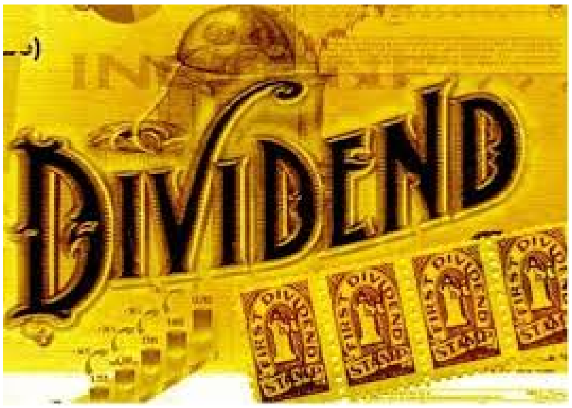
South African Tax Court rules in favour of taxpayer in most favoured nation test case



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On 12 June 2019 the Cape Town Tax Court delivered its judgment in the dividends tax test case between ABC Pty Ltd (Taxpayer) and the South African Revenue Service (SARS). The case pertained to SARSs refusal to refund dividends tax overpaid by the Taxpayer following the Taxpayers interpretation of the most favoured nation provision (MFN clause) in the double taxation agreement (DTA) between South Africa (SA) and the Netherlands (SA/Netherlands DTA) (Dutch MFN clause), read with the MFN clause in the SA/Sweden DTA (Swedish MFN clause) and the SA/Kuwait DTA.

The Tax Court found in favour of the Taxpayer, ordering SARS to refund the dividends tax overpaid to the Taxpayer with interest, as well as ordering SARS to pay the Taxpayers costs including the costs of two counsel. Cliffe Dekker Hofmeyr represented the Taxpayer in the matter.

The Tax Court judgment is of great importance to the many South African taxpayers involved in similar dividends withholding tax disputes with SARS pertaining to the interpretation of DTAs. The Tax Court is the first South African court to rule on this particular issue.

The SA case comes after the Dutch Supreme Court (Hoge Raad) on 18January2019 found in favour of a taxpayer in its judgment pertaining to the same issues. That case was an appeal by the Dutch Tax Authorities against an earlier decision of the Dutch High Court (Gerechtshof s-Hertogenbosch) in which the Dutch High Court ruled that the Dutch MFN clause read with the same clauses and DTAs apply to exempt taxpayers from dividends tax where dividends are paid by a Dutch resident company to a SA resident.

SA Judgment: Background Facts

The Taxpayer, a SA resident company, declared and paid dividends to its shareholder, a Dutch resident company, with the necessary declaration and undertaking provided. Dividends tax was withheld and paid to SARS. Subsequently, a new declaration and undertaking was given recording that the dividends tax rate for the dividends was 0%.

The Taxpayer claimed a refund of the dividends tax overpaid to SARS, and SARS rejected the claim.

Evidence Led in Court

SARS led evidence that, some time prior to September 2006, the SA government decided to substitute the secondary tax on companies regime with a dividends tax regime to align the SA corporate tax regime with that of other countries. This change in policy required that South Africa amend its existing DTAs with 10 countries, including the Netherlands, Sweden and Kuwait. The negotiation process differed with each country as each country had different relationships with SA and different interests. Each DTA was individually negotiated and contained individual terms. Each country also had its own procedures to ratify and bring into being an enforceable, binding agreement.

At the time of the hearing the SA/Netherlands DTA and the SA/Sweden DTA had already been amended and protocols concluded which provided for 5% dividends withholding tax in the category in question. However, even though renegotiations with Kuwait were concluded, Kuwait had not yet ratified the agreement and therefore the protocol with Kuwait was not yet in force. The existing SA/Kuwait DTA which came into force on 25 April 2006 provided for a 0% dividends tax rate. Even though the protocol with Kuwait was not yet in force, the SA government nevertheless proceeded to implement the dividends tax regime with effect from 1 April 2012.

