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TITLE: The tax deductibility of interest on money borrowed to pay penalties imposed by the Competition Tribunal in terms of the Competition Act, 89 of 1998.

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Research dissertation/research paper presented for the approval of Senate in fulfilment of part of the requirements for the Masters in Taxation in approved courses and a minor dissertation/paper. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Masters in Taxation dissertations/research papers, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation/research paper conforms to those regulations.

Signed

CLARE EMSLIE

Introduction

Section 59(1) of the Competition Act, 89 of 1998 authorises the Competition Tribunal to impose administrative penalties on firms who have committed prohibited forms of anti-competitive conduct, for example a penalty of R45 million was imposed on South African Airways (Pty) Ltd for abuse of dominance and a penalty of R98 784 869.90 was imposed on Tiger Consumer Brands (Pty) Ltd for price fixing.¹ This paper will consider whether the interest expenditure incurred by a company, which raises a loan in order to pay such a penalty, would be deductible in terms of the general case law on the deductibility of interest or in terms of section 24J(2) of the Income Tax Act, 58 of 1962 (“the Act”).

The types of offences that attract Competition Penalties include price-fixing, abuse of dominance, cartels etc.

‘Cartels are particularly a damaging form of anticompetitive agreement often resulting in price increases that are harmful to consumers of goods or services concerned. Not only does such activity affect consumer welfare, but it also hinders development and innovation in the industries within which this activity occurs.’²

In its most recent decision regarding a bread cartel involving Pioneer Food Group, the Competition Tribunal stated that ‘hard core cartel activities are considered to be the most egregious offences under the Competition Act and, absent mitigating factors, deserve the maximum penalty provided for in the Act’.³

Taxable income is determined by calculating gross income, as defined, from which exempt income is deducted, resulting in the amount of income (as defined in section 1 of the Act). Allowable deductions are then deducted from income in order to calculate the amount of taxable income.

¹ Joe van Dorsten “The Tax Implications of Competition Penalties” *Taxpayer* vol 58 no 8 at 142

² Competition Commission South Africa, “Corporate Leniency Policy” available at www.compcom.co.za/corporate-lenieny-policy/ [Accessed on 13 February 2010]

³ <http://www.moneyweb.co.za/mw/view/mw/en/page>

Generally, in order for expenditure to be deductible it must meet the requirements of section 11(a) read with section 23(g) of the Act, unless a specific provision provides for its deduction. Section 11(a) requires expenditure to be ‘actually incurred in the production of income, provided such expenditure is not of a capital nature’ while section 23(g) requires that the expenditure will not be deductible ‘to the extent to which such moneys were not laid out or expended for the purposes of trade’.

According to section 23B(3) of the Act:

‘No deduction shall be allowed under s 11(a) in respect of any expenditure or loss of a type for which a deduction or allowance may be granted under any other provision of this Act, notwithstanding that –

- (a) such other provision may impose any limitation on the amount of the such deduction or allowance; or
- (b) that deduction or allowance in terms of that other provision may be granted in a different year of assessment.’ **(check this in new act and insert footnote)**

As a result of section 23B(3) one must turn to section 24J when discussing the deductibility of interest.

In 2005, section 24J of the Act was amended to make provision for the deductibility of interest expenditure. Previously it had merely been a timing provision, which regulated the amount of interest that could be deducted in each year of assessment while the interest was still deductible in terms of section 11(a).⁴ Interest must now be deducted in terms of section 24J (2), which reads as follows:

- ‘(2) Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to –
 - (a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or

⁴ www.moneywebtax.co.za Accessed on 17 Oct 2009

- (b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument, which must be deductible from the *income* of that person derived from carrying on any *trade* if that amount is incurred *in the production of income*.⁵

Thus for section 24J(2) to apply there must be an “issuer” and an “instrument”. An issuer is defined as:

‘in relation to any instrument –

- (a) any person who has incurred any interest or has any obligation to repay any amount in terms of such instrument; or
- (b) at any particular time, means any person who, if any interest payable in terms of such instrument was due and payable at that time, would be liable to pay such interest.’

and an instrument “means any form of interest-bearing arrangement, whether in writing or not...”

Interest is defined in section 24J to ‘include the

- (a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;
- (b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and
- (c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party...’

As is the case in section 11(a) read with section 23(g), section 24J(2) requires that the interest expenditure be derived from trade and incurred in the production of income. However, there is no requirement in section 24J(2) that the expenditure must not be of a capital nature. The case law on the trade requirement and the production of income under section 11(a) would therefore still be relevant in determining the deductibility of interest under section 24J(2).

⁵ Income Tax Act No 58 of 1962

“In the production of income”

The case of *Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue*⁶ considered the “in the production of income” inquiry. The taxpayer was a company that was in the transport business. One of the company’s employees was injured while driving a tram during the course of his employment. The company unsuccessfully resisted a claim for damages and was obliged to pay compensation to the widow of the driver, who had subsequently died. The taxpayer sought to deduct both the damages and the legal fees incurred in resisting the claim for damages. Discussing how to determine whether an expense is “in the production of income”, the court in the *PE Electric Tramways* case stated that:

‘all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.’⁷

Thus, the test for whether expenditure is in the production of income involves a two part inquiry. Firstly, the act to which the expenditure is attached must be performed in the production of income. Secondly, the expenditure must be so closely linked to the act referred to above that it can be regarded as part of the cost of performing it.⁸ The court held that the damages were deductible as the underlying act to which the expenditure was attached was the employment of drivers and this was a necessary component of the taxpayer’s business. The court went on to say that there was an inevitable possibility, in the employment of drivers, that potential liability may arise for any injury incurred during the course of their employment. As a result the

⁶ 1936 CPD 241

⁷ at 246

⁸ Emslie, Davis, etc *Income Tax Cases & Materials* at 330

damages expenditure was deductible. With regard to the legal costs, the court held that resisting the claim for damages, that being the underlying act, was not done for the purpose of earning income. The legal costs were held not to be in the production of income and not deductible.

The underlying act for interest expenditure on a loan to pay a competition penalty would be the competition activity, such as price fixing. This would clearly be done with the intention or purpose of earning income. So it appears that it would meet the first requirement of the test. The next question is whether the interest paid on a loan acquired in order to pay such penalty is closely linked enough to be 'regarded as part of the cost of performing it'⁹. If one looks at it from this perspective it seems that the interest on the loan would not be closely enough linked to the underlying act. The interest relates to the loan, which relates to the penalty, which relates to an unlawful act, which was in the production of income. The link does not seem to be such a close one.

