section 23M looks to prevent excessive interest deductions in situations where the person receiving the interest payments is not subject to tax on those payments. While this can occur in specific domestic transactions where one entity is exempt from tax, it is far more common in cross border transactions where the withholding tax rate has been reduced to 0% by the applicable Double Taxation Treaty.[43] This section is meant to supplement South Africa's transfer pricing regulations contained in section 31 and effectively catches any excessive interest deductions that slip through the cracks.[44] Section 23M's application is similar to section 23N but it applies to transactions that are not reorganisation or acquisition transactions and that are not captured by section 31.

There are five main requirements that need to be met for section 23M to apply:

1) The interest must be incurred by a debtor whose taxable income is subject to tax in South Africa.
2) There should exist the possibility of profit shifting.[45]
3) There must be a controlling relationship.[46]

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[41] Davis Tax Committee: Second Interim Report on Base Erosion and Profit Shifting (BEPS) In South Africa at page 37

[42] Ibid

[43] D. Kruger, 'Interest-Deduction Limitation - Section 23M' *Business Tax and Company Law Quarterly, Volume 6, Issue 1* (2015) page 12

[44] This relationship will become clearer when the hierarchy of the interest rules is discussed towards the end of this Chapter.

[45] M. Stinglingh et al SILKE: '*South African Income Tax'* 21 ed (2018) at page 534

[46] A controlling relationship is defined in Section 23M(1) as holding, directly or indirectly, 50% of the equity shares or voting rights in a company.

4) The interest incurred must not be taxed in the current year of assessment.

5) The interest should not have been limited by another provision of the Income Tax Act.

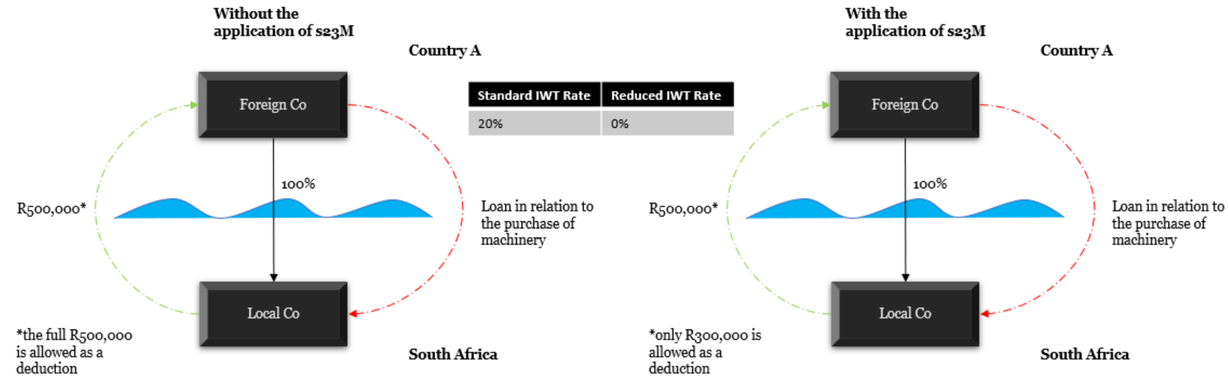
If these five requirements are met, then the following formula is used to limit the amount of interest that can be deducted:

> The maximum interest allowed as a deduction in respect of debts to which s23M applies = X + (A% x Y) -Z
>
> Where
>
> 'X' = interest accrued to or received by the debtor;
>
> 'A' = a percentage calculated by using the following formula:
>
> 40 x [(average repo rate + 400 basis points)/10];
>
> This percentage cannot exceed 60%.
>
> 'Y' = the adjusted taxable income of the debtor:
>
> And;
>
> 'Z' = interest incurred by the debtor in respect of debts to which s23M does not apply and excluding interest in respect of if which the deduction was disallowed.[47]

The explanation of the above formula need not be as detailed as the one required for section 23N as its application is almost identical. And just like with section 23N, the higher the adjusted taxable income and the lower the interest incurred outside of the debts to which section 23M and 23N apply, then the greater the amount of interest incurred in respect of the s23M debt that will be deductible.

[47] Section 23M(3) of the Income Tax Act 58 of 1962

Again, as with the previous two sections, the effects of section 23M will be highlighted through use of an example.



Profit before tax	R1,652,000
Unrelated interest	R100,000
Interest paid	R500,000
Adjusted Taxable Income	R1,052,000

Profit before tax	R1,652,000
Unrelated s23M interest	R100,000
Interest paid	R500,000
Adjusted Taxable Income	R1,052,000

A. Outcome of the transaction without applying s23M

This scenario is identical to the one laid out in the section 31 scenario except for the fact that in this instance, the amount of money that Foreign Co has loaned Local Co for the purchase of certain machinery represents an arm's length amount. Without the application of section 23M, Local Co would be allowed to deduct the full R500,00 interest expense and the tax consequences of the Foreign Co would be dealt with in terms of the applicable Double Taxation Treaty.[48]

B. The effect of section 23M

The overall effects of section 23M are similar to those of section 23N, except that interest that has already been limited in terms of section 23N needs to be subtracted in terms of the equation. Because in the above example there is no interest that has been limited in terms of section 23N,

[48] See the discussion on section 23N for a detailed explanation of how Foreign Co would be taxed in terms of the Double Taxation Treaty.

the interest expense that can be claimed as a deduction will be limited to R300,000. Foreign Co, however, will not be affected from a South African tax perspective as the entire amount will still be subjected to the same Double Taxation Treaty provisions.

V. HIERARCHY OF RULES

The last order of business with regards to South Africa's domestic laws is the order in which they are applied.

For a period of time, there was confusion surrounding the interaction between section 23M and section 23N and in which order they were to be applied. However, since section 23M's amendment in 2014, any uncertainty has been dispelled.[49] It is now clear that where an amount of interest is subject to both sections 23M and 23N, it is the latter that needs to be applied first. Once section 23N has been applied to limit the deduction of interest payments in respect of a debt incurred, it is only the amount that is allowed as a deduction that will be subject to the provisions of section 23M.[50]

Additionally, sections 23M and 23N also need to be positioned in respect of section 31. The question of whether one adjusts transactions to arm's length conditions first, and then subjects the interest to sections 23M and 23N or vice versa is of great significance. The answer is clear and is found in the wording of sections 23M and 23N. Both of these sections, in determining what portion of the interest payment is deductible, require taxable income to be determined. Crucially, in order to determine taxable income, section 31 first needs to be applied.[51] Because of this, the position that is widely adopted is that when dealing with the deductibility of interest paid to foreign

[49] Supra note 43 at page 20.
[50] Ibid
[51] Supra note 43 at page 20.

persons, the order in which the sections are applied is section 31, then section 23N, and lastly section 23M.[52]

[52] Ibid

Chapter 3: Non-Discrimination in the OECD Model and the Impact of the Savings Clause.

I. INTRODUCTION

In the previous chapter, South Africa's domestic legislation on excessive interest deductions was examined. It was explained that section 23N aims at preventing excessive interest deductions in reorganization and intra group transactions while sections 31 and 23M aim at preventing excessive interest deductions in all other types of transactions. The goal of this dissertation is to assess the compatibility of South Africa's domestic legislation dealing with excessive interest deductions with the non-discrimination provisions contained in South Africa's Double Taxation Treaties. As such, this chapter will review the non-discrimination provisions of the 2017 OECD MTC. It will begin by taking a look at the impact of the introduction of the Savings Clause before examining the non-discrimination provision contained in Article 24(4) as well as the built-in exemptions to that Article contained in Article 9(1) and 11(6).[53] After which, the non-discrimination provision contained in Article 24(5) and its exemptions will be unpacked in a similar manner before dealing with the issue of what type of comparability analysis Articles 24(4) and 24(5) require. Thereafter, the distinction between direct and indirect discrimination in relation to Article 24 will be outlined before the overlap between Article 24(4) and 24(5) is discussed. Lastly, the impact of the introduction of the Savings Clause into the 2017 of the OECD MTC will be dealt with. The reason for dealing with the Savings Clause last is that in order to understand its impact, a detailed understanding of various Articles of the OECD MTC, that will be examined in this Chapter, is

[53] R. Mitra, OECD's public discussion draft on non-discrimination: A critical analysis. *Tax planning international review* (IBFD 2007) page 2.

required. As a precursor to my analysis of the relevant OECD provisions I will discuss why it is appropriate to focus on the 2017 version of the OECD MTC as opposed to its earlier counterparts.

The provisions of the OECD Model that will be the focus of this thesis have not changed between the various versions of the OECD Model that South Africa based the majority of its Double Taxation Treaties on and the 2017 Model.[54] As such, the same language that governs the 2017 version of the OECD Model also govern South Africa's Double Taxation Treaties.[55] Additionally, the reason I refer to the 2017 Model instead of its predecessors is because the 2017 Commentary reflects the most up to date view on how the OECD provisions are supposed to be interpreted.

II. ARTICLE 24

Article 24 contains what are known as the "Non-Discrimination Clauses" or "NDCs". While paragraphs (1), (2) and (3) of Article 24 deal with discrimination based on nationality, stateless persons and permanent establishments respectively, it is subparagraphs (4) and (5) that deal with residency and foreign owned capital respectively, that will be focused on in this dissertation.[56]

A. Article 24(4)

[54] I, Du Plessis. 2012. Some thoughts on the interpretation of tax treaties in South Africa. *SA Mercantile Law Journal*, *24*(1) at page 1.
[55] Of course this does not apply to South Africa's Double Taxation Treaty that either have substantial carveouts or are based on the UN Model Tax Convention.
[56] Paragraphs 1, 2 and 3 are not relevant for the following reasons: Paragraph 1 prohibits discrimination based on the fact that an entity derives its legal status from the domestic laws of another state. As such, this paragraph will not encompass any of the potentially discriminatory domestic laws that were discussed in *Chapter 2*; Paragraph 2 applies only to individuals and so has no application in the context of companies; Paragraph 3 prohibits the discriminatory treatment of Permanent Establishments which falls outside the scope of this dissertation. See Commentary on Article 24 of the 2017 OECD Model Tax Convention and the Global Tax Treaties Commentary on Article 24.

Article 24(4) prohibits a Contracting state from treating one of its residents differently to the resident of another Contracting State with regards to interest, royalties and other disbursements paid. It provides, in relevant part, as follows:

> *Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.*[57]

Paragraph 4 is intended to prevent a specific type of discrimination, namely discrimination based on residency. While it applies equally to royalties and other disbursements, it is only the implications it has on interest that are of concern to this dissertation. It is important to note that Article 24(4) focuses exclusively on the treatment of residents as compared to non-residents. It does not pronounce on whether and when an amount of interest should be deductible. Article 24(4) cares only that residents are treated in the same manner as non-residents for the purposes of allowing or disallowing, as the case may be, interest deductions.[58]

As the text of the provision makes clear, Article 24(4) contains certain exemptions which allow, under certain circumstances, dissimilar treatment between residents and non-residents. Thus, where a Contracting State's domestic rules comply with Articles 9(1), 11(6) or 12(4), they will not

[57] Article 24(4) of the 2017 OECD Model Tax Convention on Income and on Capital.
[58] It is up to a country's domestic rules to determine which payments qualify as 'interest' and which portion of said payments are deductible.

be incompatible with Article 24(4).[59] Because Article 12(4) applies to royalty payments, and because this dissertation is concerned only with interest payments, only the relationship between Article 24(4) and Articles 9(1) and 11(6) will be dealt with. In the process of explaining these relationships, it will be necessary to examine the purpose, and then the scope of application, of Articles 9(1) and 11(6).

