A CRITICAL ANALYSIS OF THE PRINCIPAL PURPOSE TEST AND HOW IT COULD BE INTERPRETED AND APPLIED IN SOUTH AFRICA

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Abstract

The major theme of this research report is to provide a critical overview of the so-called 'principal purpose test' (PPT), which was first introduced by the Organisation for Economic Co-operation and Development (OECD) in the *OECD Action Plan on Base Erosion and Profit Shifting* during 2013. In essence, the PPT is an anti-avoidance rule of general application, which aims to operate as a mechanism to combat tax treaty abuse through avoidance transactions and will find application in instances when it is reasonable to conclude that a benefit granted by a tax treaty was 'one of the principal purposes' for implementing that arrangement or transaction. The PPT has since been incorporated in the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, more commonly referred to as the Multilateral Instrument (MLI), which was signed by 68 jurisdictions during a ceremony hosted by the OECD in Paris on 7 June 2017. The purpose of the MLI is to 'swiftly modify bilateral tax treaties to implement measures developed in the course of the work on BEPS'[1] *(own emphasis).*

Given that South Africa has signed the MLI and has indicated that it will adopt the PPT in isolation, the aim of this research report is to critically analyse the PPT and examine how it will be applied and operate in South Africa and whether the South African general anti-avoidance rules (GAAR) can be used as a tool for interpreting and understanding the nature and ambit of the PPT.

Key words:

OECD, MLI, principal purpose test, PPT, BEPS, tax treaty, avoidance transactions, benefit, South Africa, GAAR, Action 6

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1 OECD, *Explanatory Statement,* Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI Explanatory Statement), 2016, p.2. paragraph 5.

Declaration

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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I will give thanks to you, Lord, with all my heart; I will tell of all your wonderful deeds. Psalm 9:1

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Abbreviations and acronyms

2003 Commentary	2003 revisions to the commentary to the OECD MTC;
2017 Commentary	2017 revisions to the commentary to the OECD MTC;
Action 6 Report	Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report;
BEPS	Base Erosion and Profit Shifting;
BEPS Action Plan	The OECD's Action Plan on Base Erosion and Profit Shifting;
CITA	Canadian Income Tax Act RSC 1985, c. 1 (5th Supp.), as amended;
Covered Tax Agreements	as defined in Article 2(1)(a) of the MLI to essentially mean an agreement which is covered by the MLI;
CRA	Canada Revenue Agency;
DTC	Davis Tax Committee;
FA	UK Finance Act 2013;
ITA	Income Tax Act 58 of 1962, as amended;
IRS	Internal Revenue Service of the U.S.;
GAAR	General Anti-Avoidance Rules;
HMRC	HM Revenue and Customs, the tax authority in the UK;
LOB	limitation-on benefits;
MLI	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting;
OECD	Organisation for Economic Co-operation and Development;
OECD MTC	OECD Model Tax Convention on Income and on Capital;
PPT	Principal purpose test provision as set out in Article 7(1) of

	the MLI, Article X of the Action 6 Report and Article 29(9) of the 2017 Commentary;
SAARs	special anti-avoidance rules;
SARS	South African Revenue Service;
tax treaty	the term collectively refers to bilateral tax treaties, Covered Tax Agreements, double taxation agreements, and the OECD MTC;
UK	United Kingdom of Great Britain and Northern Ireland;
VCLT	Vienna Convention on the Law of Treaties; and
U.S.	United States of America.

1. Chapter 1: Introduction

1.1 Background

The OECD has publically expressed the view that in recent years the international tax framework has undergone immense strain and was rapidly becoming obsolete due to the integration of national economies and markets having increased substantially over the years.[2] International tax rules revealed certain shortcomings thus creating opportunities for BEPS to transpire.[3] The presence of BEPS has the effect of decreasing corporate tax revenue as a result of structures, transactions and arrangements aimed at eroding the tax base and shifting profits to locations where they are subject to more favourable tax treatment or tax treaty benefits.[4] International policymakers required drastic changes in order to restore confidence in the international tax environment.[5]

During 2013 the OECD Committee of Fiscal Affairs submitted the BEPS Action Plan to the G20 in terms of which 15 actions were identified to address BEPS.[6] The BEPS Action Plan recognises the need to introduce consistency into domestic rules affecting cross-border activities, reinforcing substance requirements in existing international standards, as well as improving transparency.[7] The final BEPS Action Plan was published and endorsed by the G20 Finance Ministers and leaders in October 2015 and covers all 15 identified action areas and recommends provisions for countries to make in their domestic law and tax treaties in order to enforce prescribed measures in key areas, such as treaty abuse.[8]

The Action 15 interim report of the BEPS Action Plan emphasized a need to develop a multilateral instrument for purposes of efficiently implementing tax

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2 OECD, *Explanatory Statement,* OECD/G20 Base Erosion and Profit Shifting Project, 2015, p.4 www.oecd.org/tax/beps-explanatory-statement-2015.pdf.

3 ibid.

4 ibid.

5 ibid, the author notes that these are the views as expressed by the OECD. A more critical approach is that governments started to focus on building tax revenues following the 2008 economic decline when countries were grappling to find additional sources of revenue.

6 ibid.

7 OECD, *Information Brief,* OECD/G20 Base Erosion and Profit Shifting Project. 2015 Final Reports, 2015, p.3, http://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf.

8 ibid.

treaty related measures by way of automatically modifying bilateral tax treaties. Consequently, an *ad hoc* group was established to develop a multilateral instrument. The Multilateral Instrument, officially called the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI) was adopted on 24 November 2016.[9]

On 7 June 2017, during a ceremony hosted by the OECD in Paris, 68 jurisdictions, including South Africa, signed the MLI. Since this date, ten additional jurisdictions have signed the MLI.[10] The parties to the MLI are required to make the MLI effective under domestic legislation.

As briefly stated above, the purpose of the MLI is to operate concurrently with bilateral tax treaties and amend and modify certain provisions. The MLI will also make provision for the inclusion of certain minimum standards, without requiring each jurisdiction to separately engage and renegotiate existing bilateral tax treaties. It has been argued that there is more to the MLI than its stated objectives.[11] Moreover, although it is intended to operate as a 'time-efficient bulk renegotiation mechanism'[12], it may have a disruptive effect on certain intermediary jurisdictions, given that the MLI is anticipated to unsettle certain industries in national service associated with the tax treaty shopping industry.[13] Certain countries have also indicated a preference for entering into bilateral renegotiation due to the difficulty that arises with domesticating the MLI.[14] A critical discussion on the MLI is however beyond the scope of this research report.

The new treaty anti-avoidance provisions were introduced in Action item 6 of the final BEPS Action Plan, dealing with *Preventing the Granting of Treaty*

9 OECD, *MLI Explanatory Statement*, op cit., p.2.

10 Hattingh PJ, 2018, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', *Bulletin for International Taxation*, vol. 72, no.4/5, p.1.

11 ibid.

12 ibid.

13 ibid, p.14.

14 ibid. Hattingh PJ notes that Switzerland and Mauritius have expressed a preference for bilateral renegotiation to implement BEPS minimum standards.

Benefits in Inappropriate Circumstances (Action 6 Report),[15] which highlights that treaty shopping is a crucial BEPS concern and consequently provides safeguards against abusive or avoidance transactions.[16] The OECD recommends including the following 'minimum standards' in tax treaties to target treaty shopping:

i. a clear statement in the relevant tax treaty that the countries entering into the tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements;[17]

ii. a specific anti-abuse rule, specifically, the LOB rule that limits the availability of treaty benefits to entities meeting certain criteria to be included in tax treaties.[18] These conditions are based on legal nature, ownership in, and general activities of the relevant entities.[19] The LOB rule seeks to ensure that there is a sufficient link between the relevant entity and its country of jurisdiction; and[20]

iii. for purposes of all other general forms of tax treaty abuse, including treaty shopping situations that would not be covered by the LOB rule, countries are obliged to include one of the following three alternative options into their tax treaties:[21]

    a. the PPT as a standalone mechanism. The PPT is a general anti-abuse rule based on the principal purpose of a transaction or arrangement and provides that a benefit will not be granted under a tax treaty if it is reasonable to conclude, after having regard to all relevant factors and circumstances, that obtaining that benefit was

[15] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Action 6 Report), 2015, http://dx.doi.org/10.1787/9789264241695-en.

[16] OECD, *Action 6 Report*, op.cit., p.9.

[17] ibid.

[18] ibid.

[19] ibid.

[20] ibid.

[21] ibid.

one of the principal purposes of any arrangement or transaction that resulted either directly or indirectly in that benefit (First Alternative);[22]

b. the PPT and either a simplified or detailed LOB rule, which limits the availability of treaty benefits to persons that meets certain prerequisites (Second Alternative);[23] or

c. a detailed LOB provision, supplemented by a mechanism that would deal with conduit arrangements not already covered under existing tax treaties (Third Alternative).[24]

Unlike certain other provisions encompassed in the MLI, which countries can elect to opt out of entirely, the provisions of Article 7 relating to treaty abuse oblige parties to adopt one of the minimum standards. Given that the PPT is the only alternative that can satisfy the minimum standard on its own, it is presented as the default option.[25] It is noteworthy that where parties elect an option that requires a detailed LOB provision (either one aspect of the Second Alternative or the Third Alternative), substantial bilateral customisation will be required, which would be a challenge in the context of the MLI.[26] Accordingly, the MLI does not include a provision for the adoption of a detailed LOB clause rather, parties are permitted to opt out of the PPT (for purpose of the Third Alternative) and agree to reach a bilateral agreement that satisfies the minimum standard.[27] The author observes that this seems counter-intuitive to the precise purpose of the MLI.

As a consequence of the Action 6 Report and the introduction of the MLI (with specific reference to Article 7 of the MLI), Article 29 of the 2017 Commentary has been inserted to include the relevant provisions detailing the implementation of the minimum standards (save for the Third Alternative) to be included in tax treaties. The recommended provisions in relation to the PPT are similar to those that have been included in the MLI. In addition, the

[22] ibid.
[23] ibid.
[24] ibid.
[25] OECD, *MLI Explanatory Statement*, op.cit.,p.22.
[26] ibid.
[27] ibid.

commentary provided on Article 29 in the 2017 Commentary largely replicates the commentary included in Article X of the Action 6 Report.

Curiously, the new Article 29 to the 2017 Commentary contains the relevant provisions and/or paragraphs for the adoption of the Second Alternative, namely, the combination of the PPT and the simplified LOB rule.[28] There is however no guidance in the 2017 Commentary for countries that opted to adopt the PPT in isolation under the MLI.[29] It is apparent that the even though the parties to the MLI are provided with a choice as to which minimum standard they wish to implement, the 2017 Commentary seems to prescribe the Second Alternative as the default option, being the least popular of the alternatives to the minimum standard.[30] The Second Alternative is considered to be an impractical minimum standard because as a general rule, where one country chooses to apply the simplified LOB and the other country has elected to apply the PPT in isolation, the simplified LOB will generally not apply, and, by default, the PPT would apply.[31] The two countries in question are however entitled to conduct bilateral negotiations to arrive at a compromise position, which will still satisfy the minimum standard requirement.[32] It has been submitted that the adoption of the combination of the PPT and a simplified LOB clause is unrealistic, given that treaty partners will be required to have matching LOB provisions.[33]

1.2 **Objective of the research**

1.2.1 **Statement Problem**

This research report attempts to answer the statement problem, which is to address how the PPT will be applied in South Africa and whether domestic principles established under the South African GAAR can be used as a mechanism for interpreting the key features of the PPT.

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28 Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', op.cit., p.6.
29 ibid.
30 ibid.
31 OECD, *MLI Explanatory Statement*, op.cit., paragraph 102, p.24.
32 ibid.
33 Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', loc.cit.

1.2.2 The Sub-problems

The following sub-problems have been identified and should be considered in addressing the aforementioned research statement problems:

i. Has the OECD provided adequate guidance on the nature, scope and application of the PPT?

ii. How should the phrase in the PPT 'one of the principal purposes' be interpreted?

iii. How will the reasonableness test in the PPT be applied? More specifically, will the application of this test be applied in a subjective or objective manner?

iv. How will the object and purposes of the relevant tax treaty provisions be established for purposes of operating as an exception to the application of the PPT?

v. Has any guidance been provided on how the PPT will operate in practice, including guidance from other jurisdictions?

vi. Will domestic GAARs and the PPT operate in tandem?

1.3 Significance of the study

This research report attempts to make a number of important contributions to international tax in the context of South African law.

Firstly, it summarises and critically assesses the key components of the PPT by laying out the guidance provided on these features by the OECD, as well as the criticisms thereof by academics and scholars from around the globe who specialise in international tax.

Secondly, this research report attempts to address how South Africa might attempt to approach the interpretation of the PPT with reference to the ordinary principles of tax treaty interpretation and principles established by South African courts in interpreting the provisions of the South African GAAR.

Lastly, this research report discusses an example about how the PPT might be applied in practice. In this regard, an analysis of a judgment handed down in the U.S. will be considered, which dealt with the application of a tax treaty principle included in certain U.S. tax treaties that strongly resembles the characteristics of the PPT and demonstrates how the relevant tax authority applied the test. In addition, the judgment highlights the role of the judiciary with respect to the review processes relating to decisions made by tax authorities under tax treaty provisions.

1.4 **Delimitations of the research**

This research report is limited to the following:

i. a brief overview of the objectives of the BEPS Action Plan and a summary of the introduction of the MLI into the international tax realm. This research report does not attempt to critically analyse the operation of the MLI, nor does it make any submissions detailing whether or not the MLI is anticipated to be successful in its attempt to simplify bilateral negotiations and hardcode the minimum standards into law;

ii. a discussion of the main features of the PPT, including inter alia, a critical analysis of the meaning of the phrase 'one of the principal purposes' and the reasonability test that is encapsulated in the PPT. This discussion does not attempt to critically discuss each feature of the PPT, for instance, the meaning of the terms and phrases 'benefit', 'that resulted directly or indirectly in that benefit' and 'arrangement or transaction';

iii. an overview of the South African GAAR is set out, however, a detailed critical discussion of each requirement of the GAAR is beyond the scope of this research report. The most recent approach of South African courts to a purposive interpretation of statutes is mentioned. No discussion is however included on the background to or different methods of interpreting statutes in South Africa;

iv. the interrelationship of domestic GAARs and treaty provisions will be highlighted. The argument that ensues focuses on whether the South

African GAAR should (or can) be used as a tool for interpreting the PPT. This research report makes brief mention of how Canada and the UK are intending to approach the PPT in the context of each country's domestic GAAR. These two jurisdictions are considered because, like South Africa, they are commonwealth jurisdictions with domestic GAAR legislation (which includes reasonableness tests) and can consequently be likened to South Africa from a GAAR perspective. The author was unable to undertake a thorough comparative analysis given the limitation of foreign resources available to date, for reasons such as restricted access to certain international data bases and journals, as well as copyright laws. Furthermore, this research report is limited to a discussion of GAARs and no discussion about SAARs is undertaken (including any discussion of the concurrent operation of GAARs and SAARs in a domestic and / or tax treaty context); and

v. finally, for practical purposes, this research report discusses a case decided in the U.S. dealing with the application of a treaty principal purpose test that is analogous to the PPT. This research report does not claim that this will be the approach followed when applying the PPT. The discussion is merely used as an illustrative example of how the test may be applied in the future.

1.5 **Research Methodology**

A qualitative approach is adopted in this research report, which will be achieved mainly by an examination of the available literature on the subject matter. Specifically, an extensive critical literature review of various publications made available by the OECD, as well as secondary data sources is undertaken to address the objectives and purpose of this research report as set out in in the statement problem and the sub-problems. Various internet websites have also been consulted in order to obtain current information.

The study will also be descriptive and analytical in nature as it attempts to describe various concepts, such as the BEPS concept, with specific focus on the PPT and MLI.

This research approach aims to develop a comprehensive theoretical framework against which the statement problem and sub-problems can be addressed and tested.

1.6 Chapter outline

This section contemplates on a high-level basis, the most important considerations that will be discussed in each chapter of the research report.

Chapter 2 aims to provide an overview of the PPT in the context of tax treaties. Specific reference is made to the guidance provided by the OECD on the interpretation and understanding of this principle. Furthermore, various features of the PPT are critically assessed by discussing the opinions and views of various international tax scholars and academics. This discussion will delve into how the phrase 'one of the principal purposes' is understood amongst international scholars and academics as well as an analysis of how the reasonableness test in the PPT should be applied.

Chapter 3 aims to provide a background to domestic GAARs and how they are intended to operate in the context of tax treaties, with specific focus on the PPT, which is perceived to be a treaty GAAR. This chapter will briefly discuss the provisions of the South African GAAR and whether the various components of the PPT can be reconciled with those of the South African GAAR in an attempt to assist with interpreting the requirements of the PPT.

Chapter 4 discusses a recent judgment handed down in the U.S. District Court for the District of Columbia, which focuses on the judiciary reviewing a decision taken by the U.S. tax authorities in determining whether a company relocated its jurisdiction of residence for purposes of obtaining a treaty benefit. Although this decision does not deal with the application of the PPT in the context of the Action 6 Report or MLI, it deals with a similar provision included in certain U.S. tax treaties, which provides the U.S. tax authority with the discretion to allow certain benefits under a tax treaty if it concludes that 'one of the principal purposes' for entering into the transaction was not to obtain a tax benefit. The judgment is used as a guide as to how the PPT might be applied and the role of the judiciary in assessing decisions made by tax authorities. In no way does the author submit that this decision will be binding on any jurisdiction when applying the PPT.

The concluding chapter will briefly collate the observations and findings of the previous chapters and provide a synopsis in order to appropriately address the problem statements without clinically addressing each specific issue independently.

2. Chapter 2: Overview of the PPT

2.1 Background to GAARs and treaty abuse

Prior to the introduction of the BEPS Action Report and MLI, the approach that was followed by the OECD to tackle treaty abuse in the form of GAARs was set out in the 2003 Commentary.[34] The recommended approach for disallowing treaty benefits where abuse is present is twofold in nature. In the first instance, countries are generally entitled to elect either to rely on their domestic GAARs, or alternatively, to apply the principle of good faith as enshrined in Article 31 of the VCLT.[35] The principle of good faith is premised on the notion that application of tax treaty provisions is subject to an unwritten prohibition of abuse, which relies on the object and purpose of treaties as well as the obligation to interpret them in good faith.[36] The first leg of the assessment could ultimately be based on domestic law or could have an international tax treaty flavour.[37] Under both approaches, countries are not required to grant the benefits of a tax treaty where arrangements that constitute an abuse of the provisions of the treaty have been entered into.[38]

In the 2003 Commentary, the OECD cautions that it should not be 'lightly assumed' that a taxpayer is entering into an abusive transaction.[39] Consequently, the second leg of the assessment is founded on the so called 'guiding principle', which provides that 'the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.'[40]

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34 Danon RJ , 2018, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' *Bulletin for International Taxation,* vol.72, no.1, 2018, p. 36, https://online.ibfd.org/kbase/#topic=doc&url=/collections/bit/html/bit_2018_01_int_2.html.

35 ibid, p.37.

36 ibid.

37 ibid, p.36.

38 OECD, *Model Tax Convention on Income and on Capital: Condensed Version 28 January 2003*, (OECD 2003 Commentary) OECD Publishing, 2003, p.54, paragraph 9.4.

39 ibid.

40 ibid.

Ultimately, the 'guiding principle' comprises of a subjective (a main purpose) and objective (more favourable tax position) requirement. It is commonly known that the nature and function of the 'guiding principle' as encapsulated in the 2003 Commentary is however contentious given that there is no clear guidance provided on its nature, role and application.[41] Danon states that there is uncertainty on whether the 'guiding principle' is viewed as a treaty GAAR or more a representation of a general standard imposed, which countries are required to comply with when denying treaty benefits on the basis of a domestic GAAR, or a treaty GAAR.[42]

As a result of the uncertainty stemming from the 'guiding principle', the OECD essentially codified the 'guiding principle' by creating the PPT as set out in the Action 6 Report, Article 7(1) of the MLI and the new Article 29(9) of the OECD 2017 Commentary. In Danon's view, the PPT can be viewed as a genuine form of treaty GAAR.[43]

Notwithstanding the above, the OECD expressed in the 2017 Commentary that the application of the PPT and 'guiding principle' will continue to co-exist. Moreover, the OECD provided that even in instances where a tax treaty does not contain a PPT, benefits could still be directly denied on the basis of the 'guiding principle' as the 'guiding principle' applies independently from the PPT, which merely confirms it.[44] This passage is indicative of the synonymous nature of the 'guiding principle' and PPT, as it appears that the OECD equates these two concepts as being one and the same with respect to the scope and nature. Furthermore, it is evident from the OECD's perspective that the PPT has been in existence in a nonconcrete form for a considerable amount of time and is therefore not a new concept that has been introduced into international tax policy.

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41 Danon RJ ‘Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups’, op. cit., p37.

42 ibid.

43 ibid.

44 OECD, OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017 21 November 2017*, (2017 Commentary) OECD Publishing, 2017, p.73, paragraph 61 of the commentary on Article 1 http://dx.doi.org/10.1787/mtc_cond-2017-en.

2.2 Introduction of the PPT

In order to prevent the granting of treaty benefits in inappropriate circumstances, the OECD notes in the Action 6 Report that a distinction should be made between situations where a person attempts to circumvent the provisions of domestic tax law to gain tax treaty benefits (in these instances, treaty shopping must be addressed through domestic anti-avoidance rules)[45] and situations where a person attempts to circumvent limitations provided by the tax treaty itself.[46]

As discussed in paragraph 1.1 above, the OECD recommends that at a minimum level, to protect against treaty abuse, countries should include in their tax treaties an express statement that their common intention is essentially to eliminate double taxation,[47] include LOB provisions to target specific instances of treaty abuse and include one of the following alternatives to tackle general anti-avoidance abuse.[48] The first of these alternatives is to adopt the PPT in isolation. The second alternative is to elect to use the PPT in tandem with either a simplified or detailed LOB provision. The last alternative does not involve the adoption of the PPT, but is rather focused on implementing a detailed LOB provision, supplemented by a mechanism that would deal with conduit arrangements not already dealt with in tax treaties.[49]

Sixty eight of the MLI signatories have opted to adopt the PPT alone to address treaty abuse.[50] This is unsurprising given that the PPT is the only alternative that can satisfy the minimum standard on its own. Thirteen jurisdictions have elected to adopt a combination of the PPT and the simplified LOB clause.[51] Six jurisdictions have decided to adopt the PPT as a transitional measure until such time that bilateral agreements with treaty partners are renegotiated to adopt a

45 OECD, *Action 6 Report*, op.cit., p.17.

46 ibid.

47 OECD, *Action Report*, op. cit., p.19, paragraph 22.

48 OECD, *Action 6 Report,* loc. cit.

49 ibid.

50 Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', op.cit. p.6, cited in Danon RJ & Salome H, 'MLI Summary table'.

51 ibid.

LOB clause or a combination of the PPT and LOB clause in its place.[52] This research report is limited to a discussion of the PPT and any further discussion on the alternative two options is beyond the scope of this report.

As mentioned above, the PPT rule is set out under Article 7(1) of the MLI, Article X of the Action 6 Report and the new Article 29(9) of the OECD 2017 Commentary. The MLI and *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI Explanatory Statement) do not provide practical guidance on the interpretation and application of the PPT, but rather set out what the PPT is and the attendant provisions that should be included in tax treaties, in addition to clarifying the operation of the MLI to modify Covered Tax Agreements.[53]

The MLI Explanatory Statement, however, expressly attributes importance to the Action 6 Report for the purpose of interpreting the MLI in the following passage:

> Accordingly, the provisions contained in Articles 3 through to 17 [of the MLI] should be interpreted in accordance with the ordinary principle of treaty interpretation, which is that 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 light of its object and purpose. In this regard, the object and purpose of the Convention is to implement the tax treaty-related BEPS measures. The commentary that was developed during the course of the BEPS Project and reflected in the Final BEPS Package has particular relevance in this regard (own emphasis).[54]

Given that the OECD has recently released the 2017 Commentary that virtually mirrors the commentary provided on the PPT in Article X (Entitlement to Benefits) in the Action 6 Report, this research report focuses on the more recent commentary provided by the OECD in Article 29 of the 2017 Commentary to provide guidance on the interpretation of the PPT and its practical application.

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52 ibid.

53 OECD, *MLI Explanatory Statement*, op.cit., p.2.

54 ibid.

The 2017 Commentary (and Article X of the Action 6 Report) discusses a number of practical examples to illustrate how the PPT will operate in practice. The OECD specifically caveats, however, that when reading the examples it is essential to remember that the application of the PPT must be determined on the basis of the facts and circumstances of each case.[55] Consequently, these examples are not binding and each arrangement or transaction should be assessed and analysed based on its own particular facts and circumstances, notwithstanding any similarities between the two sets of facts.[56]

It is worth highlighting that Article 7(4) of the MLI (and paragraph 10 of the 2017 Commentary on Article 29) contains an optional discretionary provision which does not constitute a minimum standard but makes provision for an additional discretionary relief clause to be adopted (discretionary relief clause) by parties to tax treaties.[57] Accordingly, a state may elect to include a clause in its tax treaty that will operate in instances where a benefit is denied to a person under the PPT and where the tax authority of that state would have otherwise granted that benefit. The discretionary relief clause provides that a taxpayer may request the relevant tax authority to treat that taxpayer as being entitled to the benefit that was denied or to different benefits under the tax treaty.[58] The tax authority may grant that benefit or different benefits if it is determined that such benefit or benefits would have been granted to that person in the absence of the transaction or arrangement referred to under the PPT after considering the relevant facts and circumstances.[59] The tax authority of the state to which the request has been made must also consult with the tax authority of the other state before rejecting a request made under this clause.[60]

[55] OECD, *2017 Commentary*, op.cit., p,591, paragraph 182 of the commentary on Article 29.
[56] ibid.
[57] OECD, *2017 Commentary*, op.cit., p.600, paragraph 184-185.
[58] ibid.
[59] ibid.
[60]ibid.

2.3 Critical analysis of the PPT with reference to guidance provided by the OECD

The standard wording of the PPT is encapsulated in article 7(1) of the MLI and provides as follows:

> Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.[61]

The wording of the PPT as set out above is analogous to the wording provided in paragraph 9 in Article 29 of the 2017 Commentary and is also in line with the wording of the minimum standard set out in Article X of the Action 6 Report. Consequently, in order for the PPT to be satisfied and find application the following requirements must be present:

i. an arrangement or transaction must be present;

ii. which directly or indirectly results in a benefit under a tax treaty;

iii. which was set up for one of the principal purposes of obtaining that benefit; and

iv. it is not proven that granting the benefit is in line with the object and purpose of the relevant provisions of the tax treaty.

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[61] OECD, Article 7(1) of the MLI, at pp 8-9. Article 2(1)(a) of the MLI defines 'Covered Tax Agreement' to mean 'an agreement for the avoidance of double taxation with respect to taxes on income (whether or not other taxes are also covered):

i) that is in force between two or more:

A) Parties; and/or

B) jurisdictions or territories which are parties to an agreement described above and for whose international relations a Party is responsible; and

ii) with respect to which each such Party has made a notification to the Depositary listing the agreement as well as any amending or accompanying instruments thereto (identified by title, names of the parties, date of signature, and, if applicable at the time of the notification, date of entry into force) as an agreement which it wishes to be covered by this Convention.'

It is essential that the elements of the PPT are understood and interpreted correctly and uniformly so that that there is no uncertainty surrounding its interpretation or the range and scope of its application. Consequently, this research report attempts to critically interpret and analyse the provision with specific reference to the guidance provided by the OECD in the OECD 2017 Commentary, read with Article X of the Action 6 Report. Given the all-encompassing nature of the PPT, this research report will not scrutinize all of the elements to the PPT but will rather focus on the controversial aspects of the PPT which have already given rise to confusion and debate among scholars and academics. These aspects include the following:

i. the meaning of 'one of the principal purposes';

ii. the meaning and effect of the words 'reasonable to conclude', which includes a discussion of the nature of the test and a discussion on the standard of proof;

iii. the interpretation of the requirement requiring the benefit to be in accordance with the object and purpose of the relevant provisions of the tax treaty; and

iv. the procedural practical application of the PPT.

2.3.1 Meaning of 'one of the principal purposes'

The 2017 Commentary provides that the term 'one of the principal purposes' essentially means that 'obtaining the benefit under a tax treaty need not be the sole or dominant purpose of a particular arrangement or transaction.[62] It is sufficient to satisfy the PPT that at least one of the principal purposes was to obtain the benefit.'[63]

One of the examples provided in the 2017 Commentary envisages a person selling a property for various reasons and notes that if before the sale that person becomes a resident of one of the contracting countries and one of the principal purposes for doing so was to obtain a benefit under a tax treaty, the

[62] OECD, *2017 Commentary*, op.cit., p.593, paragraph 180 of the commentary on Article 29.
[63] ibid.

PPT could apply, notwithstanding there being other principal purposes for changing residence, such as facilitating the sale of the property or the re-investment of the proceeds of the alienation.[64]

The OECD provides that a purpose is not a principal purpose when, after considering all the relevant circumstances it is reasonable to conclude that 'obtaining the benefit was not a principal consideration and would not have justified entering into any arrangement or transaction that has, alone or together with other transactions, resulted in the benefit. In particular, if an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit'.[65]

Criticism is advanced against the broad drafting of the PPT, which appears to result in a dangerously low threshold for transactions or arrangements to be denied tax treaty benefits as a result of treaty abuse.[66] Many academics interpret the wording of the PPT to essentially mean that where there are two equally important reasons to establish an arrangement or carry out a transaction, one being a tax related reason that arises pursuant to obtaining treaty benefits, and the other being a non-tax related commercial reason, the PPT would probably apply, given that one of the two principal purposes is to obtain a treaty benefit.[67]

In Kazaco's view,[68] the use of the words 'one of' the principal purposes is analogous to 'a principal purpose' and is consequently too broad to properly capture genuine treaty abuse.[69] A stringent interpretation and application of the PPT could consequently have detrimental results and impact the growth of multinational enterprises, which could potentially be counter-intuitive to the very

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[64] ibid. See also OECD, Action 6 Report, op.cit., p. 58, paragraph 12 of Article X.

[65] OECD,*2017 Commentary,* op.cit., p.591, paragraph 181.

[66] Kuźniacki B, 2018, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', *World Tax J*ournal, vol. 10, no.2, at p.13.

[67] ibid.

[68] Kazacos A, 2016, 'BEPS Action 6: The principal purpose test revisited – Part I', *International Tax Report* [online journal], http://www.internationaltaxreport.com/double-taxation/beps-action-6-the-principle-purpose-test-revisited–part-i–1.htm.

[69] ibid.

existence of tax treaties.[70] Moreover, the rationale for entering into tax treaties is to encourage taxpayers to engage in business and make investments in various countries. Consequently, if the PPT is construed too broadly, it could potentially result in the very purpose for implementing tax treaties becoming redundant. It is therefore crucial that a balance is achieved between eliminating double taxation and preventing treaty abuse.[71]

In Weber's view,[72] although there is nothing to show that the OECD modelled the PPT on the UK GAAR, both their purpose and reasonableness tests are strikingly similar. This is unsurprising given that the UK played an active role in assisting the OECD with the BEPS initiative.[73] The UK GAAR was introduced in Chapter 5 of the FA during 2013. Section 207(1) of the FA provides that 'arrangements are "tax arrangements" if, having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements'. The wording 'main purpose, or one of the main purposes' under the UK GAAR is substantially similar to the wording under the PPT which requires 'one of the principal purposes' to secure a benefit. Consequently, the *HM Revenue and Customs (HMRC) General anti-abuse rule guidance (Approved by the GAAR Advisory Panel with effect from 28 March 2018)* (HMRC Guidance) may be a useful supplementary (ancillary to the OECD guidance) tool to assist with interpreting and understanding the meaning of 'one of the main purposes'.[74]

The HMRC Guidance provides that:

i. The GAAR legislation does not define the meaning of the phrase 'the main purpose' or 'one of the main purposes', consequently, these expressions

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[70] ibid.

[71] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', loc. cit.

[72] Weber D, 2017, 'The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law', *Erasmus Law Review*, vol. 1, p.51.

[73] Mike Williams of HM Treasury plays an important role in guiding the UK's international tax policy was the chairman of the BEPS Action 15 working group, who brought around 100 countries to a consensus position on the development of the MLI.