The relevant dates with regard to the conclusion of the DTAs and protocols are as follows:

- the SA/Sweden DTA was concluded on 24 May 1995;
- the SA/Netherlands DTA was concluded on 10 October 2005;
- the SA/Kuwait DTA was concluded on 17 February 2004 and entered into force on 25 April 2006;
- the protocol to the SA/Netherlands DTA was concluded on 8 July2008 and entered into force on 28December 2008; and
- the protocol to the SA/Sweden DTA was concluded on 7 July 2010 and entered into force on 18 March 2012.

The Taxpayers Case

The Taxpayer argued that it was not liable for dividends tax on the dividends paid to its Dutch shareholder for the reasons set out below. Article 10 of the SA/Netherlands DTA allows for a dividend withholding tax of 5% of the gross amount of the dividends if the beneficial owner is a company holding at least 10% of the capital in the company paying the dividends. Article 10(1) and (2) state as follows:

Article 10 Dividends

(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 dividends is a resident and according to the laws of that State, but if the

beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

1. 5 per cent of the gross amount of the dividends if the beneficial owner is a company which holds at least 10 per cent of the capital of the company paying the dividends; or
2. 10 per cent of the gross amount of the dividends in all other cases.

The Dutch shareholder held 100% of the shares in the Taxpayer. Accordingly, Article10(2)(a) which provides for a 5% dividends tax rate is relevant for purposes of the Taxpayers argument.

Article 10(10) (the Dutch MFN clause) reads as follows:

(10) If under any convention for the avoidance of double taxation concluded after the date of conclusion of this Convention between the Republic of SouthAfrica and a third country, SouthAfrica limits its taxation on dividends as contemplated in subparagraph (a) of paragraph2 of this Article to a rate lower, including exemption from taxation or taxation on a reduced taxable base, than the rate provided for in subparagraph (a) of paragraph2 of this Article, the same rate, the same exemption or the same reduced taxable base as provided for in the convention with that third State shall automatically apply in both Contracting States under this Convention as from the date of the entry into force of the convention with that third State.

The Dutch MFN clause thus states that if a DTA between SA and a third party state was concluded after the date of conclusion of the SA/Netherlands DTA and that a third party DTA provided for a lower dividends tax rate than the dividends tax rate provided for in the SA/Netherlands DTA, then that lower dividends tax rate would also apply to dividends paid between SA and the Netherlands.

The Taxpayer applied the SA/Sweden DTA as the third party state DTA referred to in the Dutch MFN clause. The protocol to the SA/Sweden DTA entered into force after the SA/Netherlands protocol entered into force. Article 10(1) and (2) of the SA/Sweden DTA (as amended by the protocol) read as follows:

Article 10 Dividends

(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 dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

(a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds at least 10 per cent of the capital of the company paying the dividends; or

(b) 15 per cent of the gross amount of the dividends in all other cases.

Even though the SA/Sweden protocol does not contain a direct exemption from dividends tax, the SA/Sweden protocol introduced Article 10(6) (the Swedish MFN clause) to the SA/Sweden DTA, which reads as follows:

(6) 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 SouthAfrica 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.

The Swedish MFN clause therefore states that, if a DTA between SA and a third party state was concluded and that third party state DTA provided for a lower dividends tax rate than the dividends tax rate provided for in the SA/Sweden DTA, then that lower dividends tax rate would also apply between SA and Sweden. The Swedish MFN clause does not contain a limitation provision, ie that the DTA with the third party state must be concluded after the SA/Sweden DTA (as is the case with the SA/Netherlands DTA).

At the time that the dividends were paid, the SA/Kuwait DTA provided for a 0% dividends tax rate. Currently, the SA/Kuwait DTA still provides for the 0% dividend tax rate. Article 10(1) of the SA/Kuwait DTA provides as follows:

Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State who is the beneficial owner of such dividends shall be taxable only in that other Contracting State.

The Court noted that, while they differ in various minor respects, the Dutch MFN clause and the Swedish MFN clause have one crucial difference and that is the presence of the words after the date of conclusion of this convention in the SA/Netherlands DTA whereas there is nothing similar that suggests that it is only a future provision which will trigger the provisions of Swedish MFN clause in the SA/Sweden DTA.

The Taxpayer contended that the Swedish MFN clause was, immediately upon it coming into being, applicable because of a prior provision in the SA/Kuwait DTA. The Swedish MFN clause then triggered the Dutch MFN clause.

