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DIVIDENDS TAX

2629. "Most favoured nation" clause in tax treaties

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The Minister of Finance announced in the 2017 Budget that the dividends tax rate would be increased from 15% to 20% with effect from 22 February 2017. While resident individuals and trusts are affected by this change, it is important to note that non-residents may claim a reduction in the dividends tax rate in terms of an applicable international treaty for the avoidance of double taxation (DTA).

Relief under a tax treaty in the form of a lower withholding rate generally applies to dividends paid to a non-resident company holding 10% to 25% of the shares (depending on the relevant tax treaty) in the company paying the dividend. Normally, a lower withholding rate will not be provided for under a tax treaty if a foreign company holds less than 10% of the shares in the company paying the dividend. The reduced rate in respect of the so-called participation exemption varies between 5% and 10% depending on the particular treaty. However, even where the person owns less than 10% of the shares in the company declaring the dividend, the dividend tax rate is generally limited to 15%.

South Africa / Sweden DTA

Article 10(2) of the South Africa / Sweden DTA, read with the Protocol thereto (SA / Sweden DTA), is an example of the provision of such relief and provides as follows:

"However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident [i.e. South Africa] and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State [i.e. Sweden], the tax so charged shall not exceed:

a) 5% of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds at least 10% of the capital of the company paying the dividends; or
b) 15% of the gross amount of the dividends in all other cases.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid." [Our insertion]

In essence, the effect of Article 10(2) is that where a Swedish tax resident owns 10% or more of the shares in a South African tax resident company, any dividends declared by that South African tax resident company will be subject to a reduced dividends tax rate of 5% to the extent that the relevant formalities in section 64G(3) of the Income Tax Act, 1962 (the Act) have been complied with. Furthermore, even where a Swedish company, individual or trust owns less than 10% of the shares in a South African tax resident company, the dividends tax on any dividends declared by that company could be reduced from 20% to 15%. Generally, this relief is prevalent in the majority of the double tax treaties entered into between South Africa and other countries.

Interestingly, however, the Protocol entered into between South Africa and Sweden introduced further potential relief in respect of dividends. Article 10(6) of the SA / Sweden DTA constitutes what is commonly referred to as a "most favoured nation" clause and states the following:

"If any agreement or convention between South Africa and a third state provides that South Africa shall exempt from tax dividends (either generally or in respect of specific categories of dividends) arising in South Africa, or limit the tax charged in South Africa on such dividends (either generally or in respect of specific categories of dividends) to a rate lower than that provided for in subparagraph (a) of paragraph 2, such exemption or lower rate shall automatically apply to dividends (either generally or in respect of those specific categories of dividends) arising in South Africa and beneficially owned by a resident of Sweden and dividends (either generally or in respect of those specific categories of dividends) arising in Sweden and beneficially owned by a resident of South Africa, under the same conditions as if such exemption or lower rate had been specified in that subparagraph."

In simple terms, this further relief is applicable where South Africa has entered into any other Double Tax Agreement with a third country, which provides for either a complete exemption or reduced dividends tax rate (ie less than 5% in the SA / Sweden DTA). To the extent that this is the case, the outright exemption or further reduced rate will override Article 10(2) and automatically apply to any dividends declared by either a South African or Swedish company to a shareholder who is resident in the other country and who owns 10% of the shares of the declaring company.

South Africa / Kuwait DTA and application of "most favoured nation" clause

Having regard to the other double tax agreements entered into between South Africa and other countries, it appears that only one agreement currently provides for the complete exemption from tax under similar circumstances. Article 10(1) of the SA / Kuwait DTA provides as follows:

"Dividends paid by a company which is a resident of a Contracting State [ie South Africa] to a resident of the other Contracting State [ie Kuwait] who is the beneficial owner of such dividends shall be taxable only in that other Contracting State [ie Kuwait]." [Our insertions]

Hence where a South African resident company declares dividends to a Kuwaiti tax resident company, then Kuwait has the sole taxing rights and South Africa cannot levy any tax on such dividends. The additional benefit of this outright exemption in the SA / Kuwait DTA, is that it triggers the "most favoured nation" clause contained in Article 10(6) of the SA / Sweden DTA, such that any dividend declared by a South African company to a Swedish shareholder who owns 10% or more of the shares in the South African company, will not be subject to any South African dividends tax to the extent that the relevant formalities are complied with.

Ruling issued by SARS confirming application of the "most favoured nation" clause

The application and interaction of the "most favoured nation" clause was the crux of the issue in a recent ruling issued by the South African Revenue Service

(SARS). SARS confirmed the above principle and ruled in Binding Private Ruling 267 (Ruling) that any dividends declared by a South African tax resident subsidiary company to its Swedish tax resident holding company will not be subject to South African dividends tax to the extent that the documentary requirements in section 64G(3) of the Act are complied with.