[74] HM Revenue and Customs, *HM Revenue and Customs (HMRC) General anti-abuse rule guidance (Approved by the GAAR Advisory Panel with effect from 28 March 2018)* (HMRC Guidance), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/695255/gaar_parts_a_b_c_2018.pdf.

should be given their normal ordinary meaning and have to be applied objectively, with regard to the full context and facts.[75]

i. It is usually clear whether trying to obtain a tax advantage is the 'main purpose' of a particular transaction, however, determining whether obtaining a tax advantage is ‘one of the main purposes’ is more difficult. This test attempts to establish 'whether a transaction which would otherwise have occurred has been reshaped, or has been entered into under different terms and conditions, in order to change significantly the tax result that would otherwise have arisen, and where the desired tax result is itself a substantial objective.'[76] It is highlighted that the differences may be subtle.[77]

ii. Obtaining tax advice is not, on its own, indicative that obtaining a tax advantage is a main purpose of the agreement. Where significant amounts are at stake, most taxpayers will routinely seek tax advice.[78]

It is unclear how this interpretation of 'one of the principal purposes' test will operate in practice, especially given that tax considerations are often one of the biggest deal drivers and a primary concern for companies wishing to enter into transactions, as businesses will generally take tax considerations into account before deciding to proceed with a certain arrangement.[79] The question that arises is when this particular consideration will be regarded as 'one of the principal purposes'[80]. Kazacos is of the view that to deny tax treaty benefits to companies engaging in transactions without a strong focus on the tax implications would be to deny the practical reality of how businesses function.[81] The OECD is silent on providing any criteria to apply in distinguishing between

[75] HM Revenue and Customs, *HMRC Guidance*, op.cit., p.20, paragraph C3.4.

[76] HM Revenue and Customs, *HMRC Guidance*, op.cit., p.20, paragraph C3.5 and C3.6.

[77] ibid.

[78] ibid.

[79] Kazacos A, 'BEPS Action 6: The principal purpose test revisited – Part I'. loc. cit. See also, Bhargava A, ‘The Principal Purpose Test: Functioning, Elements and Legal Relevance’, in Blum and Seiler (eds.), *Preventing Treaty Abuse, Series on International Tax Law*, 2016, p. 318, where Bhargave submits that taxpayers generally gear arrangement or transactions to be most efficient as it is common cause for transactions to be structured in such a way that taxes are reduced to a minimum and consequently arguments submitted by taxpayers alleging that arrangement or transactions were motivated by commercial business reasons would be difficult to prove in practice.

[80] ibid.

[81] ibid.

main purposes and ancillary purposes as well as differentiating main purposes from each other.[82] In addition, no guidance is provided on the method and process to be applied in ranking those purposes. The lack of guidance on this substantial element of the PPT is unfortunate, especially since the application of the PPT and the legal consequences thereof are dependent on its application.[83]

The guidance provided by the OECD on the meaning of 'one of the principal purposes', vaguely attempts to illustrate what a principal purpose is.[84] After considering these examples it seems that there would not be principal purpose to obtain a benefit where:

i. it was not a principal consideration that would have justified the implementation of a transaction or arrangement; and

ii. where certain actions were inextricably linked to a core commercial activity.[85]

Danon expresses the view that when one considers the examples provided in the 2017 Commentary, the literal wording of the PPT is given nuance and could potentially infer that the requirement 'one of the principal purposes' is less than what it appears to be on the literal interpretation of the PPT wording.[86] The author agrees with this submission, on the literal reading of the PPT, its requirements appear to be extremely stringent, however, when interpreting the PPT in the context of the 2017 Commentary and the examples provided therein, the effect and application of the PPT appear to be less severe that initially thought.

Example C of the 2017 Commentary provides as follows:

> Example C: RCO, a company resident of State R, is in the business of producing electronic devices and its business is expanding rapidly. It is now

[82] Lang M, 2014, 'BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties' *Tax notes international*, vol.74, no.7, p.659.

[83] ibid.

[84] ibid.

[85] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', loc. cit.

[86] Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups', op cit., p.48.

> considering establishing a manufacturing plant in a developing country in order to benefit from lower manufacturing costs. After a preliminary review, possible locations in three different countries are identified. All three countries provide similar economic and political environments. After considering the fact that State S is the only one of these countries with which State R has a tax convention, the decision is made to build the plant in that State.[87]

In this example, the OECD provides that whilst the decision to invest in State S is taken in the light of the benefits provided by the State R-State S tax convention, it is clear that the principal purposes for making that investment and building the plant are related to the expansion of RCO's business and the lower manufacturing costs of that country. In this example, it cannot reasonably be considered that one of the principal purposes for building the plant is to obtain treaty benefits. In addition, given that a general objective of tax conventions is to encourage cross-border investment, obtaining the benefits of the State R-State S convention for the investment in the plant built in State S is in accordance with the object and purpose of the provisions of that convention.[88]

In light of the above example, Danon highlights the fact that the ultimate decision to choose the country that had concluded a tax treaty with State R was ignored and did not invoke the application of the PPT.[89] The author submits that this example demonstrates that the commercial rationale for entering into the transaction was the principal purposes of the transaction, while implicitly, the decision to choose a jurisdiction that had a tax treaty (where tax benefits would be derived) appears to be an ancillary purpose.

Danon is of the opinion that treaty benefits should not generally be denied when genuine business activities have taken place, moreover, the 2017 Commentary seems to support the importance of substance and genuine activities.[90] This conclusion is supported by several passages in the 2017 Commentary, one example being demonstrated in the text:

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[87] OECD, *2017 Commentary,* loc.cit.

[88] OECD, *2017 Commentary,* loc cit.

[89] Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups', op cit., p48.

[90] ibid.

> … where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit.[91]

The author submits that the above wording provides a powerful argument for tax treaty benefits not being disallowed in instances where genuine commercial activities have taken place. More uncertainty however arises with regard to the meaning of the word 'form' as the OECD has provided no guidance on the meaning. The author is of the view that the word 'form' will probably be interpreted broadly and generally relates to the manner in which a transaction is implemented, for example, whether to incorporate a branch or subsidiary company, to utilise debt funding or equity funding or whether an intermediary company should be inserted or not.

Danon expresses the view that although there is a perceived discrepancy between the literal interpretation of the PPT and the contextual analysis under the 2017 Commentary, the contextual analysis will have minimal bearing on the PPT as soon as it is detached from the 2017 Commentary and consequently the literal interpretation will probably be followed and may lead to uncertainty and give rise to international tax treaty disputes.[92]

Chand notes that if the proper objective factual analysis into all facts and circumstances leads to the conclusion that non-tax purposes outweigh tax purposes, then the taxpayer does not satisfy the subjective purpose test and will consequently fall outside the scope of the PPT.[93] Therefore, if non-tax purposes are primary drivers of the transaction, then it cannot be argued that one of the principal purposes of the transaction is to obtain a tax benefit and consequently, the PPT is interpreted in a restrictive manner.[94] Although this interpretation seems to be correct, the question that arises is how one will

[91] OECD, *2017 Commentary*, p.592, paragraph 181.

[92] Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups', op cit., p32.

[93] Chand V, 2018, 'The Principal Purpose Test in the Multilateral Convention: An in-depth Analysis', *Intertax, vol.46*, issue 1, p.23.

[94] ibid.

determine the 'weight' of each purpose of the arrangement or transaction. This question is addressed in further detail under paragraph 2.3.2 below.

Many academics are of the view that the PPT should rather encompass a test that determines whether 'the sole or dominant purpose' of the transaction was to obtain a treaty benefit, so that transactions that do not have a treaty abuse motive, but are in reality pragmatic cross-border business dealings, are not disqualified from obtaining benefits under the relevant treaty.[95]

If the OECD had chosen one of the above mentioned alternative tests, the application of the PPT would have a clearer scope with refined limits. Kok is of the opinion that if one of these other tests were chosen, it would be harder to argue that a taxpayer is abusing a tax treaty if there are two equally important motives for implementing the transaction, one tax reason and one commercial reason.[96] Kok further submits that in these instances the PPT could find application since the tax reason would be considered as 'one of the principal purposes of the transaction'[97]. The author is of the view that this statement is completely dependent on the set of facts at hand. Furthermore, in practice, tax is generally not the core driver for implementing transactions. Tax considerations are usually factors that are taken into account after the initial rationale for entering into a transaction has been established and when determining how to implement the transaction in a tax efficient manner. The question that then arises is at what point would structuring a transaction in the most tax efficient manner satisfy the PPT threshold.

2.3.2 Analysis of the meaning and effect of the words 'reasonable to conclude'

The 2017 Commentary provides that 'an objective analysis is required to determine of whether or not 'one of the principal purposes' of an arrangement or

[95] Kazacos A, 'BEPS Action 6: The principal purpose test revisited – Part I', loc.cit; Kuźniacki, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', op. cit. 16.

[96] Kok.R, 2016, 'The Principal Purpose Test in Tax Treaties under BEPS 6' *Intertax*, vol, 44, no 5, p.408, http://www.google.co.za/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0ahUKEwjM6tb1gabaAhXLK8AKHUREAekQFggIMAA&url=http%3A%2F%2Fwww.ey.com%2FPublication%2FvwLUAssets%2FEY-the-principal-purpose-test-in-tax-treaties-under-BEPS-6%2F%24File%2FEY-the-principal-purpose-test-in-tax-treaties-under-BEPS-6.pdf&usg=AOvVaw31K9od_MeafzkF34ZrWFPY

[97] ibid.

transaction is to obtain benefits under a treaty.'[98] The OECD articulates that it is important to undertake an objective analysis of the aims and objects of all persons involved in that arrangement or transaction.[99] In addition, the determination of the purposes for an arrangement or transaction is a question of fact and can only be addressed by considering the circumstances surrounding the arrangement or event on a case-by-case basis.[100]

The 2017 Commentary provides that it is unnecessary to find conclusive proof of the intent of persons involved with an arrangement or transaction, however, after an objective analysis it must be reasonable to conclude that one of the principal purposes was to obtain a benefit from the tax convention. This conclusion should not be lightly assumed and merely reviewing the effects of an arrangement should not generally enable a conclusion to be drawn about its purposes.[101] In instances where an arrangement can however only be reasonably explained by a benefit that arises under a treaty, it may be concluded that one of the principal purposes of that arrangement was to obtain such benefit.[102] Furthermore, a person cannot simply assert that the arrangement was not entered into to obtain the benefits of a tax treaty. All of the evidence must be weighed up to determine whether it is reasonable to conclude that an arrangement or transaction was undertaken for such purpose. This determination requires reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered.[103]

The OECD provides that if the facts and circumstances of a particular transaction or arrangement reveal that the arrangement has been entered into for the principal purpose of obtaining similar benefits under a number of tax treaties, it should not be considered that obtaining a benefit under one specific treaty was not one of the principal purposes for that arrangement. Similarly,

[98] OECD, *2017 Commentary,* op.cit, p.590, paragraph 178.
[99] ibid.
[100] ibid.
[101] ibid.
[102] ibid.
[103]ibid.

purposes related to the avoidance of domestic law should not be used to argue that obtaining a treaty benefit was merely accessory to such purposes.[104]

The focal requirement of the PPT is to test what the purpose for entering into the transaction or arrangement was, as per the wording of the PPT provision in paragraph 9 of the 2017 Commentary. It is somewhat unclear whether the test under the PPT is an object test, subjective test or combination thereof. This aspect of the provision has brought about much academic discussion and debate.

Some academics are of the opinion that when determining whether an arrangement was entered into for purposes of obtaining a benefit under a tax treaty, a subjective analysis should be undertaken, which becomes difficult to prove[105] as it is almost impossible to verify the intention of a taxpayer or participant to the arrangement or transaction. Lang submits that although the Action 6 Report (or paragraph 9 of Article 29 of the OECD 2017 Commentary) discusses the need to carry out an 'objective analysis of the aims and objects of all persons involved,' the rationale for this objective assessment is to draw conclusions regarding the intention of the taxpayer or participant to the arrangement or transaction, and although a subjective intention can always be deduced by considering external facts, such deduced intention is impossible to prove and for this reason legislators generally abstain from attaching fiscal consequences to the existence of such an intention.[106] Pinetz expressed the opinion that:

> objective facts may give only indications as to the motives behind certain behaviour, but proving a certain motivation or that a certain motivation did not exist is hardly possible.[107]

When asserting and applying the PPT, the domestic tax authority must draw the conclusion and justify whether it is 'reasonable to conclude'[108] that one of the

[104] ibid.

[105] Lang M, 2014, 'BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties' *Tax notes international,* vol.74, no.7, p 658.

[106] ibid.

[107] Pinetz E, 2016, 'Final Report on Action 6 of the OECD/G20 Base Erosion and Profit Shifting Initiative: Prevention of Treaty Abuse' *Bulletin for International Taxation*, vol.79, no.1 / 2.

principal purposes of the taxpayer was to obtain the benefits of the tax treaty. The standard of proof would be too challenging if domestic tax authorities were required to furnish concrete proof that one of the main objectives of entering into the arrangement or transaction in question was to obtain a tax benefit.[109] Conversely, if so required, it would also be extremely difficult for the taxpayer or participant to the arrangement in question to furnish evidence that the benefit was not one of the primary motives for implementing the transaction.[110] Consequently, in Lang's opinion, the standard of proof is not extensive, as domestic tax authorities are not required to provide complete evidence on its conclusions because the wording 'reasonable to conclude' should not be construed as being demanding, as all that is essentially required is for that outcome or conclusion to be ‘reasonable’ as opposed to for instance being compelling.[111] Lang concludes that:

> in practice, furnishing evidence of the motive will therefore not be relevant, but tax authorities will be tempted to presume intention simply because of the presence of a benefit. For this reason alone, the subjective criterion runs the risk of not gaining any significance in itself.[112]

Lang's interpretation and application of the PPT is followed by a number of academics. Bhargava's view seems to be in line with that of Lang insofar as the author is of the view that the tax authorities will generally find it easy to prove that obtaining a benefit was one of the principal purposes of an arrangement or transaction, given that the threshold of 'reasonable to conclude' is set very low.[113] Consequently, the tax authorities are in a favourable position because the requisite analysis will ultimately lead to the presumption that minimising

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[108] The 'reasonable to conclude' requirement under the PPT is often referred to as the 'reasonableness test'.

[109] Lang M, 'BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties', op. cit., p.658.

[110] ibid.

[111] ibid. See also, De Broe. L & Luts. J, 'BEPS Action 6: Tax Treaty Abuse', *Intertax*, issue 2, 2015, p. 124, where De Broe and Luts state that 'the threshold is set extremely low: it is not required for them to establish’ (beyond reasonable doubt) that obtaining a treaty benefit was one of the principal motives. Rather, it suffices that "it is reasonable to conclude" that such motives were present.'

[112]ibid.

[113] Bhargava A, ‘The Principal Purpose Test: Functioning, Elements and Legal Relevance’, loc.cit.

taxes was one of the principal purposes of the transaction and therefore the subjective reasonableness test is meaningless.[114]

On the other hand, several academics dismiss the above interpretation of the reasonableness test and provide that the wording ‘reasonable to conclude’ is not a purely subjective test but rather a subjective test (the principal purpose) that is then objectified by the reasonableness test (it is reasonable to conclude).[115] The 2017 Commentary notes that ‘the determination requires reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered’. In Weber's view, this phrase should be interpreted in such a way that a reasonable third party would have interpreted those facts and circumstances in the same way and consequently, the analysis of the facts and circumstances in objective in nature.[116]

As discussed above, the 2017 Commentary provides that that all relevant facts and circumstances ‘must be weighed' to determine whether it is reasonable to conclude that an arrangement or transaction was undertaken or arranged to obtain a benefit. Weber opines that the wording ‘be weighed’ can only be given substance in instances where the relevant tax authorities provide guidance and rationalise how the various facts and circumstances relate to one another.[117]

In addition, the contrary view provides that the phrase 'reasonable to conclude' does not refer to the standard of proof or weight of the burden of proof on the tax authorities in determining whether one of the main purposes for entering into the transaction or arrangement was to obtain a benefit.[118] Moreover, it is submitted that the meaning of phrase 'reasonable to conclude' actually means the tax authority must assess the arrangement or transaction in question by

[114] ibid.

[115] Weber D, 'The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law', op.cit. p.49.

[116] ibid.

[117] ibid, p.50.

[118] ibid.

undergoing an objective analysis of weighing up all the facts and circumstances.[119]

The 2017 Commentary uses the phrases such as 'it should not be lightly assumed' and that 'merely reviewing the effects of an arrangement will not usually enable a conclusion to be drawn about its purposes'.[120] Weber highlights that these words are indicative that the relevant tax authorities may not simply accept that the principal purpose of an arrangement is to obtain a tax treaty benefit and they may not only point out the effects of the arrangement in their assessment so to come to that conclusion.[121] More specifically, the relevant tax authorities may not highlight a substantial tax benefit and use that benefit to draw the conclusion that obtaining that benefit was one of the principal purposes of an arrangement or transaction.[122] On the other hand and in accordance with the 2017 Commentary, Weber states that a person cannot avoid the application of the PPT by 'merely asserting that the arrangement or transaction was not undertaken or arranged to obtain the benefits of the Convention' as well as there always being valid commercial reasons for entering into a transaction or arrangement.[123] Weber concludes that although there is uncertainty about how much weight should be placed on the relevant tax authorities' assessment and what the taxpayer asserts, it is clear that the application of the PPT requires a thorough study of the facts and circumstances, and that nothing may be based on assumptions.[124]

It is common for reasonableness tests to be included in domestic GAARs in common-law countries.[125] As discussed under paragraph 2.3.1 above, Weber highlights that the reasonableness tests under the PPT and UK GAAR are substantially similar. In this regard, and in relation to the application of the

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[119] Weber D, 'The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law', loc.cit.; Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', loc.cit.

[120] OECD, *2017 Commentary*, op.cit.,p.590, paragraph 178.

[121] Weber D, 'The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law'op. cit. 49.

[122] ibid.

[123] ibid.

[124] ibid.

[125] ibid.

reasonableness test, the HMRC Guidance provides that the expression 'reasonable to conclude' shows that there is an objective test, in terms of which, it is unnecessary to enquire whether the taxpayer actually had the intention of obtaining a tax benefit. In practice however, it would be extremely uncommon to be faced with a situation where objectively obtaining a tax benefit appeared to be one of the main purposes of a transaction but the participants did not subjectively have such objective in mind.

2.3.3 **The object and purpose of the relevant provisions**

Subsequent to tax authorities being able to reasonably conclude that 'one of the principal purposes of a taxpayer's arrangement or transaction is to obtain treaty benefits', the taxpayer may still have an opportunity to obtain that benefit if the taxpayer can establish that granting the benefit would be in accordance with the object and purpose of the relevant provisions of the tax treaty.[126] This requirement could be viewed as a broadly drafted exception to the application of the PPT.[127]

In terms of the 2017 Commentary, the objective test allows the taxpayer, whose claim to obtain a benefit was refused, to establish that granting that benefit in circumstances at hand would be following the object and purpose of the relevant provisions of the treaty.[128] Accordingly, the taxpayer bears the burden of demonstrating that a treaty benefit is in accordance with the object and purpose of the relevant treaty provisions.

De Broe and Luts state that:

> the PPT 'inconspicuously alters the division of the burden of proof regarding treaty abuse. Under the previous 'guiding principle', it was common ground that the tax authorities of the State desiring to refuse treaty benefits carry the burden of proving that both the subjective and objective element of abuse are fulfilled.

[126] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application' op.cit., p16.

[127] ibid.

[128] OECD, *2017 Commentary*, op.cit., p.588, paragraph 170.

> …Under the proposed PPT, the tax authorities are still obliged to 'prove' the presence of the subjective element, but only this.'[129]

The question that arises is whether the PPT introduces a 'one-sided purposive interpretation' by requiring only the taxpayer to take into account the purpose of the relevant provision.[130]

Some scholars seem to have implicitly accepted that this is the approach and consequently suggest that the tax authorities of contracting states, as negotiators of treaties, are in a better position to determine the object and purpose of each provision, and the burden of proof should consequently rather rest on the tax authorities.[131]

Kuźniacki expresses the opinion that this is positively not the case as this would result in the PPT overriding the rule of interpretation under article 31(1) of the VCLT,[132] which, as discussed in paragraph 2.1 above, provides that tax treaties should be interpreted in good faith in the context of the object and purpose of the treaty. Moreover, tax authorities must assess the taxpayers' purpose for entering into an arrangement or transaction to establish in the context of whether those reasons are consistent with the purpose of the tax treaty's provisions.[133]

2.3.4 **Practical application of the PPT**

The 2017 Commentary notes that in certain countries, the application of the GAAR found in domestic law is subject to a form of approval process.[134] In some instances the process provides for an internal acceleration of disputes on such provisions to senior officials in administration.[135] In other cases, the process may allow for advisory panels to provide their views to the

129 De Broe L & Luts J, 2015, 'BEPS Action 6: Tax Treaty Abuse', *Intertax*, issue 2, p.124.

130 Kuźniacki B, op.cit., p16.

131 Jankovic D and Cheng M 'Canada: Application and interpretation of the principal purpose test', 2018 available at http://www.internationaltaxreview.com/Article/3790209/Canada-Application-and-interpretation-of-the-principal-purpose-test.html.

132 Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', op.cit., p.16.

133 ibid.

134 OECD, *2017 Commentary*,op.cit., p.600, paragraph 183.

135 ibid.

administration on the application of the GAAR. The OECD provides that these types of approval processes are indicative of the serious nature of anti-avoidance disputes and aim to promote consistency in the application of the GAAR.[136]

The lack of guidance on the practical application and interpretation of the PPT has been criticised given that the PPT could potentially be subject to abuse. The OECD's lack of guidance has been criticised insofar as the adoption of the PPT is subject to the discretionary interpretation by a domestic tax authority, which could potentially appear to adhere to the minimum standard while in reality no significant limitations on treaty abuse are actually imposed.[137] In addition, the PPT could be manipulated to legitimise the actions of certain states in a tax competition environment.[138] On the other hand, the PPT could be applied so stringently that it could result in treaty relief being denied as a means of preserving a state's own authority to tax a person.[139]

Hattingh submits that the discretion provided to domestic tax authorities under the PPT is very broad in scope compared with domestic GAAR legislation in countries such as, *inter alia*, the UK, India and South Africa and 'in domesticating the international general anti-avoidance measures provided for in the MLI, parity in procedural safeguards should be guaranteed (at least from the perspective of the constitutional democracies used as examples)'.[140] The rationale for this proposal is that there are currently no procedural safeguards that accompany the PPT, including a notification process for the taxpayer or the formation of independent bodies to adjudicate GAAR assessments made by domestic tax authorities in order to hold them accountable for their assessment and ultimate verdict on the application of the PPT.

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136 ibid.

137 Lee CH 'The Principal Purpose Test needs Time', *Michigan Journal of International Law, Perspectives on the Multilateral Instruments 38 MJILDIGTIALSYMPOSIUM 1,* 2017, p.24, http://www.mjilonline.org/wordpress/wp-content/uploads/2017/12/Online-Tax-Symposium-v.4.pdf.

138 ibid, cited in H.J. Ault & B.J. Arnold, *Protecting the Tax Base of Developing Countries: An Overview*, in 'United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries (Alexander Trepelkov et al. eds., 2015).

139 ibid.

140 Hattingh PJ, 2017, 'The Multilateral Instrument from a Legal Perspective: What May be the Challenges?', Bulletin for International Taxation, vol. 71, no. 3/4 pp.1-10.

In Hattingh's view,[141] there should be legal justification or policy considerations introduced in order to regulate the procedures necessary for addressing tax abuse and avoidance in tax treaties.[142] Hattingh notes that in India, an approving panel was established to issue declarations about the 'impermissible' nature of an avoidance arrangement prior to tax assessments being issued based on the GAAR.[143] The UK has also established an independent advisory panel to issue non-binding advisories for instances where the GAAR is proposed to be invoked.[144].

In Canada, the CRA articulated that it would consider establishing a centralized committee (similar to the Canadian GAAR Committee), which would be responsible for the application of the PPT to certain transactions that are suspected of treaty abuse.[145] The CRA submits that the committee will be established as a result of the uncertainty accompanying the PPT and that it will be beneficial for the CRA to administer the PPT in a consistent manner, with some restraint, particularly due to the extensive manner in which the wording of the PPT is capable of being interpreted.[146]

2.4 Critical analysis of the discretionary relief clause with reference to guidance provided by the OECD

The discretionary relief clause provides that countries may allow treaty benefits on the facts, as they would have in the absence of the abusive arrangement or transaction. The 2017 Commentary provides that this discretionary relief clause grants broad discretion to the relevant tax authority for the purposes of these determinations.[147] It is noted that the provision does however require the tax authority to consider the relevant facts and circumstances before reaching a decision and must consult with the tax authority of the other country before

[141] ibid.

[142] ibid.

[143] ibid.

[144] ibid, although certain individuals at SARS are tasked with deciding whether or not GAAR should be invoked, there is no formal centralised committee established in South Africa.

[145] Osler, 'New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?', 2017, https://www.osler.com/en/resources/regulations/2017/new-ppt-rule-in-the-oecd-s-multilateral-instrument.

[146] ibid.

[147] OECD, *2017 Commentary,* op.cit. p.600, paragraph 185.

rejecting a request to grant benefits if that request was made by a resident of the other state. The consultation process does not, however, require the tax authority to which the request was presented to obtain the agreement of the tax authority that is consulted.

The discretionary relief clause will consequently allow a taxpayer to receive full or partial treaty benefits in circumstances where the tax authority agrees that it would be inappropriate to deny all treaty benefits in full under the PPT.[148] The insertion of this clause may consequently mitigate the impact of the PPT's 'all or nothing approach'.[149]

The following practical example can be used to illustrate the application of the discretionary relief clause: Various residents of treaty countries invest in companies in Country A though a holding company established in Country B (a treaty country of Country A) by a private equity fund in Country C (a treaty country to Country B but not to Country A). Under the applicable tax treaty between Country A and Country B a 5% rate of withholding tax on dividends would apply to dividends paid by companies in Country A to the holding company in Country B. If the PPT were to apply and deny all treaty benefits to the holding company, such dividends would be subject to a full 20% withholding tax rate (given that there is no treaty between Country A and Country C). If, however, a discretionary relief provision were to be inserted into the relevant tax treaty the relevant tax authority would be entitled to determine that a reduced withholding tax rate of, say, 15% could rather apply in respect of investors if they had invested into Country A directly (as a result of the tax treaty in those investors' states of resident and Country A).[150]

The application of the discretionary relief clause seems to allow more flexibility in order to ensure that tax results are determined in a manner that is reasonable in the circumstances, which includes a consideration of the tax consequences that would have arisen in the absence of the avoidance arrangement in

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148 Osler, 'New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?', loc.cit.
149 ibid.
150 ibid.

question (i.e. the interposition of a holding company in Country B by a private equity fund in Country C).[151]

A view has been expressed that in certain instances when the PPT is applied and treaty benefits are denied entirely, a country may still grant treaty benefits on the premise of a recharacterised pattern of facts, even if such country has reserved the right to not include the discretionary relief clause in its tax treaties.[152] In Danon's opinion these specific circumstances include, for example, a country such as Switzerland where it has reserved the right not to apply this provision but whose case law and practices regarding arrangements that are abusive support the granting of tax treaty benefits in recharacterised fact circumstances. In the author's view, this contention is debateable as the OECD has not provided definitive guidance or confirmation on this possibility. Consequently, from a tax certainty and policy perspective it would be preferable for countries to include this automatic discretionary relief clause in their tax treaties.[153]

2.5 **Conclusion**

From the above discussion critically analysing certain features of the PPT it is clear that even though the OECD has provided commentary and guidance on this principle in Article X of Action 6 Report and the 2017 Commentary on Article 29 the PPT is still perceived as being an abstruse treaty GAAR with its scope and range of application being uncertain and the subject matter of much debate. The adoption of the PPT will consequently depend largely on the tax authorities' approach, which may vary significantly among tax authorities in various jurisdictions.[154] Notwithstanding the common purpose of the PPT being to improve and enhance international business activity by alleviating double taxation, the varied interpretations of the PPT among jurisdictions may

[151] ibid.

[152] Danon RJ, ‘Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups, loc.cit.

[153] ibid.

[154] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', op.cit., p. 32.

aggravate the uncertainty around the PPT and result in frustration and cross border tax disputes.[155]

The next chapter will focus on how the PPT is likely to be applied in South Africa and whether the South African GAAR can be used to assist in understanding the PPT in a South African context.

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[155] ibid.

3. Chapter 3: The application of the PPT in South Africa

3.1 Introduction

The DTC released its second and final report on BEPS (the DTC Report) on 13 November 2017.[156] The purpose of the DTC Report is to provide recommendations on how South Africa can incorporate the OECD BEPS minimum standards, best practice guidelines and international standards into its international tax framework.[157] It is noteworthy that although South Africa is not a member state of the OECD it obtained observer status in 1998 and is greatly influenced by its policies and guidance.

The DTC Report discusses the feasibility of applying the PPT in South Africa and states that the PPT requires tax authorities to make factual determinations as to 'whether the principal purpose (main purpose) of certain creations or assignment of income or property, or of the establishment of the person who is the beneficial owner of the income, was to access the benefit of a particular treaty.'[158] The DTC Report provides that the actual determination required under the PPT is similar to that required to make an 'avoidance transaction' determination under the South African GAAR contained in sections 80A-80L of the ITA, in particular, whether 'the primary purpose of a transaction (or series of transactions of which the transaction was a part) was to achieve a tax benefit'.[159]

Although the DTC Report seems to summarise the basic characteristic of the PPT, the author submits that this interpretation of the PPT is narrowly construed, for example, the PPT does not require tax authorities to determine 'whether the primary purpose (main purpose)' of a transaction was to achieve a tax benefit, but rather whether obtaining a benefit was 'one of the principal purposes' of the underlying transaction. In addition, the author is of the view that the factual determination required under the PPT may not be that similar to

[156] Davis Tax Committee, 2016, 'Second and Final Report on Base Erosion and Profit Shifting in South Africa.' *Summary of DTC Report on Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstance*, pp.1-104. Although the DTC Report was only published in November 2017, it was drafted in September 2016, prior to South Africa signing the MLI.

[157] ibid, p.6.

[158] ibid, p.102.

[159] ibid.

what is required to make an 'avoidance transaction' determination under the South African GAAR due to the slight differences in wording. This aspect is discussed in more detail below.

The DTC Report provides that since the PPT and South African GAAR serve a similar purpose, the South African GAAR can be applied to prevent the abuse of tax.[160] In the DTC's opinion, the necessity for including the PPT arises in instances where the South African GAAR is applied and results in treaty override.[161] Furthermore, the DTC Report provides that the South African GAAR may have different wording to the GAAR adopted by a treaty partner and consequently it is recommended that South Africa insert a standard PPT test in its tax treaties by way of signing the MLI.[162]

On 22 February 2017, South Africa's Minister of Finance published the 2017 Budget Review which included a summary of its position on the OECD BEPS Action Plan.[163] In relation to Action Report 6, it was submitted that new treaties would be aligned with the minimum standards presented by the OECD and the MLI would be used to amend and cover existing treaties.[164]

On 7 June 2017 South Africa signed the MLI and reaffirmed its decision to apply the PPT to some of its treaties qualifying as 'Covered Tax Agreements' (this excludes treaties concluded with Germany and Zambia, which are currently under bilateral renegotiations).[165] It has been mentioned that National Treasury anticipates that South Africa will complete the required Cabinet and Parliamentary process and lodge its final Instrument of Ratification with the OECD by mid-2019.[166]

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[160] ibid.

[161] ibid.

[162] ibid.

[163] Deloitte, 2017, '2017 budget includes overall commitments to BEPS project', 2017, https://www.taxathand.com/article/9092/South-Africa/2017/2017-budget-includes-overall-commitment-to-BEPS-project.

[164] ibid.

[165] Webber Wentzel, 'Webber Wentzel Tax Seminar' Bennet A, 2018, http://www.webberwentzel.com/wwb/content/en/ww-in-the-news?oid=61533&sn=Detail-2011&pid=32704.

[166] ibid.

The South African GAAR framework currently operates to deny the availability of tax treaty benefits where the arrangement in entered into for the 'sole and main purpose' of obtaining a tax benefit or *inter alia*, in instances where a transaction is entered into in such a way that would not ordinarily be carried out.[167] Consequently, SARS have always had the authority to deny a taxpayer benefits afforded by a tax treaty through the application of the domestic South African GAAR.[168] The question that arises is whether the South African domestic GAAR is aligned with the PPT or whether it will result in two separate tests that need to be considered.[169]

3.2 **Interrelationship of domestic GAARs and the PPT**

This research report does not attempt to provide a full analysis on whether domestic anti-avoidance measures can be reconciled with tax treaty obligations; however, for purposes of the discussion that will ensue, analysing the extent to which the South African GAAR can assist with the interpretation of the PPT, it is worth briefly discussing the compatibility of domestic GAAR rules with tax treaties.

The question of whether domestic GAARs of a particular jurisdiction are consistent with their tax treaty obligations has for a number of years been a topical and controversial issue among tax specialists and academics.[170]

The OECD Commentary was amended in 2003 and an attempt was made to address the compatibility of domestic anti-avoidance rules (including 'substance over form' rules, 'economic substance' rules and other general anti-abuse rules) with treaty obligations.[171] The 2003 Commentary provided that, as a general rule, there will be no conflict between domestic GAARs and treaties.[172] In summary, the OECD's rationale for this conclusion is premised on the notion

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[167] KPMG, 'International Tax in a Disrupted World', *Tax Talk,* Berger R et al., 2018, pp 48-50.

[168] ibid.

[169] ibid.