B. The interaction between Article 24(4) and Article 9(1)

i. Purpose of Article 9(1)

Article 9(1) of the OECD Model provides as follows:

> *Where*
>
> *a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
>
> *b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*
>
> *and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have*

[59] Article 24(4) of the 2017 OECD Model Tax Convention on Income and on Capital.

not so accrued, may be included in the profits of that enterprise and taxed accordingly.[60]

Article 9(1) is concerned with transactions between related entities, one local and one foreign, which have been concluded on terms different to those which would be agreed to at arm's length. In such cases, Article 9(1) permits a Contracting State to adjust the profits of the related enterprises in accordance with arm's length terms.

Article 9(1) is not concerned with whether certain payments by a company are deductible or not. Rather, it is a distributive article that is concerned with whether or not these profits would have accrued to that particular company if the transaction were concluded between two unrelated entities.[61] This includes determining whether or not a loan from which profits accrue can prima facie be regarded as a loan.[62] This is of great consequence because if there is found to be no loan, there can of course be no interest repayments in respect of that loan and so no interest deductions will be allowed in terms of South Africa's domestic laws.

Article 24(4) prohibits a Contracting State from discriminating between residents and non-residents, Article 9(1), under certain conditions, permits such discrimination in order to prevent BEPS in transaction between related entities.

Article 9(1) therefore provides the avenue through which countries can give effect to their domestic thin capitalization rules in a treaty setting, provided that those rules meet a certain

[60] Article 9(1) of the 2017 OECD Model Tax Convention on Income and on Capital.
[61] J. Wittendorff, 2009. The Transactional Ghost of Article 9 (1) of the OECD Model. *Bulletin for International Taxation*, *63*(3) at page 110.
[62] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 9 para 3(b).

standard.[63] This standard will be dealt with below when the scope and application of Article 9(1) is discussed.

Having outlined both Article 9(1) and Article 24(4), it becomes apparent that the two Articles seek to achieve different but very interlinked goals. Article 9(1) seeks to ensure that a state can only use their domestic laws to adjust the profits of associated enterprises when those domestic laws comply with the arm's length principle, while Article 24(4) wants to ensure that contracting states do not discriminate against non-residents. Because of the potential overlap between these two Articles, it is very important to understand the nature and application of the two Articles.

ii. Scope and Application of Article 9(1)

The wording of Article 24(4) explicitly states that Article 24(4) cannot be applied if Article 9(1) has application. It is therefore important to understand when Article 9(1) is being applied correctly and when it is being applied incorrectly. In order to do this, it is necessary to understand whether Article 9(1) is restrictive or illustrative in nature. A restrictive reading of Article 9(1) means that profits can only be adjusted to an arm's length level whereas an illustrative reading of Article 9(1) would allow profits to be adjusted to a level over and above arm's length.[64]

The wording of Article 9(1) means that there is room to argue for it being illustrative or restrictive. However, it is largely accepted that Article 9(1) is restrictive in nature.[65] It becomes obvious as to why this is the popular view when one considers the ramifications of Article 9(1) were it to be of an illustrative nature.

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[63] E. Baistrochhi, Article 9: Associated enterprises, Global Tax Treaty Commentaries page 1.

[64] N. Bammens, Chapter 8: Article 24(4): Deductibility in The Principle of Non-Discrimination in International and European Tax Law (IBFD 2012) page 10 and 22.

[65] Ibid at page 22; Supra note 61 at page 112, states that it is difficult to point to a country that definitely considers Article 9(1) to be illustrative.

If Article 9(1) was illustrative, it would mean that domestic rules on interest deductibility that adjusted profits between related enterprises, one resident and the other non-resident, to an amount greater than that of an arm's length transaction would still be covered by Article 9(1). Effectively, this would allow a contracting state to adjust the profits of non-resident related enterprise in such a manner that it leaves that enterprise in a worse tax position than a resident enterprise had that resident enterprise entered into a transaction at arm's length. Furthermore, because Article 24(4) cannot apply if Article 9(1) applies, the enterprise would not be able to rely on the non-discrimination provisions to protect itself.[66] This sort of result in contrary to the purpose of Article 9(1) in that Article 9(1) wants to permit the taxation of profits in the state in which they arise, but an illustrative reading would allow a Contracting State to tax profits that have actually arisen in another Contracting State.[67] Not only would an illustrative reading be contrary to the purpose of Article 9(1), but paragraph 3(c) of the Commentary on Article 9 explicitly states that domestic rules that are designed to deal with thin capitalization should typically not increase profits to beyond what would be considered arm's length.[68]

Not only is the above view endorsed by the OECD, but it is also finds wide support from leading academics in the field.[69] Being restrictive, we know now that Article 9(1) precludes domestic rules from adjusting profits to an amount greater than an arm's length amount.[70] However, the use of the word precludes in the previous sentence does not mean that a Contracting state cannot adjust the profits to an amount greater than arm's length, it means that such a practice

[66] Supra note 64 at page 10
[67] Article 9(1) of the 2017 OECD Model Tax Convention on Income and on Capital.
[68] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 9 para 3(c).
[69] See B. J. Arnold on *Restrictions on Interest Deductions and Tax Treaties* and G. Kofler on *Some Reflections on the 'Savings Clause'*.
[70] Supra note 64 at page 10

will not be covered by Article 9(1) and will indeed be subject to Article 24(4) where the domestic rule could be declared discriminatory.[71]

C. The interaction between Article 24(4) and Article 11(6)

i. Purpose of Article 11(6)

Article 11 governs the tax treatment of interest and assigns taxation rights to the state in which the enterprise receiving the interest payments is located, but allows the state in which the interest arises the discretion, through its domestic laws, to impose a tax on the interest. Any interest payments that fall under Article 11 will be granted protection in that there is a limit on the amount of tax to which the state in which the interest arises can impose.[72] This limit will of course depend on the applicable Double Taxation Treaty.[73]

ii. Scope and Application of Article 11(6)

Paragraph 6 of Article 11states the following:

> *Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each*

[71] N. Bammens, F. Vanistendael, Article 24: Non-Discrimination, Global Tax Treaty Commentaries IBFD page 2.
[72] Article 11 of the 2017 OECD Model.
[73] The standard limit as prescribed by Article 11(2) of the OECD Model is 10%.

> *Contracting State, due regard being had to the other provisions of this Convention.*[74]

In order for Article 11(6) to apply, the following requirements need to be met. First, there needs to exist a loan on which interest repayments are made. Second, there needs to exist a special relationship between the parties to the loan. And lastly, the amount of interest needs to exceed the amount interest that would exist but for the special relationship between the parties.[75] It must be noted that Article 11(6) does not allow a state to reclassify the loan from which the interest arises.[76] The wording of the paragraph makes an express reference to a debt-claim and so it has been argued that an internal limitation in the paragraph exists that prevents the recharacterization of the debt-claim itself.[77] To recharacterize the debt-claim, would be to deny that there was a debt-claim in the first place and as such, Article 11(6) would not have been applicable to begin with. The fact that Article 11(6) is applicable is inextricably linked to the existence of a debt claim.

By discussing the operation of Article 11(6), it becomes apparent that there are several elements that need to be unpacked. Firstly, what is a "special relationship" and can it be equated to a "connected person" as used in South African Tax Law. Secondly, what happens to the portion of interest that is deemed to be "excessive"?

(1) <u>Special Relationship</u>

The phrase "special relationship" is not one used in South African Tax law so it will be useful, given that in *Chapter 4* we will be testing South Africa's domestic laws up against the OECD

[74] Article 11(6) of the 2017 OECD Model
[75] Ibid.
[76] It is important to separate the loan from which the interest arises, and the interest itself. In terms of Article 11(6), while the loan cannot be reclassified, it is possible for a certain portion of the interest payments to be reclassified.
[77] M. Helminen, Article 11: Interest, Global Tax Treaty Commentaries IBFD page 10. This view is confirmed by paragraph 35 of the OECD Commentary on Article 11(6).

Model provisions, to determine whether or not it has the same meaning as “connected persons” as used in the Income Tax Act.[78]

A “special relationship” refers to all the general commercial relationships that you would expect it to, like a specific shareholding in a company or indirect control through a holding company and in this sense, it is identical to “connected persons”. More importantly, however, it also covers non-commercial relationships like familial ties.[79] So even in cases where a certain percentage shareholding might not be held in a company, those two companies can still have a special relationship if, for example, the persons in control of each company are brothers. Again, with reference to section 1 of the ITA, you will see that ‘connected persons’ covers situations such as these as well.[80]

While South Africa may not make use of the “special relationship” phrase that the OECD Model does, it is clear that this phrase and “connected persons” can be used interchangeably.

(2) The Excess Portion

As explained above, while Article 11 as a whole governs the treatment of interest and places a cap on the amount of tax that interest can be subjected to in certain situations. What paragraph 6 does is essentially limit the scope of that “protection”. Paragraph 6 will grant any and all interest payments that are arm’s length the full protection of Article 11 in that the Contracting State in which the interest arises will not be able to tax the interest payments above a certain percentage, but any portion of interest that is deemed to be excessive will not be afforded the same luxury. The consequences of this are twofold. First, it allows the excess portion of the interest to be

[78] If “connected persons” has a wider meaning than “special relationship”, there will be some situations where South Africa cannot apply its domestic laws due to them not being covered by Article 11(6) of the OECD Model.
[79] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 11 para 34.
[80] See definition of “connected persons” in section 1 of the Income Tax Act

reclassified according to the domestic laws of the state concerned. Second, and usually as a result of the reclassification, the excess portion can now be taxed at a higher rate in terms of the domestic laws of the relevant state as the state no longer has to adhere to reduced rate provided for by Article 11.

To summarize the relationship between Article 24(4) and 11(6), if a Contracting State's domestic laws comply with the requirements set out in paragraph 6 of Article 11 in that the Contracting State adjusts profits in accordance with the arm's length principle, Article 24(4) cannot be applied. Only when a Contracting State adjusts profits without using the arm's length principle, will it be possible for the aggrieved party to invoke Article 24(4).

III. ARTICLE 24(5)

A. Background:

Article 24(5) states the following:

> *Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.*[81]

Article 24(5) prevents discrimination based on residency and provides that an establishment in a Contracting State whose capital is wholly or partly, directly or indirectly owned

[81] Article 24(5) of the 2017 OECD Model Tax Convention on Income and on Capital.

by a resident of the other Contracting State cannot be subject to other or more burdensome taxation or requirements connected therewith than similar establishments in that contracting state.