While the benefit of the "most favoured nation" clause is clear to see, taxpayers wishing to set up structures in order to take advantage of its application should be aware that most tax treaties which have such provisions also contain an anti-avoidance provision, which states that the "most favoured nation" clause will not apply where the main purpose or one of the main purposes in setting up the structure was to take advantage of the benefits of this clause.

Comment

Interestingly, other double tax treaties which have similar "most favoured nation" clauses, inter alia, include the SA / Netherlands DTA as well as the SA / United Kingdom DTA. However, both clauses in those tax treaties have their limitations in comparison to the SA/ Sweden equivalent provision. In respect of the SA / Netherlands DTA, there is a date limitation in that the "most favoured nation" clause only applies where a further tax treaty between South Africa and a third state was entered into after the date of conclusion of the SA / Netherlands DTA. There is an argument that the SA / Kuwait DTA came into force prior to the SA / Netherlands DTA and hence cannot apply, such that the application of the "most favoured nation" clause in the SA / Netherlands DTA is not triggered. Furthermore, the SA / United Kingdom DTA merely provides that the countries shall enter into negotiations with a view to providing comparable treatment as may be provided for in respect of a tax treaty with a third State.

While the application of the "most favoured nation" clause is certainly beneficial under the specific circumstances, it remains to be seen for how long this exemption will apply. It is interesting to note that while Kuwait remains the only country with an outright exemption in respect of dividends, previously the tax treaties between South Africa and Cyprus as well as Oman also provided for outright exemption under certain circumstances. Both the Cypriot and Omani tax treaties were, however, amended by protocols giving the country of source partial taxing rights and removing the outright exemption.

As it happens, the Status Overview of All DTAs and Protocols published on the SARS website (last updated on 27 January 2017) reflects that the South Africa / Kuwait Protocol is currently being negotiated and it will, therefore, be interesting to see whether the new Protocol will amend the article pertaining to dividends thereby doing away with the outright exemption of dividends as it currently stands.

Cliffe Dekker Hofmeyr
ITA: Section 64G(3)
BPR 267
South Africa/Kuwait Double Tax Agreement
South Africa/Sweden Double Tax Agreement
South Africa/Netherlands Double Tax Agreement
South Africa/United Kingdom Double Tax Agreement
Editorial Comment: SARS subsequently released another ruling (i.e. BPR 276) dealing with the most favoured nation clause in a tax treaty.

EXCHANGE CONTROL

2630. Relaxations for fund managers

In the 2017 South African Budget Review, specific statements were made from a tax and exchange control perspective in relation to fund managers. We briefly consider below whether these statements constitute a relaxation of the exchange control restrictions applicable to South African residents, and the taxes to be considered.

The first statement in the Budget Review entitled “Tax treatment of foreign member funds” reads as follows:

“The South African government will be establishing foreign member funds to enable local and foreign fund managers to establish and manage funds targeted for investments into the rest of Africa and the world. To make foreign member funds attractive, they will benefit from a special tax dispensation. Foreign investors investing in the funds for onward investment into the rest of Africa or elsewhere will be exempt from withholding tax on interest. However, fees earned by local asset managers and collective investment scheme managers for investment management services will be subject to tax in South Africa.”

The above statement implies that a special dispensation for foreign investors investing into Africa and abroad via South Africa will be created. A fund vehicle typically would constitute a company, partnership, trust or collective investment scheme. As the objective of a fund vehicle is to pool funds for investment without additional layers of tax, provided the dispensation achieves this, and is not subject to exchange control restrictions, it may be very attractive to foreign investors.

From an exchange control perspective, the above statement does not contain reference to specific exchange control relaxations for such a fund. Currently, fund vehicles established in South Africa are subject to exchange control restrictions and may only in certain instances invest offshore. For example, a company may only invest offshore in terms of the direct foreign investment dispensation. A partnership is regarded as a separate entity for exchange control purposes and it may only invest offshore if it is a private equity fund that is a member of the South African Venture Capital Association and it is mandated to invest offshore or by investing into an inward listed instrument. A trust is not able to directly invest offshore other than by way of subscribing for inward listed instruments.

A trust may obtain indirect exposure through a fund manager's foreign investment allowance or by investing into a portfolio of a collective investment scheme of which the manager has a foreign investment allowance. A collective investment scheme manager is entitled to invest 35% of retail assets under management abroad.