[170] Moreno AB, 2017, 'GAARs and Treaties. From the Guiding principle to the Principal Purpose Test. What have we gained from BEPS Action 6?', Intertax, vol 45, issue 6/7, p. 432.

[171] Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups', loc.cit.

[172] Moreno AB, 'GAARs and Treaties. From the Guiding principle to the Principal Purpose Test. What have we gained from BEPS Action 6?', loc.cit.

that such rules are part of the basic principles set by domestic tax laws for determining which facts give rise to a tax liability (the factual approach).[173] These rules are thus not addressed in tax treaties and are, according to the OECD, not affected by them.[174] Put differently, domestic GAARs enable tax authorities to discover the facts that actually occurred in a given transaction and to subsequently apply the equivalent tax rules to those facts.[175] This conclusion and explanation was criticised by international tax academics and generally not accepted by tax authorises and courts in OECD and non-OECD countries.[176]

Accordingly, the OECD attempted to clarify the position on the compatibility of domestic GAARs and tax treaties as it became clear that due to the criticism and uncertainty that arose there was a need to create a policy that firstly provided GAARs with a treaty foundation (i.e. incorporating general rules to target treaty abuse in tax treaties) and secondly switched off the application of domestic anti-avoidance in a treaty context.[177] Danon expresses the opinion that the first objective was achieved with the introduction of the PPT, however, with regard to the second objective, the principles established by the OECD that domestic GAARs do not conflict with tax treaties remained unchanged.[178]

Where countries have included in their domestic law a legislative anti-abuse rule of general application, the application of those rules raise the question of how a possible conflict with the provisions of a tax treaty will be dealt with.[179.] The 2017 Commentary states that, in most cases, no such conflict will arise in this first place as conflicts will initially be avoided for reasons such as tax treaties including specific provisions clarifying that there is no conflict or alternatively even if there is a conflict that arises, the tax treaty may include

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173 Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' loc.cit.

174 ibid.

175 Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' loc.cit.

176 Moreno AB, 'GAARs and Treaties. From the Guiding principle to the Principal Purpose Test. What have we gained from BEPS Action 6?', op.cit., p.433.

177 Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' loc.cit.

178 ibid.

179 OECD, *2017 Commentary,* op.cit., p.77, paragraph 76-77.

specific provisions allowing the application of domestic rules.[180] The OECD notes that in other cases, various tax treaty provisions depend on domestic law to determine the meaning of terms that are not defined in the tax treaties and are therefore dependant on domestic law for the ambit of its application. Consequently, the OECD provides that the GAAR found in domestic law will generally have an impact on how treaty provisions are applied rather than produce conflicting results.[181] The OECD Commentary provides that as a guiding principle, the benefits of a treaty should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and in obtaining that more favourable treatment, it would be contrary to the object and purpose of the relevant provisions.[182] Consequently, where the main aspects of domestic GAARs are in conflict with the guiding principle, the OECD is of the view that no conflict will be possible since the relevant domestic GAARs will apply in the same circumstances in which the benefits of the tax treaty would be denied under the PPT.[183]

A criticism that has been submitted against the 2017 Commentary is that it is not obvious or clear that domestic GAAR will include provisions that are synonymous to the provisions in the tax treaty.[184] Even if the OECD is correct in assuming that all domestic GAARs are governed by the guiding principle, the issue stills remains of whether the main characteristics of domestic GAARs and those of the PPT coincide.[185] Moreno expresses the view that 'even if the philosophy underlying all GAARs is similar, the subtle differences between those rules and the particular configuration of the PPT or guiding principle makes this comparison a difficult and unpredictable task *(own emphasis)*.'[186]

Furthermore, Kuźniacki is of the opinion that the compatibility between domestic GAARs and the PPT cannot be resolved by the application of domestic GAARs in the same circumstances in which the benefits would be denied under the

[180] OECD, *2017 Commentary,* op.cit., pp.75-77, paragraph 72 read with paragraph 77.

[181] OECD, *2017 Commentary*, op.cit., pp.75-77, paragraph 73 read with paragraph 77.

[182] OECD, *2017 Commentary*, op.cit., pp.73, paragraph 61.

[183] OECD, *2017 Commentary*, op.cit., pp.77, paragraph 77.

[184] Moreno AB, 'GAARs and Treaties. From the Guiding principle to the Principal Purpose Test. What have we gained from BEPS Action 6?', op.cit., p.435.

[185] ibid.

[186] ibid.

PPT.[187] In these circumstances, either the PPT will apply first and consequently there will be no need to apply the domestic rules, or alternatively, the domestic rules apply first and their compatibility with the treaties must be determined when interpreting the tax treaty provisions.[188]

3.3 The South African GAAR

The South African GAAR is contained in sections 80A to 80L of the ITA. In brief, the South African GAAR provides that a transaction (or series of transactions) is predisposed to a successful challenge under the South African GAAR if it constitutes an 'impermissible avoidance arrangement'. In this regard, the South African GAAR essentially comprises of three main prerequisite elements:

i. there must be an 'arrangement' as defined in section 80L of the ITA (First Requirement);

ii. the arrangement has to constitute an 'avoidance arrangement' as defined in section 80L of the ITA (Second Requirement); and

iii. the avoidance arrangement has to be an 'impermissible avoidance arrangement' as described in section 80A of the ITA (Third Requirement). Moreover, a transaction will constitute an 'impermissible avoidance arrangement' if:

    a) its 'sole or main purpose' is to obtain a 'tax benefit' and;

    b) one or more of the so-called 'tainted elements' (as discussed below) exists.

The Commissioner of SARS is given explicit authority to determine the tax consequences of any 'impermissible avoidance arrangement' for any party by, *inter alia*, 'disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement'.

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[187] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', op.cit. p.3.

[188] ibid.

In addition, in terms of section 80H the Commissioner of SARS is given the authority to apply the GAAR either to an 'impermissible avoidance arrangement' as a whole, or to any step in or part of such arrangement. The Commissioner of SARS can, however, only successfully challenge a transaction under the GAAR if all of the prerequisite elements are present.

3.3.1 **The First Requirement**

In accordance with section 80L of the ITA, an 'arrangement' is defined to include any transaction, operation, scheme, agreement, or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property.

3.3.2 **The Second Requirement**

In terms of section 80L of the ITA, an 'avoidance arrangement' means any 'arrangement' that results in a 'tax benefit'. The concept 'tax benefit' is defined in section 1 of the ITA as 'any avoidance, postponement or reduction of any liability for tax'.

While the courts have not adjudicated on the meaning of this term in the context of the South African GAAR, it is worth noting that a similar definition of 'tax benefit' was previously contained in the now repealed section 103(1) of the ITA, and the meaning of these words were considered by the South African courts.

In *Smith v Commissioner for Inland Revenue*,[189] the court held that the phrase 'which has the effect of avoiding ... liability for any tax ... on income' in the context of the previous requirement in section 103(1), should be interpreted to mean: '[t]he ordinary natural meaning of avoiding liability for a tax on income is to get out of the way of, escape or prevent an anticipated liability.'[190]

The interpretation of a 'tax benefit' as described in *Smith* was reaffirmed in *Hicklin v SIR*,[191] where the court held that a liability for tax was something which a taxpayer: ' ... anticipates will or may fall on him in the future. Now such a

[189] *Smith v Commissioner for Inland Revenue* 1964 (1) SA 324 (A).

[190] ibid, at p.333E.

[191] *Hicklin v SIR* 1980 (1) SA 481 AD (41 SATC 179).

liability may vary from an imminent, certain prospect to some vague, remote possibility.'[192]

In light of the above, in deciding whether or not a 'tax benefit' is or will be derived or is assumed to be derived by a taxpayer or participant to an arrangement it must be determine whether there is an anticipated liability for tax.

It should be articulated that the general provisions of the ITA allow for certain amounts to be exempt from income tax, for instances, specified dividends. It is contended that there are compelling arguments that it is not the function of section 80A to characterise normal incidents of the application of the provisions of the ITA as a 'tax benefit'. This submission is supported by the judgment reached in *Commissioner for Inland Revenue v King*.[193]

Notwithstanding the above, the Commissioner of SARS could potentially seek to establish that an alternative arrangement could have otherwise been entered into in order to produce the same commercial result and the associated tax consequences to satisfy the onus placed on him to demonstrate that a 'tax benefit' has indeed arisen.

In De Koker and Williams' view, it is not enough for the Commissioner of SARS to simply contend that a tax benefit has arisen.[194] In order to quantify the tax benefit, the Commissioner of SARS must be sufficiently clear in his mind as to the nature of an alternative arrangement, which could otherwise have been entered into, against which the tax consequences of the actual arrangement can be measured.[195]

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[192] ibid, p.492H.

[193] *Commissioner for Inland Revenue v King* 1947 (2) SA 196 (A), p. 216.

[194] De Koker AP and Williams RC, *General Anti-avoidance*, 'SILKE on South African Income Tax', Lexis Nexis.Ch. 19.4.

[195] ibid.

3.3.3 The Third Requirement

3.3.3.1 The sole or main purpose test

Section 80G(1) of the ITA sets out a rebuttable presumption that once the Commissioner of SARS has satisfied the onus of proving the existence of an 'avoidance arrangement', the onus shifts to the taxpayer to prove that, reasonably considered taking into account all relevant facts and circumstances, obtaining a 'tax benefit' was not the sole or main purpose of the 'avoidance arrangement'.

There is no guidance provided on the meaning of the terms 'solely' and 'mainly'. This requirement formed part of the previously repealed GAAR and consequently, the principles established by the South African courts through case law should still apply to the 'sole or main purpose' requirement under section 80A of the current GAAR. In *SBI v Lourens Erasmus (Edms) Bpk,*[196] the words 'solely' and 'mainly' were assessed and the court held that:

> … in the context under consideration, the word 'mainly' establishes a purely quantitative measure of more than 50% and the associated use of the word 'solely' or mainly is inserted, *ex abundante cautela*, to circumvent the possibility that what may be described as being 'solely' of a particular character would not qualify as being 'mainly' of that character.[197]

In *CIR v Bobat & others* the court held that a main purpose would obviously constitute a purpose that must be dominant over any other purpose because in ordinary language, 'mainly' is defined as meaning 'for the most part, principally or chiefly.'[198]

Accordingly, the wording in the legislation requiring 'the' sole or main purpose, as opposed to 'a' sole or main purpose is indicative the identification of a singular purpose, as opposed to a number of purposes is required.[199] Consequently, the 'sole' or 'main' purpose of an arrangement does not have to

196 *SBI v Lourens Erasmus (Eiendoms) Bpk* [1966] (4) SA 434 (A), 28 SATC.

197 ibid*,* p.233.

198 *CIR v Bobat & others* [2003] (N), 67 SATC 47.

199 Cassidy J, 2009, 'The Holy Grail: The search for the optimal GAAR', *South African Law Journa*l, vol. 126, issue 4740, p.765.

be the only purpose, however, it must be the dominant purpose for entering into a transaction.

The approach taken by South African tax scholars and academics to the 'sole or main purpose' test is not unanimous. Some scholars are of the view that a subjective approach should be taken when considering the intention of the taxpayer, while others are of the view that the test is objective in nature. Accordingly, similar issues arose in relation to the now-repealed section 103(1) of the ITA, which also required that a scheme, falling within its ambit, had to be entered into or carried out ‘solely or mainly for the purpose of obtaining a tax benefit’.[200]

Without delving into the conflicting arguments expressed by South African academics on the subjective or objective nature, the author submits that it is accepted that the 'sole or main purpose' test appears to be a subjective test. This view is supported by the judgment in *Secretary for Inland Revenue v Gallagher* (*Gallagher*),[201] where Corbett JA held that:

> It is submitted in the heads of argument of appellant‘s counsel that in determining the purpose of a transaction, operation or scheme an ‘objective’ test should be applied. By an objective test in this context is evidently meant a test which has regard rather to the effect of the scheme, objectively viewed, as opposed to a ‘subjective test’ which takes as its criterion the purpose which those carrying out the scheme intend to achieve by means of the scheme… In the circumstances it is appropriate to state that, in my view, the test is undoubtedly a subjective one.[202]

Corbett JA states further that:

> section 103(1) [a predecessor to the current GAAR contained in sections 80A to 80L] draws a clear distinction between the 'effect' of a scheme and the 'purpose' thereof and this virtually rules out an interpretation which seeks to give

[200] De Koker AP and Williams RC, *General Anti-avoidance*, 'SILKE on South African Income Tax', loc.cit. Williams and de Koker are of the view that when determining the ‘purpose’ of an avoidance arrangement in the context of section 80A, regard must be had to the objective effect of the arrangement, namely whether it results in a ‘tax benefit’ and if its only effect was the creation of a tax benefit, then it should follow that that is its sole or main purpose.

[201] *Secretary for Inland Revenue v Gallagher* [1978] 3 All SA 1 (A).

[202] ibid, p.5.

> 'purpose' an objective connotation and to equate it, more or less, to 'effect' *(own emphasis)*.[203]

Consequently, in light of *Gallagher*, one needs to draw a distinction between the subjective 'purpose' of a transaction and the objective 'result' thereof. Merely because a transaction results in a 'tax benefit' does not mean that obtaining a tax benefit was the sole or main purpose of the transaction.

Whether or not a transaction is entered into solely or mainly to obtain a tax benefit is a question of fact. In instances where a taxpayer enters into a transaction which gives rise to a tax benefit and there is no commercial rationale for such transaction, it seems clear that the 'sole or main purpose' of that transaction is the avoidance of tax.

In circumstances where a taxpayer has a clear commercial purpose, which could potentially be achieved through an alternative transaction structure, it becomes slightly more challenging to determine at which stage entering into the more tax beneficial alternative becomes an arrangement which is entered into for the 'sole or main purpose' of obtaining a tax benefit.

In *CIR v Conhage (Pty) Ltd* (*Conhage*),[204] the Supreme Court of Appeal had to determine whether the GAAR could be invoked where a taxpayer chose to procure financing through a sale and leaseback arrangement as opposed to an ordinary loan agreement. The judgment was decided under the provisions of section 103(1) of the ITA which was the predecessor of the current South African GAAR. It is notable that the repealed section 103(1) of the ITA enquiry into the 'sole or main purpose' of a transaction was identical to that which is currently required in terms of section 80A of the ITA.

Hefer JA held that:

> Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If, for example, the same commercial result can be achieved in

[203] ibid.

[204] *CIR v Conhage* (1999) 4 SA 1149 (SCA).

> different ways, he may enter into the type of transaction which does not attract tax or attracts less tax. But, when it comes to considering whether by doing so he has succeeded in avoiding or reducing the tax, the Court will give effect to the true nature and substance of the transaction and will not be deceived by its form.[205]

The court thus confirmed that, where a taxpayer enters into a transaction with a commercial objective and there is more than one alternative to achieve this result, the taxpayer is free to adopt the alternative which yields the best tax outcome. This is referred to as the 'choice principle'. The *Conhage* judgment clarifies that the available alternatives should be limited to those transactions which would be considered commercially normal taking into account the relevant facts and circumstances. Whether an arrangement is 'abnormal' would depend on the circumstances and should be determined with reference to what is normal in the context.[206]

The choice principle was reinforced in *Commissioner for the South African Revenue Service v NWK Ltd* (the NWK Case),[207] where it was held that 'it is trite that a taxpayer may organize his financial affairs in such a way as to pay the least tax permissible. There is, in principle, nothing wrong with arrangements that are tax effective.'[208]

SARS acknowledged the choice principle in the *SARS Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act 1962 (Act No 58 of 1962)* issued in 2005[209] where SARS discussed what constitutes legitimate tax planning and provides that tax planning relates to organising a taxpayer's affairs in a manner that results in the minimum tax liability within the law without

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[205] ibid,p.1155.

[206] ibid, p.1159.

[207] *Commissioner for the South African Revenue Service v NWK Ltd* 2011 (2) SA 67 (SCA).

[208] ibid,p.76.

[209] SARS, 2005, 'Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act 1962 (Act No 58 of 1962)', p.4 http://www.sars.gov.za/AllDocs/LegalDoclib/DiscPapers/LAPD-LPrep-DP-2005-01%20 %20Discussion%20Paper%20Tax%20Avoidance%20Section%20103%20of%20Income%20Tax%20Act%201962.pdf.

constituting 'impermissible tax avoidance'. SARS equates the concept of 'tax planning' with 'tax mitigation' and states that: [210]

> *In short, the "hallmark of tax mitigation…is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option*.[211]

3.3.3.2 **The tainted elements**

To the extent that a the taxpayer is not able to substantiate that the 'sole or main purpose' of the transaction is something other than to obtain a 'tax benefit', SARS would still bear the additional onus of proving the existence of one or more 'tainted elements'.

Section 80A of the ITA provides that 'tainted elements' under the South African GAAR apply to arrangements that:

i. in the context of business, were entered into or carried out by means or in a manner which would not normally be employed for *bona fide* business purposes, other than obtaining a tax benefit (the business purpose test);[212]

ii. in the context of business, lack commercial substance, in whole or in part, taking the following non-exclusive indicators into account:[213]

   a) instances where the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of the individual steps;[214]

   b) round trip financing;[215]

   c) accommodating or tax-indifferent parties;[216] and

[210] ibid.

[211] ibid.

[212] Section 80A(a)(i) of the ITA.

[213] Section 80A(a)(ii) of the ITA.

[214] Section 80C(2)(a) of the ITA.

[215] Section 80C(2)(b)(i) read with section 80D of the ITA.

d) offsetting or self-cancelling elements.[217]

(the commercial substance test)

iii. in context other than business, were entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit (bona fide purposes test);[218]

iv. have created rights or obligations which would not normally be created between persons dealing at arm's length (creating of rights and obligations test);[219] and

v. would result directly or indirectly in the 'misuse or abuse' of any provision of the ITA (misuse or abuse test).[220]

An in-depth analysis of the 'tainted elements' is beyond the scope of this research report, especially given that the PPT does not have a similar prerequisite requiring certain elements to be present. Nevertheless, the following brief overview should be useful for purposes of understanding the operation and application of the 'tainted elements' in the context of the South African GAAR:

i. The business purpose test aims to differentiate between how a certain business arrangement would ordinarily be entered into and compared against what factually happened. De Koker is of the view that the focus of this test is not on the subjective or objective purpose of the transaction, but rather the manner in which the taxpayer carried out the transaction in question.[221] If the transaction was entered into in a manner that would not normally be employed in the context of business, then section 80A(a) of the ITA would be present.

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216 Section 80C(2)(b)(ii) read with section 80E of the ITA.
217 Section 80C(2)(b)(iii) of the ITA.
218 Section 80A(b) of the ITA.
219 Section 80A(c)(i) of the ITA.
220 Section 80A(c)(ii) of the ITA.
221 De Koker AP and Williams RC, *General Anti-avoidance*, 'SILKE on South African Income Tax', loc.cit.

ii. The commercial substance test comprises a general rule set out in section 80C(1) of the ITA, which in essence compares the tax benefit that will be obtained from the arrangement and the commercial effect on the business risk or net cash flow other than that arising from the tax benefit. As noted above, there are four non-exclusive factors that can be used to indicate lack of commercial substance.

iii. The *bona fide* purpose test applies similarly to the business purpose test, except in this context any non-business *bona fide* purpose will suffice. The use of the word 'normal' in the provision indicates that a comparison with a hypothetical scenario is required.[222]

iv. The creating of rights and obligations test is a factual enquiry that should be undertaken to ascertain whether an avoidance arrangement has created rights or obligations that are not ordinarily created between parties dealing at arm's length, considered against the backdrop of a hypothetical ordinary transaction.[223] The scope of this requirement is extremely broad given that it applies in any context and is not restricted to business arrangements.

v. The misuse or abuse test has its origins in Canadian and certain European jurisdictions. In essence, these jurisdictions have adopted a two-part enquiry in determining whether or not a transaction constitutes a misuse or abuse of the tax legislation. The first enquiry is to consider the purpose for which the legislation was created. The second enquiry is then to determine whether or not the application of the tax legislation in the context of the specific transaction abuses or misuses the intended purpose thereof.

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222 ibid.

223 Loof G, 2013, A *critical analysis of the requirements of the South African General Anti Avoidance Rule*, submitted in fulfilment of part of the requirements for the Postgraduate Diploma in tax law (unpublished), Cape Town, University of Cape Town, p.31 and Garg R, 2012, 'Removing the fences: Looking through GAAR, PriceWaterHouse Cooper publication', p.47, https://www.pwc.in/assets/pdfs/publications-2012/pwc-white-paper-on-gaar.pdf in April 2016.

3.4 Interpreting the PPT in the context of South Africa

3.4.1 Overview

For purposes of this section an attempt is made to reconcile the requirements of the PPT with South African law in order to explore whether interpretation principles established by South African courts can be used as a guide to interpret and apply the PPT.

According to the OECD, the courts of various jurisdictions have developed a number of judicial doctrines and principles for interpreting tax legislation in cases dealing with tax avoidance.[224] These doctrines and principles are essentially views expressed by courts as to how tax legislation should be interpreted.[225] While it is common cause that the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the VCLT, these general rules do not prevent the application of similar judicial doctrines and principles to the interpretation of the provisions of tax treaties.[226] The OECD illustrates this point by stating that if the courts of one country determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach from being adopted with respect to the application of the provisions of a tax treaty to similar transactions.[227]

Consequently, domestic tax legislation on tax avoidance is accepted as an appropriate tool for the interpretation and application of similar provisions of a tax treaty.

Notwithstanding the above, the PPT is primarily subject to the rules of interpretation incorporated in Articles 31 to 33 of the VCLT, which were

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[224] OECD, *2017 Commentary,* p.77, paragraph 78.

[225] ibid,

[226] ibid.

[227] ibid.

established for purposes of interpreting international tax law and, more specifically, tax treaty provisions.[228]

Furthermore, as discussed above, the MLI Explanatory Statement expressly attributes importance to the Action 6 Report for the purpose of interpreting the MLI and consequently the PPT. It has been submitted that the BEPS Action Report and Action 6 Report (and by implication the 2017 Commentary which largely mirrors the commentary provided in the Action 6 Report) should be used for interpretative purposes in determining the object and purpose of the MLI and PPT, rather than Article 31(1) of the VCLT.[229]

Consequently, without undermining the relevance and usefulness of domestic GAARs and their administrative guidelines and jurisprudence, it is submitted that domestic GAARs may at most constitute supplementary means of interpreting the PPT.[230]

3.4.2 Reconciling the PPT with the South African GAAR

3.4.2.1 A literal approach to the PPT

As noted under the First Requirement of the South African GAAR, the term 'arrangement' in section 80L is defined to include any transaction, operation, scheme, agreement, or understanding (whether enforceable or not), including all steps therein or parts thereof. This definition seems to be consistent with the interpretation of 'arrangement or transaction' provided by the OECD in the 2017 Commentary which provides that the phrase 'arrangement or transaction' should be interpreted broadly and include any 'agreement, understanding, scheme, transaction or series of transactions, whether or not they are legally enforceable'[231]. Given that under both the South African GAAR and the PPT the term 'arrangement' is drafted in broad terms and should easily be able to be reconciled, any further discussion on this element is irrelevant, especially given

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[228] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', op.cit., p.6.

[229] ibid, cited J.F. Avery Jones, Treaty Interpretation – Global Tax Treaty Commentaries sec. 5.3.3., Global Tax Treaty Commentaries IBFD (accessed 4 Mar. 2018). B. Kuźniacki confirms Avery Jones' view.

[230] ibid.

[231] OECD, *2017 Commentary,* p.590, paragraph 177.

that most of the controversy and uncertainty plaguing the PPT does not concern this issue.

In respect of the Second Requirement, it is nonsensical to attempt to reconcile the meaning of 'tax benefit' under the South African GAAR with the term 'benefit' as set out in the PPT. The author submits that the basis for this view is that the term 'tax benefit' under the South African GAAR refers to an avoidance, postponement or reduction of any liability for tax that arises as a result of the application of domestic tax rules. On the other hand, the OECD interprets the word 'benefit' to include all limitations, including, *inter alia*, a tax reduction, an exemption, a deferral or a refund on taxation imposed on the state of source under Articles 6 through to Article 22 of the relevant tax treaty.[232] These limitations are interpreted to include limitations on the taxing rights of a contracting state in respect of dividends, interest or royalties arising in that state, and paid to a resident of the other state (who is the beneficial owner) and the limitation on the taxing rights of a contracting state over a capital gain derived from the alienation of movable property located in that state by a resident of the other state.[233] In addition, 'benefit' includes the relief from double taxation provided by Article 23 and the protection afforded to residents and nationals of a contracting state under Article 24 or any other similar limitations.[234] It seems irrational to try reconcile the Second Requirement under the South African GAAR with term 'benefit' under the PPT as these two concepts are considerably different and the term 'benefit' under the PPT is expected to be a lot broader.

Consequently, this analysis will focus on the Third Requirement. As discussed above, the Third Requirement under the South African GAAR provides that an 'avoidance arrangement' is an 'impermissible avoidance arrangement' if its 'sole or main purpose' was to obtain a tax benefit and one of the tainted elements is present.

It is notable that the preamble of the MLI includes the following wording:

[232] OECD, *2017 Commentary*, p.589, paragraph 175.
[233] ibid.
[234] ibid.

> Recognising that governments lose substantial corporate tax revenue because of aggressive international tax planning that has the effect of artificially shifting profits to locations where they are subject to non-taxation or reduced taxation…[235]

This aspect of the preamble sets out the main mischief that the MLI (more specifically the PPT) seeks to prevent and the primary target, being 'aggressive international tax planning by multinational corporations.[236]' The OECD does not provide any guidance in the MLI or the MLI Explanatory Statement about what constitutes 'aggressive avoidance' or how it differs from other forms of tax avoidance, such as, 'impermissible tax avoidance' or 'abusive tax avoidance'.[237] The South African GAAR applies only in instance where there is 'impermissible tax avoidance'.[238] Similarly, the UK GAAR applies only to an 'abusive tax arrangement'.[239] According to Hattingh, these are vital indicators that delineate the discretionary power of revenue authorities.[240]

Hattingh highlights that one of the most significant differences between domestic GAARs of this nature and the PPT is that the former provides specific circumstances that may give rise to 'impermissible' or 'abusive' tax avoidance.[241] For example, under the GAAR in South Africa, the UK and Canada, factors that are indicative of 'impermissible' or 'abusive' avoidance arrangements include, *inter alia*, whether rights or obligations are created which are not ordinarily created between persons dealing at arm's length or that the avoidance arrangement resulted directly or indirectly in the misuse or abuse of the provisions of the relevant tax legislation.[242] These factors must be present and additionally the requirements of the purpose test must be met.[243]

The author agrees with Hattingh and submits that when applying the South African GAAR, even if the 'sole or main purpose' of a transaction was to obtain

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[235] OECD, *MLI,* p.1.
[236] Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', p.3.
[237] ibid.
[238] ibid.
[239] ibid.
[240] ibid.
[241] ibid.
[242] ibid, fn 8.
[243] ibid.

a 'tax benefit', the limitation of the GAAR is that SARS (or a South African court) still has to find the existence of one of the 'tainted elements'. Consequently, it will be more onerous for SARS to positively determine the presence of tax avoidance in a transaction under the South African GAAR than under the PPT. The PPT merely requires a tax authority to assess whether 'one of the principal purposes' of a transaction was to obtain a treaty benefit, thus, providing a lower threshold to satisfy.

The author submits that this aspect of the GAAR cannot be compared to the PPT, given that the PPT does not provide factors that are indicative of 'impermissible' or 'abusive' avoidance arrangements. In practice, however, the specific tests under the South African GAAR (i.e. the tests applicable to the 'tainted elements') may provide guidance for the underlying approach that tax authorities should take when determining the commercial substance of a particular arrangement or transaction. More specifically, if a transaction is entered into for a genuine commercial purpose (being one of the principal purposes for that transaction) then that transaction should not fall foul of any of the specific indicators embodied in the 'tainted elements'.

The next aspect that should be considered is the 'sole or main purpose' test under the South African GAAR and how this test is comparable to the 'one of the principal purposes' test under the PPT. In the author's view, the slight difference in wording between the purpose test under the South African GAAR and under the PPT may impact the ability to use the South African 'sole or main purpose' test as a tool to interpret the 'one of the principal purposes' test under the PPT. Essentially, the slight differences in the wording result in substantially dissimilar tests with different requirements that need to be satisfied.

As discussed above, under the South African GAAR the 'sole or main' purpose of an arrangement does not have to be the only purpose, however, it must be the dominant purpose for entering into a transaction. It is clear that this requirement is narrowly construed and that the ambit of its application is clear. On the other hand, the 2017 Commentary on the 'one of the principal purposes' test is indicative that the threshold for satisfying the test is very low and the wording is far-reaching. The OECD provides that the term 'one of the principal purposes' essentially means that 'obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit.'[244]

It is questionable whether the 'choice principle' articulated in *Conhage* would be useful to South African authorities in deciding whether a particular transaction would fall foul of the PPT. In accordance with the 'choice principle', if a taxpayer enters into a transaction with a commercial objective and there is more than one alternative to achieve this outcome, the taxpayer is free to adopt the alternative which yields the optimal tax result (provided that there is still a commercial rationale and commercial substance for electing that particular step). It is possible that 'one of the principal purposes' test under the PPT may not recognise the 'choice principle'. In the context of the PPT, if a taxpayer can implement a transaction in one of two ways and elects to implement the transaction in the way that is more tax efficient, if it is successfully argued that there are two equally important reasons for entering into that specific transaction, one being a non-tax related commercial reason and one being a tax related reason that arises pursuant to obtaining treaty benefits (i.e. tax considerations being a primary driver for the transaction), the PPT would probably apply, given that one of the two principal purposes is to obtain a treaty benefit.

The following example can be used to illustrate the difference between the literal wording of the tests under the South African GAAR and PPT. The ABC Group wishes to expand its operations internationally by acquiring shares in Company X, a South African company that manufactures goods. The ABC Group may either acquire the shares in company X through a subsidiary in Company A located in State A or Company B located in State B. State A and State B both have tax treaties with South Africa, however, the rates of withholding taxes are reduced to a lower rate under the State A-South Africa tax treaty. Consequently, Company A acquires the shares in Company X.

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[244] OECD, *2017 Commentary,*op.cit.,p.591, paragraph 180.

Under the South African GAAR, it would be easier to prove the 'sole or main purpose' of the transaction, being the acquisition of shares in Company X, was a commercial reason, i.e. to expand the business of the ABC Group. The fact that the ABC Group elected to invest in Company X through Company A for purposes of obtaining lower withholding tax rates would be in line with the 'choice principle' as the ABC Group is free to adopt the alternative which results in a lower tax liability (provided of course that there is still commercial substance in State A). On the other hand, when considering the transaction under the PPT, Company A could potentially be denied tax treaty benefits if it was established on the specific facts that one of the principal reasons for Company A investing in Company X (along with the stated commercial rationale) was to obtain a benefit under the State A-South Africa tax treaty. It seems logical however that one would first have to analyse the facts of the transaction and consider to what extent tax considerations drove the form of the transaction (or steps therein).

In light of the above, it is uncertain how far along the spectrum would making a commercial transaction tax efficient likely to be regarded as a principal purpose for entering into that transaction. It is clear, however, that the PPT would be triggered before the South African GAAR, given the lower threshold that needs to be satisfied.

3.4.2.2 **A contextual approach to the PPT**

When assessing the PPT in the context of the 2017 Commentary (including the examples therein), the author submits that certain principles established by South African courts seem to be more aligned with the guidance provided by the OECD than initially thought. Consequently, it is possible that these principles may be indicative of how SARS may interpret and apply the PPT.

As discussed in Chapter 2, the 2017 Commentary on Article 29 provides that in instances where:

> 'an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit.'[245]

This is extremely powerful wording and could potentially be construed to derive similarities between the application of the South African GAAR and PPT with regard to a commercial substance analysis. More specifically, the aforementioned wording provided by the OECD, seems to nuance the PPT test by providing that the PPT will generally not find application if the core transaction has pure commercial rationale. This seems to correlate with the approach taken, and principles established by South African courts.

In the judgment of *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC* (*Roshcon*)[246] the court acknowledged the importance of commercial substance when determining whether simulation (meaning the legal substance and legal form are not the same) was present in a particular transaction. Although this decision was taken in the context of simulated transactions, the principles are still relevant for the application of the PPT, as simulation can be viewed as a type of avoidance and of relevance, is the approach taken to commercial substance in that context.