The Taxpayer argued that, at the time of the hearing, the SA/Kuwait DTA dated 25April 2006 was still in force on the terms contained therein and therefore, if its shareholder was resident in Kuwait, no dividends tax would have been payable on any dividends paid from South Africa.

The Court summarised the Taxpayers argument as follows: *the agreement between South Africa and the Netherlands provides that if any other contracting state is in the future given better terms, then those better terms also apply to the Netherlands. In so far as the contract with Sweden provides that if any other contracting state has better terms (whether existing or in the future) then those also apply to Sweden. In so far as Kuwait does have better terms, then Sweden is also entitled to the same terms and because Sweden has been benefitted by better terms after the Netherlands contract was concluded with South Africa, the Netherlands must also be given the better benefit. The assertion being therefore that resident companies of both the Netherlands and Sweden who receive dividends from a South African resident company are liable to pay taxes in the Netherlands and/or Sweden but there is no liability on the company to make any payment of tax on the dividend to SouthAfrica.*

SARSs First Argument

SARS contended that the triggering of the Swedish MFN clause by the SA/Kuwait DTA does not amount to a limitation or change and therefore there can be no triggering of the Dutch MFN clause. The argument arises from the fact that the DTAs provide for different tax rates depending on the percentage shareholding in the SA company.

The Taxpayer was wholly-owned by its foreign parent. As the foreign parent held more than 10% of the shares in the

Taxpayer, the rate in Article 10(2) of the SA/Netherlands DTA applied to it, unless a lower rate applied by virtue of the DTA.

Prior to the protocol, Article 10(2) of the SA/Sweden DTA limited the extent to which dividends may be taxed in the state from which they are paid. Three different limitations applied, depending on the circumstances:

- the general limit was 15%;
- if the recipient of the dividend was a company which held 25% or more of the capital of the company paying the dividend, the dividends were:
- exempt from tax, if exempt from tax in the state in which they were received (ie under the domestic legislation of that state); or
- taxable at a maximum rate of 7.5% in any other case.

Therefore, an outbound dividend to a qualifying Swedish shareholder –

- holding between 10% and 25% of the capital in the dividend-paying SA resident company was taxable in SA at a maximum rate of 15%;
- holding 25% or more of the capital in the dividend-paying SA resident company was exempt from tax in SA if those dividends were exempt from tax under domestic Swedish law; and
- holding 25% or more of the shares in the dividend-paying SA resident company was taxable at a maximum rate of 7.5% in SA if those dividends were not exempt from tax under domestic Swedish law.

SARS argued that under the SA/Sweden DTA (prior to the protocol), an entity in the same position as the Taxpayers parent would in any event have paid 0% dividends tax, as it held more than 25% of the shares in the Taxpayer. The implementation of the SA/Sweden protocol, having regard to the operation of the Swedish MFN clause, would thus have had no impact on dividends tax on amounts paid to an entity in the position of the Taxpayers parent as it held 100% of the shares. It would still have paid no dividends tax. In those circumstances SARS argued that the SA/Sweden protocol did not limit SAs taxation on dividends paid by a comparable entity in the position of the Taxpayer to something lower than it would otherwise have been. Such an entity paid no dividends tax before the SA/Sweden protocol and paid no dividends tax thereafter. SARS argued that the position would have been different in relation to dividends paid to Swedish entities that held between 10% and 25% of the shares in the SA company, but that is of no relevance to entities such as the Taxpayer who held 100% of the shares. The argument was then that there was no change or introduction of a new MFN status which could affect the SA/Netherlands DTA. However, SARSs argument related to only one specific category of shareholders and not all ofthem.

Only one limited subcategory of the category of dividends contemplated by Article 10(2)(a) of the SA/Netherlands DTA was already exempt from SA dividends tax under the SA/Sweden DTA prior to amendment by protocol. The exempt subcategory was outbound dividends to qualifying shareholders (i) holding more than 25% of the capital in the SA resident company, and (ii) in circumstances where those dividends were exempt from tax under domestic Swedish law. In all other cases, outbound dividends to qualifying shareholders (ie the category of dividends contemplated by article 10(2)(a) of the SA/Netherlands DTA) were taxable in SA; and these only became exempt after the SA/Sweden DTA was amended by protocol.