In the case of *Joffe and Co (Pty) Ltd v CIR*¹⁰ the taxpayer wanted to deduct expenditure in the form of damages and legal costs which it incurred as a result of being found negligent in the death of a contractor who was employed by them. The taxpayer was in the business of reinforced concrete engineering. The company supplied the steel reinforcement for a cantilever hood. The hood subsequently collapsed and killed a plumber who had been working below. The Court held that both expenditure necessarily attached to the performance of income earning operations, as well as expenditure incurred *bona fide* for the purpose of performing income earning operations was deductible but only if it was expended wholly and exclusively for the purposes of trade and was not of a capital nature. The Court held

⁹ PE Electric Tramways at 456

¹⁰ 1946 AD 157, 13 SATC 354

that it not been shown that the negligence and subsequent liability for damages were necessary concomitants of the income earning operations of the company and that, as a result, neither the damages nor the legal costs were deductible.

The same principles were applied in *PE Electric Tramways* and *Joffe's* case. In the first case the possibility of liability for damages was seen to be necessarily attached to the business of the taxpayer in the sense that it is a very real and possible expectation that accidents might occur from time to time in the transport business and liability for damages may arise. The Court in *Joffe's* case took the view that negligence can never be considered to give rise to deductible expenditure. This view was largely based on public policy considerations.

With regard to interest arising out of a loan to pay competition penalties, the difference is that in most cases which come before the Competition Tribunal, the business would in fact have chosen to run its business in a way which would fall foul of the Competition Act in order to improve its production of income. It is conceivable that, like the Court in *Joffe's* case with regard to the negligence, a court may be reluctant to allow a deduction of interest for public policy reason. It will be argued below that the interest would be deductible as it is not so closely linked to the unlawful act so as to be tainted by its unlawfulness, and that the reason for the loan which incurs interest is not directly the unlawful act. However, if there were to be any public policy reason to disallow the deduction of interest, which would otherwise be deductible, it is submitted that it should be reserved for the most serious of offences under the Competition Act. As was mentioned above, cartel activities are considered to be the most serious offences under the Competition Act and deserve the maximum

penalty that is provided for in the Act. In the case of *Competition Commission v Pioneer Foods*¹¹ the Competition Tribunal stated in its decision that

‘Hard core cartels, as contemplated in section 4(1)(b) of the Act are *per se* offences. There is no need for the Commission to show any anti-competitive effects and there are no justification grounds available to respondents. So egregious an offence is this, that harm to competition and harm to consumers is presumed by its mere existence. Moreover the extent of loss suffered or damage caused is presumed to be extensive’¹²

It is therefore submitted that, if there were any possibility that the interest could be disallowed as a deduction by reason of the underlying offence which gave rise to the penalty, only the most serious offences, such as cartel activities could possibly lead to the disallowance of the deduction. However, as will be argued below, it is submitted that the interest would, nevertheless, be deductible.

The Trade Requirement

Most of the case law on section 23(g) deals with the section before it was amended in 1993. Prior to this amendment, expenditure had to be wholly and exclusively for purposes of trade in order to be deductible. The amended section provides that expenditure is not deductible *to the extent* that it is not laid out for the purposes of trade. This allows for an apportionment where particular expenditure is laid out partly for purposes of trade and partly for some other purpose. The cases dealing with the old section are, however, still relevant as they deal with what constitutes a trade purpose and what does not constitute a trade purpose.

In general expenditure that is laid out for purposes of making a profit will always be considered to be for purposes of trade. However,

¹¹ Case No 15/CR/Feb07 at 148

¹² *Competition Commission v Pioneer Foods (Pty) Ltd* Case No 15/CR/Feb07 at 148

‘the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer’s trade...Where, however, a trader normally carries on business by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must, in order to satisfy s 23(g), be shown to have been so connected with the pursuit of the taxpayer’s trade, e.g. on ground of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively for the purposes of trade’.¹³

The nature of a competition penalty is such that it would almost always be considered to be for the purposes of trade, at least to some extent. When it comes to the interest, the trade requirement would most likely be fulfilled, depending on the circumstances. Here, one starts by looking at the purpose of the loan that gave rise to the interest. Why did the company take out a loan thereby incurring liability to pay interest? The reason for this would almost always be that competition penalties are so high that most companies would be unable to pay them out of liquid funds. If the company is to continue trading after paying the penalty, it is likely that it will need a loan in order to retain enough liquid funds for the normal running of its business.

Deductibility of interest generally

In *Financier v COT*¹⁴, the court held that the test for the deductibility of interest on money borrowed was ‘the purpose for which the money was borrowed’.¹⁵ Even if the money borrowed is ultimately used for an investment, which does not produce taxable income, the court held that if the money was borrowed for good and sufficient reasons for use in the business, that the interest is still tax deductible.¹⁶ Thus the eventual use to which the money borrowed is put, is not the decisive factor. It is the purpose for the

¹³ *De Beers Holdings (Pty) Ltd v CIR* 1986 (1) SA 8 (A), 47 SATC 229

¹⁴ 1950 (3) SA 293 (SR), 17 SATC 405

¹⁵ *Financier v COT* 1950 (3) SA 293 (SR), 17 SATC 405 at 295

¹⁶ *Ibid*

loan that is decisive, although the ultimate use may be helpful in ascertaining the purpose of the borrowing.¹⁷

The court in *CIR v Allied Building Society*¹⁸ agreed with this view, stating that in ‘determining the purpose of the borrowing, the ultimate user of the money may, no doubt, in certain cases be a relevant factor; but the dominant question remains: what was the true nature of the transaction?’¹⁹

It therefore seems reasonable that where a company regularly accepts loans in the daily running of their business and one of such loans or part thereof is then used to extinguish the liability to pay competition penalties, that the interest on such borrowed money would be deductible because if one looks to the purpose of borrowing the money, it was a legitimate business purpose, in the production of income. The fact that the money is ultimately used for something else does not alter this purpose.²⁰

However, complex question to decide is whether the interest on money borrowed specifically for the purpose of paying competition penalties would be deductible, where the penalties themselves are not deductible.

Deductibility of Competition Penalties

Before reaching a conclusion about the deductibility of interest, as is the purpose of this paper, it may be helpful to consider whether the actual competition penalties themselves would constitute deductible expenditure.