In *Roshcon*, the court was faced with determining the principles and test to be applied to simulation transactions, in terms of which Wallis JA affirmed that the test is whether the parties truly intended to conclude the contract in accordance with its terms.[247] Importantly, it was held that if a transaction serves no commercial purpose, this is one of the facts which will be taken into account in applying the test for simulation.[248] In the context of tax cases involving simulation, Wallis JA noted that parties often seek to take advantage of the complexities of the legislation in order to derive a benefit from taxation.[249] In the learned judge's view, there are various mechanisms for doing this, but they all involve taking straightforward commercial transactions and adding complex

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[245] OECD, *2017 Commentary*, op.cit., p.591, paragraph 181.
[246] *Roshcon (Pty) Limited v Anchor Auto Body Builders CC and others* [2014] JOL 31709 (SCA).
[247] ibid, p.3.
[248] ibid, p.22, paragraph 37.
[249] ibid, p.19, paragraph 33.

additional elements designed solely for the purpose of deriving a tax benefit.[250] In these tax cases, the feature to these scenarios is that the additional elements add nothing of value to the underlying transaction and are very often self-cancelling.[251]

In light of the OECD's guidance in the 2017 Commentary, the principles articulated in *Roshcon* could potentially assist SARS with applying the PPT. More specifically, that one of the principal purposes of a transaction or arrangement will not generally be to obtain treaty benefits if it is a straightforward commercial transaction. When a transaction however involves additional elements that add no value to the underlying transaction and are included for purposes of deriving a tax benefit, that particular step of the transaction should satisfy the PPT.

In addition, the OECD provides that it should not be lightly assumed that obtaining a benefit under a tax treaty was one of the principal purposes of an arrangement and reviewing the effects of an arrangement will not generally be conclusive about its purpose.[252] In this regard, the principles established in the judgment of *Commissioner SARS v Bosch* (*Bosch*)[253] may be indicative of how SARS could approach this guidance. It is noteworthy that *Bosch* was also decided in the context of simulated transactions. *In casu,* Wallis JA confirmed that the test for simulation is a question of the 'genuineness of the transaction under consideration.'[254] In short, if a transaction is genuine there is not simulation and if it is simulated then it is a dishonest transaction.[255] The court quoted the following statement articulated in *Roshcon*:

> the court examines the transaction as a whole, including all surrounding circumstances, any unusual features of the transaction and the manner in which

[250] ibid.
[251] ibid.
[252] OECD, *2017 Commentary*, op.cit., p.590, paragraph 178.
[253] *Commissioner SARS v Bosch* (394/2013)[2014] ZASCA 171 (19 November 2014).
[254]ibid, p.26, paragraph 40.
[255]ibid.

> the parties intend to implement it, before determining in any particular case whether a transaction is simulated…[256]

Wallis JA held that among those features considered will be the income tax consequences of the transaction.[257] Tax evasion is of course impermissible and therefore, if a transaction is simulated, it may amount to tax evasion.[258] Nevertheless, the court reaffirmed that there is 'nothing impermissible about arranging one's affairs so as to minimise one's tax liability.'[259]

Consequently, SARS may follow the approach as set out in *Bosch* and consider the tax effects of an arrangement amongst other considerations when determining if 'one of the principal purposes' of the transaction was to obtain a tax benefit.

In light of the OECD'S guidance provided in the 2017 Commentary on Article 29, the 'choice principle' may useful to SARS and the South African courts when applying the PPT. The 'choice principle' seems to be in line with the commercial substance commentary set out by the OECD, as it provides that if there is more than one alternative to achieve a commercial transaction, the taxpayer is free to adopt the alternative which yields the best tax result. The following examples provided by the OECD are indicative that the 'choice principle' may be useful when analysing the principal purpose of a transaction.

As discussed above, Example C in the 2017 Commentary provides that a company intended on expanding its business operations by establishing a manufacturing plant in a developing country.[260] All three of the jurisdictions considered provided the same economic and political environments, however, the difference being that the chosen jurisdiction had a tax treaty in place with the investing company's jurisdiction. In this example, it was found that the principal purpose for making that investment and building the plant was related to the expansion of the investing company's business and the lower manufacturing costs of that company. The OECD provides that it could not be

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[256] ibid.
[257] ibid, p.27, paragraph 40.
[258] ibid.
[259] ibid.
[260] OECD, *2017 Commentary*, op.cit., p.592, paragraph 182.

reasonable to consider that one of the principal purposes for building the plant is to obtain treaty benefits and given the general objective of tax conventions is to encourage cross-border investment, obtaining the benefits under the tax treaty for investment in the plant was in accordance with the object and purpose of the provisions of that convention.[261]

This example would in all likelihood be approached in the same manner by SARS and would probably yield the same outcome. More specifically, if this transaction were to be assessed under the South African GAAR, in all likelihood SARS would find that the 'sole or main purpose' for entering into the transaction would be to expand business operations and was thus commercially driven. Furthermore, the ultimate decision to establish the manufacturing plant in a jurisdiction with a tax treaty would not be considered to be the 'sole or main purpose' of the transaction and would be in accordance with the 'choice principle' established in *Conhage*.

Example D is another useful example that demonstrates how similar the South African GAAR and PPT may be when applied in practice. In terms of Example D,[262] RCO is a collective investment vehicle that is resident in State R and manages a diversified portfolio of international investments. RCO holds 15 percent of its portfolio in shares of companies resident in State S. Under the tax treaty between State R and State S the withholding tax on dividends is reduced from 30 percent to 10 percent. RCO's investment decisions take into account the existence of tax benefits provided under State R's tax treaty network. The majority of the investors in RCO are resident in State R, however, a number of investors are residents of states which do not have tax treaties with State S.[263]

The OECD provides that the mere fact that RCO considered the existence of treaty benefits when making decisions to invest in companies resident in State S is not alone sufficient to trigger the PPT. The intention of tax treaties is to provide benefits to encourage cross-border investments and therefore it is necessary to consider the context in which the investment was made. The

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[261] ibid.
[262] OECD, *2017 Commentary*, op.cit., p.593, paragraph 182.
[263] ibid.

OECD concludes that unless RCO's investments are part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining a benefit under a tax treaty, it cannot be reasonable to deny the tax benefits under the State R - State S tax treaty. [264] The transaction provided in Example D should also not fall foul under the South African GAAR, given that the 'sole or main purpose' would be to make investments for investors in commercially viable companies. Tax treaty considerations would be an ancillary consideration, as the collective investments vehicle is aiming to structure its investments in a tax efficient manner for majority of the investors. In addition, the transaction would have commercial substance.

An analysis of the 2017 Commentary (with reference to the guidance provided by the OECD in terms of its explanation of the PPT and illustrative examples) underscores that SARS may recognise principles and judicial doctrines established in case law under the guise of the South African GAAR when applying the PPT, albeit, in a different context. Specific doctrines such as the 'choice principle' and commercial substance tests applied in South African GAAR legislation and by the courts may be indicative of the approach that SARS will take when assessing whether the PPT applies to certain transactions. There is still however uncertainty with regard to how SARS will approach the difference in wording between the 'one of the principal purposes' test under the PPT and the 'sole or main purpose test' under the South African GAAR.

3.4.3 **South African general rules of interpretation**

In the event that a court is called upon to interpret the provisions of the PPT it will in all likelihood give the provisions a meaning which makes sense and gives effect to the objects of and purpose of the rule.

In the hallmark judgment of *Natal Joint Municipal Pension Fund v Endumeni Municipality* (Natal Municipal Pension Fund Case),[265] the South African

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[264] ibid.

[265] *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] 2 All SA 262 (SCA).

Supreme Court of Appeal endorsed the 'purposive approach' to the interpretation of statutes. In this regard, Wallis JA held as follows:

> Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document.[266]

In *Smyth v Investec Bank* (*Smyth*),[267] the court identified the fundamental interpretational principle and three inter-related qualifications to that principle. The fundamental principle of statutory interpretation identified by the court was that 'words in a statute must be given their ordinary meaning, unless to do so would result in absurdity'.[268] The court went on to say however that that general principle was subject to three inter-related qualifications,[269] namely:

i. the statutory provision should be interpreted purposively;[270]

ii. the relevant statutory provision must be contextualised;[271] and

iii. statutes must be interpreted consistently with the Constitution so as to preserve their constitutional validity where it is reasonably possible to do so.[272]

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266 ibid,p.14.
267 *Smyth v Investec Bank Ltd* (674/2016) [2017] ZASCA 147 (26 October 2017).
268 ibid, paragraph [28].
269 ibid.
270 ibid.
271 ibid.
272 ibid.

As a starting point, it is clear that when applying the aforementioned interpretation principles to the PPT, the court must attribute the ordinary grammatical meaning to this rule, having regard to the context in which this phrase appears and the purpose to which it is directed. It is submitted that this interpretation could potentially result in South African courts reaching a conclusion similar to that in ITC 1569,[273] where the court was required to interpret the phrase 'one of the principal shareholders'.[274] *In casu*, the court held that the term 'one of the principal shareholders' envisages there being more than one more principal shareholder. If one shareholder held more shares than any of the other shareholder he would be the 'main shareholder'. However, if shareholders each held an equal number of shares they would all be the 'principal shareholders'.[275]

If the principle established in ITC 1569 was applied to the PPT, it is likely that a South Africa court would find that where there are two equal reasons to carry out a transaction, one being a tax related reason and the other being a commercial reason. The PPT would probably apply given that one of the two principal purposes is to obtain a tax treaty benefit. On the other hand, where the core rationale for entering into a transaction is commercially driven and tax treaty benefits are considered later when deciding on how to implement the transaction, the PPT would probably not apply.

The approach taken by SARS and the South African courts in determining the ordinary and grammatical meaning of the words 'one of the principal purposes' would probably be in line with the OECD's interpretation of the phrase read within the context of the 2017 Commentary.

[273] ITC 1569 56 SATCS 86(C).

[274] PwC, 2017, Synopsis Tax today August 2017, A South African perspective on the Multilateral Instrument's principal purpose test, https://www.pwc.co.za/en/assets/pdf/synopsis-august-2017.pdf.

[275] ibid.

3.5 Guidance from Canada on the inter-relationship between the Canadian GAAR and PPT

3.5.1 Background

Canada was one of the 68 jurisdictions to sign the MLI on 7 June 2017 and consequently, up to 75 of its tax treaties will be modified.[276] Canada has elected to use the PPT as an interim measure to combat treaty abuse, however, the intention is that as each of its bilateral treaties are renegotiated, the PPT will either be replaced or supplemented with a LOB provision.[277]

The first step in the process for Canada to ratify the MLI was taken on 31 January 2018 where the MLI was tabled in the House of Commons.[278] The MLI will be effective for a particular tax treaty after the domestic ratification procedures have been completed in Canada and the jurisdiction of the relevant treaty counterparty.[279]

3.5.2 Overview of Canadian GAAR

The Canadian GAAR was introduced in 1987 and is located in Part XVI, Section 245 of the CITA.[280] The purpose for implementing the Canadian GAAR was to provide the CRA and courts with a balanced and effective legislative foundation for eradicating abusive tax avoidance.[281] The charging provision under the Canadian GAAR is section 245(2) of the CITA, which provides that:

> Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

[276] Osler, 'New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?',loc.cit.

[277] Szuminski A, 2017, 'The MLI: Canada Signs and Presents Its Choices', *Canadian Tax Focus,* vol.7, no.3, https://www.ctf.ca/ctfweb/EN/Newsletters/Canadian_Tax_Focus/2017/3/170320.aspx.

[278] Osler, 2018, 'Canada begins ratification process for multilateral tax convention to implement BEPS', https://www.osler.com/en/resources/regulations/2018/canada-begins-ratification-process-for-multilateral-tax-convention-to-implement-beps.

[279] ibid.

[280] Income Tax Act RSC 1985, c. 1 (5th Supp.), as amended.

[281] Arnold BJ, 2004, 'The Long, Slow, Steady Demise of the General Anti-Avoidance Rule', *Canada Tax Journal,* vol. 52, no.2, p.488, https://www.ctf.ca/ctfweb/Documents/PDF/2004ctj/04ctj2-arnold.pdf.

Section 245(1) of the CITA sets out the definitions of 'tax benefit', 'tax consequences' and 'transaction'.

An 'avoidance transaction' in this context means any transaction (or that is part of a series of transactions) that would result directly or indirectly in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.[282]

The GAAR will only apply to avoidance transactions that involve a misuse or an abuse of the provisions of the CITA.

Consequently, the application of the Canadian GAAR can be summarised in a three step approach:[283]

i. firstly, whether there is a tax benefit arising from a transaction or series of transactions;

ii. secondly, whether the transaction is an 'avoidance transaction' in the sense of not being arranged primarily for *bona fide* purposes other than to obtain the tax benefit; and

iii. lastly, whether there was abusive tax avoidance under section 254(4), meaning that it cannot be reasonable to conclude that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer.

3.5.3 **Operation of the Canadian GAAR and PPT**

At the Canadian Tax Foundation Conference (CTF Conference) hosted during November 2017, the CRA indicated that it may look to apply the PPT and the Canadian GAAR, as 'alternative assessing positions'.[284] This suggestion has been criticised for being nonsensical as these alternative assessments will be

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[282] Section 245(3) of the CITA.

[283] *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 S.C.R. 601, 2005 SCC 54.

[284] Osler, 'New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?',loc.cit.

based on two sets of broad and independent avoidance rules and could potentially give rise to further uncertainty as well as increased litigious costs.[285]

It is submitted that it should not be necessary for the CRA to assess a taxpayer under both the PPT and Canadian GAAR.[286] The Canadian GAAR may apply to any benefit provided under a tax treaty, as per section 4.1 of the Income Tax Conventions Interpretation Act.[287] In instances where the PPT finds application in a specific transaction or arrangement where there is suspected treaty abuse, there would be no benefit provided under the relevant tax treaty and the Canadian GAAR would not apply.[288] On the other hand, the Canadian GAAR could potentially apply if the PPT does not apply. The Canadian GAAR should not apply however apply in these situations. The rationale submitted for is that if the PPT does not apply on the basis that none of the principal purposes of the transaction were to obtain a tax benefit, then the Canadian GAAR should not apply on the basis that an 'avoidance transaction' is not present, meaning that the transaction was undertaken primarily for *bona fide* purposes other than to obtain the benefit.[289]

Similarly, if the PPT does not apply for the reason that the benefit that was obtained fell within the object and purpose of the relevant tax treaty, then the Canadian GAAR should not apply on the basis that there was no misuse or abuse element.[290]

3.6 Guidance from the UK on the inter-relationship between the UK GAAR and PPT

3.6.1 Background

The UK also signed the MLI on 7 June 2017and chose to adopt the PPT in isolation as its chosen measure to prevent treaty abuse.[291] This election was

285 ibid.

286 ibid.

287 Income Tax Conventions Interpretation Act (R.S.C., 1985, c. I-4).

288 Osler, 'New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?',loc.cit.

289 ibid.

290 ibid.

291 Squire Patton Boggs, 2017, 'Turning the Tide: The OECD's Multilateral Instrument Has Been Signed.', Martinez A, p.4,

expected, given the large number of existing UK tax treaties that contain similar clauses to the PPT. In addition, certain characteristics of the PPT are reflected throughout the UK's domestic anti-avoidance rules.[292] The UK has elected that the MLI will apply in respect of 119 of its existing tax treaties.[293]

3.6.2 **Overview of the UK GAAR**

During 2013, a GAAR was introduced in the UK and is set out in Chapter 5, Part 5 of the FA. The UK GAAR applies to transactions entered into after 17 July 2013.[294]

Section 206(1) of the FA provides that the purpose of the UK GAAR is to counteract 'tax advantages' arising from 'tax arrangements' that are abusive. Interestingly, the UK GAAR is only targeted as abusive tax avoidance, consequently, it is referred to as the general anti-abuse rule (in terms of section 206(2) of the FA) as opposed to the more commonly used term general anti-avoidance rule.[295]

Section 207(1) of the FA provides that 'arrangements are 'tax arrangements' if, after having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the 'main purpose', or 'one of the main purposes', of the arrangements.[296] The HMRC Guidance provides that the phrase 'it would be reasonable to conclude' demonstrates that the main purpose test is an objective one.[297] It has been articulated that the UK was adverse to adopting a sole purposes test because it would be simple to manipulate as it is

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https://www.squirepattonboggs.com/~/media/files/insights/publications/2017/07/turning-the-tide-oecds-multilateral-instrument-has-been-signed/27380--oecds-multilateral-instrument-has-been-signed-client-alert.pdf.

292 ibid.

293 ibid.

294 Rotley LM, 2016, *Penalties for Impermissible Tax Avoidance in South Africa*, submitted in partial fulfilment of the requirements for the LLM degree (unpublished), Pretoria, University of Pretoria, p.29 where the author provides that prior to 2013 the UK did not have GAAR provisions in place save for the targeted anti-avoidance rules and the judicial doctrines, including the Ramsay principle. This principle was established in the case of *WT Ramsay Ltd v CIR* [1981] STC 174 where the court found that a court is required to establish the legal substance of any transaction to which a tax or a tax consequence was sought to be attached and that the courts should look at all the steps in a series of transactions.

295 ibid.

296 ibid.

297 HMRC Guidance, loc.cit.

relatively easy for a taxpayer to construct a commercial rationale alongside a tax advantage and to argue that the commercial reason is the sole or main purpose for entering into the transaction or arrangement in question.[298]

The UK GAAR was designed to be a moderate, targeted GAAR, which purpose is demonstrated in the 'double reasonableness test' set out in section 207(2) of the FA, which is regarded as being the centrepiece of the UK GAAR.[299] Section 207 (2) of the FA defines 'tax arrangements' as 'abusive' if they are arrangements 'the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions' having regard to all the circumstances, including specific examples listed in section 207(2)(a) - (c). This 'double reasonableness' test seeks to establish a norm of 'acceptability'.[300] Consequently, a court (or the GAAR panel) must consider what could have been 'reasonably regarded as reasonable' as opposed to what they subjectively think would have been reasonable.[301]

Section 208 of the FA defines a 'tax advantage' to include relief or increased relief from tax; repayment or increased repayment of tax; avoidance or reduction of a charge to tax or an assessment to tax; avoidance of a possible assessment to tax; deferral of a payment of tax or advancement of a repayment of tax, and avoidance of an obligation to deduct or account for tax.

Given that the UK GAAR legislation is relatively new and only operates retrospectively, there have been no cases decided by the UK courts under the UK GAAR to date and consequently the only guidance provided on the operation of the UK GAAR is incorporated in the HMRC Guidance, which is hypothetical and speculative in nature.[302]

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[298] Freedman J, 2016, 'General Anti-Avoidance Rules (GAARs) A Key Element of Tax Systems in the Post-BEPS Tax World? The UK GAAR', https://www.researchgate.net/publication/317998301.

[299] ibid.

[300] ibid.

[301] ibid.

[302] ibid.

3.6.3 **Operation of the UK GAAR and PPT**

Although limited information was available detailing how the UK intends on interpreting and applying the PPT and how it will operate with its domestic GAAR, it is notable that the UK GAAR is generally capable of applying in cases where a tax treaty is in place, this submission is supported by the 2003 Commentary that provides that as a general rule there is no conflict between GAARs and tax treaties.[303] In addition, the UK GAAR contains provisions that clearly allow its application where a tax treaty is in place.[304]

In accordance with the HMRC Guidance, the UK GAAR can only be applied to counteract the abusive arrangements in the context of tax treaties where there are abusive arrangements which try to exploit particular provisions in a tax treaty.[305] More specifically, the mere fact that arrangements benefit from express rules on attribution of profits or allocation of taxing rights does not mean that the arrangement amounts to abuse, and so the GAAR cannot be applied to them.[306] This does not however mean that the UK GAAR can override tax treaties as specific relieving provisions in tax treaties must be observed and GAARs cannot undermine these.[307]

It has been submitted that the interaction between the UK GAAR and the anti-avoidance provisions in treaties will be treated in the same fashion as the UK GAAR and other domestic anti-avoidance provisions, consequently, both sets of provisions will be applied in an independent manner.[308]

The author is of the opinion that while the wording and requirements of the UK GAAR are similar to that of the PPT, there are unfortunately no principles, judicial doctrines or jurisprudence that has been established under the UK GAAR to assist in the interpretation of the PPT. Although the HMRC Guidance will probably be relied on for interpreting and understanding what constitutes

303 ibid.

304 ibid.

305 HMRC, HMRC Guidance, loc,cit.

306 ibid.

307 Freedman J, 'General Anti-Avoidance Rules (GAARs) A Key Element of Tax Systems in the Post-BEPS Tax World? The UK GAAR', loc.cit.

308 ibid.

'one of the main or principal purposes' of a transaction or arrangement (see paragraph 2.3.1) or the meaning of the phrase 'reasonable to conclude' (see paragraph 2.3.2 above), it has been noted above that this guidance is indicative and speculative in nature. Consequently, in the next chapter the author explores how a tax authority in the U.S. applied a purpose test akin to the PPT which is incorporated in certain U.S. tax treaties.

4. Chapter 4: Practical guidance on the application of the PPT from the U.S.

4.1 Background

As discussed in Chapter 2, due to the extensive drafting of the PPT and the limited interpretative guidance provided on its scope and application, the practical operation of the PPT is unknown and is thus considered to be a somewhat elusive concept creating doubt and frustration within the international tax community. The adoption of the PPT raises particular concern insofar as it gives a great deal of discretionary power to domestic tax authorities and appears to be representative of 'an appropriation of power by administrators from domestic courts.'[309] Essentially, the responsibility to regulate the manner in which tax authorities exercise this wide discretion falls primarily on domestic legislators and the practical application of the PPT must be aligned with the legal framework governing the application of a particular jurisdiction's domestic GAAR.[310]

Unfortunately, it will only become apparent how far reaching the impact of the PPT is once domestic tax authorities are compelled to adjudicate on its application. Hattingh expresses the opinion that the only supportable data that is available to obtain some concrete guidance on how the PPT may be applied is provided in the case of *Starr International Company Inc. v. the USA*,[311] which was decided by the U.S. District Court for Columbia (*Starr* case).

[309] Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', loc.cit.

[310] ibid.

[311] *Starr International Co Inc v. United States of America* Case No 14-cv-01593 (CRC) (14 August 2017).

It is submitted that the decision in the *Starr* case is relevant as it may provide guidance on how the PPT will practically operate and be applied by tax authorities in a tax treaty context, including the method that could potentially be adopted in reviewing these decisions. The *Starr* case does not however fit perfectly into the context of the PPT as set out in Article 7(1) of the MLI, nevertheless, the judgment can be used as persuasive and supplementary guidance on how the PPT may be applied and operate in practice.

4.2 **The Principal purpose rule**

The enquiry under the *Starr* case involved a dispute around the application of Article 22(6) of the USA-Switzerland tax treaty (U.S.-Swiss tax treaty).[312] Article 22(6) of the UK-Swiss DTA provides that:

> A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs [the LOB provision] may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income arises so determines after consultation with the competent authority of the other Contracting State.[313]

The Switzerland - USA Technical Explanation to the 1996 Treaty (1997) (Technical Explanation) provides that paragraph 6 grants a taxpayer of a contracting state a benefit under the tax treaty by the tax authority of the other contracting state in instances when the taxpayer would not otherwise be entitled to that benefit.[314] The purpose for introducing this discretionary provision was in response to the fact that there are situations where significant participation by third country residents in an enterprise of a contracting state is allowed by sound business practice or long-standing business structures and does not necessarily have a motive of attempting to derive unintended tax treaty benefits. Furthermore, the Technical Explanation provides that:

[312] Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Income signed at Washington on October 2, 1996 and the Protocol signed at Washington on October 2, 1996.General Effective Date under Article 29: 1 January 1998.

[313] ibid.

[314] Department of the Treasury Technical Explanation of the Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Income signed at Washington on October 2, 1996 and the Protocol signed at Washington on October 2, 1996.

> The competent authority of a State will base a determination under this paragraph on whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the Convention. Thus, persons that establish operations in one of the States with a principal purpose of obtaining the benefits of the Convention ordinarily will not be granted relief under paragraph 6.[315]

Although the purpose of this clause seems to be similar to the discretionary relief clause, the focus on this discussion is on the wide discretion afforded to tax authorities in determining whether 'one of the principal purposes' of the conduct of a taxpayer's operation was to obtain benefits under the tax treaty. For the sake of convenience this test will be referred to as the principal purpose standard (PPS). Hattingh expresses the opinion that the language found in the PPT is not original and contends that the wording was borrowed from U.S. tax treaty practice and consequently the *Starr* case is of significance for the discussion of the PPT.[316]

4.3 The facts of the *Starr* case

The facts in the *Starr* case relate to a company that was established in the Republic of Panama (the taxpayer) and held majority of its interests in AIG, a US insurance group.[317] In 1970, the taxpayer was relocated to Bermuda, after which, the taxpayer entered in a restructuring transaction, which resulted in the establishment of a charitable trust in Bermuda.[318] Subsequent to the restructure, the charitable trust held all the shares with an economic value in the taxpayer and all of the voting rights were held primarily by executives of AIG. All dividends that were received by the taxpayer in Bermuda from AIG in the U.S. was subject to dividends withholding tax at the rate of 30 percent.[319] During 2004 the taxpayer was relocated to Ireland, and later the charitable trust

315 ibid.

316 Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', op.cit.,p.10.

317 *Starr International Co Inc v. United States of America* op.cit., p.7.

318 ibid.

319 ibid.

was also moved to Ireland.[320] In 2005 the taxpayer began contemplating relocation, claiming that Ireland was not a suitable jurisdiction for non-tax reasons, such as regulatory restrictions on charitable distributions and litigation risk.[321]

The decision making process that the taxpayer employed in deciding where it would relocate to was summarized in a so called 'decision matrix'.[322] The decision matrix was created in 2009 in an effort to demonstrate for the Competent Authority the analysis of factors considered for purposes of relocation. The decision matrix illustrated that in 2005, four factors were considered for purposes of deciding on a new location. These factors included U.S. taxes, local taxes, litigation risk and charities regulations.[323] The taxpayer noted that its intention was to locate itself and the charitable trust to the same jurisdiction as keeping these entities together would provide 'the strongest level of legal protection' in the event of a legal challenge.[324]

Initially, there were eleven jurisdictional options, which were later reduced to five, being Bermuda, the UK, the Netherlands, Switzerland or remaining in Ireland.[325]

It was considered that Switzerland was ideal for three of the four considered factors. The exception was the 'local tax' category as relief under the 1996 U.S.-Switzerland tax treaty was based on application to the competent authority for discretionary relief. Tax treaty relief applied automatically under the tax treaties with the U.S. and the UK and the Netherlands, notwithstanding this stated disadvantage, the taxpayer and the charitable trust were relocated to Switzerland in 2006.[326]

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[320] ibid p.9.

[321] ibid.

[322] ibid, p.11.

[323] ibid.

[324] ibid.

[325] ibid.

[326] ibid, p.12.

The taxpayer made an application to the U.S. competent authority in 2007 for discretionary relief under Article 22(6) of the U.S.-Swiss tax treaty. The taxpayer conceded that it was not entitled to benefits under the LOB tests set out in Article 22 of the U.S.-Swiss tax treaty, however, the discretionary relief was sought primarily on the grounds that its move to Switzerland was motivated by charitable considerations, not tax concerns.[327] In addition, the taxpayer noted that it chose to bear the risk of not obtaining relief under Article 22(6) of the U.S.-Swiss tax treaty because it believed that Switzerland was a better jurisdiction that the available alternatives from which to achieve the company's charitable objectives, even though it was less desirable that the available alternatives from a U.S. withholding tax perspective. In addition, the taxpayer submitted that its request was 'within the spirit of the objective criteria' of Article 22(2) of the U.S.-Swiss tax treaty.[328]

During 2010, the U.S. competent authority however disallowed tax treaty relief because it considered that obtaining treaty benefits was one of the principal purposes of moving the taxpayer’s residence, to Switzerland. In summary, the U.S. competent authority provided the following reasons for disallowing the tax treaty benefit:[329]

1. the original incorporation in Panama and its management and control in Bermuda suggested the structure was developed with a tax avoidance motive and / or with a purpose of avoiding the provision of information on the taxpayer's activities to the IRS;[330]

2. the circumstances of relocation to Ireland and its movement of management out of Bermuda a relatively short time before the payments of dividends to the taxpayer suggested that the reason was to benefit from the Ireland-U.S. tax treaty;[331]

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[327] Ibid.

[328] ibid.

[329] ibid, p.13.

[330] ibid, p.14..

[331] ibid.

3. the transitory nature of residency in Ireland and subsequent move to Switzerland further suggested an intention to organize in a jurisdiction where treaty reduced rates of dividends would be available;[332] and

4. the taxpayer was largely controlled by U.S. individuals and affording treaty benefits would not accord with 'U.S. policy on acceptable corporate ownership' for LOB purposes.[333]

4.4 The *Starr* case dispute

In casu, the taxpayer challenged the IRS's denial of treaty benefits as being arbitrary and capricious under the Administrative Procedure Act (APA).[334] The taxpayer's primary contention was that the aim of the U.S.-Swiss tax treaty's PPS is designed to prevent treaty shopping and that the IRS applied an erroneous definition to that term in concluding that the company's relocation to Switzerland was largely tax driven.[335]

The court found that there was nothing arbitrary or capricious in the competent authority's application of the PPS and finding that 'at least one of the principal purposes for moving the taxpayer’s management and therefore its residency to Switzerland' was to obtain tax benefits under the U.S.-Swiss Tax Treaty.[336] Accordingly, it was found that by applying the correct legal standard to a host of indisputable relevant facts, the competent authority satisfied its obligation under the APA to 'examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made.'[337]

4.5 The application of the PPS

The taxpayer contended that the competent authority's determination was arbitrary and capricious. In essence the taxpayer alleged that there was fault in

[332] ibid.
[333] ibid.
[334] ibid, p.3.
[335] ibid.
[336] ibid.
[337] ibid.

the competent authority's analysis on the PPS and the manner in which it applied the PPS. It was submitted by the taxpayer that the competent authority, *inter alia,* overlooked essential information that would have compelled a different result.[338]

For purposes of illustrating how the competent authority went about with its analysis on the PPS, this particular argument is discussed in detail below.

The taxpayer argued that certain evidence clearly demonstrated that obtaining tax benefits under the U.S.-Swiss Tax Treaty was not 'one of its principal purposes' for relocating to Switzerland. According to the taxpayer, its U.S. tax position was not improved by relocating to Switzerland because the most favourable withholding tax rate that it would obtain in Switzerland on dividends paid by AIG was the same rate that the taxpayer was entitled to under the U.S.-Ireland Tax Treaty.[339] In addition, given that this equivalent withholding tax rate was automatic in Ireland but discretionary in Switzerland, the only change that was brought about for the taxpayer on its relocation from Ireland to Switzerland was a less certainty that it would be entitled to a reduction in the withholding tax rate (as a consequence of the reduced rate being a discretionary benefit).[340]

The court stated that the submissions put forward by the taxpayer assumes a much narrower inquiry that is required under the Technical Explanation, which necessitates a competent authority to determine 'whether the establishment, acquisition, or maintenance of a company in the relevant jurisdiction had a principal purpose of obtaining treaty benefits.'[341] Moreover, the court noted that the Technical Explanation does not require a competent authority to merely ask what made a company's current jurisdiction more favourable than its previous one, although that might be part of the analysis, but rather why a company chose to 'establish' or 'maintain' itself where it did.[342] The court found that the question that should be asked is not simply why the taxpayer chose Switzerland

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338 ibid, p.30.

339 ibid, p.31.

340 ibid.

341 ibid.

342 ibid.

over Ireland, but rather why the taxpayer chose Switzerland over any other jurisdiction where it could have moved.[343]

Furthermore, the court stated that the language used in the Technical Explanation suggests that the competent authority should engage in a 'historical, totality-of-the-circumstances enquiry in evaluating a company's reasons for choosing a jurisdiction'[344]. This would include analysing the taxpayer's history of relocation and not just the taxpayer's most recent move. In this regard, the competent authority cited the aforementioned four specific facts and circumstances that it considered to be problematic.[345]

The taxpayer argued further that the decision matrix was conclusive proof that obtaining treaty benefits was not of principal concern to the company when deciding to relocate to Switzerland and that Switzerland offered a less favourable tax regime than the other jurisdictions considered such as the Netherlands and UK, both of which guaranteed the taxpayer the low dividends withholding rate that it had in Ireland.[346] Consequently, the taxpayer contended that the decision matrix proved that the tax motive was not a chief concern for its relocation to Switzerland.

The court noted that notwithstanding the decision matrix itself constituting suspect evidence, even if the decision matrix did accurately summarize the taxpayer's decision making process, it can hardly prove that tax benefits were low on the company’s priority list.[347] Moreover, 'U.S. Tax' was stated as being one of four key criteria that the taxpayer analysed in deciding on a jurisdiction and consequently illustrated that it constituted a principal consideration. In addition, the court determined that even though it was uncertain how the taxpayer arrived at its list of five final jurisdictions, it is presumed that the process of elimination would have bearing on whether treaty benefits were a

[343] ibid.
[344] ibid, p.32.
[345] ibid.
[346] ibid.
[347] ibid.

principal factor in its ultimate selection.[348] Finally, although Switzerland was labelled as 'bad' for U.S. taxes on the decision matrix, it was at least better than Bermuda and if the taxpayer has been afforded the discretionary relief (which the taxpayer seemed to expect) then Switzerland would have tied for first place in that category along with the other three jurisdictions.[349] Consequently, for these reasons the court held that neither the taxpayer's decision matrix, nor its decision to leave Ireland in favour of Switzerland, inevitably led to the conclusion that treaty benefits were not a 'principal' concern for the company when it chose to relocate and thus the competent authority's finding was not arbitrary or capricious.[350]

4.6 The role of the judiciary

The *Starr* case also illustrates the court's approach to decisions made by competent authorities in relation to determinations made in respect of tax treaty provisions. The court adopted the review standard applicable under administrative law to determine whether there were grounds present to allow the court to interfere with the decision taken by the U.S. competent authority to not grant treaty benefits under the U.S.-Swiss Tax Treaty.[351] The decision taken by the court was premised on the principles of administrative law, which provides that the only power available to the court is to declare a decision taken by a regulator to be invalid and consequently the competent authority would be required to consider the matter afresh. In this regard, the court does not have the power to substitute its own judgment in the place on the decision taken by that regulator.[352] The *Starr* case demonstrates the role of the judiciary in assessing a competent authority or tax regulators findings when exercising its discretion in terms of a tax treaty provision is to ensure that the competent authority correctly examined the relevant information and expressed suitable explanations for its decision, which include a rational connection between the

[348] ibid., p.33.