The purpose of Article 24(5) is to prevent situations where two enterprises are taxed differently based solely on the fact that one of the enterprises' capital is owned wholly or partly by a foreign resident or residents.[82] It is important to keep in mind that while Paragraph 5 of Article 24 looks at the foreign entity to determine whether there is discrimination or not, it only concerns itself with the taxation of the resident enterprise. Effectively, this Article wants to ensure that all resident entities are treated in the same manner with regards to taxation, regardless of who owns that entity.[83] To highlight this, the following example would not be covered by Article 24(5). A is an entity incorporated and resident in South Africa and whose capital is owned by another resident of South Africa. B, on the other hand, is an entity incorporated and resident in South Africa, but its capital is wholly owned by a non-resident. When A declares a dividend to its shareholders, the dividend will not be subject to any to any withholding tax.[84] However, when B declares a dividend to its shareholders, the dividend will be subject to a dividend withholding tax of 20 percent or a reduced percentage depending on the applicable Double Taxation Treaty.[85]

The reason that the above does not fall within the scope of Article 24(5) in this example, is because both resident entities are being subjected to the same tax. The withholding tax being levied on B's dividend is not a tax on B, but rather its foreign shareholder. And as has been explained, as long as both resident entities are treated the same for tax purposes regardless of whether their capital is owned by local or foreign persons, then Article 24(5) is not triggered.

[82] Supra note 71 at page 31
[83] Ibid; 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 24(5) para 76.
[84] Section 64F of the Income Tax Act 58 of 1962.
[85] Section 64E of the Income Tax Act 58 of 1962

B. Requirements for the application of Article 24(5)

There are three requirements that can be gleaned from the above wording of Article 24(5), all of which need to be met in order for the Article to apply:

i) The discrimination must be based solely on the capital ownership by a non-resident;[86]

ii) The one enterprise must be treated differently in relation to "other similar enterprises".[87]

iii) The enterprise with the foreign shareholding must be subject to taxation that is other or more burdensome that the taxation of the other enterprise that is the subject of comparison.[88]

i. <u>Solely based</u>

The purpose of Article 24(5) is to prevent discrimination based on the residency of the owner of the capital, and so it is necessarily the case that a requirement for this Article to apply is that the discrimination must be based on this residency. The issue revolves around the following phrase in paragraph 79 of the Commentary on Article 24(5) of the 2017 OECD MTC

> *"Since the paragraph prevents the discrimination of a resident enterprise that is solely based on who owns or controls the capital of that enterprise…"*[89]

On a plain reading of the above quote, it appears that discrimination is only prevented when it is based solely on who owns or controls the capital of the enterprise. If there is more than one ground one which discrimination is based, Article 24(5) cannot apply.[90] If this were the correct

[86] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 24(5) para 79.
[87] Article 24(5) of the 2017 OECD Model Tax Convention on Income and on Capital.
[88] Article 24(5) of the 2017 OECD Model Tax Convention on Income and on Capital.
[89] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 24(5) para 79.
[90] N. Bammens, Chapter 9: Article 24(5): foreign ownership in The Principle of Non-Discrimination in International and European Tax Law (IBFD 2012) page 8.

interpretation, it would narrow the provision to such an extent that it would not cover hybrid situations where discrimination is effectively based on residency, but in conjunction with another type of discrimination.[91] For example, there could exist a scenario where a Contracting State has a set of thin capitalisation rules which apply only to enterprises whose capital is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, but only if that company operates in the mining sector. Here, there is clear discrimination on the grounds of residency, albeit in conjunction with sector discrimination, but if we adopt the restrictive interpretation of Article 24(5) situations like this would not be covered. In light of the entire Article and Convention, this cannot be an intended consequence of Article 24(5) and as such, an overly narrow interpretation of "solely" should not be adopted.[92]

It is thus suggested that "based solely on" means not that the only form of discrimination must be residency, but rather that there exists discrimination based on residency. This view is supported by various academics and is in accordance with the intention of the paragraph as a whole and ensures that an enterprise with foreign ownership is not treated differently from domestically owned enterprises with all relevant circumstances being the same.[93]

ii. <u>Similar circumstances</u>

It is submitted that the similar circumstances requirement is of little importance to the application of Article 24(5). The reason for this is that this requirement is implicit in the "solely based" requirement.[94] As was explained above, Article 24(5) is concerned only with whether there is

[91] Ibid.

[92] Article 31 of the Vienna Convention requires one to interpret provisions of a Treaty in the wider context of the whole Article and indeed entire the Treaty in which the relevant provision forms a part of.

[93] See N. Bammens' discussion on the phrase "solely based" in his chapter on foreign ownership in *The Principle of Non-Discrimination in International and European Tax Law*. See paragraph 76 of the OECD Commentary on Article 24(5) for an insight into the intention of the Article.

[94] Supra note 90 at page 15.

discrimination based on foreign ownership. In order to determine whether such discrimination exists, all other circumstances would need to be relevant. It would not be possible to determine if there is discrimination based on foreign ownership if the entities circumstances surrounding the entities of comparison differ markedly.

iii. More Burdensome

Perhaps most obviously, Article 24(5) only applies where the discrimination leads to the foreign owned enterprise being subject to taxation that is more burdensome that the domestically owned enterprise. There would be no need to apply paragraph 5 of Article 24, and indeed there would be no discrimination, if the foreign owned enterprise were subjected to taxation that was less burdensome than their domestically owned counterparts. What is worth discussing, however, is what the term "other or more burdensome" covers. Academics are of the opinion that "more burdensome" should be taken to mean the payment of a higher amount of tax or the advance payment of taxation.[95] The meaning of the term "other" covers any sort of tax treatment that non-foreign owned resident entities are not subjected to. For example, if a foreign owned resident enterprise is denied certain tax benefits that a non-foreign owned resident enterprise is entitled to and both enterprises are in similar circumstances, then this denial of a benefit can be considered "other" taxation.[96]

C. Interaction between Article 24(5) and Articles 9(1) and 11(6)

Based solely on the wording of Article 24(5) an apparent distinction between this Article and Article 24(4), is that Article 24(5) does not contain any exceptions. This would imply that the relationship between Article 24(5) and Articles 9(1) and 11(6) is not important because according

[95] F. Boulogne, 2011. Group Taxation within the European Union: Did Papillon and Art. 24 (5) of the OECD Model Tax Convention Create a Butterfly Effect?. *European Taxation*, *51*(5) at section 3.2.1.

[96] Ibid. See also the Supreme Administrative Court of Sweden (Regeringsrätten), 26 November 1993, ref. 91 case.

to the wording of Article 24(5), such a relationship does not exist. The result of this would be that even if domestic laws comply with Article 9(1) and 11(6), they can still fall foul of Article 24(5). This interpretation, however, would not be correct.

According to Article 31 of the Vienna Convention on the Law of Treaties, when interpreting a provision or paragraph of an Article, once must do so within context of the Article as a whole, as well as the treaty in its entirety. This would mean that when interpreting Article 24(5), regard must be had for context of Article 24 and all of its paragraphs, as well as the OECD MTC. This view is backed up by paragraph 79 of the Commentary on Article 24(5), added as a result of an examination by the Working Party in 2008, which provides that *"paragraph 1 of Article 9 or paragraph 6 of Article 11 form part of the context in which paragraph 5 must be read".*[97]

It appears then, that despite Article 24(5) not making express reference to Articles 9(1) and 11(6), that there is an implicit relationship between these provisions and Article 24(5).[98] This peculiarity can perhaps be explained by the fact that Article 24(5) is an older provision, having its roots in the 1950s and being incorporated into the 1963 OECD Draft Model, while Article 24(4) is more recent and was only added to the 1977 OECD Model.[99] Despite this being the prevailing view, it is suggested that in order to avoid any unnecessary confusion going forward, Article 24(5) be amended by the OECD to expressly include the phrase that is currently having to be read into the Article.. The relationship between Article 24(5) and Articles 9(1) and 11(6) functions similarly to the relationship between the two latter Articles and Article 24(4) in that when a domestic law

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[97] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 24(5) para 79.
[98] This was the view adopted in a Russian case concerning the application of domestic thin capitalization rules in a treaty setting. See *RU: SAC, 15 Nov. 2011, Ugolnaya kompania Severniy Kuzbass, Presidium Ruling No. 8654/11*, Tax Treaty Case Law IBFD
[99] C. Elliffe, 'Unfinished Business: Domestic Thin Capitalization Rules and the Non-Discrimination Article in the OECD Model'. *Bulletin for International Tax, 67(1)* (2013) at page 17.

complies with one of these two Articles, they cannot be incompatible with Article 24(5). As such, Article 24(5) will only have application where a country's domestic thin capitalization rules target only companies whose capital is wholly or partly owned by non-residents.

Because the relationship between Article 24(5) and Articles 9(1) and 11(6) has been shown to be the same as the relationship between Article 24(4) and these two Articles and we have already dealt with the inner workings of that relationship above, it will not be discussed again.

IV. DIRECT VERSUS INDIRECT DISCRIMINATION

As so much of this minor-dissertation hinges on whether or not the three domestic provisions in question constitute discrimination, it is important to understand whether Article 24 encompasses all forms of discrimination.

Being a non-discrimination clause, it is clear that direct, or overt, discrimination falls within the scope of Article 24.[100] What needs to be determined is how broad the discrimination is that Article 24 aims to prevent and whether indirect and disguised discrimination are also covered.

Indirect discrimination is discrimination where the prohibited ground is not being used as a distinguishing criterion, but rather another distinguishing criterion is used that happens to affect the persons protected by the relevant provision.[101] To illustrate this, Article 24(1) can be used as an example. This provision, in summary, prohibits discrimination based on nationality. Now imagine that South Africa had a domestic law that discriminated based on residency. Despite the fact that a portion of the same people that will be subjected to the discrimination based on residency do form part of the protected group, this would still only amount to indirect discrimination.

[100] N. Bammens, Chapter 19: A Comparison of Article 24 of the OECD Model Convention and the Non-discrimination Standard of the European Court of Justice in The Principle of Non-Discrimination in International and European Tax Law (IBFD 2012), Books IBFD at page 1

[101] N. Bammens, Chapter 4: Origin of Article 24 of the OECD Model Convention in The Principle of Non-Discrimination in International and European Tax Law (IBFD 2012) at page 14.

Discrimination of this type is generally thought of as not being prohibited by Article 24 the OECD Model and so in the example above, South Africa's hypothetical domestic law would not contravene Article 24.[102]

While indirect discrimination is not covered by Article 24, disguised discrimination is.[103] Disguised discrimination differs from indirect discrimination in that disguised discrimination makes use of a distinguishing criterion that is inextricably linked to the prohibited criterion. While there is some overlap between the distinguishing criterion and the prohibited criterion when there is indirect discrimination, with regards to disguised discrimination, the distinguishing criterion is a thinly veiled version of the prohibited criterion.[104]

The result of the above is that should be it found that any or all of the three provisions that will be examined in the following chapter constitute discrimination, a brief enquiry will need to take place to determine whether or not the discrimination in question constitutes direct or disguised discrimination, or whether it constitutes indirect discrimination.