The reference in the first statement to the interest withholding tax implies that the fund will be paying South African source interest to the foreign investors. It is noted that the Income Tax Act, 1962 contains statutory provisions dealing with the source of interest income and a fund vehicle that constitutes a tax transparent vehicle (such as a partnership) would not necessarily result in the interest income from investments outside of South Africa being subject to the withholding tax on interest. However, a specific exemption from the withholding tax on interest will ensure greater tax certainty for investors.

It is noted that the first statement does not deal with any other potential tax implications that may arise for foreign investors investing via a South African vehicle (e.g. income tax, capital gains tax, dividends tax and foreign taxes).

The second statement entitled "Exchange-traded funds referencing foreign assets" reads as follows:

"Government proposes that local collective investment scheme management companies registered with the Financial Services Board and regulated under the Collective Investment Scheme Control Act (2002) ["CISCA"] be allowed to list exchange-traded funds referencing foreign assets on South African exchanges. These funds will not be subject to macroprudential limits on amounts that may be invested offshore. South African institutional investors and authorised dealers will be allowed to invest in such funds, subject to their respective macroprudential limits. These funds will be classified as foreign assets for prudential purposes. The Reserve Bank has released circulars on these policy measures."

The circulars subsequently released do not elaborate on these policy measures and the updated Exchange Control Manual for Authorised Dealers (the Manual) merely contains the following statement:

"…Local collective investment scheme management companies registered with the Financial Services Board and regulated under CISCA are only allowed to inward list exchange traded funds referencing foreign assets on the JSE Limited. These entities require prior written approval of the Financial Surveillance Department in respect of all issuances of inward listed instruments."

The reference to the inward listing of exchange traded funds (ETFs) in the Manual implies that the ETFs will be issued by a foreign entity (seemingly established by the local manager or a foreign entity).

From an exchange control perspective, the benefit of investing into ETFs lies in the fact that South African companies, individuals, partnerships and trusts may invest in approved inward listed instruments without restriction. It is noted that institutional investors will still be required to utilise their foreign investment allowance to invest in the ETFs. However, certain South African residents, namely companies, individuals and trusts may invest into the ETFs without restriction.

It is noted that the second statement contains no reference to the tax implications of either the foreign issuer, the fund manager or the investor. It is recommended that the income tax, capital gains tax, dividends tax, withholding tax on interest and securities transfer tax implications for all the parties to such an arrangement be considered.

ENSafrica
2017 Budget Review
Collective Investment Scheme Control Act, 2002
Exchange Control Manual for Authorised Dealers

GENERAL

2631. Prescribed loans

Understanding the tax effects of such prescription

Numerous loans which are payable on demand are provided within groups of companies, to trusts and between family members. Unfortunately, most parties are not aware that such loans can prescribe after three years. More importantly, such prescription comes with its own tax consequences and it is vital for individuals and companies to be aware of what the tax implications are.

A recent case and the law

In the case of *Trinity Asset Management (Pty) Ltd vs Grindstone Investments 132 (Pty) Ltd* (1040/15) [2016] ZASCA 135 (Trinity) the issue of prescription was looked at by the Supreme Court of Appeal (SCA).

The facts are fairly simple; Trinity lent funds to Grindstone, and in terms of the written agreement:

"The Loan Capital shall be due and payable to the Lender within 30 days from the date of Lender's written demand"

When did the loan prescribe?

In terms of the Prescription Act, 1969 the period of prescription for a debt is three years, and such period commences as soon as the debt is due.

One could be forgiven for thinking that the time for payment would be from the date of demand, or even 30 days later. In this regard the SCA stated that it was far from clear that the parties intended "demand" to be a condition precedent for the debt to become due. Per the court, a loan without any specific agreement regarding the time for repayment is, at common law, repayable on demand. The SCA also provided that a debt which is repayable on demand becomes due the moment the money is lent to the debtor.

Further, that while the loan capital was immediately claimable from Grindstone it would only become payable once Grindstone had received written demand, and once the notice period had expired.

What this means is that prescription formally commences as soon as the loan is provided. The court said one must not merge, or conflate, the date when a debt becomes due and that upon which repayment thereof is demanded. In Trinity's case, the loan was advanced in February 2008, there was no interruption of prescription and therefore the debt prescribed in February 2011.

The court briefly considered what must be done to postpone the running of prescription. They referred to Professor Max Loubser, who stated that:
"The courts will require a clear indication that the parties intended demand to be a condition precedent for the debt to become due, in which case prescription will only begin to run from the date of demand."

Unfortunately, the court stated that it is not necessary to express itself on whether such comment is correct. This deals with the first issue, i.e. has the debt prescribed? In Trinity's case, the answer is yes.

On the basis that the debt has prescribed, what are the resultant tax consequences?