[349] ibid.

[350] Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', op.cit., pp.10 -11.

[351] ibid.

[352] ibid.

facts at hand and the choices made.[353] The court will generally presume validity and expertise on the part of the competent authority. Furthermore, the court 'should have before it neither more nor less information' that what was available to the competent authority.[354]

4.7 Concluding remarks on the *Starr* case

The *Starr* case provides a useful practical illustration of how a tax authority may approach the application of the PPT and the relevant facts that may be considered by that authority. From the decision it is, however, clear that the 'one of the principal purposes' test is indeed a low threshold and should be simple for the tax authority to meet.

In addition the outcome of the case is indicative of the 'potential extent of transfer of power under a PPT from courts to tax administrators as ultimate arbitrators to grant access to tax treaties.'[355]

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[353] ibid.

[354] ibid.

[355] ibid.

5. Conclusion

5.1 Summarising remarks

While legal certainty is identified as being one of the key objectives of the BEPS Action Report, it appears that the creation of the PPT is producing an unpalatable outcome due to the extensive wording of the provision and vague guidance provided by the OECD on its interpretation and scope of application.[356]

For example, the 2017 Commentary provides that the phrase 'one of the principal purposes' means that obtaining the benefit under a tax convention need not be the 'sole or dominant purpose' of a particular arrangement or transaction.[357] It is sufficient that at least one of the principal purposes was to obtain the benefit. This explanation leads one to question whether the 'choice principle' developed in *Conhage* and the commercial substance tests established in South African law will be used by SARS when assessing the relevant transaction in the context of tax treaties. In these circumstances, SARS may be of the view that if the eventual decision for entering into a certain type of transaction was tax driven, it is unlikely that obtaining a tax benefit was not one of the key considerations or principal purposes for entering into a specific type of transaction.

Notwithstanding the above, having regard to the OECD's approach to Example C and Example D in the 2017 Commentary, it is not clear that this would be the definitive position and that the 'choice principle' is unworkable. These examples seem to recognise the existence of commercial substance and choice by ultimately concluding that provided that the core transaction was commercially driven, structuring such transaction in a tax efficient manner in order to obtain tax treaty benefits will not in itself necessitate the application of the PPT.

The OECD, however, qualifies that the examples provided in the 2017 Commentary are provided for illustrative purposes only and should not be

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[356] Cunha RC, n.d, 'BEPS Action 6: Uncertainty in the Principal Purpose Test Rule', *10th Asia / Africa Conference* available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2796565.

[357] OECD, *2017 Commentary*, op.cit., p.593, paragraph 180 of the commentary on Article 29.

interpreted as providing a clear standard or static requirements which similar transactions must meet in order to avoid application of the PPT. Moreover, the application of the PPT must be determined based on the facts and circumstances on a case-by-case basis.

This contradictory guidance provided by the OECD leaves one in an uncertain position as to how the PPT will be applied in practice. The *Starr* case discussed above, although it does not consider the PPT in the context of Article 7(1) of the MLI (Article 29 of the 2017 Commentary), seems to apply the test in a more rigorous fashion by providing that, in the circumstances, it was relevant for the competent authority to ask why the taxpayer was established in a certain jurisdiction. If the answer was that tax treaty benefits were a consideration, then it was a purpose for establishment in that country and if that consideration featured as a main priority (along with any other considerations), obtaining tax treaty benefits would be considered as 'one of the principal purposes'.

From the above, it is notable that in practice the circumstances and considerations surrounding transactions and arrangements are a great deal more intricate and the considerations affecting the implementation of certain structures are not always clear cut. The OECD's examples are standard scenarios that do not deal with actual scenarios where there are copious factors to be considered and weighed up. In addition, the explanation provided by the OECD that accompanies the application of the PPT and outcome is brief and ambiguous.

Although the principles and doctrines established in South Africa for interpreting and applying the South African GAAR could potentially be of relevance in understanding the operation of the PPT which has been dubbed as a form of treaty GAAR, it is essential to note that that although the wording in the GAAR provisions and the PPT test seem to be *prima facie* substantially similar, the slight differences and nuances may result in two different tests with independent requirements that will not necessarily yield the same outcome. In addition, the principles developed by the South African courts should only be relied on for supplementary guidance, given that tax treaty provisions must be interpreted in accordance with the ordinary principle of tax treaty interpretation, more specifically, in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.

The lack of comparative material available regarding the direction and approach that other jurisdictions are considering taking towards integrating the PPT into domestic rules seems indicative that tax authorities are uncertain about how these rules will operate in practice. In addition, the wide discretionary powers that tax authorities will be entitled to exercise when applying the PPT should be subject to certain domestic checks and balances to ensure that the application strikes a balance between deterring treaty abuse without impeding on cross-border investment and business activities. Another concern that arises in terms of the wide discretion afforded to tax authorities is capacity constraints and corruption in government departments.

It is too early to assess how the introduction of the MLI and PPT will influence the international tax environment and whether these proposed changes will be positive developments in curbing tax treaty abuse or whether the effect of its operation will discourage cross border investment and curb international expansion for multinational corporations.

From a practical corporate tax governance perspective, it is advisable that multinational enterprises are informed in advance about the range of scope that is given to the PPT by the jurisdictions in which they operate and whether the interpretation of the PPT by the relevant jurisdictions is in line with the OECD's guidance and interpretation.[358] This will be of particular importance for the initial implementation phase of the PPT.[359]

The practical effects of adopting the PPT in South Africa must be determined with reference to non-residents wishing to invest in South Africa, as well as South African corporates investing offshore. Provision should be made in South Africa to adopt and implement the PPT in domestic legislation and for procedural safeguards to be established to accompany the application of the

[358] Chand V, 'The Principal Purpose Test in the Multilateral Convention: An in-depth Analysis', loc.cit.
[359] ibid.

PPT. South African legislators should also consider following Canada's lead by implementing an independent advisory panel that is responsible for the application of the PPT to certain arrangements or transactions that are suspected of abusing the provisions of tax treaties. Lastly, the role of the judiciary in reviewing decisions taken by SARS to disallow treaty benefits should also be clearly defined.

5.2 Limitations and areas for future research

It is considered appropriate to note that this research report is focussed solely on the main characteristics and criticisms levied on specific aspects of the PPT that have brought about the most controversy and academic debate among international tax scholars worldwide. This research report is inherently limited insofar as it does not fully critically assess each feature of the PPT or its practical operation. There is a wide range of scope for comprehensive studies to be performed into the nature and shortfalls of the PPT in its entirety, especially once this rule evolves and develops over time. In addition, this research report has not attempted to discuss the contemporaneous operation of the PPT with a simplified or detailed LOB provision nor does it consider how the mechanics of the PPT will integrate with other special anti-avoidance rules.

This research report briefly compares the approach taken by Canada, and to a lesser extent the UK, for the implementation of the PPT and how it might operate alongside domestic GAARs that are currently in place to deal with abusive or impermissible avoidance transactions. Unfortunately, a full study on this issue was not possible given a shortage of commentary and academic information available in these jurisdictions. This comparative enquiry should be expanded upon once tax authorities in these jurisdictions (as well as others) initiate drafting domestic guidance for the application and operation of the PPT in those specific jurisdictions.

The author notes that this research report makes an important theoretical contribution to assessing how the PPT could potentially be interpreted and applied in South Africa. Given the lack of guidance provided by the OECD, coupled with National Treasury and SARS' silence to date, this assessment is purely speculative in nature and expresses the author's own opinions and views. Consequently, there is scope for a comprehensive discussion on the topic once SARS and National Treasury issue draft legislation, explanatory memoranda, guidelines and other information on how the PPT will function in South Africa.

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A CRITICAL ANALYSIS OF THE PRINCIPAL PURPOSE TEST AND HOW IT COULD BE INTERPRETED AND APPLIED IN SOUTH AFRICA

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

Johannesburg, 2018

Abstract

The major theme of this research report is to provide a critical overview of the so-called 'principal purpose test' (PPT), which was first introduced by the Organisation for Economic Co-operation and Development (OECD) in the *OECD Action Plan on Base Erosion and Profit Shifting* during 2013. In essence, the PPT is an anti-avoidance rule of general application, which aims to operate as a mechanism to combat tax treaty abuse through avoidance transactions and will find application in instances when it is reasonable to conclude that a benefit granted by a tax treaty was 'one of the principal purposes' for implementing that arrangement or transaction. The PPT has since been incorporated in the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, more commonly referred to as the Multilateral Instrument (MLI), which was signed by 68 jurisdictions during a ceremony hosted by the OECD in Paris on 7 June 2017. The purpose of the MLI is to 'swiftly modify bilateral tax treaties to implement measures developed in the course of the work on BEPS'[1] *(own emphasis)*.

Given that South Africa has signed the MLI and has indicated that it will adopt the PPT in isolation, the aim of this research report is to critically analyse the PPT and examine how it will be applied and operate in South Africa and whether the South African general anti-avoidance rules (GAAR) can be used as a tool for interpreting and understanding the nature and ambit of the PPT.

Key words:

OECD, MLI, principal purpose test, PPT, BEPS, tax treaty, avoidance transactions, benefit, South Africa, GAAR, Action 6

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1 OECD, *Explanatory Statement,* Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI Explanatory Statement), 2016, p.2. paragraph 5.

Declaration

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

Lisa Lumley
October 2018

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I will give thanks to you, Lord, with all my heart; I will tell of all your wonderful deeds. Psalm 9:1

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Abbreviations and acronyms

2003 Commentary	2003 revisions to the commentary to the OECD MTC;
2017 Commentary	2017 revisions to the commentary to the OECD MTC;
Action 6 Report	Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report;
BEPS	Base Erosion and Profit Shifting;
BEPS Action Plan	The OECD's Action Plan on Base Erosion and Profit Shifting;
CITA	Canadian Income Tax Act RSC 1985, c. 1 (5th Supp.), as amended;
Covered Tax Agreements	as defined in Article 2(1)(a) of the MLI to essentially mean an agreement which is covered by the MLI;
CRA	Canada Revenue Agency;
DTC	Davis Tax Committee;
FA	UK Finance Act 2013;
ITA	Income Tax Act 58 of 1962, as amended;
IRS	Internal Revenue Service of the U.S.;
GAAR	General Anti-Avoidance Rules;
HMRC	HM Revenue and Customs, the tax authority in the UK;
LOB	limitation-on benefits;
MLI	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting;
OECD	Organisation for Economic Co-operation and Development;
OECD MTC	OECD Model Tax Convention on Income and on Capital;
PPT	Principal purpose test provision as set out in Article 7(1) of

	the MLI, Article X of the Action 6 Report and Article 29(9) of the 2017 Commentary;
SAARs	special anti-avoidance rules;
SARS	South African Revenue Service;
tax treaty	the term collectively refers to bilateral tax treaties, Covered Tax Agreements, double taxation agreements, and the OECD MTC;
UK	United Kingdom of Great Britain and Northern Ireland;
VCLT	Vienna Convention on the Law of Treaties; and
U.S.	United States of America.

1. Chapter 1: Introduction

1.1 Background

The OECD has publically expressed the view that in recent years the international tax framework has undergone immense strain and was rapidly becoming obsolete due to the integration of national economies and markets having increased substantially over the years.[2] International tax rules revealed certain shortcomings thus creating opportunities for BEPS to transpire.[3] The presence of BEPS has the effect of decreasing corporate tax revenue as a result of structures, transactions and arrangements aimed at eroding the tax base and shifting profits to locations where they are subject to more favourable tax treatment or tax treaty benefits.[4] International policymakers required drastic changes in order to restore confidence in the international tax environment.[5]

During 2013 the OECD Committee of Fiscal Affairs submitted the BEPS Action Plan to the G20 in terms of which 15 actions were identified to address BEPS.[6] The BEPS Action Plan recognises the need to introduce consistency into domestic rules affecting cross-border activities, reinforcing substance requirements in existing international standards, as well as improving transparency.[7] The final BEPS Action Plan was published and endorsed by the G20 Finance Ministers and leaders in October 2015 and covers all 15 identified action areas and recommends provisions for countries to make in their domestic law and tax treaties in order to enforce prescribed measures in key areas, such as treaty abuse.[8]

The Action 15 interim report of the BEPS Action Plan emphasized a need to develop a multilateral instrument for purposes of efficiently implementing tax

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2 OECD, *Explanatory Statement,* OECD/G20 Base Erosion and Profit Shifting Project, 2015, p.4 www.oecd.org/tax/beps-explanatory-statement-2015.pdf.

3 ibid.

4 ibid.

5 ibid, the author notes that these are the views as expressed by the OECD. A more critical approach is that governments started to focus on building tax revenues following the 2008 economic decline when countries were grappling to find additional sources of revenue.

6 ibid.

7 OECD, *Information Brief,* OECD/G20 Base Erosion and Profit Shifting Project. 2015 Final Reports, 2015, p.3, http://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf.

8 ibid.

treaty related measures by way of automatically modifying bilateral tax treaties. Consequently, an *ad hoc* group was established to develop a multilateral instrument. The Multilateral Instrument, officially called the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI) was adopted on 24 November 2016.[9]

On 7 June 2017, during a ceremony hosted by the OECD in Paris, 68 jurisdictions, including South Africa, signed the MLI. Since this date, ten additional jurisdictions have signed the MLI.[10] The parties to the MLI are required to make the MLI effective under domestic legislation.

As briefly stated above, the purpose of the MLI is to operate concurrently with bilateral tax treaties and amend and modify certain provisions. The MLI will also make provision for the inclusion of certain minimum standards, without requiring each jurisdiction to separately engage and renegotiate existing bilateral tax treaties. It has been argued that there is more to the MLI than its stated objectives.[11] Moreover, although it is intended to operate as a 'time-efficient bulk renegotiation mechanism'[12], it may have a disruptive effect on certain intermediary jurisdictions, given that the MLI is anticipated to unsettle certain industries in national service associated with the tax treaty shopping industry.[13] Certain countries have also indicated a preference for entering into bilateral renegotiation due to the difficulty that arises with domesticating the MLI.[14] A critical discussion on the MLI is however beyond the scope of this research report.

The new treaty anti-avoidance provisions were introduced in Action item 6 of the final BEPS Action Plan, dealing with *Preventing the Granting of Treaty*

9 OECD, *MLI Explanatory Statement*, op cit., p.2.

10 Hattingh PJ, 2018, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', *Bulletin for International Taxation*, vol. 72, no.4/5, p.1.

11 ibid.

12 ibid.

13 ibid, p.14.

14 ibid. Hattingh PJ notes that Switzerland and Mauritius have expressed a preference for bilateral renegotiation to implement BEPS minimum standards.

Benefits in Inappropriate Circumstances (Action 6 Report),[15] which highlights that treaty shopping is a crucial BEPS concern and consequently provides safeguards against abusive or avoidance transactions.[16] The OECD recommends including the following 'minimum standards' in tax treaties to target treaty shopping:

i. a clear statement in the relevant tax treaty that the countries entering into the tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements;[17]

ii. a specific anti-abuse rule, specifically, the LOB rule that limits the availability of treaty benefits to entities meeting certain criteria to be included in tax treaties.[18] These conditions are based on legal nature, ownership in, and general activities of the relevant entities.[19] The LOB rule seeks to ensure that there is a sufficient link between the relevant entity and its country of jurisdiction; and[20]

iii. for purposes of all other general forms of tax treaty abuse, including treaty shopping situations that would not be covered by the LOB rule, countries are obliged to include one of the following three alternative options into their tax treaties:[21]

    a. the PPT as a standalone mechanism. The PPT is a general anti-abuse rule based on the principal purpose of a transaction or arrangement and provides that a benefit will not be granted under a tax treaty if it is reasonable to conclude, after having regard to all relevant factors and circumstances, that obtaining that benefit was

15 OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Repor*t, OECD/G20 Base Erosion and Profit Shifting Project (Action 6 Report), 2015, http://dx.doi.org/10.1787/9789264241695-en.

16 OECD, *Action 6 Report*, op.cit., p.9.

17 ibid.

18 ibid.

19 ibid.

20 ibid.

21 ibid.

one of the principal purposes of any arrangement or transaction that resulted either directly or indirectly in that benefit (First Alternative);[22]

b. the PPT and either a simplified or detailed LOB rule, which limits the availability of treaty benefits to persons that meets certain prerequisites (Second Alternative);[23] or

c. a detailed LOB provision, supplemented by a mechanism that would deal with conduit arrangements not already covered under existing tax treaties (Third Alternative).[24]

Unlike certain other provisions encompassed in the MLI, which countries can elect to opt out of entirely, the provisions of Article 7 relating to treaty abuse oblige parties to adopt one of the minimum standards. Given that the PPT is the only alternative that can satisfy the minimum standard on its own, it is presented as the default option.[25] It is noteworthy that where parties elect an option that requires a detailed LOB provision (either one aspect of the Second Alternative or the Third Alternative), substantial bilateral customisation will be required, which would be a challenge in the context of the MLI.[26] Accordingly, the MLI does not include a provision for the adoption of a detailed LOB clause rather, parties are permitted to opt out of the PPT (for purpose of the Third Alternative) and agree to reach a bilateral agreement that satisfies the minimum standard.[27] The author observes that this seems counter-intuitive to the precise purpose of the MLI.

As a consequence of the Action 6 Report and the introduction of the MLI (with specific reference to Article 7 of the MLI), Article 29 of the 2017 Commentary has been inserted to include the relevant provisions detailing the implementation of the minimum standards (save for the Third Alternative) to be included in tax treaties. The recommended provisions in relation to the PPT are similar to those that have been included in the MLI. In addition, the

[22] ibid.
[23] ibid.
[24] ibid.
[25] OECD, *MLI Explanatory Statement*, op.cit.,p.22.
[26] ibid.
[27] ibid.

commentary provided on Article 29 in the 2017 Commentary largely replicates the commentary included in Article X of the Action 6 Report.

Curiously, the new Article 29 to the 2017 Commentary contains the relevant provisions and/or paragraphs for the adoption of the Second Alternative, namely, the combination of the PPT and the simplified LOB rule.[28] There is however no guidance in the 2017 Commentary for countries that opted to adopt the PPT in isolation under the MLI.[29] It is apparent that the even though the parties to the MLI are provided with a choice as to which minimum standard they wish to implement, the 2017 Commentary seems to prescribe the Second Alternative as the default option, being the least popular of the alternatives to the minimum standard.[30] The Second Alternative is considered to be an impractical minimum standard because as a general rule, where one country chooses to apply the simplified LOB and the other country has elected to apply the PPT in isolation, the simplified LOB will generally not apply, and, by default, the PPT would apply.[31] The two countries in question are however entitled to conduct bilateral negotiations to arrive at a compromise position, which will still satisfy the minimum standard requirement.[32] It has been submitted that the adoption of the combination of the PPT and a simplified LOB clause is unrealistic, given that treaty partners will be required to have matching LOB provisions.[33]

1.2 Objective of the research

1.2.1 Statement Problem

This research report attempts to answer the statement problem, which is to address how the PPT will be applied in South Africa and whether domestic principles established under the South African GAAR can be used as a mechanism for interpreting the key features of the PPT.

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28 Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', op.cit., p.6.
29 ibid.
30 ibid.
31 OECD, *MLI Explanatory Statement*, op.cit., paragraph 102, p.24.
32 ibid.
33 Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', loc.cit.

1.2.2 The Sub-problems

The following sub-problems have been identified and should be considered in addressing the aforementioned research statement problems:

i. Has the OECD provided adequate guidance on the nature, scope and application of the PPT?

ii. How should the phrase in the PPT 'one of the principal purposes' be interpreted?

iii. How will the reasonableness test in the PPT be applied? More specifically, will the application of this test be applied in a subjective or objective manner?

iv. How will the object and purposes of the relevant tax treaty provisions be established for purposes of operating as an exception to the application of the PPT?

v. Has any guidance been provided on how the PPT will operate in practice, including guidance from other jurisdictions?

vi. Will domestic GAARs and the PPT operate in tandem?

1.3 Significance of the study

This research report attempts to make a number of important contributions to international tax in the context of South African law.

Firstly, it summarises and critically assesses the key components of the PPT by laying out the guidance provided on these features by the OECD, as well as the criticisms thereof by academics and scholars from around the globe who specialise in international tax.

Secondly, this research report attempts to address how South Africa might attempt to approach the interpretation of the PPT with reference to the ordinary principles of tax treaty interpretation and principles established by South African courts in interpreting the provisions of the South African GAAR.

Lastly, this research report discusses an example about how the PPT might be applied in practice. In this regard, an analysis of a judgment handed down in the U.S. will be considered, which dealt with the application of a tax treaty principle included in certain U.S. tax treaties that strongly resembles the characteristics of the PPT and demonstrates how the relevant tax authority applied the test. In addition, the judgment highlights the role of the judiciary with respect to the review processes relating to decisions made by tax authorities under tax treaty provisions.

1.4 Delimitations of the research

This research report is limited to the following:

i. a brief overview of the objectives of the BEPS Action Plan and a summary of the introduction of the MLI into the international tax realm. This research report does not attempt to critically analyse the operation of the MLI, nor does it make any submissions detailing whether or not the MLI is anticipated to be successful in its attempt to simplify bilateral negotiations and hardcode the minimum standards into law;

ii. a discussion of the main features of the PPT, including inter alia, a critical analysis of the meaning of the phrase 'one of the principal purposes' and the reasonability test that is encapsulated in the PPT. This discussion does not attempt to critically discuss each feature of the PPT, for instance, the meaning of the terms and phrases 'benefit', 'that resulted directly or indirectly in that benefit' and 'arrangement or transaction';

iii. an overview of the South African GAAR is set out, however, a detailed critical discussion of each requirement of the GAAR is beyond the scope of this research report. The most recent approach of South African courts to a purposive interpretation of statutes is mentioned. No discussion is however included on the background to or different methods of interpreting statutes in South Africa;

iv. the interrelationship of domestic GAARs and treaty provisions will be highlighted. The argument that ensues focuses on whether the South

African GAAR should (or can) be used as a tool for interpreting the PPT. This research report makes brief mention of how Canada and the UK are intending to approach the PPT in the context of each country's domestic GAAR. These two jurisdictions are considered because, like South Africa, they are commonwealth jurisdictions with domestic GAAR legislation (which includes reasonableness tests) and can consequently be likened to South Africa from a GAAR perspective. The author was unable to undertake a thorough comparative analysis given the limitation of foreign resources available to date, for reasons such as restricted access to certain international data bases and journals, as well as copyright laws. Furthermore, this research report is limited to a discussion of GAARs and no discussion about SAARs is undertaken (including any discussion of the concurrent operation of GAARs and SAARs in a domestic and / or tax treaty context); and

v. finally, for practical purposes, this research report discusses a case decided in the U.S. dealing with the application of a treaty principal purpose test that is analogous to the PPT. This research report does not claim that this will be the approach followed when applying the PPT. The discussion is merely used as an illustrative example of how the test may be applied in the future.

1.5 **Research Methodology**

A qualitative approach is adopted in this research report, which will be achieved mainly by an examination of the available literature on the subject matter. Specifically, an extensive critical literature review of various publications made available by the OECD, as well as secondary data sources is undertaken to address the objectives and purpose of this research report as set out in in the statement problem and the sub-problems. Various internet websites have also been consulted in order to obtain current information.

The study will also be descriptive and analytical in nature as it attempts to describe various concepts, such as the BEPS concept, with specific focus on the PPT and MLI.

This research approach aims to develop a comprehensive theoretical framework against which the statement problem and sub-problems can be addressed and tested.

1.6 Chapter outline

This section contemplates on a high-level basis, the most important considerations that will be discussed in each chapter of the research report.

Chapter 2 aims to provide an overview of the PPT in the context of tax treaties. Specific reference is made to the guidance provided by the OECD on the interpretation and understanding of this principle. Furthermore, various features of the PPT are critically assessed by discussing the opinions and views of various international tax scholars and academics. This discussion will delve into how the phrase 'one of the principal purposes' is understood amongst international scholars and academics as well as an analysis of how the reasonableness test in the PPT should be applied.

Chapter 3 aims to provide a background to domestic GAARs and how they are intended to operate in the context of tax treaties, with specific focus on the PPT, which is perceived to be a treaty GAAR. This chapter will briefly discuss the provisions of the South African GAAR and whether the various components of the PPT can be reconciled with those of the South African GAAR in an attempt to assist with interpreting the requirements of the PPT.

Chapter 4 discusses a recent judgment handed down in the U.S. District Court for the District of Columbia, which focuses on the judiciary reviewing a decision taken by the U.S. tax authorities in determining whether a company relocated its jurisdiction of residence for purposes of obtaining a treaty benefit. Although this decision does not deal with the application of the PPT in the context of the Action 6 Report or MLI, it deals with a similar provision included in certain U.S. tax treaties, which provides the U.S. tax authority with the discretion to allow certain benefits under a tax treaty if it concludes that 'one of the principal purposes' for entering into the transaction was not to obtain a tax benefit. The judgment is used as a guide as to how the PPT might be applied and the role of the judiciary in assessing decisions made by tax authorities. In no way does the author submit that this decision will be binding on any jurisdiction when applying the PPT.

The concluding chapter will briefly collate the observations and findings of the previous chapters and provide a synopsis in order to appropriately address the problem statements without clinically addressing each specific issue independently.

2. Chapter 2: Overview of the PPT

2.1 Background to GAARs and treaty abuse

Prior to the introduction of the BEPS Action Report and MLI, the approach that was followed by the OECD to tackle treaty abuse in the form of GAARs was set out in the 2003 Commentary.[34] The recommended approach for disallowing treaty benefits where abuse is present is twofold in nature. In the first instance, countries are generally entitled to elect either to rely on their domestic GAARs, or alternatively, to apply the principle of good faith as enshrined in Article 31 of the VCLT.[35] The principle of good faith is premised on the notion that application of tax treaty provisions is subject to an unwritten prohibition of abuse, which relies on the object and purpose of treaties as well as the obligation to interpret them in good faith.[36] The first leg of the assessment could ultimately be based on domestic law or could have an international tax treaty flavour.[37] Under both approaches, countries are not required to grant the benefits of a tax treaty where arrangements that constitute an abuse of the provisions of the treaty have been entered into.[38]

In the 2003 Commentary, the OECD cautions that it should not be 'lightly assumed' that a taxpayer is entering into an abusive transaction.[39] Consequently, the second leg of the assessment is founded on the so called 'guiding principle', which provides that 'the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.'[40]

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34 Danon RJ , 2018, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' *Bulletin for International Taxation,* vol.72, no.1, 2018, p. 36, https://online.ibfd.org/kbase/#topic=doc&url=/collections/bit/html/bit_2018_01_int_2.html.

35 ibid, p.37.

36 ibid.

37 ibid, p.36.

38 OECD, *Model Tax Convention on Income and on Capital: Condensed Version 28 January 2003*, (OECD 2003 Commentary) OECD Publishing, 2003, p.54, paragraph 9.4.

39 ibid.

40 ibid.

Ultimately, the 'guiding principle' comprises of a subjective (a main purpose) and objective (more favourable tax position) requirement. It is commonly known that the nature and function of the 'guiding principle' as encapsulated in the 2003 Commentary is however contentious given that there is no clear guidance provided on its nature, role and application.[41] Danon states that there is uncertainty on whether the 'guiding principle' is viewed as a treaty GAAR or more a representation of a general standard imposed, which countries are required to comply with when denying treaty benefits on the basis of a domestic GAAR, or a treaty GAAR.[42]

As a result of the uncertainty stemming from the 'guiding principle', the OECD essentially codified the 'guiding principle' by creating the PPT as set out in the Action 6 Report, Article 7(1) of the MLI and the new Article 29(9) of the OECD 2017 Commentary. In Danon's view, the PPT can be viewed as a genuine form of treaty GAAR.[43]

Notwithstanding the above, the OECD expressed in the 2017 Commentary that the application of the PPT and 'guiding principle' will continue to co-exist. Moreover, the OECD provided that even in instances where a tax treaty does not contain a PPT, benefits could still be directly denied on the basis of the 'guiding principle' as the 'guiding principle' applies independently from the PPT, which merely confirms it.[44] This passage is indicative of the synonymous nature of the 'guiding principle' and PPT, as it appears that the OECD equates these two concepts as being one and the same with respect to the scope and nature. Furthermore, it is evident from the OECD's perspective that the PPT has been in existence in a nonconcrete form for a considerable amount of time and is therefore not a new concept that has been introduced into international tax policy.

41 Danon RJ 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups', op. cit., p37.

42 ibid.

43 ibid.

44 OECD, OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017 21 November 2017*, (2017 Commentary) OECD Publishing, 2017, p.73, paragraph 61 of the commentary on Article 1 http://dx.doi.org/10.1787/mtc_cond-2017-en.

2.2 **Introduction of the PPT**

In order to prevent the granting of treaty benefits in inappropriate circumstances, the OECD notes in the Action 6 Report that a distinction should be made between situations where a person attempts to circumvent the provisions of domestic tax law to gain tax treaty benefits (in these instances, treaty shopping must be addressed through domestic anti-avoidance rules)[45] and situations where a person attempts to circumvent limitations provided by the tax treaty itself.[46]

As discussed in paragraph 1.1 above, the OECD recommends that at a minimum level, to protect against treaty abuse, countries should include in their tax treaties an express statement that their common intention is essentially to eliminate double taxation,[47] include LOB provisions to target specific instances of treaty abuse and include one of the following alternatives to tackle general anti-avoidance abuse.[48] The first of these alternatives is to adopt the PPT in isolation. The second alternative is to elect to use the PPT in tandem with either a simplified or detailed LOB provision. The last alternative does not involve the adoption of the PPT, but is rather focused on implementing a detailed LOB provision, supplemented by a mechanism that would deal with conduit arrangements not already dealt with in tax treaties.[49]

Sixty eight of the MLI signatories have opted to adopt the PPT alone to address treaty abuse.[50] This is unsurprising given that the PPT is the only alternative that can satisfy the minimum standard on its own. Thirteen jurisdictions have elected to adopt a combination of the PPT and the simplified LOB clause.[51] Six jurisdictions have decided to adopt the PPT as a transitional measure until such time that bilateral agreements with treaty partners are renegotiated to adopt a

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45 OECD, *Action 6 Report*, op.cit., p.17.

46 ibid.

47 OECD, *Action Report*, op. cit., p.19, paragraph 22.

48 OECD, *Action 6 Report,* loc. cit.

49 ibid.

50 Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', op.cit. p.6, cited in Danon RJ & Salome H, 'MLI Summary table'.

51 ibid.

LOB clause or a combination of the PPT and LOB clause in its place.[52] This research report is limited to a discussion of the PPT and any further discussion on the alternative two options is beyond the scope of this report.

As mentioned above, the PPT rule is set out under Article 7(1) of the MLI, Article X of the Action 6 Report and the new Article 29(9) of the OECD 2017 Commentary. The MLI and *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI Explanatory Statement) do not provide practical guidance on the interpretation and application of the PPT, but rather set out what the PPT is and the attendant provisions that should be included in tax treaties, in addition to clarifying the operation of the MLI to modify Covered Tax Agreements.[53]

The MLI Explanatory Statement, however, expressly attributes importance to the Action 6 Report for the purpose of interpreting the MLI in the following passage:

> Accordingly, the provisions contained in Articles 3 through to 17 [of the MLI] should be interpreted in accordance with the ordinary principle of treaty interpretation, which is that 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 light of its object and purpose. In this regard, the object and purpose of the Convention is to implement the tax treaty-related BEPS measures. The commentary that was developed during the course of the BEPS Project and reflected in the Final BEPS Package has particular relevance in this regard (own emphasis).[54]

Given that the OECD has recently released the 2017 Commentary that virtually mirrors the commentary provided on the PPT in Article X (Entitlement to Benefits) in the Action 6 Report, this research report focuses on the more recent commentary provided by the OECD in Article 29 of the 2017 Commentary to provide guidance on the interpretation of the PPT and its practical application.

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52 ibid.

53 OECD, *MLI Explanatory Statement*, op.cit., p.2.

54 ibid.