V. THE COMPARABILITY ANALYSIS

Article 24(4)'s sole purpose is to ensure that non-residents are treated in the same manner as residents when it comes to the deductibility of certain payments. Despite this, the clause itself offers very little guidance as to what comparison, if any, should be used. This paragraph makes no reference to the "similar enterprises" phrase that is referenced in paragraph (5) of the same

[102] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 24 para 8. See also supra note 101 at page 14.
[103] This position is confirmed in paragraph 1 of the commentary on Article 24 of the 2017 OECD Model Tax Convention on Income and on Capital. See also the Global Tax Treaty Commentary on Article 1.
[104] Supra note 101.

Article, casting doubt on whether you are comparing a non-resident to a resident in the same circumstances, or just to any resident.[105]

There exists an argument that centers around the phrase "the same circumstances" being implicit in Article 24(4).[106] This argument is based on paragraph 3 of the Commentary on Article 24 which provides the following:

> *The various provisions of Article 24 prevent differences in tax treatment that are solely based on certain specific grounds (e.g. nationality, in the case of paragraph 1). Thus, for these paragraphs to apply, other relevant aspects must be the same.*[107]

The above paragraph states that the purpose of all of the provisions of Article 24 is to prevent discrimination based on various grounds and that in order for these provisions to apply, other relevant aspects must be the same. The Commentary goes further and explains that despite the various provisions using different language, the result achieved is the same and even goes on to provide examples of what is meant and references every paragraph of Article 24 except paragraph 4.[108]

In addition to the above commentary, it must be the case that it was the intention of the OECD for Article 24(4) to have a built in "similar circumstances" test for two reasons. First, without the paragraph containing the built-in test, its application would be far too broad, give rise to unwanted results and effectively nullify the Article all together. The reason for this is that if there isn't an inherent "similar circumstances" requirement in Article 24(4), objects of comparison can be in

[105] Supra note 64 at page 3.
[106] Supra note 64 at page 4.
[107] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 24 para 3.
[108] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 24 para 3.

entirely different circumstances which would lead to highly undesirable results. To illustrate this, imagine the following scenario: state A has highly discriminatory thin capitalization laws that tax resident companies making payments to non-resident companies fare more harshly than payments between two resident companies in similar situations. However, state A has equally harsh tax practices towards payments being made by a local company to a local tax-exempt company. Now instead of comparing the payment between the resident and non-resident company to the payment made between to the two resident companies, with the outcome being that State A would be incompatible with Article 24(4), State A could compare the resident to non-resident payment to the payment by the resident company to the tax exempt entity, whose circumstances are entirely different and avoid the effect of Article 24(4).[109]

Second, in the context of the Article of a whole, and indeed the entire convention, and that is how individual paragraphs need to be interpreted, it is clear that discrimination is trying to be prevented where relevant factors are similar.[110] It would be without apparent reason that paragraph 4 would differ in such a distinct manner from the other provisions.[111]

VI. THE OVERLAP BETWEEN PARAGRAPHS 24(4) AND 24(5)

The last issue that this Chapter will deal with is the overlap between paragraphs 4 and 5 of Article 24. Unlike the relationship between these paragraphs and Articles 9(1) and 11(6), where the order in which they are to be applied is clear, the determination of whether to apply Article 24(4) or 24(5) when a situation falls within the scope of both Articles, is not as straightforward. The reason that the uncertainty exists is due to the fact that neither paragraph references the other. This has

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[109] Supra note 64 at page 3.
[110] Article 31 of the Vienna Convention on the Law of Treaties.
[111] See supra note 71 at page 27 for support that Article 24(4) contains an implicit "same circumstances" requirement.

resulted in the stance on which of the two aforementioned articles should apply to change quite significantly throughout the years.[112] Initially, the stance adopted by the Commentary was that if both paragraphs could apply, Article 24(4) should take preference as it is what is called "lex specialis".[113] Effectively, Article 24(5) was viewed as being too general in its application and that the more specific rule contained in paragraph 4 should be applied.

This, however, is no longer the accepted position on the application of the two paragraphs. And the reason for this change is not that it is no longer widely accepted that the more specific rule should be applied, but rather because it is now common ground that Article 24(5) can, in certain circumstances, be the more specific rule.[114] So, where a domestic thin capitalization rule applies exclusively to interest payments made to resident entities whose capital is wholly or partly owned by a resident of another state, this is clearly discrimination on the basis of foreign ownership and so Article 24(5) is the lex specialis rule. To all other rules that deal generally with interest payments and the taxation thereof, Article 24(4) would be the lex specialis.[115] Effectively, one must determine on a case by case basis which Article is more specific to the situation at hand and then apply that Article.

VII. THE SAVINGS CLAUSE

A. Incorporation into existing Double Taxation Agreements

Before the implications of the Savings Clause are outlined, it is important to understand how the addition of a clause into the 2017 OECD Model can affect South Africa's existing Double Taxation Treaties. South Africa are a signatory to the Multilateral Instrument (**"MLI"**) which is

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[112] Supra note 71 at page 40
[113] N. Bammens, 'Articles 24(4) and 24(5) of the OECD Model Applied to Domestic Thin Capitalization Rules', 5 World Tax J. (2013) page 15.
[114] Ibid page 16.
[115] Ibid

a device created by the OECD to allow numerous changes made to the OECD Model to be incorporated into existing Double Taxation Treaties without countries having to renegotiate every single one of their Double Taxation Treaties.[116] If both parties to the relevant Double Taxation Treaty signed the MLI, then the changes to the OECD Model will be incorporated into said Double Taxation Treaty. When South Africa signed the MLI, it listed 76 of its existing Double Taxation Treaties to which the MLI would apply.[117] As such, the Savings Clause will not only have an impact on future Double Taxation Treaties that South Africa concludes, but also existing Double Taxation Treaties to which South Africa and the other Contracting State agree that the MLI should apply to. Lastly, it must be noted that where there is a conflict between the MLI and an existing Double Taxation Treaty to which the MLI applies, the MLI will override the existing Double Taxation Agreement to the extent to which they are not compatible.[118]

B. Implication of the Savings Clause

Except for Articles such as 23A and B, most of the Articles contained in treaties are geared towards limiting a Contracting State's rights to tax residents of the other Contracting State.[119] However, some provisions have been interpreted as limiting a Contracting State's right to tax its *own* residents.[120] According to the OECD Commentary this is the incorrect interpretation and so in response, Article 1(3), the Savings Clause, was introduced into the 2017 OECD Model. The Savings Clause states the following:

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[116] A.W. Oguttu, 'OECD multilateral instrument on treaty-related BEPS measures : benefits, challenges and recommended options for South Africa and other developing countries' *South African Yearbook of International Law, Volume 42 Number 1*, (2017) at page 221.
[117] Ibid at page 225.
[118] Ibid at page 230.
[119] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 para 17.
[120] B.J. Arnold, The Evolution of Controlled Foreign Corporation Rules and Beyond, 73 Bull. Intl. Taxn. 12 (2019), Journal Articles & Papers IBFD at page 641

This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.[121]

According to the OECD Commentary on Article 1, the introduction of the Savings Clause is purely for clarification purposes and all but confirms the stance that treaties do not affect a Contracting State's exclusive right to tax their own residents unless the relevant treaty explicitly states that it does. [122] However, various academics have argued that the introduction of the Savings Clause will have several unintended consequences.[123]

For the purposes of this dissertation, the most important consequence that needs to be noted regarding the introduction of the Savings Clause is its impact on Article 9(1) of the OECD MTC. As explained above, the Savings Clause lists certain Articles that are exempt from its application. Article 9(1), however, is not one of the exemptions.[124] This means that when taxing its own residents, a Contracting State does not have to do so in a manner which is consistent with Article 9(1) of the OECD MTC.[125]

As was discussed above at "The Scope and Application of Article 9(1)", Article 9(1) is either restrictive or illustrative in nature. If you adopt the view that Article is 9(1) is illustrative in nature, then the addition of the Savings Clause will not affect Article 9(1).[126] This is because if

[121] Article 1(3) of the 2017 OECD Model Tax Convention on Income and on Capital.
[122] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 para 17; B.J. Arnold, Restrictions on Interest Deductions and Tax Treaties, 73 Bull. Intl. Taxn. 4 (2019), Journals IBFD at page 175.
[123] See G. Kofler, 'Some Reflections on the 'Saving Clause'. *Intertax*, *44*(8)(2016) for a discussion on the unintended consequences of the Savings Clause.
[124] Article 1(3) of the 2017 OECD Model Tax Convention on Income and on Capital.
[125] G. Kofler, 'Some Reflections on the 'Saving Clause'. *Intertax*, *44*(8)(2016) page 575.
[126] V. Chand, 'Should States Adopt the Saving Clause in the Multilateral Instrument?' *Tax Notes International* (2017) at page 691.

Article 9(1) is illustrative, states could adjust profits of their residents to a level above arm's length in any event.

However, if you adopt the dominant, and correct, view that Article 9(1) is restrictive in nature, the introduction of the Savings Clause does present problems. This is because despite the restrictive nature of Article 9(1), states would be free to adjust the profits of resident enterprises to any level that they choose.[127] Effectively, the introduction of the Savings Clause would serve as a mechanism whereby states can implement their domestic laws regardless of whether or not they comply with Article 9(1). Given that the goal of this thesis is to determine whether or not South Africa's domestic laws on interest deductibility are compatible with the non-discrimination clauses in its Double Taxation Treaties, and that one way in which to ensure that these domestic laws are in line with the non-discrimination clauses is for them to comply with Article 9(1), the fact that the Savings Clause means that these laws no longer have to comply with Article 9(1) to have effect within the treaty framework appears problematic.[128] Or at least it would be problematic if it were not for Articles 24(4) and 24(5) of the OECD MTC. This is because Article 24 is an exception to the Savings Clause and as such, does impact a Contracting State's ability to tax its own residents provided there exists discrimination based on various grounds. As such, if a Contracting State's domestic law allows for an adjustment of profits to a level over and above what would be considered arm's length it does not fall within the ambit of Article 9(1). And because it does not fall within the ambit of Article 9(1), one of the exceptions to the non-discrimination provisions contained in the OECD MTC, it can be challenged on the basis of either Article 24(4) or 24(5).[129] What the above means is that in relation to whether South Africa's domestic laws on interest

[127] Supra note 126 at page 692.
[128] Supra note 125 at page 587
[129] Supra note 126 at page 692

deductibility are compatible with their Double Taxation Treaties, it does not matter whether South Africa adopts the Savings Clause or not. Either way, for South Africa's domestic laws to be compatible with their Treaties, they need to comply with either Article 9(1) or 11(6).

For the reason that the Savings Clause does not affect the treaty provisions relevant to this dissertation in a meaningful way, the 2017 version of the OECD Model remains a suitable proxy for earlier models and that any conflict between South Africa's domestic legislation and the 2017 OECD MTC will pervade prior versions of the same Model regardless of whether or not the Savings Clause is present.

Chapter 4: Are South Africa's Interest Deduction Rules Compatible with the OECD Model?