Based on the above, the Court rejected SARSs argument. The Court stated thefollowing:

I agree with the appellants submission that the respondents argument, in reliance on this factual matrix, stands to be rejected. While one category of shareholders might have *experienced no change in treatment, the other categories did, including the one at issue in this matter, namely a category where the shareholder holds more than 10% of the shares. Such a shareholder in Sweden had a change in treatment. From having to pay tax to South Africa of 5% it became exempted when Sweden became able to place reliance on the better treatment being afforded to Kuwait. Respondents reliance on this ground thereforefails.*

SARSs Second Argument

This argument related to the interpretation of DTAs and the intention of the parties. SARS relied on the judgment of Bothma-Batho Transport (Edms) Bpk v S Bothma & Seun Transport (Edms) Bpk 2014 (2) SA 494 (SCA) in respect of the principles of interpretation, in particular that one must apply the golden rule of interpretation after having ascertained the literal meaning of the word or phrase in question, in particular to have regard to –

- the context in which the word or phrase is used with its interrelation to contract as a whole, including the nature and purpose of the contract;
- the background circumstances which explain the genesis and purpose of the contract, ie to matters probably present to the minds of the parties when they contracted; and
- extrinsic evidence regarding the surrounding circumstance when the language of the document is on the face of it ambiguous, by considering previous negotiations and correspondence between the parties, subsequent conduct of the parties showing the sense in which they acted on the document, save direct evidence of their own intentions.

In *Bothma-Batho* it was stated that, whilst the starting point remains the words of the document, the process of interpretation does not stop at a perceived literal meaning of those words, but considers them in light of all relevant and admissible context, including the circumstances in which the document came into being. Interpretation is no longer a process that occurs in stages, rather it is one unitaryexercise.

SARS argued that the Court must find the true intention of the parties and if the written words do not mirror that intention, the words should either be ignored, augmented and/or supplemented to give effect to the true intention. The Court must then consider whether the words result in absurd or unanticipated consequences or consequences that are contrary to what all contracting parties aimed to achieve.

SARS led evidence as to SAs intention in concluding the DTAs and that the Netherlands had the same intention. SARS argued that SA decided to change its dividends tax regime, which was properly and legitimately motivated to align it with other countries. It renegotiated DTAs and when such negotiations concluded SA amended its law. It anticipated that all the countries would imminently ratify the DTAs, however, this did not happen. SA tried to remedy the situation, but SARS argued that the Taxpayer is now exploiting an unanticipated, unforeseen and unfortunate occurrence. The contracting parties never meant for this to happen.

SARS then submitted that the Dutch MFN clause must be read as if it is restricted only to circumstances where preferential treatment is being afforded directly to another country in terms of a subsequent agreement and not indirectly through the operation of a provision in an agreement that is dependent upon the existence of another earlier DTA. SARS argued that the Court must consider the intention of SA and all other relevant parties with whom it negotiated and contracted. Then, in interpreting the SA/Netherlands DTA there must be imputed a provision in terms of which any other DTA and specifically the SA/Sweden DTA refers to only a future better deal or treatment for its resident taxpayers.

As stated by the Court, SARS was asking that *..the court must, not only look at the words used but must inevitably also look to the intention of the parties utilising the various criteria comprising the circumstances in which the document came into being. In doing that the court must find that the change of SouthAfrican tax regime was the purpose of the agreement and if they were able, by some form of crystal ball, [to] foresee that Kuwait would not timeously ratify its agreement with South Africa they would have included more precise provisions in the treaties and the agreements must be read as if they were incorporated.*

The Taxpayer, on the other hand, argued that the terms of the DTAs are clear, unambiguous and that there is no scope to look at the intention of the parties or the consequences of the Taxpayers interpretation or reading of the DTAs. The Taxpayer had read the terms of the DTAs, structured its affairs accordingly and there is no scope to penalise it by the imposition of additional words into the DTAs so as to give effect to what SARS calls the true intention of the parties or the avoidance of unexpected circumstances. The DTAs are clear and there is no justification not to enforce them in accordance with their written terms.