¹⁷ David Clegg *Income Tax in South Africa* at [http://butterworths.uct.ac.za.ezproxy.uct.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://butterworths.uct.ac.za.ezproxy.uct.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu)

¹⁸ (4) SA 1 (A), 25 SATC 343

¹⁹ *CIR v Allied Building Society* (4) SA 1 (A), 25 SATC 343 at [13]

²⁰ *Financier v COT* 1950 (3) SA 293 (SR), 17 SATC 405 at 295

Policy considerations are a factor to be considered and count against the deductibility of penalties imposed by the Competition Tribunal. In the *Port Elizabeth Tramway*²¹ case Watermeyer CJ stated that where an act is ‘unlawful or negligent and the attendant expense is occasioned by the unlawfulness or, possibly, the negligence of the act, then probably it would not be deductible’.²²

In *ITC 1199*²³ Margo J stated that when considering an income producing transaction, which constitutes unlawful behaviour, one must differentiate between the business operation and the unlawful behaviour, which is committed coincidentally to the business operation. He goes on to say that the ‘nature and character of a fine as a punishment exacted by the State are such that it could not properly, naturally or reasonably be regarded as part of the cost of performing the business operation’.²⁴

Melamet J in *ITC 1490*²⁵ stated that ‘to allow fines imposed for an infraction of the law to be deducted as an expense... would be contrary to public policy in that it would frustrate the legislative intent and allow a punishment imposed to be diminished or lightened’.²⁶ The purpose of the penalties imposed by the Competition Tribunal is that they should be ‘sufficiently high to deter repetition of contraventions’.²⁷ If such penalties were then allowed to be deducted from a taxpayer’s taxable income, this would reduce the deterrent effect of the penalty.²⁸

In addition to the policy reasons why fines and penalties should not be deductible, section 23(o) of the Act specifically provides that expenditure which

²¹ *Port Elizabeth Tramway Co Ltd v Commissioner for Inland Revenue* 1936 CPD 241 at 245 - 6

²² *Ibid*

²³ (1973) 36 SATC 16 (T) at 20 – 21

²⁴ *Ibid*

²⁵ (1990) 53 SATC 108 (T)

²⁶ *ITC 1490* (1990) 53 SATC 108 (T) at 113-114

²⁷ Joe van Dorsten 2009 *Taxpayer* 58 at 144-145

²⁸ *ibid*

constitutes ‘a fine charged or penalty imposed as a result of an unlawful activity’ will not be allowed as a deduction.

Thus competition penalties, for various reasons, would not be deductible from taxable income. The question still remains, however, whether interest on money borrowed in order to pay such penalties would be deductible.

It has been held that the interest on money borrowed with the purpose of acquiring shares will normally not be deductible due to the fact that shares produce dividend income which is exempt and therefore does not form part of income, as defined, in the hands of the taxpayer.²⁹

In *CIR v Standard Bank of South Africa Ltd*³⁰ the court set out certain principles to be applied in determining the deductibility of interest on money borrowed. These include:

- ‘(1) Generally, in deciding whether moneys outlaid by a taxpayer constitute expenditure incurred in the production of the income (in terms of the general deduction formula) important and sometimes overriding factors are the *purpose of the expenditure and what the expenditure actually effects*; and in this regard the *closeness of the connection between the expenditure and the income-earning operations* must be assessed... (my emphasis)
- (2) More specifically, in determining whether interest (or other like expenditure) incurred by a taxpayer in respect of moneys borrowed for use in his business is deductible in terms of the general deduction formula and its negative counterpart in the Act, a distinction may in certain circumstances have to be drawn between the case where a taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and the case where, as in the *Allied Building Society* case and the Bank in the present case, the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in his (or its) business.
- (3) In the former type of case both the purpose of the expenditure (in the form of interest) and what it actually effects can readily be determined and identified: a clear and close causal connection can be traced. Both these factors are, therefore, important considerations in determining the deductibility of the expenditure.

²⁹ *CIR v Drakensberg Garden Hotel (Pty) Ltd* 1960 (2) SA 475 (A), 23 SATC 251

³⁰ 1985 (4) SA 485 (A), 47 SATC 179

- (4) In the latter type of case, however, and more particularly in the case of institutions like the Society and the Bank, there are certain factors, which prevent the identification of such a causal connection and one cannot say that the expenditure was incurred in order to achieve a particular effect. All that one can say is that in a general sense the expenditure is incurred in order to provide the institution with the capital with which to run its business; but it is not possible to link particular expenditure with the various ways in which the capital is in turn utilised...the most important factor was the purpose of the borrowing.³¹

The purpose of the interest expenditure would be to pay a penalty, which the taxpayer is legally obligated to pay. If the taxpayer needs or chooses to borrow money in order to do what is in fact required by law, the likely reason for this is that without borrowing money, and after paying the penalty the taxpayer would have insufficient liquid funds in order to perform its income earning operations or that it would sometime in the near future have insufficient liquid funds. Thus the purpose of the expenditure would relate to the taxpayer's income earning operations.

Application to interest on money borrowed to pay competition penalties

It has been shown above that the Competition Penalties themselves are not deductible both due to policy reasons and in terms of section 23(o) of the Act, which prohibits the deduction of fines and penalties. The reason for the disallowance of such deductions is because the penalties relate to unlawful behaviour. Once the penalty is imposed, the company has an obligation to pay such penalties, either out of the company's capital or with borrowed money. The borrowing of money in order to pay such a penalty is not itself an unlawful act and would therefore not be affected by section 23(o) or the policy considerations discussed above.

³¹ *CIR v Standard Bank of South Africa Ltd* 1985 (4) SA 485 (A), 47 SATC 179 at 500

In *Ticktin Timbers CC v CIR*³² it was held that the

‘the making of the distribution, on the one hand, and the making of the loan, on the other, were not intended to be separate and unconnected transactions. They were plainly interdependent and neither was intended to exist without the other. It is this linkage which, to my mind, is fatal for appellant’s case for it shows that the true reason why appellant had to borrow back at interest from Dr Ticktin money which it had in its coffers and was under no obligation to part with was because it wanted to make a distribution to Ticktin.’³³

This case can be distinguished from the situation being examined in this paper for two reasons. The first is that the *Ticktin* case related to a dividend distribution which was the ultimate reason for the non-deductibility of the interest expenditure in that case. The second reason is that the taxpayer in the *Ticktin* case was ‘under no obligation to part with’ the money used to make the distribution of dividends. When the Competition Tribunal imposes penalties on a taxpayer, the taxpayer is under an obligation to part with that money, and the company would have to, in some way, ensure that after paying the penalty, it is left with sufficient liquid funds to continue to run its business.