I. INTRODUCTION

The purpose of Chapter 2 was to gain an understanding of South Africa's domestic laws on interest deductibility. It was explained that section 23N governs any transaction that is deemed an acquisition and reorganisation transaction, while section 31 and 23M deal with every other type of transaction between a resident and a non-resident. The way in which these three sections limit interest was also explained, section 23N and 23M apply a formula to calculate the amount of interest that would be deductible, while section 31 makes use of the arm's length principle to determine the portion of deductible interest. The purpose of Chapter 3 was to gain an understanding of the non-discrimination clauses contained in Article 24(4) and 24(5) of the 2017 OECD MTC. It was explained that Article 24(4) prohibits discrimination based on residency while Article 24(5) prohibits discrimination based on foreign ownership. The Chapter then went on to detail the interaction between these two Articles and the exemptions contained in Articles 9(1) and

11(6) with the conclusion being reached that any law that is within the ambit of either exemption, cannot be discriminatory in terms of Article 24(4) or 24(5). The purpose of this Chapter will be to draw on the understandings from Chapters 2 and 3 and determine whether sections 23N, 31 and 23M are compatible with Articles 24(4) and 24(5) and thus compatible with South Africa's Double Taxation Treaties that are based thereon.

In order to determine whether each of South Africa's three interest deduction provisions, namely sections 23N, 31 and 23M, are compatible with South Africa's Double Taxation Treaties, it is possible to adopt two approaches. The first approach would be to see whether or not each domestic law complies with either Article 9(1) or 11(6) and if not, then determine whether the same law falls foul of either Articles 24(4) or (5).

The second approach entails determining whether or not the domestic laws contain any potential prima facie discrimination in terms of Article 24(4) or (5), before then seeing whether each domestic law is saved by either Article 9(1) or 11(6).

For the purposes of this Chapter, the second approach will be adopted and will be done so for the following reason - it would be a waste of time to consider whether each of South Africa's domestic laws on interest deduction fell within the scope of Articles 9(1) or 11(6) before we even know if there exists the possibility of discrimination. As the point of this minor-dissertation as a whole is to determine whether or not South Africa's domestic laws are compatible with the non-discrimination clauses contained in South African Double Taxation Treaties, if it is found that there is no basis for a discrimination claim then South Africa's domestic laws are automatically compatible with its Double Taxation Treaties and the enquiry ends there. If the domestic laws fall foul of the discrimination clauses, then the inquiry moves on to determine whether each domestic law is exempt under either Article 9(1) or 11(6).

This Chapter will begin with 23M by looking at how it constitutes prima facie discrimination in terms of Article 24(4) and falls outside the scope of both exemptions due to a lack of an arm's length requirement. Thereafter, section 23N will be examined where it will be found that no discrimination exists in terms of Article 24(4) or 24(5). Finally, it will be detailed why South Africa's transfer pricing rules contained in section 31 do constitute prima facie discrimination in terms of Article 24(4) but that it is encompassed by Article 9(1).

II. SECTION 23M

A. Discrimination Based on Residency

The first step that will be taken, as was explained above, in determining whether or not Section 23M is compatible with South Africa's treaties, is to see if there even exists the possibility of discrimination. And this discrimination refers not to any form of discrimination, but discrimination based on either residency or capital ownership.

As was discussed in Chapter 2, section 23M allows a state to limit the amount of interest a resident company can deduct provided the following requirements are met: the interest must be incurred by a debtor whose taxable income is subject to tax in South Africa; there must exist the possibility of profit shifting; the risk must exist within the same economic unit; there must be a controlling relationship; the interest incurred must not be taxed in the current year of assessment; the interest should not have been limited by another provision of the Income Tax Act.[130] While all the requirements were important to understand the application of section 23M in Chapter 2, for the purposes of this Chapter and indeed going forward, only the requirements that draw a line between residents and non-residents will be in focus.

[130] Davis Tax Committee: Second Interim Report on Base Erosion and Profit Shifting (BEPS) In South Africa at page 37

While there are no requirements that make express reference to residents, non-residents or foreign owned residents, there are two requirements that could potentially amount to disguised discrimination based on non-residency.[131] The first potentially discriminatory requirement provides that, in order for section 23M to be applicable, the entity receiving the interest payment must not be subject to tax.[132] On an initial reading of this requirement, it is easy to assume that this must mean that the entity receiving the interest payment must be outside of the South Africa and must be exempt from tax in terms of a Double Taxation Treaty. This assumption, however, is not strictly correct. While that is an example of an entity receiving an interest payment and not being subject to tax on that payment, it is not the only example. It is possible for an entity to be resident in South Africa and still not pay tax on interest payments received. This is the case where the South African resident entity qualifies for a tax emption in terms of section 30 of the Income Tax Act.[133] Because this requirement does not necessarily entail that section 23M is only applicable to transactions where one entity is not a resident of South Africa, it cannot be said that this requirement results in section 23M constituting discrimination based on residency.[134]

Requirement two provides that in order for section 23M to apply, there must exist the possibility of base erosion. As touched on in Chapter 1, base erosion is where profits that arise in

[131] As was discussed earlier in the chapter, disguised discrimination is covered by Article 24 of the OECD Model.
[132] Section 23M(2)(i)(aa) of the Income Tax Act. It must be noted that, while this minor-dissertation does not intend on unpacking the ‘subject to tax’ requirement in detail, this requirement is subject to much debate in terms of what qualifies as not being subject to tax. What is certain, however, is that when payments are made by residents to non-residents and these payments are not subject to any withholding tax due to the applicable Double Taxation Treaty reducing the effective withholding rate to 0%, this will qualify as not being subject to tax and section 23M will apply. Please see page 17 of Des Kruger, ‘Interest-Deduction Limitation - Section 23M’ *Business Tax and Company Law Quarterly, Volume 6, Issue 1* (2015) for a brief outline of the issues surrounding this requirement.
[133] As per section 30 of the Income Tax Act in order to qualify for an exemption from income tax, entities have to meet the requirements of a Public Benefit Organization (PBO) and then satisfy additional governance and operational requirements.
[134] When an entity is exempt from tax in South Africa, it is of course far more likely that the reason for the entity not being taxed on certain amounts received is due to the fact that that these amounts are exempt in terms of a Double Taxation Treaty rather than the entity being an exempt resident entity. This likeliness, however, is not enough to constitute direct discrimination and while it may amount to indirect discrimination, as discussed earlier indirect discrimination does not violate Article 24.

one country are moved to another without the appropriate taxes being paid to the country they arose in.[135] Because base erosion can only occur when profits move outside of the country, this means that section 23M is only concerned with transactions whereby the entity receiving the interest payments is a non-resident. Unlike the previous requirement, this requirement does therefore distinguish, in a disguised manner, between arrangements where a resident repays interest to another resident and arrangements where a resident repays interest to a non-resident.

Determining that section 23M only applies to resident to non-resident interest payments does not necessarily mean that there is discrimination. In order for there to be discrimination in terms of Article 24(4), the domestic law must result in the interest payments not being "deductible under the same conditions as if they had been paid to a resident of the first-mentioned State".[136] In this case because the resident entity making payments to a non-resident entity will only be allowed to deduct a certain amount of its interest payments, while residents who make interest payments to other residents, where all other relevant circumstances are the same, will be entitled to deduct the full amount, there is clear discrimination.

Based on the above, it is clear that section 23M discriminates based on residency and as such, falls foul of the general prohibition contained in Article 24(4). However, section 23M can still be saved if it falls within the scope of either Articles 9(1) or 11(6). It must be noted that section 23M is being tested against Article 24(4) as opposed to Article 24(5) because in this instance, the lex specialis rule demands it.[137] While it is possible for section 23M to be

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[135] OECD (2016), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris
[136] Article 24(4) of the 2017 OECD Model Tax Convention on Income and on Capital
[137] Supra note 113 at page 16

incompatible with both of these paragraphs, because section 23M deals specifically with the deductibility of interest payments, Article 24(4) is the more applicable provision.[138]

B. What does Article 9(1) allow?

Article 9(1) allows a State to adjust the profits, to a certain degree, of related enterprises where the conditions that lead to the payment of interest from the resident enterprise to the non-resident enterprise were not at arm's length.[139] Against this background, it becomes clear that two questions need to be asked when determining whether section 23M complies with Article 9(1). Firstly, does section 23M only allow an adjustment of profits of interest repayments between a related resident and non-resident company when the terms of the underlying loan are not at an arm's length? And secondly, does section 23M only allow South Africa to adjust profits to an arm's length level or does it allow profits to be increased to a level above which would be considered arm's length.

C. Does Section 23M only apply to non-arm's length transactions?

This question, like with the above enquiry, can be answered in the main by looking at the requirements of section 23M. If section 23M contains a requirement or requirements that in order for section 23M to be applied, the terms of the transaction in question need to not represent arm's length terms, then section 23M will be in line with Article 9(1) of the OECD model and it does not breach the non-discrimination provision contained in Article 24(4). Section 23M, and indeed section 23N, have a peculiar feature that makes answering the arm's length question slightly more complex than upon initial inspection. As was detailed in Chapter 2, once certain requirements

[138] Supra note 113 page 15.
[139] Article 9(1) of the 2017 OECD Model Tax Convention on Income and on Capital.

have been met and section 23M is deemed applicable, a formula is then applied to determine how much interest is going to be allowed as a deduction, and how much is not.[140]

The important question that arises from this, and in fact the question that the entire conflict between this domestic law and the OECD provisions hinge on, is whether this formula, that will determine what percentage of interest payments will be allowed as a deduction, can be considered an arm's length requirement.

A plain reading of section 23M gives the impression that there is no arm's length requirement built into the provision. Firstly, the requirements themselves make no reference to 'arm's length conditions' nor do they mention any sort of comparison that needs to be made.[141] As such, section 23M is applicable to any transaction, provided the requirements are met, regardless of whether or not the transaction was concluded at an arm's length. However, the formula can still save section 23M if it ensures that only non-arm's length transactions are affected. Again, like with the requirements of section 23M, the formula itself appears to contain nothing that looks similar to an arm's length requirement. While the formula does incorporate several factors such as interest accrued to or received by the debtor, adjusted taxable income of the debtor and interest incurred by the debtor in respect of debts to which s23M does not apply, none of these factors seem to prevent section 23M from applying to transactions whose terms are at arm's length.[142]

The goal of the formula of section 23M is to reduce the amount of interest that is deductible in situations where the arrangement, or at least the level of debt pumped into the resident entity,

[140] Supra note 43 at page 13
[141] Section 23M of the Income Tax Act; Ibid.
[142] Section 23M of the Income Tax Act

was done precisely for avoidance purposes.[143] Effectively section 23M is trying to protect against non-arm's length transactions. The problem is that because there is no mention of an arm's length or anything closely resembling it, there will inevitably be scenarios where related parties enter into an arrangement, at arm's length, but where the formula still limits the amount of interest that is allowed to be deducted.