Donations tax

If a debt is no longer due, donations tax could be due at 20% of the value of the loan waived/prescribed. But it is important to remember here, that there are certain exemptions.

Waiver of loans – recoupments/capital gains

If the loans were used to fund the acquisition of assets or to fund expenses, there could be capital gains tax on the waiver of the loan, and/or a recoupment on the waiver of such loan. This could potentially result in tax being levied on the value of the loan that has prescribed!

Loans to trusts

With effect from 1 March 2017, there are various possible negative tax issues in regard to loans to trusts. If the loan has prescribed, there is no loan, however this could be worse due to donations tax issues, and / or the waiver of loans mentioned above.

Re-instate the loan

Some advisors have suggested that if the loan has indeed prescribed, the parties could agree to re-instate such loan. However, it is advisable that, prior to any re-instatement, tax advice should be obtained as such re-instatement could have additional tax considerations.

Conclusion

Individuals, trusts and companies should carefully examine the terms to ascertain whether the loan still exists (prescription can be interrupted in limited scenarios), and if there are any tax issues if the loan has indeed prescribed. Finally, if you are about to take out a loan that is payable on demand, care should be taken to ascertain if prescription can be delayed, either by the terms of the agreement or by the interruption of prescription. If neither of the above options is possible, the loan should be carefully monitored, in case the claim prescribes, and this results in some unfortunate tax consequences.

Grant Thornton
Prescription Act

INTERNATIONAL TAX

2632. Multilateral Convention and pensions

On 7 June 2017, South Africa was one of more than 70 countries that signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI).

The MLI is the result of certain of the Organisation for Economic Co-operation and Development's action points aimed at preventing base erosion and profit shifting (BEPS). It is aimed at facilitating swift, coordinated and consistent implementation of treaty-related BEPS measures in a bilateral context. In particular, it is intended to function as a mechanism to facilitate agreement to changes to treaties without the need for time consuming bilateral renegotiation.

The MLI applies to the signatories thereof that have taken the necessary steps to ratify it. Each party that has signed or will sign the MLI has provided or will provide a list of reservation and notifications, in terms of which it notifies:

- which agreements are covered by the MLI;
- which agreements contain provisions that are not subject to reservations under specific articles of the MLI; and
- it elects optional provisions/reservations.

Provided that South Africa and the other Contracting State are both parties to the MLI and have both deposited notifications that the agreement is covered by the MLI (Covered Agreement), the MLI may, depending on the reservations and notifications of each Contracting State, amend the existing provisions of the Covered Agreement.

The MLI contains certain provisions that apply and cannot be opted out of, as well as certain optional provisions. The manner in which these optional provisions will apply is dictated by each country's list of reservations and notifications.

For example, article 7(8) of the MLI contains certain Simplified Limitation on Benefits (SLB) provisions. This means that if a party qualifies as a resident under a treaty but does not qualify as a "qualified person" under article 7(9) of the MLI, it is not entitled to certain benefits provided by the Covered Agreement, as determined in terms of the SLB provisions.

Article 7(14) states that the SLB provisions shall apply in place of or in the absence of provisions of a Covered Agreement that would limit the benefits of the Covered Agreement. Although a party may reserve the right that the SLB provisions do not apply to a Covered Agreement that already contains such provisions, South Africa has not done so in respect of any of its treaties. As such, from a South African perspective, the SLB provisions apply to Covered Agreements.

The question is whether the MLI is relevant to South African pension funds that are exempt from South African income and capital gains tax.

The MLI is relevant to pension funds that invest offshore, as they may be exposed to foreign taxes and the double taxation agreements that South Africa has entered into may provide exemption or reduction from such foreign taxes.

As such, the MLI may impact on the relief that a pension fund is entitled to claim in respect of existing treaties to which South Africa is a party. In particular, the SLB provisions will be very important to the pension fund. If the benefits of a pension fund are limited, it may suffer foreign taxes which it cannot set off against

South African taxes.

Provided that the pension fund qualifies as a resident of an existing treaty and such treaty constitutes a "Covered Agreement", the pension fund will have to consider if it constitutes a "qualified person" in terms of the above in order to be entitled to the benefits of the agreement. Therefore, a pension fund should take advice whether it will constitute a "qualified person" for purposes of the MLI.

It is noted that the MLI contains specific provisions as to when it will enter into force and these should only apply from a South African perspective once the MLI has been promulgated in the Government Gazette.

ENSafrica

OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

2633. Permanent establishment status

One of the principal tasks that was assigned to the working group that investigated base erosion and profit shifting within the OECD was to examine the ease with which recognition of a permanent establishment might be avoided.

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (2017) (MLI) embodies the measures intended to address shortcomings in the existing double taxation agreements network.