In *Commissioner, SARS v BP South Africa (Pty) Ltd*³⁴ the court referred to the *Ticktin* case and stated that on the facts of the *BP* case, it could not be said that without the loan there would have been no dividend. There was no need to borrow the money in order to declare the dividend, however, ‘it was clear that cash would in the future be needed to carry on with the business of BPSA unless the business was to be run down. The court held that the purpose of BPSA regarding the loan was ‘to continue its income producing activities and that the interest was an expense incurred in order to produce income within the meaning of s11(a)’.³⁵

³² 1999 (4) SA 939 (SCA)

³³ At [9]

³⁴ 2006 (5) SA 559 (SCA)

³⁵ at [15]

The closeness of the connection between the expenditure and the company's income earning operations must be examined. One must look at the purpose of the expenditure and its actual effect. Competition penalties are imposed for prohibited activities such as 'price-fixing; dividing markets and collusive tendering; minimum resale price maintenance; where a dominant firm charges excessive prices or engages in exclusionary acts; and various merger related contraventions'.³⁶ Despite the unlawful nature of the activities to which the interest expenditure relates, such activities would clearly have been carried on for the purpose of producing income. The purpose of the borrowing of money is to extinguish a debt, which has arisen out of the income earning operations of the company carried out in the course of its trade.

A counter argument would be that because the act to which the expenditure relates is unlawful, the interest expenditure that relates to such act is tainted by the unlawful act and should not be deductible. The issue here would be whether the interest expenditure is far removed enough from the original unlawful act that it can be examined separately from the penalty itself. It could be argued that without the unlawful conduct of the taxpayer, the penalty would not have been imposed and the obligation to pay which led to the borrowing of money and the consequent interest expenditure would not have arisen, so the interest expenditure cannot be separated from the unlawful conduct. While the interest is most certainly linked to the original offence before the competition tribunal, it is not 'so closely connected' as to be part of the original act. If it were, it would have to be disallowed as a deduction due to the unlawfulness of the original underlying act. That original act, while it may be the first in a chain of events leading to the interest expenditure, should not be considered to be

³⁶ van Dorsten 2009 *Taxpayer* 58 at 142

the underlying act to which the expenditure relates. The interest expenditure arises out of the taxpayer's ability to fulfil its obligation to pay the fine.

The borrowing of money to pay such a penalty is more closely linked to the taxpayer's need to retain liquid funds in the business; funds which are required in order to perform its income earning activities. It is submitted that the borrowing of money is one step further removed from the unlawful conduct and the interest expenditure would therefore relate more to the taxpayer's ability to pay the penalty which it is legally obligated to do, than to the original unlawful act.

With regard to whether public policy considerations should be taken into account when determining the deductibility of interest, it is submitted that allowing the interest to be deductible would not lessen the penalty that is imposed nor would it lessen the deterrent effect of the penalty, which has been shown to be one of the major policy reasons for the imposition of the penalty.

It would, possibly, be prudent for taxpayer's faced with penalties imposed by the Competition Tribunal to pay such penalties out of the company's capital and subsequently borrow whatever money is needed to carry on its trade and carry out its income producing activities. However, it is submitted that, while the question is by no means certain, the argument for the deductibility of interest outweighs the argument against it. Section 23(o) of the Act does not prohibit the deduction of expenditure that relates to a penalty or fine. It only prohibits the deduction of the penalty itself. In addition there is no convincing public policy reason why the interest expenditure should not be deductible, as doing so would not diminish the punishment in any way. The interest reason for the interest expenditure is the company's ability to pay the fine and still be able to continue to carry on its trade and earn income. The interest does not relate directly to the offence, which incurred the fine and therefore should not be

tainted by such offence. It is submitted that the interest expenditure should be deductible in most, if not all circumstances.

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Research dissertation/research paper presented for the approval of Senate in fulfilment of part of the requirements for the Masters in Taxation in approved courses and a minor dissertation/paper. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Masters in Taxation dissertations/research papers, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation/research paper conforms to those regulations.

Signed

CLARE EMSLIE

TREATY SHOPPING AND THE CONCEPT OF BENEFICIAL OWNERSHIP

Clare Emslie

INTRODUCTION

Double Taxation Agreements (which are concluded between two States to avoid the occurrence of double taxation) are increasingly being used as a tax-planning tool by residents of a third State which is not party to the relevant Double Taxation Agreement. These arrangements are increasingly being used to take advantage of more favourable tax dispensations in other jurisdictions in order to reduce or avoid tax liability. This often leads to loss of tax revenue for the parties to the Double Taxation Agreement.¹ The term “beneficial ownership” was inserted into the OECD Model Tax Convention in 1977 in an attempt to curb treaty shopping. It is now included in the OECD, UN & US Models. Many countries, including South Africa, have incorporated this term in their Double Taxation Agreements with other countries. There has been much disagreement amongst writers on the subject as to the correct way to interpret the term. This paper will look at “beneficial ownership” in the context of treaty shopping and discuss the difficulties with the term.

WHAT IS TREATY SHOPPING

Treaty shopping ‘refers to any intentional effort to structure a transaction so that it can harvest the benefits of a particular tax treaty that would otherwise not be applicable’.² This is generally achieved by setting up a conduit company as a resident in a State which has a favourable treaty with the source State of the income.³ This kind of treaty shopping is done to achieve either the avoidance or reduction of withholding taxes in the source State.

A conduit company ‘is an intermediary company with very narrow powers which is used for holding assets or rights as an agent or nominee would on behalf of another company’.⁴ The conduit company is used to reduce the withholding tax imposed on a taxpayer by routing a transaction or arrangement through a jurisdiction

¹ Annet Wanyana Oguttu “Curbing ‘treaty shopping’: the ‘beneficial ownership’ provision analysed from a South African perspective” (2007) XL *CILSA* 237 at 237

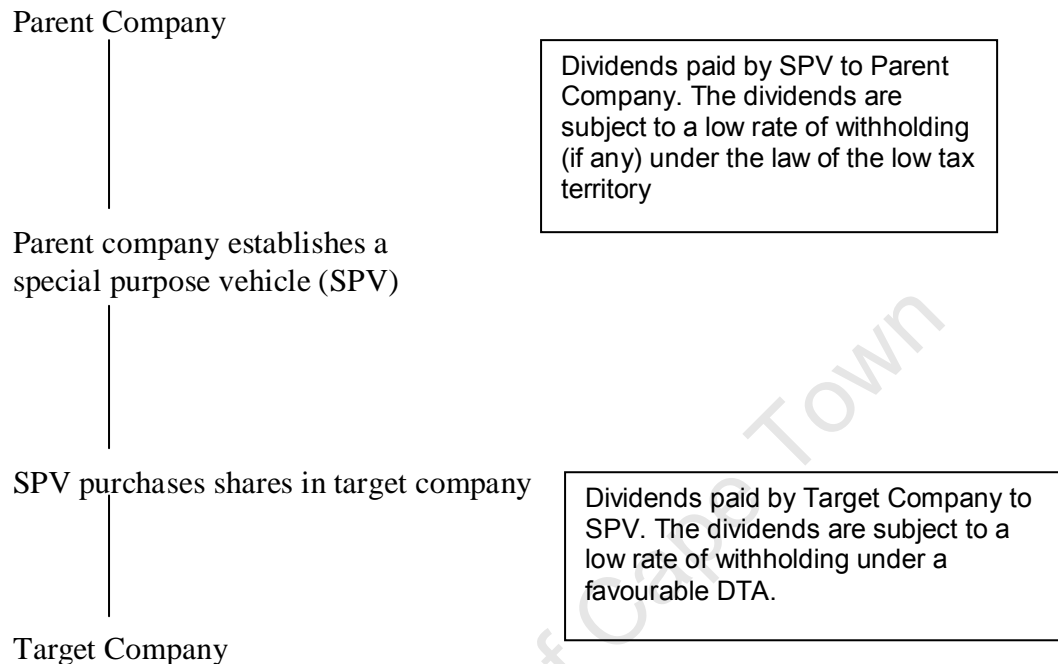
² Sophie Chatel “Treaty Shopping: A Canadian Case Study and the International Scene” at 5