To illustrate this point, an example in the mining industry will be used. The mining industry, for several reasons, is characterized by financing through high levels of debt rather than equity.[144] Now of course in South Africa's mining industry, there will exist several arrangements where high levels of debt are used to finance a local subsidiary instead of equity for the exact purpose of deducting the interest payments and the transaction does not represent an arm's length arrangement. However, there are simultaneously examples where a subsidiary has a higher debt to equity ratio than perhaps is the norm in other industries, but the conditions of the arrangement are the same as they would be had the arrangement been entered into between two independent enterprises.

Despite the two above mentioned scenarios being different, in that one arrangement is abusing the interest deduction rules and would fail any arm's length test, while the other is a victim of circumstance and would pass an arm's length test, both are treated equally by section 23M and both would have a certain percentage of their interest payments disallowed as a deduction.

Based on the above, section 23M does not fall within the parameters of Article 9(1) and it is not necessary to address the second question of whether section 23M ever results in increasing the profits of the resident entity to a level above what would be considered arm's length. Failure

[143] Supra note 21 at page 1.
[144] D. Devlin, *'Limiting the Impact of Excessive Interest Deductions on Mining Revenue'* IGF-OECD Program To Address BEPS in Mining (2018) at page 5

to comply with the requirements set out in Article 9(1) leaves only Article 11(6) left to test section 23M against. Failure to fall within the scope of this provision will prove a fatal blow for this particular interest deduction rule.[145]

D. What does Article 11(6) allow?

Article 11(6) again, like Article 9(1), allows a state to implement its domestic interest deduction rules within the context of that state's Double Taxation Treaties. In order for a state to be allowed to deny the deductibility of interest under the shield of Article 11(6), the interest payment needs to be between parties that have a special relationship and there must be an 'excess portion' of interest that is paid that would not have been paid had it not been for the special relationship between the parties.[146]

Section 23M contains a "controlling relationship" requirement that is covered by the special relationship requirement contained in Article 11(6).[147] This means that again, like with Article 9(1), section 23M's compatibly with Article 11(6), comes down to whether section 23M is concerned only with transactions that were not concluded at an arm's length and result in an excess portion of interest being paid. We have already determined that section 23M, provided all the requirements are met, applies to all transactions and not just those whose terms and conditions are not considered 'arms-length'. Because section 23M does not only concern itself with transactions involving an excess portion of interest, but rather applies arbitrarily, section 23M does not fall within the scope of Article 11(6) of the OECD MTC.

It has now been shown that not only does section 23M discriminate based on residency, but it has now also been proven that section 23M does not fall within the parameters of either

[145] Supra note 71 at page 2
[146] Article 11(6) of the OECD Model Tax Convention
[147] See the discussion in Chapter 3 on the meaning of "special relationship".

Article 9(1) or Article 11(6). Failing to be covered by one of these two Articles means that section 23M is incompatible with the non-discrimination provision contained in Article 24(4). The consequences of such incompatibility will be discussed in Chapter 5.

III. SECTION 23N:

A. A case for no discrimination

Similarly to section 23M, section 23N uses a formula to limit the amount of interest that can be claimed as deductible in certain situations. While section 23M applies to a broader group of transactions, section 23N was enacted for the purpose of policing reorganisation and acquisition transactions.[148] What needs to be determined is whether section 23N applies to all reorganisation and acquisition transactions or whether it only applies to reorganisation and acquisition transactions where one party to the transaction is a non-resident or owned by a non-resident.

Answering the above question can be done by simply looking at the definitions of "reorganisation transactions" and "acquisition transactions" in the Income Tax Act.[149] As was explained in *Chapter 2,* reorganisation transactions are made up of intra group and liquidation transactions, while acquisition transactions are those in where one company, by way of acquiring equity shares, is now in a controlling position over another company.[150] While the requirements in order to qualify as a reorganisation or acquisition transaction are convoluted, what is important to note is that there is no requirement, explicit or implicit, whereby by one of the companies involved in the transaction needs to be a non-resident or a foreign owned resident.[151] In fact, the opposite is true. When looking at what constitutes a "group" for the purposes of section 23N, it is

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[148] As was touched on in Chapter 2, the hierarchy of rules dictates that section 23N, the more specific rule, is applied before the broader catch-all rule contained in section 23M.
[149] See sections 45 and 47 for detailed definitions of the respective transactions.
[150] Section 45 and 47 of the Income Tax Act.
[151] Ibid; Supra note 4.

explicitly stated that foreign companies are excluded from the definition and as such, section 23N can never apply to non-resident companies.[152]

With regards to the above, it can confidently be concluded that section 23N does not discriminate based on residency or on the ownership of capital.

IV. SECTION 31:

Section 31 contains South Africa's transfer pricing and thin capitalization rules.[153] As detailed in Chapter 2, section 31 applies to all transactions concluded between a resident and a non-resident for the benefit of one or either of the parties, where a special relationship exists between the parties, and where a term or terms of the agreement differ from a similar agreement between two unrelated parties.[154] The enquiry into whether section 31 is incompatible with Article 24 of the OECD Model will follow the same approach as with the preceding sections and as such, we will begin by looking at whether any of the requirements result in differential treatment between residents and non-residents.

A. Discrimination: a case by case basis

Section 31, unlike sections 23M and 23N, has an explicit requirement that states that in order for this section to apply, one of the parties to the agreement must be a resident while the other must be a non-resident. Clearly, it is section 31's purpose to only apply to cross border situations and as such, treat transactions differently based on residency.[155] It is now necessary to see whether the difference in treatment amounts to discrimination. This is done by examining

[152] Sections 45 and 47 both make reference to a "group of companies" as defined in section 41. Section 41 defines a group of companies as meaning any group of companies as defined in section 1 but excluding any company whose place of effective management is located outside of South Africa. This place of effective management effectively rules out non-resident companies from the definition.
[153] Supra note 29.
[154] Section 31 of the Income Tax Act.
[155] Supra note 29.

whether, through the application of section 31, a harsher tax will be imposed on resident to non-resident payment as opposed to resident to resident payments.

Section 31 permits a Contracting State to adjust profits of residents in such a manner as to make them resemble the situation that would have been the case had the parties concluded the agreement at an arm's length.[156] This means that the profits of the local enterprise will be increased and thus so will their tax burden.[157] Compare this to a transaction between two resident entities, to which section 31 does not apply and the profits are left unchanged, and it is clear to see that section 31 imposes a harsher tax burden on resident to non-resident payments. The fact that section 31 distinguishes based on residency added to the harsher tax treatment means that section 31 constitutes discrimination in terms of Article 24(4).

B. Does section 31 fall within Article 9(1) or 11(6)?

Article 9(1) of the OECD Model is the avenue through which states can apply their domestic transfer pricing rules. It would then make sense that, provided section 31 is not far removed from the standard transfer pricing rules that the OECD Model had in mind when crafting Article 9(1), South Africa's transfer pricing rule would comply with Article 9(1)'s requirements.

We know from the explanation in *Chapter 3* that Article 9(1) requires domestic interest deduction laws to only adjust profits of transactions whose terms are not considered to be at arm's length. We have already explained that one of section 31's requirements demands that in order for it to apply, the agreement underlying the transaction must have a term or terms that differ from

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[156] Section 31 of the Income Tax Act.
[157] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010) Organization for Economic Co-Operation and Development at page 33

a similar agreement between two unrelated parties.[158] What does, however, need to be looked at further is if section 31 ever adjusts profits beyond what would be considered at an arm's length.

Article 9(1) is restrictive rather than illustrative meaning that states are only allowed to adjust the profits of an enterprise to a level that would have been the case had the transaction been entered into at arm's length.[159] Therefore, if a state uses its domestic transfer pricing provisions to increase the profits of a domestic enterprise to a level beyond what would be considered an appropriate level if two independent enterprises had concluded the agreement, then that that domestic transfer pricing provision would fall outside the protection of Article 9(1). For example, imagine that A, a company resident in South Africa, enters into an agreement with B, a non-resident company, whereby B provides A with a loan to purchase certain machinery. The machinery costs R100 million but the loan is for R200 million, allowing A to claim a larger interest deduction (which in turn decreases A's profits) than if the loan hand been granted on arm's length terms for R100 million.[160] Article 9(1) allows any domestic transfer pricing provision that decreases the value of the loan to an arm's length level, which in this instance is R100 million. However, if a domestic transfer pricing provision decreased the value of the loan to R50 million, which is below the arm's length amount, this provision would fall outside the protection of Article 9(1) as A's interest deductions drop to such a level where A's profits are now increased to a level above what would have been the case had the loan been concluded at arm's length.

Section 31 caters for two adjustments – a primary adjustment and a secondary adjustment. The primary adjustments corrects the profits of the enterprises involved in the transaction while the secondary adjustment recharacterises the part of the payment deemed excessive. Given that

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[158] Section 31 of the Income Tax Act.
[159] Supra note 125 at page 587
[160] An increase in A's interest deductions would decrease their taxable income and as a result decrease their profits.

the second adjustment can only recharacterise the amount of interest that the first adjustment deemed excessive, the second adjustment does not need to be tested against Article 9(1). If the primary adjustment is in line with Article 9(1), then so is the secondary adjustment and vice versa.

South Africa's transfer pricing policy and Article 9(1) are substantially similar, due to the fact that South Africa modelled section 31 on the OECD's arm's length principle.[161] The only real difference being that section 31 is slightly narrower in application than Article 9(1).[162] Section 31, or more precisely, section 31(2), makes no reference to anything other than adjusting profits in accordance with the arm's length principle. In lieu of this, one cannot categorically say whether or not South Africa's transfer pricing rule allows the state to tax adjust in excess of arm's length standards. However, in accordance with section 31 being based on the OECD's arm's length principle, it is not presumptuous to assume that section 31 should be interpreted in the same manner as the OECD transfer pricing provision. The conclusion that is drawn from this is that section 31 of the Income Tax Act does not allow the South African State to adjust profits to a level over and above what would be considered arm's length. This naturally means that section 31 falls within the scope of Article 9(1) of the OECD Model and as a result of this, is not in violation of the non-discrimination clauses contained in Article 24.

It must be noted that in practice, if the aggrieved party can demonstrate that South Africa have misapplied Section 31 and adjusted profits to a level beyond what would be considered arm's length, then in that particular instance the aggrieved party could seek protection from Article 24(4).

[161]Explanatory Memorandum to the Taxation Law Amendment Bill 2011 at page 116.
[162] Section 31 applies only to transactions involving 'connected persons' while Article 9(1) applies to transactions involving 'associated enterprises. The latter is broader than the former and, in a bid to align South Africa's transfer pricing policy wholly with that of the OECD, the legislature have released a draft amendment bill seeking to replace the 'connected persons' requirement with 'associated enterprises' – see W. Horak & A.J. Bakker, South Africa - Transfer Pricing, Country Tax Guides IBFD at page 11.

However, it must be stressed that section 31 does not cater for such an overstep on the State's part, but that it can, through negligence, be applied in a manner that would be discriminatory.

V. CONCLUSION

The goal of this chapter was to examine the compatibility of South Africa's interest deductibility laws with the 2017 OECD Model provisions. The results of the investigation have yielded what can only be described as a mixed bag.