The general thrust of double taxation agreements in relation to the taxation of business profits has consistently been that the source country can only tax the business profits of a resident of a treaty counterparty if those profits were derived through a permanent establishment (PE) of that foreign resident in the source country.

A double taxation agreement (DTA) that is based on the OECD Model Tax Convention on Income and on Capital (Model Convention) contains an article that defines what constitutes a PE.

There are two principal categories of PE:

- A physical PE, which is a fixed place of business or operations in the source country from which the non-resident person carries on business activities; and
- An agency PE, where a person within the source country acts on behalf of the non-resident person and concludes business contracts to which that non-resident person is legally bound.

In each instance, there are exceptions or limitations to the general description of the PE requirement. The major concern that was expressed was that the exceptions provided fertile ground for persons anxious to avoid recognition of a PE and the attendant taxation consequences attached to such a recognition.

The MLI therefore contains articles the purpose of which is to enable signatories to elect to apply overriding provisions that reduce the ease with which exceptions or limitations on the definitions may apply. South Africa as a signatory to the MLI on 7 June 2017 has elected certain provisions of the articles that apply in DTAs to which South Africa is a party. The landscape for the conduct of business in South Africa by non-residents will alter.
Editorial Comment: Signatories to the MLI have a certain period of time to review their elections and options before the MLI comes into force.

Three articles in the MLI are discussed, namely articles 12, 13 and 14.

Editorial Comment: South Africa has thus far elected that article 12 and 14 do not apply to any of its bilateral treaties. It remains to be seen if South Africa will amend any of its elections on final adoption.

Article 12 Strengthening the agency PE

General purpose

The purpose of the agency PE principle is encapsulated in the following extract from Article 5.5 of the Model Convention:

"… where a person … is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise …"

In effect, the Model Convention seeks to establish that a PE will be created if an employee or agent within the source country has, and habitually exercises, a right to conclude contracts on behalf of a non-resident.

This principle could be applied for the purposes of avoidance simply by denying the employee/agent any right to bind the non-resident under a contract. However, this did not stop the employee/agent from negotiating the significant contractual issues, including the subject matter and scope of the proposed agreement and the price, after which the non-resident would procure that the agreement was signed by a representative in their country of residence.

Article 12 seeks to broaden the concept of 'concluding contracts'. It does so in paragraph 1 by way of the following statement:

"… where a person is acting in a Contracting Jurisdiction … on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely

concluded without material modification by the enterprise, and these contracts are:

a) in the name of the enterprise; or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use; or

c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that Contracting Jurisdiction in respect of any activities which that person undertakes for the enterprise …"

This extends the focus to take account of the role of the employee/agent in relation to the formal conclusion of the contract as well as the negotiation process. If the employee/agent does not formally conclude the contract, the second question is whether the formal conclusion takes place as a result of the employee/agent's negotiations without material modification. In that event, the activities of the employee/agent may create a PE.

Independent agent exception

The Model Convention contains a saving to the agency principle, which is found in Article 5.6:

"An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business."

Concern was expressed at the ease with which the exception might be invoked. There has always been an element of interpretation to be applied in determining whether a person has independent status. The term may refer to ownership connections or it may refer to financial dependency on the business of a particular person, for example.

Paragraph 2 of Article 12 seeks to address this issue:

"Paragraph 1 shall not apply where the person acting in a Contracting Jurisdiction to a Covered Tax Agreement on behalf of an enterprise of the other Contracting Jurisdiction carries on business in the first-mentioned Contracting Jurisdiction as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise."

The concept of independence is now identified by reference to the extent to which the agent relies on the principal and the existence of a close relationship. Interpretative guidance is found in Article 15 of the MLI:

"… a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise."

The litmus test is therefore found in the concept of close relationship. If the parties are factually not closely connected, financial dependency on the business of the principal as the sole or main agency of the agent is apparently not a factor. Unless it is established that the agent is 'closely related' to the principal based on direct or indirect ownership, paragraph 2 of Article 12 will exclude the existence of a permanent establishment. The degree of business dependence will assume relevance only if the agent is closely related to the principal.

These will be important issues if South Africa subsequently elects for paragraphs 1 and 2 of Article 12 to apply to a DTA, and much will hinge on whether it also elects to adopt Article 15 to govern interpretation of Article 12.

Article 13 Bolstering the physical PE

In Article 5.4 of the Model Convention, provision is made to exclude physical locations that are apparently a PE where the nature of the activities carried on within the location is such that they are not regarded as income generating. Thus Article 5.4 states:

"Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include:

- *a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;*
- *b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;*
- *c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*
- *d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;*
- *e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;*
- *f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e) of this paragraph, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character."*

Thus custodial and display activities or the operation of a buying office were excluded from the scope of a PE, as were activities that were regarded as being of a preparatory or auxiliary character.