The 2017 Commentary (and Article X of the Action 6 Report) discusses a number of practical examples to illustrate how the PPT will operate in practice. The OECD specifically caveats, however, that when reading the examples it is essential to remember that the application of the PPT must be determined on the basis of the facts and circumstances of each case.[55] Consequently, these examples are not binding and each arrangement or transaction should be assessed and analysed based on its own particular facts and circumstances, notwithstanding any similarities between the two sets of facts.[56]

It is worth highlighting that Article 7(4) of the MLI (and paragraph 10 of the 2017 Commentary on Article 29) contains an optional discretionary provision which does not constitute a minimum standard but makes provision for an additional discretionary relief clause to be adopted (discretionary relief clause) by parties to tax treaties.[57] Accordingly, a state may elect to include a clause in its tax treaty that will operate in instances where a benefit is denied to a person under the PPT and where the tax authority of that state would have otherwise granted that benefit. The discretionary relief clause provides that a taxpayer may request the relevant tax authority to treat that taxpayer as being entitled to the benefit that was denied or to different benefits under the tax treaty.[58] The tax authority may grant that benefit or different benefits if it is determined that such benefit or benefits would have been granted to that person in the absence of the transaction or arrangement referred to under the PPT after considering the relevant facts and circumstances.[59] The tax authority of the state to which the request has been made must also consult with the tax authority of the other state before rejecting a request made under this clause.[60]

[55] OECD, *2017 Commentary*, op.cit., p,591, paragraph 182 of the commentary on Article 29.
[56] ibid.
[57] OECD, *2017 Commentary*, op.cit., p.600, paragraph 184-185.
[58] ibid.
[59] ibid.
[60]ibid.

2.3 Critical analysis of the PPT with reference to guidance provided by the OECD

The standard wording of the PPT is encapsulated in article 7(1) of the MLI and provides as follows:

> Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.[61]

The wording of the PPT as set out above is analogous to the wording provided in paragraph 9 in Article 29 of the 2017 Commentary and is also in line with the wording of the minimum standard set out in Article X of the Action 6 Report. Consequently, in order for the PPT to be satisfied and find application the following requirements must be present:

i. an arrangement or transaction must be present;

ii. which directly or indirectly results in a benefit under a tax treaty;

iii. which was set up for one of the principal purposes of obtaining that benefit; and

iv. it is not proven that granting the benefit is in line with the object and purpose of the relevant provisions of the tax treaty.

[61] OECD, Article 7(1) of the MLI, at pp 8-9. Article 2(1)(a) of the MLI defines 'Covered Tax Agreement' to mean 'an agreement for the avoidance of double taxation with respect to taxes on income (whether or not other taxes are also covered):

i) that is in force between two or more:

A) Parties; and/or

B) jurisdictions or territories which are parties to an agreement described above and for whose international relations a Party is responsible; and

ii) with respect to which each such Party has made a notification to the Depositary listing the agreement as well as any amending or accompanying instruments thereto (identified by title, names of the parties, date of signature, and, if applicable at the time of the notification, date of entry into force) as an agreement which it wishes to be covered by this Convention.'

It is essential that the elements of the PPT are understood and interpreted correctly and uniformly so that that there is no uncertainty surrounding its interpretation or the range and scope of its application. Consequently, this research report attempts to critically interpret and analyse the provision with specific reference to the guidance provided by the OECD in the OECD 2017 Commentary, read with Article X of the Action 6 Report. Given the all-encompassing nature of the PPT, this research report will not scrutinize all of the elements to the PPT but will rather focus on the controversial aspects of the PPT which have already given rise to confusion and debate among scholars and academics. These aspects include the following:

i. the meaning of 'one of the principal purposes';

ii. the meaning and effect of the words 'reasonable to conclude', which includes a discussion of the nature of the test and a discussion on the standard of proof;

iii. the interpretation of the requirement requiring the benefit to be in accordance with the object and purpose of the relevant provisions of the tax treaty; and

iv. the procedural practical application of the PPT.

2.3.1 Meaning of 'one of the principal purposes'

The 2017 Commentary provides that the term 'one of the principal purposes' essentially means that 'obtaining the benefit under a tax treaty need not be the sole or dominant purpose of a particular arrangement or transaction.[62] It is sufficient to satisfy the PPT that at least one of the principal purposes was to obtain the benefit.'[63]

One of the examples provided in the 2017 Commentary envisages a person selling a property for various reasons and notes that if before the sale that person becomes a resident of one of the contracting countries and one of the principal purposes for doing so was to obtain a benefit under a tax treaty, the

[62] OECD, *2017 Commentary*, op.cit., p.593, paragraph 180 of the commentary on Article 29.
[63] ibid.

PPT could apply, notwithstanding there being other principal purposes for changing residence, such as facilitating the sale of the property or the re-investment of the proceeds of the alienation.[64]

The OECD provides that a purpose is not a principal purpose when, after considering all the relevant circumstances it is reasonable to conclude that 'obtaining the benefit was not a principal consideration and would not have justified entering into any arrangement or transaction that has, alone or together with other transactions, resulted in the benefit. In particular, if an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit'.[65]

Criticism is advanced against the broad drafting of the PPT, which appears to result in a dangerously low threshold for transactions or arrangements to be denied tax treaty benefits as a result of treaty abuse.[66] Many academics interpret the wording of the PPT to essentially mean that where there are two equally important reasons to establish an arrangement or carry out a transaction, one being a tax related reason that arises pursuant to obtaining treaty benefits, and the other being a non-tax related commercial reason, the PPT would probably apply, given that one of the two principal purposes is to obtain a treaty benefit.[67]

In Kazaco's view,[68] the use of the words 'one of' the principal purposes is analogous to 'a principal purpose' and is consequently too broad to properly capture genuine treaty abuse.[69] A stringent interpretation and application of the PPT could consequently have detrimental results and impact the growth of multinational enterprises, which could potentially be counter-intuitive to the very

[64] ibid. See also OECD, Action 6 Report, op.cit., p. 58, paragraph 12 of Article X.

[65] OECD,*2017 Commentary*, op.cit., p.591, paragraph 181.

[66] Kuźniacki B, 2018, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', *World Tax J*ournal, vol. 10, no.2, at p.13.

[67] ibid.

[68] Kazacos A, 2016, 'BEPS Action 6: The principal purpose test revisited – Part I', *International Tax Report* [online journal], http://www.internationaltaxreport.com/double-taxation/beps-action-6-the-principle-purpose-test-revisited–part-i–1.htm.

[69] ibid.

existence of tax treaties.[70] Moreover, the rationale for entering into tax treaties is to encourage taxpayers to engage in business and make investments in various countries. Consequently, if the PPT is construed too broadly, it could potentially result in the very purpose for implementing tax treaties becoming redundant. It is therefore crucial that a balance is achieved between eliminating double taxation and preventing treaty abuse.[71]

In Weber's view,[72] although there is nothing to show that the OECD modelled the PPT on the UK GAAR, both their purpose and reasonableness tests are strikingly similar. This is unsurprising given that the UK played an active role in assisting the OECD with the BEPS initiative.[73] The UK GAAR was introduced in Chapter 5 of the FA during 2013. Section 207(1) of the FA provides that 'arrangements are "tax arrangements" if, having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements'. The wording 'main purpose, or one of the main purposes' under the UK GAAR is substantially similar to the wording under the PPT which requires 'one of the principal purposes' to secure a benefit. Consequently, the *HM Revenue and Customs (HMRC) General anti-abuse rule guidance (Approved by the GAAR Advisory Panel with effect from 28 March 2018)* (HMRC Guidance) may be a useful supplementary (ancillary to the OECD guidance) tool to assist with interpreting and understanding the meaning of 'one of the main purposes'.[74]

The HMRC Guidance provides that:

i. The GAAR legislation does not define the meaning of the phrase 'the main purpose' or 'one of the main purposes', consequently, these expressions

[70] ibid.

[71] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', loc. cit.

[72] Weber D, 2017, 'The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law', *Erasmus Law Review*, vol. 1, p.51.

[73] Mike Williams of HM Treasury plays an important role in guiding the UK's international tax policy was the chairman of the BEPS Action 15 working group, who brought around 100 countries to a consensus position on the development of the MLI.

[74] HM Revenue and Customs, *HM Revenue and Customs (HMRC) General anti-abuse rule guidance (Approved by the GAAR Advisory Panel with effect from 28 March 2018)* (HMRC Guidance), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/695255/gaar_parts_a_b_c_2018.pdf.

should be given their normal ordinary meaning and have to be applied objectively, with regard to the full context and facts.[75]

i. It is usually clear whether trying to obtain a tax advantage is the 'main purpose' of a particular transaction, however, determining whether obtaining a tax advantage is 'one of the main purposes' is more difficult. This test attempts to establish 'whether a transaction which would otherwise have occurred has been reshaped, or has been entered into under different terms and conditions, in order to change significantly the tax result that would otherwise have arisen, and where the desired tax result is itself a substantial objective.'[76] It is highlighted that the differences may be subtle.[77]

ii. Obtaining tax advice is not, on its own, indicative that obtaining a tax advantage is a main purpose of the agreement. Where significant amounts are at stake, most taxpayers will routinely seek tax advice.[78]

It is unclear how this interpretation of 'one of the principal purposes' test will operate in practice, especially given that tax considerations are often one of the biggest deal drivers and a primary concern for companies wishing to enter into transactions, as businesses will generally take tax considerations into account before deciding to proceed with a certain arrangement.[79] The question that arises is when this particular consideration will be regarded as 'one of the principal purposes'[80]. Kazacos is of the view that to deny tax treaty benefits to companies engaging in transactions without a strong focus on the tax implications would be to deny the practical reality of how businesses function.[81] The OECD is silent on providing any criteria to apply in distinguishing between

[75] HM Revenue and Customs, *HMRC Guidance*, op.cit., p.20, paragraph C3.4.

[76] HM Revenue and Customs, *HMRC Guidance*, op.cit., p.20, paragraph C3.5 and C3.6.

[77] ibid.

[78] ibid.

[79] Kazacos A, 'BEPS Action 6: The principal purpose test revisited – Part I'. loc. cit. See also, Bhargava A, 'The Principal Purpose Test: Functioning, Elements and Legal Relevance', in Blum and Seiler (eds.), *Preventing Treaty Abuse, Series on International Tax Law*, 2016, p. 318, where Bhargave submits that taxpayers generally gear arrangement or transactions to be most efficient as it is common cause for transactions to be structured in such a way that taxes are reduced to a minimum and consequently arguments submitted by taxpayers alleging that arrangement or transactions were motivated by commercial business reasons would be difficult to prove in practice.

[80] ibid.

[81] ibid.

main purposes and ancillary purposes as well as differentiating main purposes from each other.[82] In addition, no guidance is provided on the method and process to be applied in ranking those purposes. The lack of guidance on this substantial element of the PPT is unfortunate, especially since the application of the PPT and the legal consequences thereof are dependent on its application.[83]

The guidance provided by the OECD on the meaning of 'one of the principal purposes', vaguely attempts to illustrate what a principal purpose is.[84] After considering these examples it seems that there would not be principal purpose to obtain a benefit where:

i. it was not a principal consideration that would have justified the implementation of a transaction or arrangement; and

ii. where certain actions were inextricably linked to a core commercial activity.[85]

Danon expresses the view that when one considers the examples provided in the 2017 Commentary, the literal wording of the PPT is given nuance and could potentially infer that the requirement 'one of the principal purposes' is less than what it appears to be on the literal interpretation of the PPT wording.[86] The author agrees with this submission, on the literal reading of the PPT, its requirements appear to be extremely stringent, however, when interpreting the PPT in the context of the 2017 Commentary and the examples provided therein, the effect and application of the PPT appear to be less severe that initially thought.

Example C of the 2017 Commentary provides as follows:

> Example C: RCO, a company resident of State R, is in the business of producing electronic devices and its business is expanding rapidly. It is now

[82] Lang M, 2014, 'BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties' *Tax notes international*, vol.74, no.7, p.659.

[83] ibid.

[84] ibid.

[85] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', loc. cit.

[86] Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups', op cit., p.48.

> considering establishing a manufacturing plant in a developing country in order to benefit from lower manufacturing costs. After a preliminary review, possible locations in three different countries are identified. All three countries provide similar economic and political environments. After considering the fact that State S is the only one of these countries with which State R has a tax convention, the decision is made to build the plant in that State.[87]

In this example, the OECD provides that whilst the decision to invest in State S is taken in the light of the benefits provided by the State R-State S tax convention, it is clear that the principal purposes for making that investment and building the plant are related to the expansion of RCO's business and the lower manufacturing costs of that country. In this example, it cannot reasonably be considered that one of the principal purposes for building the plant is to obtain treaty benefits. In addition, given that a general objective of tax conventions is to encourage cross-border investment, obtaining the benefits of the State R-State S convention for the investment in the plant built in State S is in accordance with the object and purpose of the provisions of that convention.[88]

In light of the above example, Danon highlights the fact that the ultimate decision to choose the country that had concluded a tax treaty with State R was ignored and did not invoke the application of the PPT.[89] The author submits that this example demonstrates that the commercial rationale for entering into the transaction was the principal purposes of the transaction, while implicitly, the decision to choose a jurisdiction that had a tax treaty (where tax benefits would be derived) appears to be an ancillary purpose.

Danon is of the opinion that treaty benefits should not generally be denied when genuine business activities have taken place, moreover, the 2017 Commentary seems to support the importance of substance and genuine activities.[90] This conclusion is supported by several passages in the 2017 Commentary, one example being demonstrated in the text:

[87] OECD, *2017 Commentary,* loc.cit.

[88] OECD, *2017 Commentary,* loc cit.

[89] Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups', op cit., p48.

[90] ibid.

> … where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit.[91]

The author submits that the above wording provides a powerful argument for tax treaty benefits not being disallowed in instances where genuine commercial activities have taken place. More uncertainty however arises with regard to the meaning of the word 'form' as the OECD has provided no guidance on the meaning. The author is of the view that the word 'form' will probably be interpreted broadly and generally relates to the manner in which a transaction is implemented, for example, whether to incorporate a branch or subsidiary company, to utilise debt funding or equity funding or whether an intermediary company should be inserted or not.

Danon expresses the view that although there is a perceived discrepancy between the literal interpretation of the PPT and the contextual analysis under the 2017 Commentary, the contextual analysis will have minimal bearing on the PPT as soon as it is detached from the 2017 Commentary and consequently the literal interpretation will probably be followed and may lead to uncertainty and give rise to international tax treaty disputes.[92]

Chand notes that if the proper objective factual analysis into all facts and circumstances leads to the conclusion that non-tax purposes outweigh tax purposes, then the taxpayer does not satisfy the subjective purpose test and will consequently fall outside the scope of the PPT.[93] Therefore, if non-tax purposes are primary drivers of the transaction, then it cannot be argued that one of the principal purposes of the transaction is to obtain a tax benefit and consequently, the PPT is interpreted in a restrictive manner.[94] Although this interpretation seems to be correct, the question that arises is how one will

[91] OECD, *2017 Commentary*, p.592, paragraph 181.

[92] Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups', op cit., p32.

[93] Chand V, 2018, 'The Principal Purpose Test in the Multilateral Convention: An in-depth Analysis', *Intertax, vol.46*, issue 1, p.23.

[94] ibid.

determine the 'weight' of each purpose of the arrangement or transaction. This question is addressed in further detail under paragraph 2.3.2 below.

Many academics are of the view that the PPT should rather encompass a test that determines whether 'the sole or dominant purpose' of the transaction was to obtain a treaty benefit, so that transactions that do not have a treaty abuse motive, but are in reality pragmatic cross-border business dealings, are not disqualified from obtaining benefits under the relevant treaty.[95]

If the OECD had chosen one of the above mentioned alternative tests, the application of the PPT would have a clearer scope with refined limits. Kok is of the opinion that if one of these other tests were chosen, it would be harder to argue that a taxpayer is abusing a tax treaty if there are two equally important motives for implementing the transaction, one tax reason and one commercial reason.[96] Kok further submits that in these instances the PPT could find application since the tax reason would be considered as 'one of the principal purposes of the transaction'[97]. The author is of the view that this statement is completely dependent on the set of facts at hand. Furthermore, in practice, tax is generally not the core driver for implementing transactions. Tax considerations are usually factors that are taken into account after the initial rationale for entering into a transaction has been established and when determining how to implement the transaction in a tax efficient manner. The question that then arises is at what point would structuring a transaction in the most tax efficient manner satisfy the PPT threshold.

2.3.2 Analysis of the meaning and effect of the words 'reasonable to conclude'

The 2017 Commentary provides that 'an objective analysis is required to determine of whether or not 'one of the principal purposes' of an arrangement or

[95] Kazacos A, 'BEPS Action 6: The principal purpose test revisited – Part I', loc.cit; Kuźniacki, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', op. cit. 16.

[96] Kok.R, 2016, 'The Principal Purpose Test in Tax Treaties under BEPS 6' *Intertax*, vol, 44, no 5, p.408, http://www.google.co.za/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0ahUKEwjM6tb1gabaAhXLK8AKHUREAekQFgglMAA&url=http%3A%2F%2Fwww.ey.com%2FPublication%2FvwLUAssets%2FEY-the-principal-purpose-test-in-tax-treaties-under-BEPS-6%2F%24File%2FEY-the-principal-purpose-test-in-tax-treaties-under-BEPS-6.pdf&usg=AOvVaw31K9od_MeafzkF34ZrWFPY

[97] ibid.

transaction is to obtain benefits under a treaty.'[98] The OECD articulates that it is important to undertake an objective analysis of the aims and objects of all persons involved in that arrangement or transaction.[99] In addition, the determination of the purposes for an arrangement or transaction is a question of fact and can only be addressed by considering the circumstances surrounding the arrangement or event on a case-by-case basis.[100]

The 2017 Commentary provides that it is unnecessary to find conclusive proof of the intent of persons involved with an arrangement or transaction, however, after an objective analysis it must be reasonable to conclude that one of the principal purposes was to obtain a benefit from the tax convention. This conclusion should not be lightly assumed and merely reviewing the effects of an arrangement should not generally enable a conclusion to be drawn about its purposes.[101] In instances where an arrangement can however only be reasonably explained by a benefit that arises under a treaty, it may be concluded that one of the principal purposes of that arrangement was to obtain such benefit.[102] Furthermore, a person cannot simply assert that the arrangement was not entered into to obtain the benefits of a tax treaty. All of the evidence must be weighed up to determine whether it is reasonable to conclude that an arrangement or transaction was undertaken for such purpose. This determination requires reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered.[103]

The OECD provides that if the facts and circumstances of a particular transaction or arrangement reveal that the arrangement has been entered into for the principal purpose of obtaining similar benefits under a number of tax treaties, it should not be considered that obtaining a benefit under one specific treaty was not one of the principal purposes for that arrangement. Similarly,

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[98] OECD, *2017 Commentary,* op.cit, p.590, paragraph 178.
[99] ibid.
[100] ibid.
[101] ibid.
[102] ibid.
[103]ibid.

purposes related to the avoidance of domestic law should not be used to argue that obtaining a treaty benefit was merely accessory to such purposes.[104]

The focal requirement of the PPT is to test what the purpose for entering into the transaction or arrangement was, as per the wording of the PPT provision in paragraph 9 of the 2017 Commentary. It is somewhat unclear whether the test under the PPT is an object test, subjective test or combination thereof. This aspect of the provision has brought about much academic discussion and debate.

Some academics are of the opinion that when determining whether an arrangement was entered into for purposes of obtaining a benefit under a tax treaty, a subjective analysis should be undertaken, which becomes difficult to prove[105] as it is almost impossible to verify the intention of a taxpayer or participant to the arrangement or transaction. Lang submits that although the Action 6 Report (or paragraph 9 of Article 29 of the OECD 2017 Commentary) discusses the need to carry out an 'objective analysis of the aims and objects of all persons involved,' the rationale for this objective assessment is to draw conclusions regarding the intention of the taxpayer or participant to the arrangement or transaction, and although a subjective intention can always be deduced by considering external facts, such deduced intention is impossible to prove and for this reason legislators generally abstain from attaching fiscal consequences to the existence of such an intention.[106] Pinetz expressed the opinion that:

> objective facts may give only indications as to the motives behind certain behaviour, but proving a certain motivation or that a certain motivation did not exist is hardly possible.[107]

When asserting and applying the PPT, the domestic tax authority must draw the conclusion and justify whether it is 'reasonable to conclude'[108] that one of the

[104] ibid.

[105] Lang M, 2014, 'BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties' *Tax notes international,* vol.74, no.7, p 658.

[106] ibid.

[107] Pinetz E, 2016, 'Final Report on Action 6 of the OECD/G20 Base Erosion and Profit Shifting Initiative: Prevention of Treaty Abuse' *Bulletin for International Taxation*, vol.79, no.1 / 2.

principal purposes of the taxpayer was to obtain the benefits of the tax treaty. The standard of proof would be too challenging if domestic tax authorities were required to furnish concrete proof that one of the main objectives of entering into the arrangement or transaction in question was to obtain a tax benefit.[109] Conversely, if so required, it would also be extremely difficult for the taxpayer or participant to the arrangement in question to furnish evidence that the benefit was not one of the primary motives for implementing the transaction.[110] Consequently, in Lang's opinion, the standard of proof is not extensive, as domestic tax authorities are not required to provide complete evidence on its conclusions because the wording 'reasonable to conclude' should not be construed as being demanding, as all that is essentially required is for that outcome or conclusion to be 'reasonable' as opposed to for instance being compelling.[111] Lang concludes that:

> in practice, furnishing evidence of the motive will therefore not be relevant, but tax authorities will be tempted to presume intention simply because of the presence of a benefit. For this reason alone, the subjective criterion runs the risk of not gaining any significance in itself.[112]

Lang's interpretation and application of the PPT is followed by a number of academics. Bhargava's view seems to be in line with that of Lang insofar as the author is of the view that the tax authorities will generally find it easy to prove that obtaining a benefit was one of the principal purposes of an arrangement or transaction, given that the threshold of 'reasonable to conclude' is set very low.[113] Consequently, the tax authorities are in a favourable position because the requisite analysis will ultimately lead to the presumption that minimising

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[108] The 'reasonable to conclude' requirement under the PPT is often referred to as the 'reasonableness test'.

[109] Lang M, 'BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties', op. cit., p.658.

[110] ibid.

[111] ibid. See also, De Broe. L & Luts. J, 'BEPS Action 6: Tax Treaty Abuse', *Intertax*, issue 2, 2015, p. 124, where De Broe and Luts state that 'the threshold is set extremely low: it is not required for them to establish' (beyond reasonable doubt) that obtaining a treaty benefit was one of the principal motives. Rather, it suffices that "it is reasonable to conclude" that such motives were present.'

[112]ibid.

[113] Bhargava A, 'The Principal Purpose Test: Functioning, Elements and Legal Relevance', loc.cit.

taxes was one of the principal purposes of the transaction and therefore the subjective reasonableness test is meaningless.[114]

On the other hand, several academics dismiss the above interpretation of the reasonableness test and provide that the wording ‘reasonable to conclude’ is not a purely subjective test but rather a subjective test (the principal purpose) that is then objectified by the reasonableness test (it is reasonable to conclude).[115] The 2017 Commentary notes that ‘the determination requires reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered’. In Weber's view, this phrase should be interpreted in such a way that a reasonable third party would have interpreted those facts and circumstances in the same way and consequently, the analysis of the facts and circumstances in objective in nature.[116]

As discussed above, the 2017 Commentary provides that that all relevant facts and circumstances ‘must be weighed' to determine whether it is reasonable to conclude that an arrangement or transaction was undertaken or arranged to obtain a benefit. Weber opines that the wording ‘be weighed’ can only be given substance in instances where the relevant tax authorities provide guidance and rationalise how the various facts and circumstances relate to one another.[117]

In addition, the contrary view provides that the phrase 'reasonable to conclude' does not refer to the standard of proof or weight of the burden of proof on the tax authorities in determining whether one of the main purposes for entering into the transaction or arrangement was to obtain a benefit.[118] Moreover, it is submitted that the meaning of phrase 'reasonable to conclude' actually means the tax authority must assess the arrangement or transaction in question by

[114] ibid.

[115] Weber D, 'The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law', op.cit. p.49.

[116] ibid.

[117] ibid, p.50.

[118] ibid.

undergoing an objective analysis of weighing up all the facts and circumstances.[119]

The 2017 Commentary uses the phrases such as ‘it should not be lightly assumed’ and that ‘merely reviewing the effects of an arrangement will not usually enable a conclusion to be drawn about its purposes’.[120] Weber highlights that these words are indicative that the relevant tax authorities may not simply accept that the principal purpose of an arrangement is to obtain a tax treaty benefit and they may not only point out the effects of the arrangement in their assessment so to come to that conclusion.[121] More specifically, the relevant tax authorities may not highlight a substantial tax benefit and use that benefit to draw the conclusion that obtaining that benefit was one of the principal purposes of an arrangement or transaction.[122] On the other hand and in accordance with the 2017 Commentary, Weber states that a person cannot avoid the application of the PPT by 'merely asserting that the arrangement or transaction was not undertaken or arranged to obtain the benefits of the Convention’ as well as there always being valid commercial reasons for entering into a transaction or arrangement.[123] Weber concludes that although there is uncertainty about how much weight should be placed on the relevant tax authorities' assessment and what the taxpayer asserts, it is clear that the application of the PPT requires a thorough study of the facts and circumstances, and that nothing may be based on assumptions.[124]

It is common for reasonableness tests to be included in domestic GAARs in common-law countries.[125] As discussed under paragraph 2.3.1 above, Weber highlights that the reasonableness tests under the PPT and UK GAAR are substantially similar. In this regard, and in relation to the application of the

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119 Weber D, 'The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law', loc.cit.; Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', loc.cit.

120 OECD, *2017 Commentary*, op.cit.,p.590, paragraph 178.

121 Weber D, 'The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law'op. cit. 49.

122 ibid.

123 ibid.

124 ibid.

125 ibid.

reasonableness test, the HMRC Guidance provides that the expression 'reasonable to conclude' shows that there is an objective test, in terms of which, it is unnecessary to enquire whether the taxpayer actually had the intention of obtaining a tax benefit. In practice however, it would be extremely uncommon to be faced with a situation where objectively obtaining a tax benefit appeared to be one of the main purposes of a transaction but the participants did not subjectively have such objective in mind.

2.3.3 **The object and purpose of the relevant provisions**

Subsequent to tax authorities being able to reasonably conclude that 'one of the principal purposes of a taxpayer's arrangement or transaction is to obtain treaty benefits', the taxpayer may still have an opportunity to obtain that benefit if the taxpayer can establish that granting the benefit would be in accordance with the object and purpose of the relevant provisions of the tax treaty.[126] This requirement could be viewed as a broadly drafted exception to the application of the PPT.[127]

In terms of the 2017 Commentary, the objective test allows the taxpayer, whose claim to obtain a benefit was refused, to establish that granting that benefit in circumstances at hand would be following the object and purpose of the relevant provisions of the treaty.[128] Accordingly, the taxpayer bears the burden of demonstrating that a treaty benefit is in accordance with the object and purpose of the relevant treaty provisions.

De Broe and Luts state that:

> the PPT 'inconspicuously alters the division of the burden of proof regarding treaty abuse. Under the previous 'guiding principle', it was common ground that the tax authorities of the State desiring to refuse treaty benefits carry the burden of proving that both the subjective and objective element of abuse are fulfilled.

[126] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application' op.cit., p16.

[127] ibid.

[128] OECD, *2017 Commentary*, op.cit., p.588, paragraph 170.

> …Under the proposed PPT, the tax authorities are still obliged to 'prove' the presence of the subjective element, but only this.'[129]

The question that arises is whether the PPT introduces a 'one-sided purposive interpretation' by requiring only the taxpayer to take into account the purpose of the relevant provision.[130]

Some scholars seem to have implicitly accepted that this is the approach and consequently suggest that the tax authorities of contracting states, as negotiators of treaties, are in a better position to determine the object and purpose of each provision, and the burden of proof should consequently rather rest on the tax authorities.[131]

Kuźniacki expresses the opinion that this is positively not the case as this would result in the PPT overriding the rule of interpretation under article 31(1) of the VCLT,[132] which, as discussed in paragraph 2.1 above, provides that tax treaties should be interpreted in good faith in the context of the object and purpose of the treaty. Moreover, tax authorities must assess the taxpayers' purpose for entering into an arrangement or transaction to establish in the context of whether those reasons are consistent with the purpose of the tax treaty's provisions.[133]

2.3.4 **Practical application of the PPT**

The 2017 Commentary notes that in certain countries, the application of the GAAR found in domestic law is subject to a form of approval process.[134] In some instances the process provides for an internal acceleration of disputes on such provisions to senior officials in administration.[135] In other cases, the process may allow for advisory panels to provide their views to the

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129 De Broe L & Luts J, 2015, 'BEPS Action 6: Tax Treaty Abuse', *Intertax*, issue 2, p.124.

130 Kuźniacki B, op.cit., p16.

131 Jankovic D and Cheng M 'Canada: Application and interpretation of the principal purpose test', 2018 available at http://www.internationaltaxreview.com/Article/3790209/Canada-Application-and-interpretation-of-the-principal-purpose-test.html.

132 Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', op.cit., p.16.

133 ibid.

134 OECD, *2017 Commentary*,op.cit., p.600, paragraph 183.

135 ibid.

administration on the application of the GAAR. The OECD provides that these types of approval processes are indicative of the serious nature of anti-avoidance disputes and aim to promote consistency in the application of the GAAR.[136]

The lack of guidance on the practical application and interpretation of the PPT has been criticised given that the PPT could potentially be subject to abuse. The OECD's lack of guidance has been criticised insofar as the adoption of the PPT is subject to the discretionary interpretation by a domestic tax authority, which could potentially appear to adhere to the minimum standard while in reality no significant limitations on treaty abuse are actually imposed.[137] In addition, the PPT could be manipulated to legitimise the actions of certain states in a tax competition environment.[138] On the other hand, the PPT could be applied so stringently that it could result in treaty relief being denied as a means of preserving a state's own authority to tax a person.[139]

Hattingh submits that the discretion provided to domestic tax authorities under the PPT is very broad in scope compared with domestic GAAR legislation in countries such as, *inter alia*, the UK, India and South Africa and 'in domesticating the international general anti-avoidance measures provided for in the MLI, parity in procedural safeguards should be guaranteed (at least from the perspective of the constitutional democracies used as examples)'.[140] The rationale for this proposal is that there are currently no procedural safeguards that accompany the PPT, including a notification process for the taxpayer or the formation of independent bodies to adjudicate GAAR assessments made by domestic tax authorities in order to hold them accountable for their assessment and ultimate verdict on the application of the PPT.

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[136] ibid.

[137] Lee CH 'The Principal Purpose Test needs Time', *Michigan Journal of International Law, Perspectives on the Multilateral Instruments 38 MJILDIGTIALSYMPOSIUM 1,* 2017, p.24, http://www.mjilonline.org/wordpress/wp-content/uploads/2017/12/Online-Tax-Symposium-v.4.pdf.

[138] ibid, cited in H.J. Ault & B.J. Arnold, *Protecting the Tax Base of Developing Countries: An Overview*, in 'United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries (Alexander Trepelkov et al. eds., 2015).

[139] ibid.

[140] Hattingh PJ, 2017, 'The Multilateral Instrument from a Legal Perspective: What May be the Challenges?', Bulletin for International Taxation, vol. 71, no. 3/4 pp.1-10.

In Hattingh's view,[141] there should be legal justification or policy considerations introduced in order to regulate the procedures necessary for addressing tax abuse and avoidance in tax treaties.[142] Hattingh notes that in India, an approving panel was established to issue declarations about the 'impermissible' nature of an avoidance arrangement prior to tax assessments being issued based on the GAAR.[143] The UK has also established an independent advisory panel to issue non-binding advisories for instances where the GAAR is proposed to be invoked.[144].

In Canada, the CRA articulated that it would consider establishing a centralized committee (similar to the Canadian GAAR Committee), which would be responsible for the application of the PPT to certain transactions that are suspected of treaty abuse.[145] The CRA submits that the committee will be established as a result of the uncertainty accompanying the PPT and that it will be beneficial for the CRA to administer the PPT in a consistent manner, with some restraint, particularly due to the extensive manner in which the wording of the PPT is capable of being interpreted.[146]

2.4 Critical analysis of the discretionary relief clause with reference to guidance provided by the OECD

The discretionary relief clause provides that countries may allow treaty benefits on the facts, as they would have in the absence of the abusive arrangement or transaction. The 2017 Commentary provides that this discretionary relief clause grants broad discretion to the relevant tax authority for the purposes of these determinations.[147] It is noted that the provision does however require the tax authority to consider the relevant facts and circumstances before reaching a decision and must consult with the tax authority of the other country before

141 ibid.

142 ibid.

143 ibid.

144 ibid, although certain individuals at SARS are tasked with deciding whether or not GAAR should be invoked, there is no formal centralised committee established in South Africa.

145 Osler, 'New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?', 2017, https://www.osler.com/en/resources/regulations/2017/new-ppt-rule-in-the-oecd-s-multilateral-instrument.

146 ibid.