Section 23N was found to not distinguish based on residency or foreign ownership and so the investigation into discrimination stopped there. This means that South Africa is free to apply section 23N without fear of contravening any of its treaties that are based on the 2017 OECD Model.

The enquiry into Section 31 was far murkier. Section 31, like most countries' transfer pricing provisions, only applies to transactions concerning a domestic and foreign entity and necessarily constitutes discrimination.[163] However, because section 31 adjusts profits based on the arm's length principle, it is line with Article 9(1) of the OECD Model and is therefore exempt from Article 24(4) and (5). As such, Section 31 is compatible with the OECD 2017 Model and any treaties based thereon. However, there can exist individual cases where section 31 is applied incorrectly and the state over adjusts profits which can result in a one-time breach of the non-discrimination clauses. A breach of this nature does not mean that section 31 is not compatible with the 2017 OECD Model, it just allows an aggrieved party the Article 24 relief due to misapplication of domestic law.

[163] Explanatory Memorandum on the Draft Taxation Laws Amendment Bill (2019) page 44.

On the other end of the spectrum, section 23M is entirely incompatible with South Africa's treaties that are based on the 2017 OECD Model. In order for section 23M to apply, there has to exist the risk of base erosion which amounts to disguised discrimination based on residency as base erosion can only occur when a non-resident is involved in the arrangement. Furthermore, this disguised discrimination cannot be saved by Articles 9(1) or 11(6) as section 23M does not adjust profits or deny interest deductibility based on the arm's length principle. The lack of protection from Articles 9(1) and 11(6) result in section 23M conflicting with Article 24(4) and as such not being compatible with South Africa's treaties that contain all of the relevant provisions.

Chapter 5: The Consequences of a Conflict and Possible Solutions

I. INTRODUCTION

The purpose of the preceding chapters has been to shine a light on the interaction between South Africa's domestic rules on interest deductions and the relevant provisions of the 2017 OECD MTC and South Africa's treaties based thereon. Chapter 4 is where we concluded that the interactions between domestic law and international law is not so smooth, and in particular found that one domestic rule is in conflict with South Africa's treaties that are based on the 2017 OECD MTC. This Chapter will focus on the aftermath of such a conflict in that it will attempt to explain how a conflict of laws is resolved in a South African context and whether domestic or international law takes precedence. This will be done by first explaining how international treaties become binding on South Africa and the position these agreements occupy in South Africa's legal hierarchy. Thereafter, this Chapter will draw on South Africa's rules on interpreting statues as well as international rules of interpretation in order to reach some recommendations on how this conflict can be resolved.

II. THE ROLE OF TREATY LAW IN SOUTH AFRICA

A necessary step before one can offer insight into how a conflict of laws can be resolved is to understand treaty law's legal status in South Africa.

There are two systems that a State can adopt with regards to bringing international agreements into force domestically, monism and dualism. Under monism, domestic legislation is not required in order for the international agreements to have direct effect. Dualism, on the other hand, requires international agreements to be incorporated into domestic law in order for it to be enforceable. South Africa actually adopts a hybrid of the two systems in that with regards to international agreements of a technical, administrative or executive nature, ratification is not required.[164] However, for other international agreements, they have to be incorporated into domestic law in order for them to be enforced.[165] Double Taxation agreements fall into the latter category.

Now that it has been explained how Double Taxation Agreements become law in South Africa, the next step is to understand their legal status in relation to domestic law. According to Vogel, the authority and relationship between domestic law and treaty law has to be determined by looking at the particular country's legal framework.[166] When discussing South Africa's legal framework in relation to tax law, the two relevant pieces of legislation are the Constitution and the Income Tax Act. Section 231 of the Constitution read in conjunction with section 108(2) of the Income Tax Act allows the government to enter into agreements with other countries to govern the tax of income, profits, donations etc. which might be taxable in both countries and those agreements, once ratified, have the same legal effect as if they were contained in the Income Tax Act.[167] This makes understanding whether domestic law or treaty law takes precedence even more challenging as it appears that they are effectively on level footing and are both considered 'provisions' of the Income Tax Act.[168]

Having looked at the Constitution and the Income Tax Act, it is clear that our approach to resolving the conflict between domestic law and treaty law must change. The question is no longer whether domestic law or treaty law occupy a higher position in the legislative hierarchy, but rather

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[164] G. Ferreira and A. Ferreira-Snyman, '*The Incorporation of Public International Law Into Municipal Law And Regional Law Against the Background of the Dichotomy Between Monism and Dualism*' PER/PELJ 2014(17)4 at page 1477.
[165] Constitution section 231(4).
[166] K. Vogel, *'Klaus Vogel on double taxation conventions: a commentary to the OECD-, UN- and US model conventions for the avoidance of double taxation of income and capital: with particular reference to German treaty practice*. 3rd ed. Deventer: Kluwer (1997) at paragraph 30.
[167] L. Olivier and M. Honiball, 'International tax: a South African perspective' at 395
[168] This view is supported by cases such as *Pan American World Airways Inc v SA Fire and Accident Insurance Co Ltd* and *South African Inlands Development Corporation Ltd v Buchan*.

how can the conflict between two equally weighted pieces of law be resolved through the rules of interpretation.

III. RULES OF INTERPRETATION

A. Introduction

This part of a chapter will follow the procedure that a court would adopt in an attempt to interpret the two pieces of legislation in order to reconcile them. This procedure will entail the courts reading the actual words of both the domestic legislation and the treaties in the context of which they were enacted. Effectively this requires that the object and the purpose of the pieces of legislation be unpacked. If this does not lead to a reconciliation of the laws, then other rules of interpretation will be looked such as ‘lex posterior derogate legi priori’ and ‘generalia specialibus non derogant’.[169]

Furthermore, South African courts are also bound to consult international customary law when interpreting legislation provided that the international law is not inconsistent with the laws in South Africa. In this instance, the relevant pieces of international law are the Vienna Convention on Treaties and the Commentary on the latest OECD MTC.[170]

B. The Object and Purpose of section 23M and Treaties

The object and purpose of a Double Taxation Agreement as a whole, is to prevent double taxation. However, in our case, the specific Article that is in conflict with the domestic law has a slightly different purpose. Article 24(4), as was explained in detail in Chapter 3, is concerned with preventing discrimination regardless of whether there is double taxation or not. Therefore, I

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[169] A.W. Oguttu, ‘Resolving the conflict between 'controlled foreign company' legislation and tax treaties: a South African perspective, *The Comparative and International Law Journal of Southern Africa, Vol. 42, No. 1* (2009) page 109.
[170] Ibid at page 111.

believe it is this purpose, and the not the purpose of the entire Double Taxation Agreement, that should be focused on. This purpose must be viewed against the competing goal of section 23M which is concerned with preventing base erosion and profit shifting and was enacted for the express purpose to prevent such with regards to interest payments. It is clear that if the reasoning in Chapter 4 is accepted, then section 23M in its current form cannot be reconciled with the object and purpose of Article 24(4).

Another very important piece of context can be found by looking at the intention of countries entering into Double Taxation Agreements. Yes, as previously stated, they do so to prevent double taxation. But looking deeper into that, states understand that in order to prevent double taxation, it means that in certain situations they are not going to be able to tax certain income or profits that their domestic legislation ordinarily allows to be taxed. This would mean that whenever a treaty and a domestic provision clash, it is to be assumed that the treaty supersede the domestic law because this is what was envisaged when the treaty was concluded. This view is supported by various other authors who are also of the opinion that, while section 108(1) allows for a tax liability to be imposed in terms of South Africa's domestic legislation it does make provision for this tax liability to be overridden by treaties.[171]

An argument against allowing South Africa's treaties to override section 23M is that section 23M was enacted later than most of South Africa's Double Taxation Agreements were concluded.[172] This argument is in line with the internationally accepted doctrine of 'lex posterior derogate legi priori' which effectively translates to the 'later in time rule'.[173] Under this doctrine,

[171] Supra note 167; Section 108(1) of the Income Tax Act
[172] Section 23M was enacted in January of 2015 which post the conclusion of the majority of South Africa's Double Taxation Agreements.
[173] Supra note 169.

the younger law overrides the older law. I am of the view that this doctrine is far less persuasive in a domestic versus treaty setting as opposed to a purely domestic dispute. Unlike when two pieces of domestic legislation clash and it is only that country affected by the conflict of laws and any resolution or interpretation adopted, in the situation where it's a country's domestic law versus a substantial number of international treaties it has signed, the outcome is going to affect far more states than just South Africa. By using the later in time doctrine and letting section 23M override the treaties, South Africa would, in essence, be in breach of every single Double Taxation Agreement that it is party to that section 23M conflicts with. A Double Taxation Agreement represents the combined intentions of the parties to that treaty and so the argument that a piece of legislation enacted that is in conflict with a prior piece of legislation and so it must have been the intention of the legislature to override the earlier piece of legislation does not hold up when the intention of one of the parties to the previous piece of legislation has not been consulted. A such, the later in time doctrine should not be taken into account for current purposes.

Another internationally accepted doctrine that some authors suggest should be taken into account in the domestic versus international clash of laws is the 'generalia specialibus non derogant'.[174] This doctrine provides that a general Act should not be construed as having repealed a previous particular Act.[175] Again, the reasoning behind the doctrine is clear but the suitability of the doctrine to a conflict of laws that involves bilateral international agreements is dubious at best. Like with the aforementioned doctrine, I do not believe that any doctrine concerning which piece of law was enforced first or is more specific should have any sway if all parties to the international agreement did not get together to discuss the enactment of all legislation concerned.

[174] Supra note 169 at page 110.
[175] A.W. Oguttu, 'The Challenges of Taxing Profits Attributed to Permanent Establishments: A South African Perspective', *64 Bull. Intl. Taxn. 3* (2010), Journals IBFD at page 172

C. International Customary Law

According to section 232 of the Constitution, South African courts are bound to reach an interpretation that is in line with international law.[176] As such, when reaching their conclusion, courts need to consider any relevant customary international law. Based on the current set of facts, there are two pieces of international law that need to be considered: The Vienna Convention on the Law of Treaties; and the Commentary on the OECD MTC.

i. <u>The Vienna Convention:</u>

When dealing with treaties of any nature, one must have regard for the Vienna Convention. The Article that deals with interpretation is Article 31 which makes one point in particular that will count in favor of the treaties overriding section 23M. Article 31(3) states:

> *There shall be taken into account, together with the context:*
>
> *(a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;*
>
> *(b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;*
>
> *(c) Any relevant rules of international law applicable in the relations between the parties.*[177]

When interpreting any treaty or Article contained therein, the context that one must have regard to includes the above. What is important to note is that no reference is made to domestic legislation, but rather to "agreements made between parties" or "any practice which establishes agreement". The emphasis here is on the **agreement** between the parties to the relevant treaty

[176] Constitution of the Republic of South Africa, 1996 section 232.
[177] Vienna Convention on the Law of Treaties Article 31.

which supports the above view that it is difficult to argue that the domestic law, section 23M, which was unilaterally enacted, should override the bilaterally concluded treaties.