Article 13 of the MLI provides two options to a contracting state:

- Option A in substance limits the exceptions from applying unless each of the activities undertaken or the combination of activities is of a preparatory or auxiliary nature. (***Editorial Comment: South Africa elected option A on signature of the MLI.***)
- Option B envisages that the contracting state in question is comfortable with the exceptions as specified in the option. In this case it is expected that the contracting states will strengthen their PE rules by the adoption of Article 14 of the MLI.

The Explanatory Statement that accompanied the issue of the MLI text explained that many countries were satisfied with the scope of the provisions of Article 5.4 of the Model Convention. For this reason, Article 13 was drafted to provide an election to signatories. Thus a signatory may first determine whether it wishes Article 13 to apply to a DTA and, having so decided, then elect the form of the modification that should apply.

Whichever option may be elected, both provide that the exceptions may not apply in combination in respect of a single location unless the overall nature of the combined activities is preparatory or auxiliary.

Paragraph 4 of Article 13 states that a PE may be created in the following circumstances:

- Where a non-resident carries on activities from a single place in a host jurisdiction and one of the activities qualifies as a PE but the other does not;

- Where a non-resident carries on activities in a host jurisdiction from two different places and one of the places is a PE and the other is not;
- Where two closely related non-residents carry on activities from a single place in a host jurisdiction and one of the activities qualifies as a PE but the other does not; or
- Where two closely related non-residents carry on activities in a host jurisdiction from two different places and one of the places is a PE and the other is not.

In any of these circumstances, the combined activities may be treated as creating a PE in respect of each location or activity if the activities constitute complementary functions that are part of a cohesive business operation.

Article 5.3 of the Model Convention deals with the position in relation to construction or assembly projects:
"A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."

Article 14 Splitting of contracts
The *de minimis* period for which a project should endure is frequently a matter of negotiation, and the length of the period that is agreed may vary from one DTA to another. Further, the activities carried on at the site may be limited to only the actual construction or assembly activities, or extended to include consultancy or supervisory services in connection with the project. The PE requirement will vary between different DTAs.

Article 14 of the MLI is concerned with the structuring of construction or assembly activities into modules or discrete elements, none of which will exceed the *de minimis* period. It therefore proposes to address the issue in the following manner:

"For the sole purpose of determining whether the period (or periods) referred to in a provision of a Covered Tax Agreement that stipulates a period (or periods) of time after which specific projects or activities shall constitute a permanent establishment has been exceeded:

a) where an enterprise of a Contracting Jurisdiction carries on activities in the other Contracting Jurisdiction at a place that constitutes a building site, construction project, installation project or other specific project identified in the relevant provision of the Covered Tax Agreement, or carries on supervisory or consultancy activities in connection with such a place, in the case of a provision of a Covered Tax Agreement that refers to such activities, and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding the period or periods referred to in the relevant provision of the Covered Tax Agreement; and

b) where connected activities are carried on in that other Contracting Jurisdiction at (or, where the relevant provision of the Covered Tax Agreement applies to supervisory or consultancy activities, in connection with) the same building site, construction or installation project, or other place identified in the relevant provision of the Covered Tax Agreement during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise, these different periods of time shall be added to the aggregate period of time during which the first-mentioned enterprise has carried on activities at that building site, construction or installation project, or other place identified in the relevant provision of the Covered Tax Agreement."

Conclusion

The implementation of the MLI will present challenges not only for non-residents who carry on business activities in South Africa but also for South African enterprises that carry on operations in other countries. The precise principles applicable to the determination of whether a permanent establishment will be created will change when the MLI comes into effect. The nature and extent of the changes will be contingent on elections made by signatory states as to whether and to what extent articles 12, 13 and 14 of the MLI will apply to particular DTAs, and it would be advisable for persons with external operations to consider carefully the implications that the proposed changes to DTAs may hold for those operations.

Essentially, two issues must be identified:

- Were activities carried on by the non-resident at the site in connection with a specific project during one or more periods that exceeded 30 days in aggregate but did not exceed the relevant *de minimis* period?
- Were connected activities carried on at that site (or, where the DTA includes supervisory or consulting activities in connection with a specific project, such activities) by persons who are closely related to the non-resident, and was any single activity carried on for a period of time that exceeded 30 days?

Where any activity is identified as meeting these requirements of the inquiry, then the time spent in relation to that activity must be added to the aggregate period of time during which the non-resident carried on activities at that site.