³ Luc De Broe *International Tax Planning and Prevention of Abuse*

⁴ Annet Wanyana Oguttu “Curbing ‘treaty shopping’: the ‘beneficial ownership’ provision analysed from a South African perspective” (2007) XL *CILSA* 237 at 239-240

with a favourable tax treaty. The conduit company is used purely for purposes of gaining the benefit of a particular tax treaty.

Diagram of an example conduit arrangement⁵:



One of the reasons why treaty shopping occurs is because of the ‘differences in tax relief offered by other countries’ treaties. International investors might thus be tempted to look for the most beneficial treaty to take advantage of.⁶

It can be debated whether treaty shopping is, *per se*, wrong. In the case of *The Queen v Mil (Investments) S.A.*⁷ the court *a quo* said that the ‘shopping or selection of a treaty to minimise tax on its own cannot be viewed as being abusive; it is the use of the selected treaty that must be examined...’⁸ The appeal court in that case remained silent on this statement. A distinction must be made between “tax avoidance” and “tax

⁵ King, F “The Indofoods and Prevost Cases - The Meaning of Beneficial Ownership” 2009 *Taxation Today* February edition

⁶ Ibid 240

⁷ [2007] 4 C.T.C. 2007 FCA 23

⁸ Sophie Chatel “Treaty Shopping: A Canadian Case Study and the International Scene” at 7

evasion”. Tax avoidance refers to the situation where a taxpayer arranges its affairs in such a way as to legitimately pay the least tax possible within the law. ‘This is done by utilising loopholes in tax laws and exploiting them within legal parameters’.⁹ Tax evasion on the other hand is an illegal offence, which refers to the use of fraud in order to avoid paying tax which the taxpayer is in fact liable to pay. While treaty shopping may amount to tax avoidance rather than tax evasion, it is understandable that countries would attempt to limit the use of treaty shopping in order to protect themselves from loss of tax revenue.

Article 1 of the OECD Model Tax Convention states that the tax treaty only applies to ‘persons who are residents of one or both of the Contracting States’.¹⁰ The definition of “persons” refers to legal persons as well as natural persons. Treaty shopping structures are therefore ‘usually designed to meet the legal requirement of residence’ for tax purposes¹¹ in the relevant State in order to fall under the scope of the Double Taxation Agreement.

Treaty shopping is generally considered to be contrary to the object and purpose of a tax treaty. A Double Taxation Agreement between two countries is designed to benefit residents of the contracting States, to protect them from double taxation. To intentionally become a “resident” of a particular State for the sole purpose of obtaining a tax benefit through a Double Taxation Agreement would seem to be contrary to the purpose of the treaty and could be seen as an abuse of the treaty.¹² The use of a company that has a legitimate reason for operating in a specific jurisdiction, other than to obtain a tax benefit would be less likely to be considered an abuse of the treaty. The question is whether the drafters of the treaty intended it to apply to ‘a person that became a “resident” mainly, if not solely, to benefit from the treaty.’¹³

METHODS FOR DEALING WITH TREATY SHOPPING

The OECD commentary recommends various types of provisions which countries could incorporate into their Double Taxation Agreements to prevent abuse

⁹ Oguttu, AW “Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts” at 2

¹⁰ OECD Model Tax Convention, Article 1

¹¹ Sophie Chatel “Treaty Shopping: A Canadian Case Study and the International Scene” at 5

¹² Sophie Chatel “Treaty Shopping: A Canadian Case Study and the International Scene” at 8

¹³ Ibid at 9

of the treaty through the use of conduit companies.¹⁴ These include: the “subject-to-tax” provision which would provide that the benefits of a treaty in the State of source can only be available if the relevant income is subject to tax in the State of residence; the “look through” method which does not allow treaty benefits if the company is not owned (either directly or indirectly) by residents of the State of which the company is resident; the “channel approach” which is a provision that specifies cases of improper use with reference to conduit companies; a “limitations of benefits” provision which aims at preventing non-resident persons from accessing treaty benefits by using an entity that would qualify as a resident of one of the States.¹⁵ Another method suggested by the OECD is the “beneficial ownership” provision, which will be discussed in more detail. Some countries also rely on provisions in their domestic legislation “aimed at combating tax avoidance in general, or on domestic legislation specifically aimed at combating treaty shopping.”¹⁶ For example, Germany has enacted domestic anti-treaty shopping legislation, while countries such as Canada and South Africa have a general anti-avoidance rule that can be applied to treaty shopping. South Africa’s general anti-avoidance rule, ‘*inter alia*, does not allow a taxpayer to enter into a transaction if the sole or main purpose of entering into such transaction is to avoid or postpone a South African tax liability’.¹⁷

In the French Supreme Court decision in the *Bank of Scotland* case, the court considered the concept of *fraude a la loi* in the context of treaty shopping. *Fraude a la loi* is translated to mean legal fraud and ‘refers to any action undertaken with the sole purpose of avoiding tax in a way not previously envisaged by the legislator’.¹⁸ This concept has two requirements. The first requirement is that the arrangement must, objectively, be contrary to the intention of the legislator. The second requirement is that the arrangement must have been designed solely for the purpose of obtaining a tax benefit.¹⁹ Using this concept, and taking into account the purpose of the relevant provision of the treaty, the court came to the conclusion that the treaty could only be

¹⁴ Luc De Broe *International Tax Planning and Prevention of Abuse* 653-654

¹⁵ Annet Wanyana Oguttu “Curbing ‘treaty shopping’: the ‘beneficial ownership’ provision analysed from a South African perspective” (2007) XL *CILSA* 237 at 242

¹⁶ Sophie Chatel “Treaty Shopping: A Canadian Case Study and the International Scene” at 5

¹⁷ Peter Dachs “South Africa: New withholding tax on dividends” Available at <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=24924&SID=710737&TYPE=20> [Accessed 05/06/2009]

¹⁸ Sophie Chatel “Treaty Shopping: A Canadian Case Study and the International Scene” at 10

¹⁹ *Ibid* at 11

applied to the beneficial owner of the dividend, even where the particular provision did not specifically refer to “beneficial ownership”.