The Taxpayer relied on the case of *TheCity of Tshwane Metropolitan Municipality v Blair Atholl Homeowners Association* [2019] 1 All SA 291 (SCA) where it was stated that, since the Endumeni judgment, there has been a spate of cases in which evidence is allowed to be led in trial courts about the meaning to be attributed to words in legislation and written agreements. The Supreme Court of Appeal (SCA) has consistently stated that in the interpretation exercise the point of departure is the language of the document. Without the written text there would be no interpretive exercise. Courts have chosen to keep the admission of evidence within manageable bounds. The SCA had seen too many cases of extensive, inconclusive and inadmissible evidence being led.

The SCA referred to the case of *KPMG Chartered Accountants (SA) v Securefin Ltd & Another* 2009 (4) SA 399 (SCA) where that court confirmed that the parol evidence rule remains part of our law. If a document was intended to provide a complete memorial of a jural act, extrinsic evidence may not contradict, add to or modify its meaning. Second, interpretation is a matter of law and not of fact, and therefore a matter for the court and not for witnesses. Third, the rules about admissibility of evidence do not depend on the nature of the document, whether statute, contract or patent. Fourth, to the extent that evidence may be admissible to contextualise the document to establish its factual matrix or purposes or for purposes of identification, one must use it as conservatively as possible. The court was intent on ensuring that extrinsic evidence to contextualise a document was just that and did not extend beyond established parameters.

The Tax Court in the current instance agreed with the Taxpayers argument that it should not consider the evidence led by SARS regarding the intention of SA, the Netherlands, Sweden and Kuwait in considering whether the Taxpayer was liable to pay dividends tax in SA. It agreed that the provisions of the SA/Netherlands DTA are clear and provide that, in the event of another state receiving preferential treatment from SA in the future, the Dutch resident must be given the same treatment. The Court further agreed that the Swedish MFN clause that provides that the residents of Sweden should receive the same preferential treatment as any other party contracting with SA applies regardless of when such other states residents obtain such preferential treatment. When the SA/Sweden protocol was concluded the residents of Kuwait already had preferential treatment and therefore the residents of Sweden were entitled to the same treatment. This is what the DTAs say. That having been determined, the Court stated that:

there are therefore no grounds upon which this court can find *that certain words were missing from the Netherlands agreement unless this court jettisons the parol evidence rule. This court cannot do so. It is bound by the rule and prevailing decision of the Supreme Court of Appeal. The foundational principles set out in KPMG do apply and as found in Blair Atholl there is no ground upon which they can be abandoned. Those principles continue to be applicable and as the court in Blair Atholl said; Endumeni, at 603F, reaffirmed those principles and did not detract from them.*

The Court understood SARSs frustration, however, it was of the view that it is the role of the executive and/or the legislature to remedy the problem. The Court cannot rewrite the DTAs to remedy the problem.

The Court arrived at its decision based on the principles of South African domestic law, and not international law or the Dutch Court decisions. The Court explained its reasoning as follows:

The appellant placed significant reliance on decisions that have already been taken in courts in the Netherlands. This court has made its decision on SouthAfrican domestic law, which in my view is the appropriate course, and there is no purpose served, on the merits of the decision, in referring further to either international law or the prior decisions of a foreign court or the principles of comity. The parties are ad idem that the principles applicable to the interpretation of international tax treaties in South African law and International Law are the same as those applied by our courts in construing statues and agreements.

Conclusion

This judgment comes as a relief to many taxpayers who are currently engaged in similar disputes with SARS (and who may have followed the Dutch High Court and Supreme Court decisions), as it gives an indication as to how a SA court would apply the rules of interpretation to the DTAs. The judgment may also be of interest to taxpayers who had not previously considered interpreting the three DTAs in the manner referred to in thejudgment.

Unfortunately, at the time of writing this article it was still unclear what SARS and/or National Treasurys next step would be and whether they intended to appeal this judgment, terminate the SA/Kuwait DTA unilaterally or whether the protocol to the SA/Kuwait DTA would be ratified with retrospective effect (as was the case with the SA/Cyprus DTA).

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