147 OECD, *2017 Commentary,* op.cit. p.600, paragraph 185.

rejecting a request to grant benefits if that request was made by a resident of the other state. The consultation process does not, however, require the tax authority to which the request was presented to obtain the agreement of the tax authority that is consulted.

The discretionary relief clause will consequently allow a taxpayer to receive full or partial treaty benefits in circumstances where the tax authority agrees that it would be inappropriate to deny all treaty benefits in full under the PPT.[148] The insertion of this clause may consequently mitigate the impact of the PPT's 'all or nothing approach'.[149]

The following practical example can be used to illustrate the application of the discretionary relief clause: Various residents of treaty countries invest in companies in Country A though a holding company established in Country B (a treaty country of Country A) by a private equity fund in Country C (a treaty country to Country B but not to Country A). Under the applicable tax treaty between Country A and Country B a 5% rate of withholding tax on dividends would apply to dividends paid by companies in Country A to the holding company in Country B. If the PPT were to apply and deny all treaty benefits to the holding company, such dividends would be subject to a full 20% withholding tax rate (given that there is no treaty between Country A and Country C). If, however, a discretionary relief provision were to be inserted into the relevant tax treaty the relevant tax authority would be entitled to determine that a reduced withholding tax rate of, say, 15% could rather apply in respect of investors if they had invested into Country A directly (as a result of the tax treaty in those investors' states of resident and Country A).[150]

The application of the discretionary relief clause seems to allow more flexibility in order to ensure that tax results are determined in a manner that is reasonable in the circumstances, which includes a consideration of the tax consequences that would have arisen in the absence of the avoidance arrangement in

[148] Osler, 'New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?', loc.cit.
[149] ibid.
[150] ibid.

question (i.e. the interposition of a holding company in Country B by a private equity fund in Country C).[151]

A view has been expressed that in certain instances when the PPT is applied and treaty benefits are denied entirely, a country may still grant treaty benefits on the premise of a recharacterised pattern of facts, even if such country has reserved the right to not include the discretionary relief clause in its tax treaties.[152] In Danon's opinion these specific circumstances include, for example, a country such as Switzerland where it has reserved the right not to apply this provision but whose case law and practices regarding arrangements that are abusive support the granting of tax treaty benefits in recharacterised fact circumstances. In the author's view, this contention is debateable as the OECD has not provided definitive guidance or confirmation on this possibility. Consequently, from a tax certainty and policy perspective it would be preferable for countries to include this automatic discretionary relief clause in their tax treaties.[153]

2.5 Conclusion

From the above discussion critically analysing certain features of the PPT it is clear that even though the OECD has provided commentary and guidance on this principle in Article X of Action 6 Report and the 2017 Commentary on Article 29 the PPT is still perceived as being an abstruse treaty GAAR with its scope and range of application being uncertain and the subject matter of much debate. The adoption of the PPT will consequently depend largely on the tax authorities' approach, which may vary significantly among tax authorities in various jurisdictions.[154] Notwithstanding the common purpose of the PPT being to improve and enhance international business activity by alleviating double taxation, the varied interpretations of the PPT among jurisdictions may

[151] ibid.

[152] Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups, loc.cit.

[153] ibid.

[154] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', op.cit., p. 32.

aggravate the uncertainty around the PPT and result in frustration and cross border tax disputes.[155]

The next chapter will focus on how the PPT is likely to be applied in South Africa and whether the South African GAAR can be used to assist in understanding the PPT in a South African context.

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[155] ibid.

3. Chapter 3: The application of the PPT in South Africa

3.1 Introduction

The DTC released its second and final report on BEPS (the DTC Report) on 13 November 2017.[156] The purpose of the DTC Report is to provide recommendations on how South Africa can incorporate the OECD BEPS minimum standards, best practice guidelines and international standards into its international tax framework.[157] It is noteworthy that although South Africa is not a member state of the OECD it obtained observer status in 1998 and is greatly influenced by its policies and guidance.

The DTC Report discusses the feasibility of applying the PPT in South Africa and states that the PPT requires tax authorities to make factual determinations as to 'whether the principal purpose (main purpose) of certain creations or assignment of income or property, or of the establishment of the person who is the beneficial owner of the income, was to access the benefit of a particular treaty.'[158] The DTC Report provides that the actual determination required under the PPT is similar to that required to make an 'avoidance transaction' determination under the South African GAAR contained in sections 80A-80L of the ITA, in particular, whether 'the primary purpose of a transaction (or series of transactions of which the transaction was a part) was to achieve a tax benefit'.[159]

Although the DTC Report seems to summarise the basic characteristic of the PPT, the author submits that this interpretation of the PPT is narrowly construed, for example, the PPT does not require tax authorities to determine 'whether the primary purpose (main purpose)' of a transaction was to achieve a tax benefit, but rather whether obtaining a benefit was 'one of the principal purposes' of the underlying transaction. In addition, the author is of the view that the factual determination required under the PPT may not be that similar to

[156] Davis Tax Committee, 2016, 'Second and Final Report on Base Erosion and Profit Shifting in South Africa.' *Summary of DTC Report on Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstance*, pp.1-104. Although the DTC Report was only published in November 2017, it was drafted in September 2016, prior to South Africa signing the MLI.

[157] ibid, p.6.

[158] ibid, p.102.

[159] ibid.

what is required to make an 'avoidance transaction' determination under the South African GAAR due to the slight differences in wording. This aspect is discussed in more detail below.

The DTC Report provides that since the PPT and South African GAAR serve a similar purpose, the South African GAAR can be applied to prevent the abuse of tax.[160] In the DTC's opinion, the necessity for including the PPT arises in instances where the South African GAAR is applied and results in treaty override.[161] Furthermore, the DTC Report provides that the South African GAAR may have different wording to the GAAR adopted by a treaty partner and consequently it is recommended that South Africa insert a standard PPT test in its tax treaties by way of signing the MLI.[162]

On 22 February 2017, South Africa's Minister of Finance published the 2017 Budget Review which included a summary of its position on the OECD BEPS Action Plan.[163] In relation to Action Report 6, it was submitted that new treaties would be aligned with the minimum standards presented by the OECD and the MLI would be used to amend and cover existing treaties.[164]

On 7 June 2017 South Africa signed the MLI and reaffirmed its decision to apply the PPT to some of its treaties qualifying as 'Covered Tax Agreements' (this excludes treaties concluded with Germany and Zambia, which are currently under bilateral renegotiations).[165] It has been mentioned that National Treasury anticipates that South Africa will complete the required Cabinet and Parliamentary process and lodge its final Instrument of Ratification with the OECD by mid-2019.[166]

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160 ibid.

161 ibid.

162 ibid.

163 Deloitte, 2017, '2017 budget includes overall commitments to BEPS project', 2017, https://www.taxathand.com/article/9092/South-Africa/2017/2017-budget-includes-overall-commitment-to-BEPS-project.

164 ibid.

165 Webber Wentzel, 'Webber Wentzel Tax Seminar' Bennet A, 2018, http://www.webberwentzel.com/wwb/content/en/ww-in-the-news?oid=61533&sn=Detail-2011&pid=32704.

166 ibid.

The South African GAAR framework currently operates to deny the availability of tax treaty benefits where the arrangement in entered into for the 'sole and main purpose' of obtaining a tax benefit or *inter alia*, in instances where a transaction is entered into in such a way that would not ordinarily be carried out.[167] Consequently, SARS have always had the authority to deny a taxpayer benefits afforded by a tax treaty through the application of the domestic South African GAAR.[168] The question that arises is whether the South African domestic GAAR is aligned with the PPT or whether it will result in two separate tests that need to be considered.[169]

3.2 **Interrelationship of domestic GAARs and the PPT**

This research report does not attempt to provide a full analysis on whether domestic anti-avoidance measures can be reconciled with tax treaty obligations; however, for purposes of the discussion that will ensue, analysing the extent to which the South African GAAR can assist with the interpretation of the PPT, it is worth briefly discussing the compatibility of domestic GAAR rules with tax treaties.

The question of whether domestic GAARs of a particular jurisdiction are consistent with their tax treaty obligations has for a number of years been a topical and controversial issue among tax specialists and academics.[170]

The OECD Commentary was amended in 2003 and an attempt was made to address the compatibility of domestic anti-avoidance rules (including 'substance over form' rules, 'economic substance' rules and other general anti-abuse rules) with treaty obligations.[171] The 2003 Commentary provided that, as a general rule, there will be no conflict between domestic GAARs and treaties.[172] In summary, the OECD's rationale for this conclusion is premised on the notion

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[167] KPMG, 'International Tax in a Disrupted World', *Tax Talk,* Berger R et al., 2018, pp 48-50.

[168] ibid.

[169] ibid.

[170] Moreno AB, 2017, 'GAARs and Treaties. From the Guiding principle to the Principal Purpose Test. What have we gained from BEPS Action 6?', Intertax, vol 45, issue 6/7, p. 432.

[171] Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups', loc.cit.

[172] Moreno AB, 'GAARs and Treaties. From the Guiding principle to the Principal Purpose Test. What have we gained from BEPS Action 6?', loc.cit.

that such rules are part of the basic principles set by domestic tax laws for determining which facts give rise to a tax liability (the factual approach).[173] These rules are thus not addressed in tax treaties and are, according to the OECD, not affected by them.[174] Put differently, domestic GAARs enable tax authorities to discover the facts that actually occurred in a given transaction and to subsequently apply the equivalent tax rules to those facts.[175] This conclusion and explanation was criticised by international tax academics and generally not accepted by tax authorises and courts in OECD and non-OECD countries.[176]

Accordingly, the OECD attempted to clarify the position on the compatibility of domestic GAARs and tax treaties as it became clear that due to the criticism and uncertainty that arose there was a need to create a policy that firstly provided GAARs with a treaty foundation (i.e. incorporating general rules to target treaty abuse in tax treaties) and secondly switched off the application of domestic anti-avoidance in a treaty context.[177] Danon expresses the opinion that the first objective was achieved with the introduction of the PPT, however, with regard to the second objective, the principles established by the OECD that domestic GAARs do not conflict with tax treaties remained unchanged.[178]

Where countries have included in their domestic law a legislative anti-abuse rule of general application, the application of those rules raise the question of how a possible conflict with the provisions of a tax treaty will be dealt with.[179.] The 2017 Commentary states that, in most cases, no such conflict will arise in this first place as conflicts will initially be avoided for reasons such as tax treaties including specific provisions clarifying that there is no conflict or alternatively even if there is a conflict that arises, the tax treaty may include

173 Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' loc.cit.

174 ibid.

175 Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' loc.cit.

176 Moreno AB, 'GAARs and Treaties. From the Guiding principle to the Principal Purpose Test. What have we gained from BEPS Action 6?', op.cit., p.433.

177 Danon RJ, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' loc.cit.

178 ibid.

179 OECD, *2017 Commentary,* op.cit., p.77, paragraph 76-77.

specific provisions allowing the application of domestic rules.[180] The OECD notes that in other cases, various tax treaty provisions depend on domestic law to determine the meaning of terms that are not defined in the tax treaties and are therefore dependant on domestic law for the ambit of its application. Consequently, the OECD provides that the GAAR found in domestic law will generally have an impact on how treaty provisions are applied rather than produce conflicting results.[181] The OECD Commentary provides that as a guiding principle, the benefits of a treaty should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and in obtaining that more favourable treatment, it would be contrary to the object and purpose of the relevant provisions.[182] Consequently, where the main aspects of domestic GAARs are in conflict with the guiding principle, the OECD is of the view that no conflict will be possible since the relevant domestic GAARs will apply in the same circumstances in which the benefits of the tax treaty would be denied under the PPT.[183]

A criticism that has been submitted against the 2017 Commentary is that it is not obvious or clear that domestic GAAR will include provisions that are synonymous to the provisions in the tax treaty.[184] Even if the OECD is correct in assuming that all domestic GAARs are governed by the guiding principle, the issue stills remains of whether the main characteristics of domestic GAARs and those of the PPT coincide.[185] Moreno expresses the view that 'even if the philosophy underlying all GAARs is similar, the subtle differences between those rules and the particular configuration of the PPT or guiding principle makes this comparison a difficult and unpredictable task *(own emphasis)*.'[186]

Furthermore, Kuźniacki is of the opinion that the compatibility between domestic GAARs and the PPT cannot be resolved by the application of domestic GAARs in the same circumstances in which the benefits would be denied under the

[180] OECD, *2017 Commentary,* op.cit., pp.75-77, paragraph 72 read with paragraph 77.

[181] OECD, *2017 Commentary*, op.cit., pp.75-77, paragraph 73 read with paragraph 77.

[182] OECD, *2017 Commentary*, op.cit., pp.73, paragraph 61.

[183] OECD*, 2017 Commentary*, op.cit., pp.77, paragraph 77.

[184] Moreno AB, 'GAARs and Treaties. From the Guiding principle to the Principal Purpose Test. What have we gained from BEPS Action 6?', op.cit., p.435.

[185] ibid.

[186] ibid.

PPT.[187] In these circumstances, either the PPT will apply first and consequently there will be no need to apply the domestic rules, or alternatively, the domestic rules apply first and their compatibility with the treaties must be determined when interpreting the tax treaty provisions.[188]

3.3 The South African GAAR

The South African GAAR is contained in sections 80A to 80L of the ITA. In brief, the South African GAAR provides that a transaction (or series of transactions) is predisposed to a successful challenge under the South African GAAR if it constitutes an 'impermissible avoidance arrangement'. In this regard, the South African GAAR essentially comprises of three main prerequisite elements:

i. there must be an 'arrangement' as defined in section 80L of the ITA (First Requirement);

ii. the arrangement has to constitute an 'avoidance arrangement' as defined in section 80L of the ITA (Second Requirement); and

iii. the avoidance arrangement has to be an 'impermissible avoidance arrangement' as described in section 80A of the ITA (Third Requirement). Moreover, a transaction will constitute an 'impermissible avoidance arrangement' if:

    a) its 'sole or main purpose' is to obtain a 'tax benefit' and;

    b) one or more of the so-called 'tainted elements' (as discussed below) exists.

The Commissioner of SARS is given explicit authority to determine the tax consequences of any 'impermissible avoidance arrangement' for any party by, *inter alia*, 'disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement'.

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[187] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', op.cit. p.3.

[188] ibid.

In addition, in terms of section 80H the Commissioner of SARS is given the authority to apply the GAAR either to an 'impermissible avoidance arrangement' as a whole, or to any step in or part of such arrangement. The Commissioner of SARS can, however, only successfully challenge a transaction under the GAAR if all of the prerequisite elements are present.

3.3.1 **The First Requirement**

In accordance with section 80L of the ITA, an 'arrangement' is defined to include any transaction, operation, scheme, agreement, or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property.

3.3.2 **The Second Requirement**

In terms of section 80L of the ITA, an 'avoidance arrangement' means any 'arrangement' that results in a 'tax benefit'. The concept 'tax benefit' is defined in section 1 of the ITA as 'any avoidance, postponement or reduction of any liability for tax'.

While the courts have not adjudicated on the meaning of this term in the context of the South African GAAR, it is worth noting that a similar definition of 'tax benefit' was previously contained in the now repealed section 103(1) of the ITA, and the meaning of these words were considered by the South African courts.

In *Smith v Commissioner for Inland Revenue*,[189] the court held that the phrase 'which has the effect of avoiding ... liability for any tax ... on income' in the context of the previous requirement in section 103(1), should be interpreted to mean: '[t]he ordinary natural meaning of avoiding liability for a tax on income is to get out of the way of, escape or prevent an anticipated liability.'[190]

The interpretation of a 'tax benefit' as described in *Smith* was reaffirmed in *Hicklin v SIR*,[191] where the court held that a liability for tax was something which a taxpayer: ' ... anticipates will or may fall on him in the future. Now such a

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[189] *Smith v Commissioner for Inland Revenue* 1964 (1) SA 324 (A).

[190] ibid, at p.333E.

[191] *Hicklin v SIR* 1980 (1) SA 481 AD (41 SATC 179).

liability may vary from an imminent, certain prospect to some vague, remote possibility.'[192]

In light of the above, in deciding whether or not a 'tax benefit' is or will be derived or is assumed to be derived by a taxpayer or participant to an arrangement it must be determine whether there is an anticipated liability for tax.

It should be articulated that the general provisions of the ITA allow for certain amounts to be exempt from income tax, for instances, specified dividends. It is contended that there are compelling arguments that it is not the function of section 80A to characterise normal incidents of the application of the provisions of the ITA as a 'tax benefit'. This submission is supported by the judgment reached in *Commissioner for Inland Revenue v King*.[193]

Notwithstanding the above, the Commissioner of SARS could potentially seek to establish that an alternative arrangement could have otherwise been entered into in order to produce the same commercial result and the associated tax consequences to satisfy the onus placed on him to demonstrate that a 'tax benefit' has indeed arisen.

In De Koker and Williams' view, it is not enough for the Commissioner of SARS to simply contend that a tax benefit has arisen.[194] In order to quantify the tax benefit, the Commissioner of SARS must be sufficiently clear in his mind as to the nature of an alternative arrangement, which could otherwise have been entered into, against which the tax consequences of the actual arrangement can be measured.[195]

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192 ibid, p.492H.

193 *Commissioner for Inland Revenue v King* 1947 (2) SA 196 (A), p. 216.

194 De Koker AP and Williams RC, *General Anti-avoidance*, 'SILKE on South African Income Tax', Lexis Nexis.Ch. 19.4.

195 ibid.

3.3.3 **The Third Requirement**

3.3.3.1 **The sole or main purpose test**

Section 80G(1) of the ITA sets out a rebuttable presumption that once the Commissioner of SARS has satisfied the onus of proving the existence of an 'avoidance arrangement', the onus shifts to the taxpayer to prove that, reasonably considered taking into account all relevant facts and circumstances, obtaining a 'tax benefit' was not the sole or main purpose of the 'avoidance arrangement'.

There is no guidance provided on the meaning of the terms 'solely' and 'mainly'. This requirement formed part of the previously repealed GAAR and consequently, the principles established by the South African courts through case law should still apply to the 'sole or main purpose' requirement under section 80A of the current GAAR. In *SBI v Lourens Erasmus (Edms) Bpk,*[196] the words 'solely' and 'mainly' were assessed and the court held that:

> … in the context under consideration, the word 'mainly' establishes a purely quantitative measure of more than 50% and the associated use of the word 'solely' or mainly is inserted, *ex abundante cautela*, to circumvent the possibility that what may be described as being 'solely' of a particular character would not qualify as being 'mainly' of that character.[197]

In *CIR v Bobat & others* the court held that a main purpose would obviously constitute a purpose that must be dominant over any other purpose because in ordinary language, 'mainly' is defined as meaning 'for the most part, principally or chiefly.'[198]

Accordingly, the wording in the legislation requiring 'the' sole or main purpose, as opposed to 'a' sole or main purpose is indicative the identification of a singular purpose, as opposed to a number of purposes is required.[199] Consequently, the 'sole' or 'main' purpose of an arrangement does not have to

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196 *SBI v Lourens Erasmus (Eiendoms) Bpk* [1966] (4) SA 434 (A), 28 SATC.

197 ibid, p.233.

198 *CIR v Bobat & others* [2003] (N), 67 SATC 47.

199 Cassidy J, 2009, 'The Holy Grail: The search for the optimal GAAR', *South African Law Journal*, vol. 126, issue 4740, p.765.

be the only purpose, however, it must be the dominant purpose for entering into a transaction.

The approach taken by South African tax scholars and academics to the 'sole or main purpose' test is not unanimous. Some scholars are of the view that a subjective approach should be taken when considering the intention of the taxpayer, while others are of the view that the test is objective in nature. Accordingly, similar issues arose in relation to the now-repealed section 103(1) of the ITA, which also required that a scheme, falling within its ambit, had to be entered into or carried out ‘solely or mainly for the purpose of obtaining a tax benefit’.[200]

Without delving into the conflicting arguments expressed by South African academics on the subjective or objective nature, the author submits that it is accepted that the 'sole or main purpose' test appears to be a subjective test. This view is supported by the judgment in *Secretary for Inland Revenue v Gallagher* (*Gallagher*),[201] where Corbett JA held that:

> It is submitted in the heads of argument of appellant‘s counsel that in determining the purpose of a transaction, operation or scheme an ‘objective’ test should be applied. By an objective test in this context is evidently meant a test which has regard rather to the effect of the scheme, objectively viewed, as opposed to a ‘subjective test’ which takes as its criterion the purpose which those carrying out the scheme intend to achieve by means of the scheme… In the circumstances it is appropriate to state that, in my view, the test is undoubtedly a subjective one.[202]

Corbett JA states further that:

> section 103(1) [a predecessor to the current GAAR contained in sections 80A to 80L] draws a clear distinction between the 'effect' of a scheme and the 'purpose' thereof and this virtually rules out an interpretation which seeks to give

200 De Koker AP and Williams RC, *General Anti-avoidance*, 'SILKE on South African Income Tax', loc.cit. Williams and de Koker are of the view that when determining the ‘purpose’ of an avoidance arrangement in the context of section 80A, regard must be had to the objective effect of the arrangement, namely whether it results in a ‘tax benefit’ and if its only effect was the creation of a tax benefit, then it should follow that that is its sole or main purpose.

201 *Secretary for Inland Revenue v Gallagher* [1978] 3 All SA 1 (A).

202 ibid, p.5.

> 'purpose' an objective connotation and to equate it, more or less, to 'effect' *(own emphasis)*.[203]

Consequently, in light of *Gallagher*, one needs to draw a distinction between the subjective 'purpose' of a transaction and the objective 'result' thereof. Merely because a transaction results in a 'tax benefit' does not mean that obtaining a tax benefit was the sole or main purpose of the transaction.

Whether or not a transaction is entered into solely or mainly to obtain a tax benefit is a question of fact. In instances where a taxpayer enters into a transaction which gives rise to a tax benefit and there is no commercial rationale for such transaction, it seems clear that the 'sole or main purpose' of that transaction is the avoidance of tax.

In circumstances where a taxpayer has a clear commercial purpose, which could potentially be achieved through an alternative transaction structure, it becomes slightly more challenging to determine at which stage entering into the more tax beneficial alternative becomes an arrangement which is entered into for the 'sole or main purpose' of obtaining a tax benefit.

In *CIR v Conhage (Pty) Ltd* (*Conhage*),[204] the Supreme Court of Appeal had to determine whether the GAAR could be invoked where a taxpayer chose to procure financing through a sale and leaseback arrangement as opposed to an ordinary loan agreement. The judgment was decided under the provisions of section 103(1) of the ITA which was the predecessor of the current South African GAAR. It is notable that the repealed section 103(1) of the ITA enquiry into the 'sole or main purpose' of a transaction was identical to that which is currently required in terms of section 80A of the ITA.

Hefer JA held that:

> Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If, for example, the same commercial result can be achieved in

[203] ibid.

[204] *CIR v Conhage* (1999) 4 SA 1149 (SCA).

> different ways, he may enter into the type of transaction which does not attract tax or attracts less tax. But, when it comes to considering whether by doing so he has succeeded in avoiding or reducing the tax, the Court will give effect to the true nature and substance of the transaction and will not be deceived by its form.[205]

The court thus confirmed that, where a taxpayer enters into a transaction with a commercial objective and there is more than one alternative to achieve this result, the taxpayer is free to adopt the alternative which yields the best tax outcome. This is referred to as the 'choice principle'. The *Conhage* judgment clarifies that the available alternatives should be limited to those transactions which would be considered commercially normal taking into account the relevant facts and circumstances. Whether an arrangement is 'abnormal' would depend on the circumstances and should be determined with reference to what is normal in the context.[206]

The choice principle was reinforced in *Commissioner for the South African Revenue Service v NWK Ltd* (the NWK Case),[207] where it was held that 'it is trite that a taxpayer may organize his financial affairs in such a way as to pay the least tax permissible. There is, in principle, nothing wrong with arrangements that are tax effective.'[208]

SARS acknowledged the choice principle in the *SARS Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act 1962 (Act No 58 of 1962)* issued in 2005[209] where SARS discussed what constitutes legitimate tax planning and provides that tax planning relates to organising a taxpayer's affairs in a manner that results in the minimum tax liability within the law without

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205 ibid,p.1155.

206 ibid, p.1159.

207 *Commissioner for the South African Revenue Service v NWK Ltd* 2011 (2) SA 67 (SCA).

208 ibid,p.76.

209 SARS, 2005, 'Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act 1962 (Act No 58 of 1962)', p.4 http://www.sars.gov.za/AllDocs/LegalDoclib/DiscPapers/LAPD-LPrep-DP-2005-01%20%20Discussion%20Paper%20Tax%20Avoidance%20Section%20103%20of%20Income%20Tax%20Act%201962.pdf.

constituting 'impermissible tax avoidance'. SARS equates the concept of 'tax planning' with 'tax mitigation' and states that: [210]

> *In short, the "hallmark of tax mitigation…is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option*.[211]

3.3.3.2 **The tainted elements**

To the extent that a the taxpayer is not able to substantiate that the 'sole or main purpose' of the transaction is something other than to obtain a 'tax benefit', SARS would still bear the additional onus of proving the existence of one or more 'tainted elements'.

Section 80A of the ITA provides that 'tainted elements' under the South African GAAR apply to arrangements that:

i. in the context of business, were entered into or carried out by means or in a manner which would not normally be employed for *bona fide* business purposes, other than obtaining a tax benefit (the business purpose test);[212]

ii. in the context of business, lack commercial substance, in whole or in part, taking the following non-exclusive indicators into account:[213]

   a) instances where the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of the individual steps;[214]

   b) round trip financing;[215]

   c) accommodating or tax-indifferent parties;[216] and

[210] ibid.

[211] ibid.

[212] Section 80A(a)(i) of the ITA.

[213] Section 80A(a)(ii) of the ITA.

[214] Section 80C(2)(a) of the ITA.

[215] Section 80C(2)(b)(i) read with section 80D of the ITA.

d) offsetting or self-cancelling elements.[217]

(the commercial substance test)

iii. in context other than business, were entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit (bona fide purposes test);[218]

iv. have created rights or obligations which would not normally be created between persons dealing at arm's length (creating of rights and obligations test);[219] and

v. would result directly or indirectly in the 'misuse or abuse' of any provision of the ITA (misuse or abuse test).[220]

An in-depth analysis of the 'tainted elements' is beyond the scope of this research report, especially given that the PPT does not have a similar prerequisite requiring certain elements to be present. Nevertheless, the following brief overview should be useful for purposes of understanding the operation and application of the 'tainted elements' in the context of the South African GAAR:

i. The business purpose test aims to differentiate between how a certain business arrangement would ordinarily be entered into and compared against what factually happened. De Koker is of the view that the focus of this test is not on the subjective or objective purpose of the transaction, but rather the manner in which the taxpayer carried out the transaction in question.[221] If the transaction was entered into in a manner that would not normally be employed in the context of business, then section 80A(a) of the ITA would be present.

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216 Section 80C(2)(b)(ii) read with section 80E of the ITA.
217 Section 80C(2)(b)(iii) of the ITA.
218 Section 80A(b) of the ITA.
219 Section 80A(c)(i) of the ITA.
220 Section 80A(c)(ii) of the ITA.
221 De Koker AP and Williams RC, *General Anti-avoidance*, 'SILKE on South African Income Tax', loc.cit.

ii. The commercial substance test comprises a general rule set out in section 80C(1) of the ITA, which in essence compares the tax benefit that will be obtained from the arrangement and the commercial effect on the business risk or net cash flow other than that arising from the tax benefit. As noted above, there are four non-exclusive factors that can be used to indicate lack of commercial substance.

iii. The *bona fide* purpose test applies similarly to the business purpose test, except in this context any non-business *bona fide* purpose will suffice. The use of the word 'normal' in the provision indicates that a comparison with a hypothetical scenario is required.[222]

iv. The creating of rights and obligations test is a factual enquiry that should be undertaken to ascertain whether an avoidance arrangement has created rights or obligations that are not ordinarily created between parties dealing at arm's length, considered against the backdrop of a hypothetical ordinary transaction.[223] The scope of this requirement is extremely broad given that it applies in any context and is not restricted to business arrangements.

v. The misuse or abuse test has its origins in Canadian and certain European jurisdictions. In essence, these jurisdictions have adopted a two-part enquiry in determining whether or not a transaction constitutes a misuse or abuse of the tax legislation. The first enquiry is to consider the purpose for which the legislation was created. The second enquiry is then to determine whether or not the application of the tax legislation in the context of the specific transaction abuses or misuses the intended purpose thereof.

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[222] ibid.

[223] Loof G, 2013, A *critical analysis of the requirements of the South African General Anti Avoidance Rule*, submitted in fulfilment of part of the requirements for the Postgraduate Diploma in tax law (unpublished), Cape Town, University of Cape Town, p.31 and Garg R, 2012, 'Removing the fences: Looking through GAAR, PriceWaterHouse Cooper publication', p.47, https://www.pwc.in/assets/pdfs/publications-2012/pwc-white-paper-on-gaar.pdf in April 2016.

3.4 Interpreting the PPT in the context of South Africa

3.4.1 Overview

For purposes of this section an attempt is made to reconcile the requirements of the PPT with South African law in order to explore whether interpretation principles established by South African courts can be used as a guide to interpret and apply the PPT.

According to the OECD, the courts of various jurisdictions have developed a number of judicial doctrines and principles for interpreting tax legislation in cases dealing with tax avoidance.[224] These doctrines and principles are essentially views expressed by courts as to how tax legislation should be interpreted.[225] While it is common cause that the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the VCLT, these general rules do not prevent the application of similar judicial doctrines and principles to the interpretation of the provisions of tax treaties.[226] The OECD illustrates this point by stating that if the courts of one country determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach from being adopted with respect to the application of the provisions of a tax treaty to similar transactions.[227]

Consequently, domestic tax legislation on tax avoidance is accepted as an appropriate tool for the interpretation and application of similar provisions of a tax treaty.

Notwithstanding the above, the PPT is primarily subject to the rules of interpretation incorporated in Articles 31 to 33 of the VCLT, which were

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224 OECD, *2017 Commentary,* p.77, paragraph 78.

225 ibid,

226 ibid.

227 ibid.

established for purposes of interpreting international tax law and, more specifically, tax treaty provisions.[228]

Furthermore, as discussed above, the MLI Explanatory Statement expressly attributes importance to the Action 6 Report for the purpose of interpreting the MLI and consequently the PPT. It has been submitted that the BEPS Action Report and Action 6 Report (and by implication the 2017 Commentary which largely mirrors the commentary provided in the Action 6 Report) should be used for interpretative purposes in determining the object and purpose of the MLI and PPT, rather than Article 31(1) of the VCLT.[229]

Consequently, without undermining the relevance and usefulness of domestic GAARs and their administrative guidelines and jurisprudence, it is submitted that domestic GAARs may at most constitute supplementary means of interpreting the PPT.[230]

3.4.2 **Reconciling the PPT with the South African GAAR**

3.4.2.1 **A literal approach to the PPT**

As noted under the First Requirement of the South African GAAR, the term 'arrangement' in section 80L is defined to include any transaction, operation, scheme, agreement, or understanding (whether enforceable or not), including all steps therein or parts thereof. This definition seems to be consistent with the interpretation of 'arrangement or transaction' provided by the OECD in the 2017 Commentary which provides that the phrase 'arrangement or transaction' should be interpreted broadly and include any 'agreement, understanding, scheme, transaction or series of transactions, whether or not they are legally enforceable'[231]. Given that under both the South African GAAR and the PPT the term 'arrangement' is drafted in broad terms and should easily be able to be reconciled, any further discussion on this element is irrelevant, especially given

[228] Kuźniacki B, 'The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application', op.cit., p.6.

[229] ibid, cited J.F. Avery Jones, Treaty Interpretation – Global Tax Treaty Commentaries sec. 5.3.3., Global Tax Treaty Commentaries IBFD (accessed 4 Mar. 2018). B. Kuźniacki confirms Avery Jones' view.

[230] ibid.

[231] OECD, *2017 Commentary,* p.590, paragraph 177.

that most of the controversy and uncertainty plaguing the PPT does not concern this issue.

In respect of the Second Requirement, it is nonsensical to attempt to reconcile the meaning of 'tax benefit' under the South African GAAR with the term 'benefit' as set out in the PPT. The author submits that the basis for this view is that the term 'tax benefit' under the South African GAAR refers to an avoidance, postponement or reduction of any liability for tax that arises as a result of the application of domestic tax rules. On the other hand, the OECD interprets the word 'benefit' to include all limitations, including, *inter alia*, a tax reduction, an exemption, a deferral or a refund on taxation imposed on the state of source under Articles 6 through to Article 22 of the relevant tax treaty.[232] These limitations are interpreted to include limitations on the taxing rights of a contracting state in respect of dividends, interest or royalties arising in that state, and paid to a resident of the other state (who is the beneficial owner) and the limitation on the taxing rights of a contracting state over a capital gain derived from the alienation of movable property located in that state by a resident of the other state.[233] In addition, 'benefit' includes the relief from double taxation provided by Article 23 and the protection afforded to residents and nationals of a contracting state under Article 24 or any other similar limitations.[234] It seems irrational to try reconcile the Second Requirement under the South African GAAR with term 'benefit' under the PPT as these two concepts are considerably different and the term 'benefit' under the PPT is expected to be a lot broader.