WHERE DOES BENEFICIAL OWNERSHIP COME FROM?

The OECD first included the term “beneficial ownership” in its Model Tax Convention in 1977. Articles 10(2), 11(2) and 12(1) are the only articles of the OECD Model Tax Convention which aim to deal with treaty abuse and they all contain the term “beneficial ownership”. For example, Article 10 dealing with dividends reads as follows:

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividend is a resident and according to the laws of that State, but if the **beneficial owner** of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
 - (a) 5 per cent of the gross amount of the dividends if the **beneficial owner** is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends.
 - (b) 15 per cent of the gross amount of the dividends in all other cases.

Article 10(1) provides that the country which has the right to tax on dividend income is the country where the recipient of that income is resident (the same applies to interest and royalties under the Model Tax Convention). The effect of Article 10(2) is to deny treaty benefits to conduit companies unless the beneficial owner is also a resident of one of the contracting states.²⁰

The OECD Commentary indicates that the term was introduced as an anti-avoidance provision. The 2003 commentary said that the concept of beneficial ownership was introduced into article 10(2) ‘to clarify the interpretation of the words ‘paid to (...) a resident’ as they are used in paragraph 1 of the article. It makes it clear that the State of source is not obliged to give up taxing rights over dividend income

²⁰ Annet Wanyana Oguttu, “Curbing Treaty Shopping: the ‘beneficial ownership’ provision analysed from a South African perspective” (2007) *CILSA* 237 at 243

merely because that income was immediately received by a resident of a State with which the State of source has concluded a convention'.²¹

The wording of the OECD Model Convention used to say that the recipient must be the beneficial owner. This has subsequently been changed to say that the beneficial owner should be a resident of the other contracting State.²² Therefore 'the limitation of tax in the State of source is available even if the beneficial owner is not the direct recipient. The direct recipient may be a resident of one or the other contracting State or of a third State, provided always that of those involved, only the beneficial owner must be a resident of the other contracting State'.²³

While it is clear that the "beneficial ownership" provisions are 'designed to avoid treaty shopping by making use of intermediaries in cases where the beneficial owner is not entitled to treaty protection',²⁴ it remains unclear how "beneficial owner" is to be interpreted.

DISCUSSION OF THE MEANING OF BENEFICIAL OWNERSHIP:

Beneficial ownership is not defined in the OECD Model Tax Convention. It is a common law term which was borrowed from the law of the United Kingdom. The term has been used in the United Kingdom, Australia and Canada for some time, in both tax and other legislation.²⁵ There is no such concept as "beneficial ownership" in civil law jurisdictions. South African law is a combination of both civil and common law.

Article 3(2) of the OECD model convention provides that where a term is not defined in the treaty it should be interpreted in terms of the domestic law meaning in the State applying the treaty. This is fine for common law jurisdictions but there is a problem in applying this in civil law jurisdictions as many of them do not recognise

²¹ Luc De Broe *International Tax Planning and Prevention of Abuse* 656-657 citing the 2003 commentary (get original reference).

²² Olivier p474

²³ OECD Commentary 722

²⁴ Klaus Vogel *Double Taxation Conventions* 3 ed (1999) 597

²⁵ Luc De Broe *International Tax Planning and Prevention of Abuse* 662

the concept of beneficial ownership and therefore have no domestic law meaning to work from.²⁶

Articles 10, 11 & 12 of the OECD Model Tax Convention which all use the concept of beneficial ownership, deal with dividends, interest and royalties, respectively. These articles provide for a reduced level of withholding tax on the relevant type of income.²⁷ ‘Hence, the beneficial ownership limitation...is a restriction on the availability of the reduced tax rate.’²⁸ To qualify for this reduced rate the beneficial owner of the income must be a resident of one of the Contracting States. Taxing rights are granted to the place of residence of the beneficial owner, however the source country still has limited taxing rights and “may” tax as well, depending where the beneficial owner is.

Domestic Law Meaning vs International Meaning

When interpreting “beneficial ownership” many authors disagree on whether the term should be interpreted in terms of domestic law or should be given an independent treaty meaning. As the concept was borrowed from common law systems, civil law systems do not have a domestic definition to fall back on. Vogel argues that it cannot be interpreted in terms of domestic law because ‘none of the national tax systems in question offer a precise definition...’²⁹ He argues that “beneficial ownership” should be interpreted in its treaty context, taking into account the ‘purpose pursued by the restriction’³⁰

Another argument is that domestic law is in some sense relevant, because the term was originally borrowed from common law systems and it should be interpreted with these domestic law definitions in mind. Some argue that ‘the common law states represent the source that the term was taken from, and the meaning in those states should be taken as the starting point for interpretation in terms of the Vienna Convention.’³¹ The meaning in common law states should then be modified, if

²⁶ “Structuring international transactions in Ireland”, Available at <http://www.deloitte.com/dtt/article/0,1002,cid%3D100997%26pv%3DY,00.html> [Accessed on 02/06/2009]

²⁷ Philip Baker, *Beneficial ownership: After Indofood* 15, Available at www.taxbar.com/documents/Beneficial_Ownership.PB.pdf, [Accessed on 02 June 2009]

²⁸ Ibid 15

²⁹ Klaus Vogel *Double Taxation Conventions* 3ed (1999) 562

³⁰ Ibid

³¹ Vienna Convention on the Law of Treaties, 1969 (1969) 8 *ILM* 679

necessary, in the context of the treaty and in the light of its object and purpose.’³²
 Article 31 of the Vienna Convention applies to international treaties and reads as follows:

‘1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its objects and purpose.’³³

Article 31(4) of the Vienna Convention goes on to say that ‘A special meaning shall be given to a term if it is established that the parties so intended’.³⁴

The argument for the use of domestic law is supported by Article 3(2) of the OECD Model Convention, which states that where there is no definition of a term in a tax treaty, the interpreter should use the meaning used in the domestic law of the State applying the term, to the extent that the treaty context does not require otherwise.³⁵

De Broe argues that domestic law should not be used to define “beneficial ownership” due to the fact that in many cases ‘there is not such meaning, and where there is one, the context of the treaty requires not to use the domestic law meaning.’³⁶

Article 31(2) of the Vienna Convention states that:

‘2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
 (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.’³⁷

This could be what De Broe means when he refers to the context of the treaty. De Broe suggests that the term “beneficial ownership” has an autonomous treaty meaning. One reason for this view is that if the domestic law meaning is to be used by a civil law State it can lead to inappropriate results. Using Belgium as an example, authors have argued that in terms of Article 3(2) the term should be interpreted according to Belgian private law. However, the term has no meaning in Belgian private law so the authors say that the classical interpretation of “legal ownership” should be applied.