This provision raises questions:

- Is it relevant that the activities are concurrent with other activities or whether the activities are consecutive? It is submitted that the activities referred to must be undertaken at a time when the non-resident is not carrying out other activities at the site –without this requirement, overlapping periods will be double-counted.

- To what extent do activities of a preparatory or auxiliary nature fall within the scope of the PE? In many projects, it may be necessary for the contractor to take measurements or conduct preliminary surveys which will inform its design or engineering decisions. If these are of a preparatory or auxiliary nature, it is submitted that the activities are not drawn into the PE net by reason that they are activities in connection with a construction site. The overriding exclusion afforded under Article 5.4 of the Model Convention to activities of a preparatory or auxiliary nature should not be disturbed.

- What criteria are applied to determine whether activities are connected? The Model Convention refers to supervisory activities in connection with the construction site or project. It is submitted that the interpretation has to be considered in light of paragraph 4 of Article 13, and that the activities should be regarded as complementary functions that are part of a cohesive business operation.

If a state is a signatory to the MLI, Article 14 will apply automatically unless the signatory elects that it shall not apply to a specific DTA or DTAs. **Editorial comment: South Africa has reserved the right not to apply Article 14 of the MLI.**

Alternatively, a signatory may elect to exclude its application in relation to the exploration for or exploitation of natural resources.

PwC
OECD Model Tax Convention on Income and on Capital
OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
Statement to the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

Editorial comment: It must be noted that in terms of section 231 of the Constitution an international agreement must follow due process before it can become law in South Africa.

TAX ADMINISTRATION

2634. Retrospective tax legislation – when is it acceptable?

The Gauteng Division, Pretoria, of the High Court recently had occasion to consider the constitutionality of retrospective legislation, in *Pienaar Brothers (Pty) Ltd v CSARS & the Minister of Finance* Case 87760/2014 (not yet reported). The Court in effect condoned retrospective legislation where adequate warning existed of its imminent introduction. This article will not attempt to canvass the 156 page judgment in full, but will summarise the facts and the rationale for the judgment.

The circumstances hark back to the unlamented secondary tax on companies (STC) and in particular a loophole provided by section 44(9) of the Income Tax Act, 1962 (the Act) that needed to be closed.

Pienaar Brothers (Pty) Ltd (not the taxpayer) was an operating company. It needed to introduce a BEE element of ownership into the company. To this end, acting on legal advice, section 44 of the Act was used. The taxpayer was acquired in March 2007. A condition of an amalgamation transaction as applied to the current matter was that the company, the "amalgamated company", disposed of its assets to the newly acquired company, the "resultant company" in exchange for shares in the resultant company. The amalgamated company then disposed of those shares, being its only asset, to its shareholders and its existence was terminated.

On 16 March 2007 the taxpayer, then bearing the name Sererebule Trading 15 (Pty) Ltd, concluded the amalgamation transaction, effective from 1 March 2007, in terms of which it acquired the assets of Pienaar Brothers (Pty) Ltd partly in exchange for shares in the taxpayer. The value of the assets was of course treated as the subscription price for the shares, and credited, to the extent of their par value to the share capital of the taxpayer and the rest, amounting to R29.5 million, to its share premium account. The reason for the transaction was to introduce a BEE component into the shareholding.

On 3 May 2007 the taxpayer distributed the R29.5 million to its shareholders from its share premium account. At that date, paragraph (*f*) of the former, and equally unlamented, definition of "dividend" in section 1 of the Act excluded from the definition any amount distributed from the share premium account of a company. Section 44(9) confirmed that this exemption applied to distributions in terms of an amalgamation transaction.

On 7 May 2007 the BEE shareholders acquired 25.1% of the share capital of the taxpayer, now shorn of its substantial share premium account, for what was presumably a small, affordable amount, thus achieving the BEE objective of the transaction.

The problem that led to the present matter arose when SARS imposed STC on the taxpayer's R29.5 million distribution to its shareholders. In other words, SARS denied the exemption provided for in paragraph (*f*) of the definition of "dividend". The taxpayer objected on the grounds that on 3 May 2007 paragraph (*f*) still applied, as the amending legislation following the annual Budget proposals on 20 February 2007 had not yet been promulgated.

In his Budget speech on 20 February 2007 the Minister announced that certain retrospective amendments would be introduced to deal with certain anti-avoidance arrangements relating to STC.

On the following day SARS issued a press release announcing that the STC exemption for amalgamation transactions contained in Section 44(9) of the Act was to be withdrawn with immediate effect and replaced with section 44(9A), which closed the loophole with effect from that day, 21 February 2007.