Apart from what should be considered when interpreting a treaty, the only other relevant Article is Article 26 which will be dealt with below when discussing the OECD Commentary.

ii. OECD Commentary

Although South Africa is not a member of the OECD, most of its Double Taxation Treaties are based on the OECD MTC.[178] As such, the OECD commentary should be relevant when interpreting a treaty and has in fact been confirmed in the case of SIR v Downing.[179]

The Commentary recognizes that there is debate around whether a convention can prevent the application of domestic anti-abuse provisions and dedicates 14 paragraphs to address it.[180] In paragraph 69 of the Commentary, it mentions specific examples of a State applying its domestic thin capitalization rules to prevent base eroding interest payments as well as transfer pricing rules to prevent the artificial shifting of profits and recognizes that these rules in particular can conflict with treaties.[181] In the very next paragraph, the commentary states that where these domestic provisions conflict with treaty provisions, the treaty provisions should override the domestic rules.[182] The reason for this, according to the Commentary, is due to the 'pacta sunt servanda' principle contained in Article 26 of the Vienna Convention.[183] This offers further support for the argument laid out above that a unilaterally enacted domestic law should not trump a bilaterally concluded agreement and that agreements must be honoured.

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[178] L. Steenkamp, 'An Analysis of the Applicability of the OOED Model Tax Convention To Non-OECD Member Countries: The South African Case' *University of Business School* (2016) page 87.
[179] *SIR v Downing 1975 4 SA 518* at 525 (AD)
[180] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 at para 58
[181] Ibid at para 69
[182] Ibid at para 70
[183] Vienna Convention on the Law of Treaties Article 26.

D. Conflict resolution

It is my view, and one that is shared by various other authors, that South Africa's treaties should override domestic laws when there is a conflict. However, regardless of whether or not my view is adopted, what has to be acknowledged is that the something needs to be done to remove the conflict altogether. South Africa entered into various treaties for a purpose, and section 23M was enacted for a purpose, and currently both of those purposes cannot co-exist. Furthermore, the fix is necessitated by the fact that Article 60 of the Vienna Convention states that "material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part".[184]

Perhaps the most important consideration when thinking of a solution to this problem is which piece of law do South Africa want to prevail. It was stated in the above paragraph that it was the legislature's intention for both pieces of law to have an effect but the reality is that one piece of legislation will need to be altered in a way to remove the conflict and in doing so, its purpose, or ability to achieve its purpose, will be changed somewhat. Determining whether the South African State feels more strongly towards section 23M or towards its Double Taxation Treaties is something that can never be done with a 100% certainty and so the recommendations contained below will be based on what I believe should be the approach adopted by the State. Additionally, one must also keep in mind that not only will South Africa have to implement the proposed solution, or at least some variation of this solution, going forward when concluding new Double Taxation Treaties with other countries, but the solution also needs to fix the conflict that section 23M has with existing treaties.

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[184] Vienna Convention on the Law of Treaties Article 60.

All proposed solutions can effectively be boxed into two categories in that they will either require an amendment to section 23M or an amendment to South Africa's Double Taxation Agreements. As such, the pros and cons of each option will be discussed.

IV. AMENDING SECTION 23M

Before discussing the pros and cons of amending section 23M, it needs to be decided whether or not it is even feasible to amend the section in a manner that would make it consistent with South Africa's Double Taxation Treaties. The reason section 23M and South Africa's Double Taxation Treaties clash is because section 23M does not contain any sort of arm's length test. Therefore, the simplest solution would be to insert and arm's length requirement into section 23M. Effectively this would require very little to no modification of the existing provisions of section 23M as well as leaving the formula unchanged. With this amendment, in order for section 23M to apply, all of the same requirements would need to be met, but with the added condition that the interest being paid by the local to the foreign entity needs to represent an amount over above what would be expected if the two entities were unrelated.

While it is possible for the legislature to amend section 23M to make it compatible with South Africa's Double Taxation Agreements, in the manner described above, it does not necessarily mean that it is desirable to do so. The two biggest consequences of amending section 23M is that firstly, it will substantially narrow the scope of said provision. And secondly, it will place a far larger burden on the South African Revenue Service as they will need to show that the arrangements in question do not represent an arm's length transaction in order for the section to apply. With regards to the first consequence, narrowing the scope of section 23M will not necessarily affect the purpose of this section. Section 23M was enacted to prevent base erosion through excessive interest deductions, and the introduction of an arm's length rule would, if anything, ensure that only arrangements that are specifically geared towards profit shifting are targeted. With regards to the second consequence, there is no easy fix to this. The burden of proof cannot be shifted onto the taxpayer because that too could be challenged on the grounds of discrimination in terms of Article 24. However, as far as consequences go, this is not quite as dire as it could be and with SARS looking to rebuild and upskill, the increased burden that the arm's length requirement would impose could be eaten up over the course of a few years.

The single biggest advantage to amending section 23M is that South Africa can do it unilaterally and there will be no need to renegotiate any of its existing Double Taxation Treaties. While one of the disadvantages discussed above was an increased burden on SARS, it pales in comparison to the burden that the State would be under to renegotiate each of its treaties that conflict with the current section 23M.

V. AMENDING THE TREATIES

The only other way to resolve the current conflict would be for South Africa to amend all of its Double Taxation Treaties that are currently incompatible with section 23M. As with the above discussion on section 23M, before getting into the advantages and disadvantages, we need to first look at how South Africa could amend its treaties to allow for section 23M in its current form to not be in breach of Article 24.

There are a number of possible ways to amend its treaties that South Africa could adopt, however there aren't many realistic options. For example, South Africa could try remove Article 24(4) and (5) in its entirety. And while this would solve the problem, it is not at all feasible for several reasons. Quite possibly the only reasonable amendment that South Africa could make is to insert a clause that provides that South Africa's domestic interest deduction rules trump the

Double Taxation Treaties provisions when there is a conflict.[185] This is the approach favored by Oguttu in her discussion on the compatibly of South Africa's CFC legislation with its Double Taxation Treaties.[186]

Double Taxation Treaties, being bilateral in nature, cannot be amended unilaterally, and this is where the first of many negatives arises. South Africa would need to meet with representatives of every single nation that it has a Double Taxation Treaty with and attempt to convince the other party to agree to South Africa's proposed amendments. Not only is this an incredibly large administrative burden, but there is also no guarantee that the counterparties would agree to such amendments. In fact, it is highly unlikely that the proposed amendments would be accepted as countries would be weary of allowing South Africa to take profits that the countries feel like they are entitled to. Additionally, but admittedly less burdensome, South Africa would have to be sure to negotiate the addition of the same clause into future Double Taxation Agreements should any be concluded in the future. They would of course encounter the same issue in trying to convince relevant countries to accept the proposed amendment. Despite the difficulties presented by renegotiating, it is actually an approach endorsed by the OECD. [187] But it must be noted that this was not said within the context of whether a domestic fix is preferred to a treaty amendment but rather in terms of what international solutions were plausible.

VI. CONCLUSION

As was stated at the beginning of this section, it is not possible to predict how this conflict will be resolved and whether the South African State would prefer its domestic or its international law on

[185] Supra note 175 at page 114.
[186] A.W. Oguttu, 'The Challenges of Taxing Profits Attributed to Permanent Establishments: A South African Perspective,' *64 Bull. Intl. Taxn. 3* (2010), Journals IBFD
[187] 2017 OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 at para 62

interest deductions to take precedence. However, as has been demonstrated, it is possible to put forward arguments as to which approach South Africa should adopt. And by far the strongest argument is that South Africa should amend section 23M to make it compatible with the non-discrimination provisions contained in its Double Taxation Treaties. The amendment would look something like the addition of a requirement that focuses on only taxing non-arm's length arrangements. This amendment would not go against the purpose of section 23M as BEPS will now be the only focus of this provision. Furthermore, it will represent a far more streamlined, one shot, solution as opposed to amending each individual Double Taxation Treaty. It is also a guaranteed solution in a way that amending South Africa's Double Taxation Treaties is not. This is the case because amending section 23M is a uniliteral act while amending each treaty requires the other contracting state to agree which of course is not guaranteed.

Chapter 6: Conclusion

The aim of this thesis was to determine whether any of South Africa's interest deduction laws conflict with the South Africa's Double Taxation Treaties based on the 2017 OECD MTC. South Africa is not a member of the OECD and occupies observer status and so having laws that are in conflict with the OECD Model Tax Convention is in and of itself not an issue. What is cause for concern, however, is that because South Africa bases most of its Double Taxation Treaties on the OECD Model Tax Convention, if South Africa's domestic laws on interest deductions conflict with the OECD Model Tax Convention, then they also clash with the majority of its Double Taxation Treaties which has international ramifications.

In order to explain how the conflict potentially arises, the first step was to discuss South Africa's domestic laws on excessive interest deductions. South Africa's interest deduction laws can be separated into laws that govern reorganization and acquisition transactions, and laws that govern all other types of transactions. Section 23N applies to reorganization and acquisition transactions and sections 31 and 23M apply to all other types of transactions. It was shown that while all three of these laws limit the amount of interest expenses that may be claimed in various circumstances, sections 23N and M do so by use of a formula, whereas section 31 makes use of the arm's length principle.

The next step, taken in Chapter 3, was to discuss the relevant provisions of the 2017 OECD Model, which was shown to be a suitable proxy for previous models that South Africa based the majority of their Double Taxation Treaties on. Article 24(4) dealing with discrimination based on residency, and Article 24(5) dealing with discrimination based on the residency of capital ownership, were discussed before the exemptions contained in Articles 9(1) and 11(6) were explained. In order to comply with the aforementioned exemptions, a domestic law found to be discriminatory would either have to limit interest using an arm's length principle, or only target the 'excess' portion of interest.

Chapter 4 then looked at whether any of South Africa's three domestic laws on excessive interest deduction conflicted with Article 24 of the 2017 OECD Model. It was found that section 23N does not constitute prima facie discrimination and so does fall within Article 24's scope. Section 31, on the other hand, necessarily constitutes discrimination as it only applies to situations between a resident and non-resident transaction, and so does conflict with Article 24. However, because section 31 limits excessive interest deductions in accordance with the arm's length principle, it falls within the Article 9(1) exemption and as such, is compatible with the 2017 OECD MTC. Section 23M, like section 31, constitutes prima facie discrimination in that it only applies to scenarios where the party receiving interest payments is a non-resident. The result of this is that section 23M is in conflict with Article 24 and it does not fall within the exemptions contained in Article 9(1) or 11(6) as section 23M does not contain an arm's length requirement nor does it only target the 'excess' portion of the interest payment. Chapter 4 concluded that section 23M is not compatible with the 2017 OECD MTC and therefore not compatible with its Double Taxation Treaties.

Chapter 5 dealt with the aftermath of the conclusion reached in the preceding chapter. It discussed whether a domestic tax law or a treaty tax law took precedence before stating that both are in fact on equal footing. The chapter then dealt with the best way in which the conflict could be resolved. The two most feasible options are for South Africa to amend section 23M to align it with its Double Taxation Treaties, or for South Africa to amend all of its Double Taxation Treaties.

For certainty and ease of convenience, Chapter 5 concluded that South Africa should opt for the former as opposed to the latter.

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