³² Brincker, Honiball, Olivier, *International Tax*” A South African Perspective 2ed (2004) 156 citing Charl du Toit

³³ Vienna Convention on the Law of Treaties, 1969 (1969) 8 *ILM* 679, Article 31

³⁴ *Ibid*

³⁵ Luc De Broe *International Tax Planning and Prevention of Abuse* at 667

³⁶ *Ibid* at 667

³⁷ Vienna Convention on the Law of Treaties, 1969 (1969) 8 *ILM* 679, Article 31

This means that an agent or nominee who holds title for a principal who receives all the benefit would be a beneficial owner, which clearly negates the purpose of introducing the concept of beneficial ownership in the first place.³⁸

The OECD commentary appears to support the view that beneficial ownership be given a “treaty meaning” rather than a domestic law meaning. The OECD Commentary to Article 10 states that:

‘The term ‘beneficial owner’ is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.’³⁹

De Broe argues that there are many reasons why the domestic law meaning should not be used even in common law jurisdictions where there is a domestic law meaning. He argues that:

‘where the treaty contains in itself a provision to counter its improper use, the prevention of such use should as much as possible be achieved through the common interpretation of that term between the two Contracting States and, more in general, through a uniform interpretation by all States that include such a term in their tax treaties with a view to avoid such treaty to be shopped... If one leaves it to each State to define the term “beneficial owner” through recourse to its domestic law, there may be a significant risk that the meaning emerging from domestic law goes well beyond the ordinary meaning of the term used in the treaty... If it is left to each State to construe the term under its domestic law, one abandons the principle of reciprocity, a fundamental cornerstone on which each tax treaty is built, and no longer strives to achieve a uniform application and interpretation of tax treaties, which is one of the goals pursued by the OECD.’⁴⁰

One of the issues with interpreting this concept is how broadly it should be interpreted, i.e. ‘how artificial must the conduit arrangement have been for the benefit of the treaty to be denied?’⁴¹

The OECD Commentary attempts to clarify the meaning of beneficial ownership in the following paragraph by showing the difference between a recipient who hold on behalf of the beneficial owner and the beneficial owner itself:

‘The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of

³⁸ Ibis at 699

³⁹ OECD Commentary on article 10 at 80

⁴⁰ Luc De Broe *International Tax Planning and Prevention of Abuse* 670-671

⁴¹ <http://www.taxationweb.co.uk/international-tax/general/beneficial-ownership-after-indofood>

the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies" concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.'

The meaning of beneficial ownership was considered in the case of *Indofood International Finance v JPMorgan Chase Bank N.A., London Branch*⁴². This was not a tax case but a civil litigation suit. The case was between two parties to a loan agreement. The facts of the case were that an Indonesian company wanted to raise a loan but if it had done so directly there would have been a 20 per cent withholding tax on the interest. So the Indonesian company established a subsidiary in Mauritius, which then issued the loan, thus benefiting from the Indonesian Tax Treaty with Mauritius which allowed a reduced withholding tax of 10 per cent. The Indonesia-Mauritius Tax Treaty was subsequently terminated which meant that the withholding tax on the interest would revert back to 20 per cent. The loan agreement provided that if no reasonable steps could be taken to revert to the reduced withholding tax, that the borrower could repay the loan early. Indofood alleged that there were no such reasonable steps that could be taken, whilst JP Morgan (wanting the loan to remain in place) proposed that a Dutch company be set up to take advantage of the Indonesia-Netherlands Tax Treaty, which also had a 10 per cent withholding tax on interest.

The issue was whether 'a newly interposed Dutch company would be the "beneficial owner" of the interest as required under the "Interest" Article of the Indonesia-Netherlands tax treaty, ie would the Dutch company be entitled to the reduced withholding tax under the Indonesia-Netherlands treaty. The court had to decide whether the Dutch company would be viewed as the beneficial owner from an Indonesian perspective.

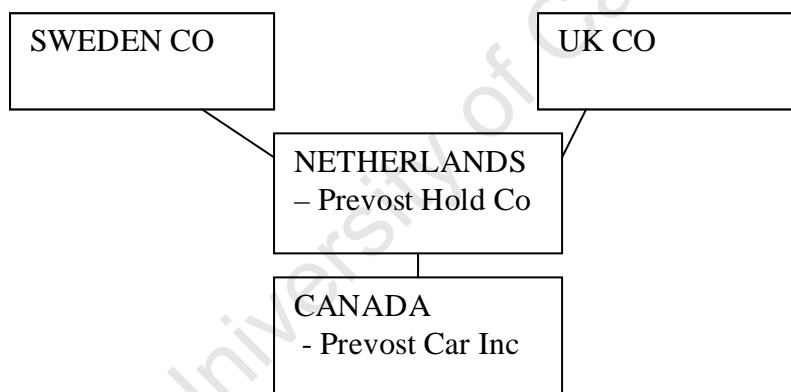
The court held that the OECD commentary together with expert opinion showed that the term "beneficial owner" should be given an 'international fiscal

⁴² [2006] EWCA Civ 158

meaning not derived from the domestic laws of contracting states'⁴³. The court further stated that the meaning of the term 'is plainly not to be limited by a technical and legal approach. Regard is to be had to the substance of the matter...' The court of appeal based its reasoning on whether the recipient enjoyed the full privilege of the interest or whether it was simply an administrator of the income. This case led to much concern about 'the possibility that while [certain] structures may be fine under domestic law, they may fail the international test.'⁴⁴

In 2008, in the case of *Prevost Car Inc v Her Majesty the Queen*⁴⁵, the Canadian Tax Court had to interpret the term "beneficial ownership" with regards to Article 10(2) of the Double Taxation Agreement between Canada and the Netherlands. The court had to decide whether a Netherlands holding company was the beneficial owner of dividends paid by its Canadian subsidiary. The only issue before the court was the meaning of "beneficial owner" in the treaty between Canada and the Netherlands.

Diagram of the arrangement:



The court took note of the OECD commentary on which Article 10(2) of the Canada-Netherlands Treaty was based. The Court found that 'the "beneficial owner" of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is the beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership'.⁴⁶ The tax court found that the Netherlands

⁴³ *Indofood International Finance v JPMorgan Chase Bank N.A., London Branch*⁴³ [2006] EWCA Civ 158 at 42

⁴⁴ www.cgsh.com/files...