The amending legislation was promulgated on 8 August 2007, deleting section 44(9) and in effect ensuring that distributions such as the one carried out by the taxpayer on 3 May 2007 would be subject to STC, with effect from 21 February 2007. The taxpayer contended that it had never received any formal notice of this retrospective legislation, and it was unconstitutional for legislation to affect transactions already concluded under previous legislation.

The court proceeded with a long and interesting analysis of retrospective and retroactive legislation, which is beyond the scope of this article. Perhaps the discussion may be very briefly summarised by saying that the court found that the retrospective legislation did not arbitrarily deprive the taxpayer of its property.

Parliament had used a well-accepted mechanism for amending legislation to protect the government's ability and need for taxes in order to run the country. Taxpayers had been warned, by the Minister on 20 February, and by SARS on 21 February, and by vigorous discussions between interested parties and SARS and National Treasury, which led to amendments to the original proposals, that the amending legislation was on the way and would be back dated to 21 February 2007. Consequently, the backdating to 21 February could not be considered to be unconstitutional.

As the court, with respect correctly, pointed out, this is a familiar mechanism.

As far back as December 1988, for example, just as taxpayers were going off for their end of year break, the then Minister of Finance, Barend du Plessis, warned taxpayers that in the amending legislation following the 1989 Budget he was going to introduce two anti-avoidance measures, to take effect from the day of this announcement. The resultant additions to the Act were section 8E, at that time called preference share schemes, and section 103(5), the interest/dividend swap schemes.

Taxpayers were thus put on notice that between then and the promulgation date of the 1989 amending legislation that they entered into preference share schemes and dividend/interest swaps at their peril. In 1989 we did not yet have our current constitution, but it is submitted that retrospective legislation with advance warning is both constitutional and an understandable weapon in the hands of the *fiscus*.

Finally, most recently in their draft response dated 14 June 2017 to comments raised at the hearings of the Parliamentary Standing Committee on Finance, National Treasury (NT) and SARS referred to *Pienaar Brothers* in their response to complaints that the Budget announcement, published on 22 February 2017, that the rate of dividends tax was to be increased from 15% to 20% with effect from that date, was retroactive and made without a mandate from the legislature. NT and SARS pointed out that the court in *Pienaar Brothers* had found that retrospective legislation was acceptable. Dividends tax is imposed when a dividend is paid in the case of listed companies, and on the earlier of when it is paid or due and payable in the case of unlisted companies.

The response continued:

"South African law distinguishes between retroactive legislation and retrospective legislation. Retroactive legislation means legislation that changes the law with effect from a date in the past, in respect of events or transactions irrespective of whether they occurred before that date, typically where legislation provides that from a past date, the new law shall be deemed to have been in operation. On the other hand, retrospective legislation means legislation that affects an event that occurred prior to the date on which the legislation was promulgated but on or after the date on which the proposed change in the law was first announced.

Applying the above to the given circumstances, the proposed increase of the DT rate from 15 per cent to 20 per cent with effect from 22 February 2017 is not retroactive as it does not seek to tax dividends that were paid before 22 February 2017. The proposal was effective from the date of the announcement, not from a date in the past. However, the proposed increase can be viewed as retrospective as it has been implemented before the legislation has been promulgated.

Other proposals in the Draft Rates Bill, such as changes to personal income taxes, can be characterised in the same manner. In fact, most rates and threshold changes take place after the announcement on Budget Day, and begin to be implemented before the tax laws are enacted (normally around December, about ten months after the announcement). Given the market sensitivity of tax announcements, this practice is the norm in order to ensure that taxpayers do not rush to restructure their tax affairs to lower or avoid paying the full amount of the expected tax.

All over the world, it is not uncommon for taxation measures to be enacted with retrospective operation and for those measures to commence from the date of the budget announcement, rather than the date of a transaction or enactment of legislation. Generally, there is acceptance that amendments to tax legislation may apply retrospectively, where the Government has made an announcement of its intention to introduce legislation with sufficient detail of the proposal and subsequent legislation providing for commencement with effect from the date of announcement.

It is international practice for countries to accept that retrospective amendments may be appropriate where a retrospective provision (i) corrects an unintended consequence of a provision, (ii) addresses tax avoidance and (iii) might otherwise lead to a significant behavioural change that would create undesirable consequences.

The dividends tax issue is now water under the bridge, but *Pienaar Brothers* has confirmed the acceptability of retrospective legislation in appropriate circumstances.

Professor Peter Surtees
2017 Budget Review
ITA: Section 1(1) definition of 'dividend', section 44 and Part VII
Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2017

SARS NEWS

2635. Interpretation notes, media releases and other documents

Readers are reminded that the latest developments at SARS can be accessed on their website http://www.sars.gov.za.

research or specialist advice. The views of the authors are not necessarily the views of SAICA.