⁴⁵ 2008 DTC 3080 (TCC) para [100]

⁴⁶ *Prevost Car Inc The Queen* 2008 DTC 3080 (TCC) at [100]

holding company was the beneficial owner of the dividends. The case went on appeal to the Federal Court of Appeal⁴⁷ where the court rejected the argument that “beneficial ownership” should have an international fiscal meaning, thus rejecting the finding in the *Indofood* case. The court upheld the finding of the Tax Court and emphasised that when interpreting tax treaties the OECD Commentaries, including revisions made after a tax treaty is signed, and the OECD Conduit Companies Report, should be taken into account.

In determining whether a company is merely a conduit company which is not the beneficial owner of specific income one should look at whether the company has any discretion as to the subsequent use of the income. The court *a quo* in the *Prévost Car* case said that ‘one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of the funds put through it as conduit.’⁴⁸

China recently issued a circular to provide guidance as to the meaning of beneficial ownership, as used in many of China’s double taxation agreements regarding passive income. The circular defines the beneficial owner as ‘the person who has ownership and control over the income or the rights or assets that generates such income’. According to the circular the beneficial owner could be an individual or any kind of corporation or organisation. The beneficial owner would ‘engage in “substantive business activities” [such as] manufacturing, trading and management activities’.⁴⁹ The circular goes on to say that the term should be interpreted in the light of the facts and circumstances of each case and in accordance with the principle of substance over form. Factors that indicate against a particular entity being the beneficial owner include:

- if the resident is obligated to pay or distribute a large portion or all of the income within a specific timeframe.
- Where the resident is a corporation and its assets, operations and employees are few and not commensurate with the amount of income
- Where the resident has no or almost no controlling rights on over the income or assets or rights that generate the income and bears little or no risk

⁴⁷ *The Queen v Prévost Car Inc.* 2009 FCA 57

⁴⁸ *Prévost Car Inc The Queen* 2008 DTC 3080 (TCC)

⁴⁹ http://www.pwchk.com/home/printeng/chinatax_news_nov2009_24.html accessed on 13 February 2010

- The other treaty country does not tax or exempts the income, or taxes it at a very low rate...⁵⁰

The circular specifies that agents and conduit companies cannot be beneficial owners.

THE CONCEPT IN SOUTH AFRICA

South Africa has included the beneficial ownership provisions recommended by the OECD in some of its Double Taxation Agreements. Up to now, the beneficial ownership provisions have not been particularly advantageous from a South African perspective as South Africa did not impose withholding taxes on dividends and interest earned by non-residents which have their source in South Africa.⁵¹ South Africa has recently made the decision to introduce a withholding tax on dividends which is expected to come into operation in 2010. As a result of this decision many of South Africa's Double Taxation Agreements have been renegotiated to include a reduced withholding tax on dividends, for example the Double Taxation Agreement with The Netherlands, which now provides for a 5 per cent withholding tax on dividends.⁵²

South African company law uses the term "beneficial ownership" with respect to ownership of shares. The beneficial owner of shares is not necessarily the same as the registered owner. For example, "a member could...sell or cede the rights attaching to the shares by passing "the property" in them to a purchaser who may not be registered as a member of the company. The purchaser owns the shares whereas the seller is the member of the company and he alone (the seller) can enforce the rights attaching to the shares against the company (but this he does in the interest of the purchaser)."⁵³ The purchaser would be the "beneficial owner".

Article 3(2) states that the meaning of the term contained in domestic *tax* laws must prevail over the meaning given in any other domestic law. Up to now the term "beneficial owner" has not been used in the South African Income Tax Act ("the

⁵⁰ http://www.pwchk.com/home/printeng/chinatax_news_nov2009_24.html accessed on 13 February 2010

⁵¹ Annet Wanyana Oguttu, "Curbing Treaty Shopping: the 'beneficial ownership' provision analysed from a South African perspective" (2007) *CILSA* 237 at 254-255

⁵² Peter Dachs *South Africa: New withholding tax on dividends* Available at <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=24924&SID=710737&TYPE=20> [Accessed 7 June 2009]

⁵³ Annet Wanyana Oguttu, "Curbing Treaty Shopping: the 'beneficial ownership' provision analysed from a South African perspective" (2007) *CILSA* 237 at 251

Act”), however, the term is used in the new dividend withholding tax provisions in the Act, which have not yet come into effect. In the definitions section of Part VII of the Act, “beneficial owner” is defined as meaning ‘the person entitled to the benefit of the dividend attaching to a share’⁵⁴. This definition appears to have a very similar meaning to the company law meaning. Thus the company law meaning would probably be persuasive if interpreting the term in accordance with South African domestic legislation. The lack of a good domestic definition highlights the difficulties in interpreting the term in the treaty in accordance with Article 3(2). Perhaps South Africa, and other countries, should take note of this problem and should include a definition of beneficial ownership in its domestic tax legislation. But while the problem still exists, the argument for an international, “treaty meaning” of the term is strengthened.

Perhaps the solution is that countries concluding Double Taxation Agreements should include a definition of beneficial ownership that will apply to the individual treaty, which is agreed upon by both contracting States. ‘The first ever treaty definition of the term is to be found in Germany’s DTC with USA [in] 1989’.⁵⁵

One can also argue that because our tax treaties become incorporated into the Income Tax Act through the operation of s 108(2) read with s 231 of the Constitution of South Africa, they are part of our domestic law and should thus be interpreted in accordance with our domestic laws, specifically our Income Tax Act, in keeping with article 3(2). In this regard it would be helpful if a definition of beneficial ownership were included in the Income Tax Act, which can be used in interpreting the term in South African Double Taxation Agreements.

Maybe one cannot impose an “international meaning” for the term “beneficial ownership” onto all Double Taxation Agreements. In certain circumstances an “international meaning” may be more appropriate, such as where there is no domestic law meaning of the term in a particular State. However, a Double Taxation Agreement is an agreement between two individual States, and where they omit to include a specific definition in the treaty, it would seem that the domestic law meaning should at least be taken into account when interpreting the term, alongside the OECD commentary as was done in the *Prévost Car* case. The concept of beneficial ownership can be a useful tool in curbing treaty shopping once the problem

⁵⁴ Income Tax Act 58 of 1962, inserted by s 56(1) of Act 60 of 2008

⁵⁵ Klaus Vogel *Double Taxation Conventions* 3ed (1999) 562

of interpretation has been resolved. It seems clear, taking into account international case law and the OECD commentaries and domestic law meanings from common law jurisdictions, that nominees, agents and conduit companies with little to no discretion in dealing with the income would not be considered the beneficial owners of income. It is unlikely that the term could be interpreted more widely than that. The most effective solution for the problem of determining the beneficial owner would be if states could define the term in the Double Taxation Agreement itself, so that it does in fact have a “treaty meaning”.

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