Consequently, this analysis will focus on the Third Requirement. As discussed above, the Third Requirement under the South African GAAR provides that an 'avoidance arrangement' is an 'impermissible avoidance arrangement' if its 'sole or main purpose' was to obtain a tax benefit and one of the tainted elements is present.

It is notable that the preamble of the MLI includes the following wording:

[232] OECD, *2017 Commentary*, p.589, paragraph 175.
[233] ibid.
[234] ibid.

> Recognising that governments lose substantial corporate tax revenue because of aggressive international tax planning that has the effect of artificially shifting profits to locations where they are subject to non-taxation or reduced taxation…[235]

This aspect of the preamble sets out the main mischief that the MLI (more specifically the PPT) seeks to prevent and the primary target, being 'aggressive international tax planning by multinational corporations.[236]' The OECD does not provide any guidance in the MLI or the MLI Explanatory Statement about what constitutes 'aggressive avoidance' or how it differs from other forms of tax avoidance, such as, 'impermissible tax avoidance' or 'abusive tax avoidance'.[237] The South African GAAR applies only in instance where there is 'impermissible tax avoidance'.[238] Similarly, the UK GAAR applies only to an 'abusive tax arrangement'.[239] According to Hattingh, these are vital indicators that delineate the discretionary power of revenue authorities.[240]

Hattingh highlights that one of the most significant differences between domestic GAARs of this nature and the PPT is that the former provides specific circumstances that may give rise to 'impermissible' or 'abusive' tax avoidance.[241] For example, under the GAAR in South Africa, the UK and Canada, factors that are indicative of 'impermissible' or 'abusive' avoidance arrangements include, *inter alia*, whether rights or obligations are created which are not ordinarily created between persons dealing at arm's length or that the avoidance arrangement resulted directly or indirectly in the misuse or abuse of the provisions of the relevant tax legislation.[242] These factors must be present and additionally the requirements of the purpose test must be met.[243]

The author agrees with Hattingh and submits that when applying the South African GAAR, even if the 'sole or main purpose' of a transaction was to obtain

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[235] OECD, *MLI,* p.1.
[236] Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', p.3.
[237] ibid.
[238] ibid.
[239] ibid.
[240] ibid.
[241] ibid.
[242] ibid, fn 8.
[243] ibid.

a 'tax benefit', the limitation of the GAAR is that SARS (or a South African court) still has to find the existence of one of the 'tainted elements'. Consequently, it will be more onerous for SARS to positively determine the presence of tax avoidance in a transaction under the South African GAAR than under the PPT. The PPT merely requires a tax authority to assess whether 'one of the principal purposes' of a transaction was to obtain a treaty benefit, thus, providing a lower threshold to satisfy.

The author submits that this aspect of the GAAR cannot be compared to the PPT, given that the PPT does not provide factors that are indicative of 'impermissible' or 'abusive' avoidance arrangements. In practice, however, the specific tests under the South African GAAR (i.e. the tests applicable to the 'tainted elements') may provide guidance for the underlying approach that tax authorities should take when determining the commercial substance of a particular arrangement or transaction. More specifically, if a transaction is entered into for a genuine commercial purpose (being one of the principal purposes for that transaction) then that transaction should not fall foul of any of the specific indicators embodied in the 'tainted elements'.

The next aspect that should be considered is the 'sole or main purpose' test under the South African GAAR and how this test is comparable to the 'one of the principal purposes' test under the PPT. In the author's view, the slight difference in wording between the purpose test under the South African GAAR and under the PPT may impact the ability to use the South African 'sole or main purpose' test as a tool to interpret the 'one of the principal purposes' test under the PPT. Essentially, the slight differences in the wording result in substantially dissimilar tests with different requirements that need to be satisfied.

As discussed above, under the South African GAAR the 'sole or main' purpose of an arrangement does not have to be the only purpose, however, it must be the dominant purpose for entering into a transaction. It is clear that this requirement is narrowly construed and that the ambit of its application is clear. On the other hand, the 2017 Commentary on the 'one of the principal purposes' test is indicative that the threshold for satisfying the test is very low and the wording is far-reaching. The OECD provides that the term 'one of the principal purposes' essentially means that 'obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit.'[244]

It is questionable whether the 'choice principle' articulated in *Conhage* would be useful to South African authorities in deciding whether a particular transaction would fall foul of the PPT. In accordance with the 'choice principle', if a taxpayer enters into a transaction with a commercial objective and there is more than one alternative to achieve this outcome, the taxpayer is free to adopt the alternative which yields the optimal tax result (provided that there is still a commercial rationale and commercial substance for electing that particular step). It is possible that 'one of the principal purposes' test under the PPT may not recognise the 'choice principle'. In the context of the PPT, if a taxpayer can implement a transaction in one of two ways and elects to implement the transaction in the way that is more tax efficient, if it is successfully argued that there are two equally important reasons for entering into that specific transaction, one being a non-tax related commercial reason and one being a tax related reason that arises pursuant to obtaining treaty benefits (i.e. tax considerations being a primary driver for the transaction), the PPT would probably apply, given that one of the two principal purposes is to obtain a treaty benefit.

The following example can be used to illustrate the difference between the literal wording of the tests under the South African GAAR and PPT. The ABC Group wishes to expand its operations internationally by acquiring shares in Company X, a South African company that manufactures goods. The ABC Group may either acquire the shares in company X through a subsidiary in Company A located in State A or Company B located in State B. State A and State B both have tax treaties with South Africa, however, the rates of withholding taxes are reduced to a lower rate under the State A-South Africa tax treaty. Consequently, Company A acquires the shares in Company X.

[244] OECD, *2017 Commentary,*op.cit.,p.591, paragraph 180.

Under the South African GAAR, it would be easier to prove the 'sole or main purpose' of the transaction, being the acquisition of shares in Company X, was a commercial reason, i.e. to expand the business of the ABC Group. The fact that the ABC Group elected to invest in Company X through Company A for purposes of obtaining lower withholding tax rates would be in line with the 'choice principle' as the ABC Group is free to adopt the alternative which results in a lower tax liability (provided of course that there is still commercial substance in State A). On the other hand, when considering the transaction under the PPT, Company A could potentially be denied tax treaty benefits if it was established on the specific facts that one of the principal reasons for Company A investing in Company X (along with the stated commercial rationale) was to obtain a benefit under the State A-South Africa tax treaty. It seems logical however that one would first have to analyse the facts of the transaction and consider to what extent tax considerations drove the form of the transaction (or steps therein).

In light of the above, it is uncertain how far along the spectrum would making a commercial transaction tax efficient likely to be regarded as a principal purpose for entering into that transaction. It is clear, however, that the PPT would be triggered before the South African GAAR, given the lower threshold that needs to be satisfied.

3.4.2.2 **A contextual approach to the PPT**

When assessing the PPT in the context of the 2017 Commentary (including the examples therein), the author submits that certain principles established by South African courts seem to be more aligned with the guidance provided by the OECD than initially thought. Consequently, it is possible that these principles may be indicative of how SARS may interpret and apply the PPT.

As discussed in Chapter 2, the 2017 Commentary on Article 29 provides that in instances where:

> 'an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit.'[245]

This is extremely powerful wording and could potentially be construed to derive similarities between the application of the South African GAAR and PPT with regard to a commercial substance analysis. More specifically, the aforementioned wording provided by the OECD, seems to nuance the PPT test by providing that the PPT will generally not find application if the core transaction has pure commercial rationale. This seems to correlate with the approach taken, and principles established by South African courts.

In the judgment of *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC* (*Roshcon*)[246] the court acknowledged the importance of commercial substance when determining whether simulation (meaning the legal substance and legal form are not the same) was present in a particular transaction. Although this decision was taken in the context of simulated transactions, the principles are still relevant for the application of the PPT, as simulation can be viewed as a type of avoidance and of relevance, is the approach taken to commercial substance in that context.

In *Roshcon*, the court was faced with determining the principles and test to be applied to simulation transactions, in terms of which Wallis JA affirmed that the test is whether the parties truly intended to conclude the contract in accordance with its terms.[247] Importantly, it was held that if a transaction serves no commercial purpose, this is one of the facts which will be taken into account in applying the test for simulation.[248] In the context of tax cases involving simulation, Wallis JA noted that parties often seek to take advantage of the complexities of the legislation in order to derive a benefit from taxation.[249] In the learned judge's view, there are various mechanisms for doing this, but they all involve taking straightforward commercial transactions and adding complex

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[245] OECD, *2017 Commentary*, op.cit., p.591, paragraph 181.
[246] *Roshcon (Pty) Limited v Anchor Auto Body Builders CC and others* [2014] JOL 31709 (SCA).
[247] ibid, p.3.
[248] ibid, p.22, paragraph 37.
[249] ibid, p.19, paragraph 33.

additional elements designed solely for the purpose of deriving a tax benefit.[250] In these tax cases, the feature to these scenarios is that the additional elements add nothing of value to the underlying transaction and are very often self-cancelling.[251]

In light of the OECD's guidance in the 2017 Commentary, the principles articulated in *Roshcon* could potentially assist SARS with applying the PPT. More specifically, that one of the principal purposes of a transaction or arrangement will not generally be to obtain treaty benefits if it is a straightforward commercial transaction. When a transaction however involves additional elements that add no value to the underlying transaction and are included for purposes of deriving a tax benefit, that particular step of the transaction should satisfy the PPT.

In addition, the OECD provides that it should not be lightly assumed that obtaining a benefit under a tax treaty was one of the principal purposes of an arrangement and reviewing the effects of an arrangement will not generally be conclusive about its purpose.[252] In this regard, the principles established in the judgment of *Commissioner SARS v Bosch* (*Bosch*)[253] may be indicative of how SARS could approach this guidance. It is noteworthy that *Bosch* was also decided in the context of simulated transactions. *In casu,* Wallis JA confirmed that the test for simulation is a question of the 'genuineness of the transaction under consideration.'[254] In short, if a transaction is genuine there is not simulation and if it is simulated then it is a dishonest transaction.[255] The court quoted the following statement articulated in *Roshcon*:

> the court examines the transaction as a whole, including all surrounding circumstances, any unusual features of the transaction and the manner in which

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[250] ibid.
[251] ibid.
[252] OECD, *2017 Commentary*, op.cit., p.590, paragraph 178.
[253] *Commissioner SARS v Bosch* (394/2013)[2014] ZASCA 171 (19 November 2014).
[254]ibid, p.26, paragraph 40.
[255]ibid.

> the parties intend to implement it, before determining in any particular case whether a transaction is simulated…[256]

Wallis JA held that among those features considered will be the income tax consequences of the transaction.[257] Tax evasion is of course impermissible and therefore, if a transaction is simulated, it may amount to tax evasion.[258] Nevertheless, the court reaffirmed that there is 'nothing impermissible about arranging one's affairs so as to minimise one's tax liability.'[259]

Consequently, SARS may follow the approach as set out in *Bosch* and consider the tax effects of an arrangement amongst other considerations when determining if 'one of the principal purposes' of the transaction was to obtain a tax benefit.

In light of the OECD'S guidance provided in the 2017 Commentary on Article 29, the 'choice principle' may useful to SARS and the South African courts when applying the PPT. The 'choice principle' seems to be in line with the commercial substance commentary set out by the OECD, as it provides that if there is more than one alternative to achieve a commercial transaction, the taxpayer is free to adopt the alternative which yields the best tax result. The following examples provided by the OECD are indicative that the 'choice principle' may be useful when analysing the principal purpose of a transaction.

As discussed above, Example C in the 2017 Commentary provides that a company intended on expanding its business operations by establishing a manufacturing plant in a developing country.[260] All three of the jurisdictions considered provided the same economic and political environments, however, the difference being that the chosen jurisdiction had a tax treaty in place with the investing company's jurisdiction. In this example, it was found that the principal purpose for making that investment and building the plant was related to the expansion of the investing company's business and the lower manufacturing costs of that company. The OECD provides that it could not be

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[256] ibid.
[257] ibid, p.27, paragraph 40.
[258] ibid.
[259] ibid.
[260] OECD, *2017 Commentary*, op.cit., p.592, paragraph 182.

reasonable to consider that one of the principal purposes for building the plant is to obtain treaty benefits and given the general objective of tax conventions is to encourage cross-border investment, obtaining the benefits under the tax treaty for investment in the plant was in accordance with the object and purpose of the provisions of that convention.[261]

This example would in all likelihood be approached in the same manner by SARS and would probably yield the same outcome. More specifically, if this transaction were to be assessed under the South African GAAR, in all likelihood SARS would find that the 'sole or main purpose' for entering into the transaction would be to expand business operations and was thus commercially driven. Furthermore, the ultimate decision to establish the manufacturing plant in a jurisdiction with a tax treaty would not be considered to be the 'sole or main purpose' of the transaction and would be in accordance with the 'choice principle' established in *Conhage*.

Example D is another useful example that demonstrates how similar the South African GAAR and PPT may be when applied in practice. In terms of Example D,[262] RCO is a collective investment vehicle that is resident in State R and manages a diversified portfolio of international investments. RCO holds 15 percent of its portfolio in shares of companies resident in State S. Under the tax treaty between State R and State S the withholding tax on dividends is reduced from 30 percent to 10 percent. RCO's investment decisions take into account the existence of tax benefits provided under State R's tax treaty network. The majority of the investors in RCO are resident in State R, however, a number of investors are residents of states which do not have tax treaties with State S.[263]

The OECD provides that the mere fact that RCO considered the existence of treaty benefits when making decisions to invest in companies resident in State S is not alone sufficient to trigger the PPT. The intention of tax treaties is to provide benefits to encourage cross-border investments and therefore it is necessary to consider the context in which the investment was made. The

[261] ibid.
[262] OECD, *2017 Commentary*, op.cit., p.593, paragraph 182.
[263] ibid.

OECD concludes that unless RCO's investments are part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining a benefit under a tax treaty, it cannot be reasonable to deny the tax benefits under the State R - State S tax treaty. [264] The transaction provided in Example D should also not fall foul under the South African GAAR, given that the 'sole or main purpose' would be to make investments for investors in commercially viable companies. Tax treaty considerations would be an ancillary consideration, as the collective investments vehicle is aiming to structure its investments in a tax efficient manner for majority of the investors. In addition, the transaction would have commercial substance.

An analysis of the 2017 Commentary (with reference to the guidance provided by the OECD in terms of its explanation of the PPT and illustrative examples) underscores that SARS may recognise principles and judicial doctrines established in case law under the guise of the South African GAAR when applying the PPT, albeit, in a different context. Specific doctrines such as the 'choice principle' and commercial substance tests applied in South African GAAR legislation and by the courts may be indicative of the approach that SARS will take when assessing whether the PPT applies to certain transactions. There is still however uncertainty with regard to how SARS will approach the difference in wording between the 'one of the principal purposes' test under the PPT and the 'sole or main purpose test' under the South African GAAR.

3.4.3 South African general rules of interpretation

In the event that a court is called upon to interpret the provisions of the PPT it will in all likelihood give the provisions a meaning which makes sense and gives effect to the objects of and purpose of the rule.

In the hallmark judgment of *Natal Joint Municipal Pension Fund v Endumeni Municipality* (Natal Municipal Pension Fund Case),[265] the South African

[264] ibid.

[265] *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] 2 All SA 262 (SCA).

Supreme Court of Appeal endorsed the 'purposive approach' to the interpretation of statutes. In this regard, Wallis JA held as follows:

> Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document.[266]

In *Smyth v Investec Bank* (*Smyth*),[267] the court identified the fundamental interpretational principle and three inter-related qualifications to that principle. The fundamental principle of statutory interpretation identified by the court was that 'words in a statute must be given their ordinary meaning, unless to do so would result in absurdity'.[268] The court went on to say however that that general principle was subject to three inter-related qualifications,[269] namely:

i. the statutory provision should be interpreted purposively;[270]

ii. the relevant statutory provision must be contextualised;[271] and

iii. statutes must be interpreted consistently with the Constitution so as to preserve their constitutional validity where it is reasonably possible to do so.[272]

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266 ibid,p.14.

267 *Smyth v Investec Bank Ltd* (674/2016) [2017] ZASCA 147 (26 October 2017).

268 ibid, paragraph [28].

269 ibid.

270 ibid.

271 ibid.

272 ibid.

As a starting point, it is clear that when applying the aforementioned interpretation principles to the PPT, the court must attribute the ordinary grammatical meaning to this rule, having regard to the context in which this phrase appears and the purpose to which it is directed. It is submitted that this interpretation could potentially result in South African courts reaching a conclusion similar to that in ITC 1569,[273] where the court was required to interpret the phrase 'one of the principal shareholders'.[274] *In casu*, the court held that the term 'one of the principal shareholders' envisages there being more than one more principal shareholder. If one shareholder held more shares than any of the other shareholder he would be the 'main shareholder'. However, if shareholders each held an equal number of shares they would all be the 'principal shareholders'.[275]

If the principle established in ITC 1569 was applied to the PPT, it is likely that a South Africa court would find that where there are two equal reasons to carry out a transaction, one being a tax related reason and the other being a commercial reason. The PPT would probably apply given that one of the two principal purposes is to obtain a tax treaty benefit. On the other hand, where the core rationale for entering into a transaction is commercially driven and tax treaty benefits are considered later when deciding on how to implement the transaction, the PPT would probably not apply.

The approach taken by SARS and the South African courts in determining the ordinary and grammatical meaning of the words 'one of the principal purposes' would probably be in line with the OECD's interpretation of the phrase read within the context of the 2017 Commentary.

[273] ITC 1569 56 SATCS 86(C).

[274] PwC, 2017, Synopsis Tax today August 2017, A South African perspective on the Multilateral Instrument's principal purpose test, https://www.pwc.co.za/en/assets/pdf/synopsis-august-2017.pdf.

[275] ibid.

3.5 Guidance from Canada on the inter-relationship between the Canadian GAAR and PPT

3.5.1 Background

Canada was one of the 68 jurisdictions to sign the MLI on 7 June 2017 and consequently, up to 75 of its tax treaties will be modified.[276] Canada has elected to use the PPT as an interim measure to combat treaty abuse, however, the intention is that as each of its bilateral treaties are renegotiated, the PPT will either be replaced or supplemented with a LOB provision.[277]

The first step in the process for Canada to ratify the MLI was taken on 31 January 2018 where the MLI was tabled in the House of Commons.[278] The MLI will be effective for a particular tax treaty after the domestic ratification procedures have been completed in Canada and the jurisdiction of the relevant treaty counterparty.[279]

3.5.2 Overview of Canadian GAAR

The Canadian GAAR was introduced in 1987 and is located in Part XVI, Section 245 of the CITA.[280] The purpose for implementing the Canadian GAAR was to provide the CRA and courts with a balanced and effective legislative foundation for eradicating abusive tax avoidance.[281] The charging provision under the Canadian GAAR is section 245(2) of the CITA, which provides that:

> Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

[276] Osler, 'New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?',loc.cit.

[277] Szuminski A, 2017, 'The MLI: Canada Signs and Presents Its Choices', *Canadian Tax Focus,* vol.7, no.3, https://www.ctf.ca/ctfweb/EN/Newsletters/Canadian_Tax_Focus/2017/3/170320.aspx.

[278] Osler, 2018, 'Canada begins ratification process for multilateral tax convention to implement BEPS', https://www.osler.com/en/resources/regulations/2018/canada-begins-ratification-process-for-multilateral-tax-convention-to-implement-beps.

[279] ibid.

[280] Income Tax Act RSC 1985, c. 1 (5th Supp.), as amended.

[281] Arnold BJ, 2004, 'The Long, Slow, Steady Demise of the General Anti-Avoidance Rule', *Canada Tax Journal,* vol. 52, no.2, p.488, https://www.ctf.ca/ctfweb/Documents/PDF/2004ctj/04ctj2-arnold.pdf.

Section 245(1) of the CITA sets out the definitions of 'tax benefit', 'tax consequences' and 'transaction'.

An 'avoidance transaction' in this context means any transaction (or that is part of a series of transactions) that would result directly or indirectly in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.[282]

The GAAR will only apply to avoidance transactions that involve a misuse or an abuse of the provisions of the CITA.

Consequently, the application of the Canadian GAAR can be summarised in a three step approach:[283]

i. firstly, whether there is a tax benefit arising from a transaction or series of transactions;

ii. secondly, whether the transaction is an 'avoidance transaction' in the sense of not being arranged primarily for *bona fide* purposes other than to obtain the tax benefit; and

iii. lastly, whether there was abusive tax avoidance under section 254(4), meaning that it cannot be reasonable to conclude that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer.

3.5.3 Operation of the Canadian GAAR and PPT

At the Canadian Tax Foundation Conference (CTF Conference) hosted during November 2017, the CRA indicated that it may look to apply the PPT and the Canadian GAAR, as 'alternative assessing positions'.[284] This suggestion has been criticised for being nonsensical as these alternative assessments will be

282 Section 245(3) of the CITA.

283 *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 S.C.R. 601, 2005 SCC 54.

284 Osler, 'New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?',loc.cit.

based on two sets of broad and independent avoidance rules and could potentially give rise to further uncertainty as well as increased litigious costs.[285]

It is submitted that it should not be necessary for the CRA to assess a taxpayer under both the PPT and Canadian GAAR.[286] The Canadian GAAR may apply to any benefit provided under a tax treaty, as per section 4.1 of the Income Tax Conventions Interpretation Act.[287] In instances where the PPT finds application in a specific transaction or arrangement where there is suspected treaty abuse, there would be no benefit provided under the relevant tax treaty and the Canadian GAAR would not apply.[288] On the other hand, the Canadian GAAR could potentially apply if the PPT does not apply. The Canadian GAAR should not apply however apply in these situations. The rationale submitted for is that if the PPT does not apply on the basis that none of the principal purposes of the transaction were to obtain a tax benefit, then the Canadian GAAR should not apply on the basis that an 'avoidance transaction' is not present, meaning that the transaction was undertaken primarily for *bona fide* purposes other than to obtain the benefit.[289]

Similarly, if the PPT does not apply for the reason that the benefit that was obtained fell within the object and purpose of the relevant tax treaty, then the Canadian GAAR should not apply on the basis that there was no misuse or abuse element.[290]

3.6 Guidance from the UK on the inter-relationship between the UK GAAR and PPT

3.6.1 Background

The UK also signed the MLI on 7 June 2017and chose to adopt the PPT in isolation as its chosen measure to prevent treaty abuse.[291] This election was

285 ibid.

286 ibid.

287 Income Tax Conventions Interpretation Act (R.S.C., 1985, c. I-4).

288 Osler, 'New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?',loc.cit.

289 ibid.

290 ibid.

291 Squire Patton Boggs, 2017, 'Turning the Tide: The OECD's Multilateral Instrument Has Been Signed.', Martinez A, p.4,

expected, given the large number of existing UK tax treaties that contain similar clauses to the PPT. In addition, certain characteristics of the PPT are reflected throughout the UK's domestic anti-avoidance rules.[292] The UK has elected that the MLI will apply in respect of 119 of its existing tax treaties.[293]

3.6.2 Overview of the UK GAAR

During 2013, a GAAR was introduced in the UK and is set out in Chapter 5, Part 5 of the FA. The UK GAAR applies to transactions entered into after 17 July 2013.[294]

Section 206(1) of the FA provides that the purpose of the UK GAAR is to counteract 'tax advantages' arising from 'tax arrangements' that are abusive. Interestingly, the UK GAAR is only targeted as abusive tax avoidance, consequently, it is referred to as the general anti-abuse rule (in terms of section 206(2) of the FA) as opposed to the more commonly used term general anti-avoidance rule.[295]

Section 207(1) of the FA provides that 'arrangements are 'tax arrangements' if, after having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the 'main purpose', or 'one of the main purposes', of the arrangements.[296] The HMRC Guidance provides that the phrase 'it would be reasonable to conclude' demonstrates that the main purpose test is an objective one.[297] It has been articulated that the UK was adverse to adopting a sole purposes test because it would be simple to manipulate as it is

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https://www.squirepattonboggs.com/~/media/files/insights/publications/2017/07/turning-the-tide-oecds-multilateral-instrument-has-been-signed/27380--oecds-multilateral-instrument-has-been-signed-client-alert.pdf.

292 ibid.

293 ibid.

294 Rotley LM, 2016, *Penalties for Impermissible Tax Avoidance in South Africa*, submitted in partial fulfilment of the requirements for the LLM degree (unpublished), Pretoria, University of Pretoria, p.29 where the author provides that prior to 2013 the UK did not have GAAR provisions in place save for the targeted anti-avoidance rules and the judicial doctrines, including the Ramsay principle. This principle was established in the case of *WT Ramsay Ltd v CIR* [1981] STC 174 where the court found that a court is required to establish the legal substance of any transaction to which a tax or a tax consequence was sought to be attached and that the courts should look at all the steps in a series of transactions.

295 ibid.

296 ibid.

297 HMRC Guidance, loc.cit.

relatively easy for a taxpayer to construct a commercial rationale alongside a tax advantage and to argue that the commercial reason is the sole or main purpose for entering into the transaction or arrangement in question.[298]

The UK GAAR was designed to be a moderate, targeted GAAR, which purpose is demonstrated in the 'double reasonableness test' set out in section 207(2) of the FA, which is regarded as being the centrepiece of the UK GAAR.[299] Section 207 (2) of the FA defines 'tax arrangements' as 'abusive' if they are arrangements 'the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions' having regard to all the circumstances, including specific examples listed in section 207(2)(a) - (c). This 'double reasonableness' test seeks to establish a norm of 'acceptability'.[300] Consequently, a court (or the GAAR panel) must consider what could have been 'reasonably regarded as reasonable' as opposed to what they subjectively think would have been reasonable.[301]

Section 208 of the FA defines a 'tax advantage' to include relief or increased relief from tax; repayment or increased repayment of tax; avoidance or reduction of a charge to tax or an assessment to tax; avoidance of a possible assessment to tax; deferral of a payment of tax or advancement of a repayment of tax, and avoidance of an obligation to deduct or account for tax.

Given that the UK GAAR legislation is relatively new and only operates retrospectively, there have been no cases decided by the UK courts under the UK GAAR to date and consequently the only guidance provided on the operation of the UK GAAR is incorporated in the HMRC Guidance, which is hypothetical and speculative in nature.[302]

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[298] Freedman J, 2016, 'General Anti-Avoidance Rules (GAARs) A Key Element of Tax Systems in the Post-BEPS Tax World? The UK GAAR', https://www.researchgate.net/publication/317998301.

[299] ibid.

[300] ibid.

[301] ibid.

[302] ibid.

3.6.3 Operation of the UK GAAR and PPT

Although limited information was available detailing how the UK intends on interpreting and applying the PPT and how it will operate with its domestic GAAR, it is notable that the UK GAAR is generally capable of applying in cases where a tax treaty is in place, this submission is supported by the 2003 Commentary that provides that as a general rule there is no conflict between GAARs and tax treaties.[303] In addition, the UK GAAR contains provisions that clearly allow its application where a tax treaty is in place.[304]

In accordance with the HMRC Guidance, the UK GAAR can only be applied to counteract the abusive arrangements in the context of tax treaties where there are abusive arrangements which try to exploit particular provisions in a tax treaty.[305] More specifically, the mere fact that arrangements benefit from express rules on attribution of profits or allocation of taxing rights does not mean that the arrangement amounts to abuse, and so the GAAR cannot be applied to them.[306] This does not however mean that the UK GAAR can override tax treaties as specific relieving provisions in tax treaties must be observed and GAARs cannot undermine these.[307]

It has been submitted that the interaction between the UK GAAR and the anti-avoidance provisions in treaties will be treated in the same fashion as the UK GAAR and other domestic anti-avoidance provisions, consequently, both sets of provisions will be applied in an independent manner.[308]

The author is of the opinion that while the wording and requirements of the UK GAAR are similar to that of the PPT, there are unfortunately no principles, judicial doctrines or jurisprudence that has been established under the UK GAAR to assist in the interpretation of the PPT. Although the HMRC Guidance will probably be relied on for interpreting and understanding what constitutes

[303] ibid.

[304] ibid.

[305] HMRC, HMRC Guidance, loc,cit.

[306] ibid.

[307] Freedman J, 'General Anti-Avoidance Rules (GAARs) A Key Element of Tax Systems in the Post-BEPS Tax World? The UK GAAR', loc.cit.

[308] ibid.

'one of the main or principal purposes' of a transaction or arrangement (see paragraph 2.3.1) or the meaning of the phrase 'reasonable to conclude' (see paragraph 2.3.2 above), it has been noted above that this guidance is indicative and speculative in nature. Consequently, in the next chapter the author explores how a tax authority in the U.S. applied a purpose test akin to the PPT which is incorporated in certain U.S. tax treaties.

4. Chapter 4: Practical guidance on the application of the PPT from the U.S.

4.1 Background

As discussed in Chapter 2, due to the extensive drafting of the PPT and the limited interpretative guidance provided on its scope and application, the practical operation of the PPT is unknown and is thus considered to be a somewhat elusive concept creating doubt and frustration within the international tax community. The adoption of the PPT raises particular concern insofar as it gives a great deal of discretionary power to domestic tax authorities and appears to be representative of 'an appropriation of power by administrators from domestic courts.'[309] Essentially, the responsibility to regulate the manner in which tax authorities exercise this wide discretion falls primarily on domestic legislators and the practical application of the PPT must be aligned with the legal framework governing the application of a particular jurisdiction's domestic GAAR.[310]

Unfortunately, it will only become apparent how far reaching the impact of the PPT is once domestic tax authorities are compelled to adjudicate on its application. Hattingh expresses the opinion that the only supportable data that is available to obtain some concrete guidance on how the PPT may be applied is provided in the case of *Starr International Company Inc. v. the USA*,[311] which was decided by the U.S. District Court for Columbia (*Starr* case).

[309] Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', loc.cit.

[310] ibid.

[311] *Starr International Co Inc v. United States of America* Case No 14-cv-01593 (CRC) (14 August 2017).

It is submitted that the decision in the *Starr* case is relevant as it may provide guidance on how the PPT will practically operate and be applied by tax authorities in a tax treaty context, including the method that could potentially be adopted in reviewing these decisions. The *Starr* case does not however fit perfectly into the context of the PPT as set out in Article 7(1) of the MLI, nevertheless, the judgment can be used as persuasive and supplementary guidance on how the PPT may be applied and operate in practice.

4.2 The Principal purpose rule

The enquiry under the *Starr* case involved a dispute around the application of Article 22(6) of the USA-Switzerland tax treaty (U.S.-Swiss tax treaty).[312] Article 22(6) of the UK-Swiss DTA provides that:

> A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs [the LOB provision] may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income arises so determines after consultation with the competent authority of the other Contracting State.[313]

The Switzerland - USA Technical Explanation to the 1996 Treaty (1997) (Technical Explanation) provides that paragraph 6 grants a taxpayer of a contracting state a benefit under the tax treaty by the tax authority of the other contracting state in instances when the taxpayer would not otherwise be entitled to that benefit.[314] The purpose for introducing this discretionary provision was in response to the fact that there are situations where significant participation by third country residents in an enterprise of a contracting state is allowed by sound business practice or long-standing business structures and does not necessarily have a motive of attempting to derive unintended tax treaty benefits. Furthermore, the Technical Explanation provides that:

[312] Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Income signed at Washington on October 2, 1996 and the Protocol signed at Washington on October 2, 1996.General Effective Date under Article 29: 1 January 1998.

[313] ibid.

[314] Department of the Treasury Technical Explanation of the Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Income signed at Washington on October 2, 1996 and the Protocol signed at Washington on October 2, 1996.

> The competent authority of a State will base a determination under this paragraph on whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the Convention. Thus, persons that establish operations in one of the States with a principal purpose of obtaining the benefits of the Convention ordinarily will not be granted relief under paragraph 6.[315]

Although the purpose of this clause seems to be similar to the discretionary relief clause, the focus on this discussion is on the wide discretion afforded to tax authorities in determining whether 'one of the principal purposes' of the conduct of a taxpayer's operation was to obtain benefits under the tax treaty. For the sake of convenience this test will be referred to as the principal purpose standard (PPS). Hattingh expresses the opinion that the language found in the PPT is not original and contends that the wording was borrowed from U.S. tax treaty practice and consequently the *Starr* case is of significance for the discussion of the PPT.[316]

4.3 The facts of the *Starr* case

The facts in the *Starr* case relate to a company that was established in the Republic of Panama (the taxpayer) and held majority of its interests in AIG, a US insurance group.[317] In 1970, the taxpayer was relocated to Bermuda, after which, the taxpayer entered in a restructuring transaction, which resulted in the establishment of a charitable trust in Bermuda.[318] Subsequent to the restructure, the charitable trust held all the shares with an economic value in the taxpayer and all of the voting rights were held primarily by executives of AIG. All dividends that were received by the taxpayer in Bermuda from AIG in the U.S. was subject to dividends withholding tax at the rate of 30 percent.[319] During 2004 the taxpayer was relocated to Ireland, and later the charitable trust

[315] ibid.

[316] Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', op.cit.,p.10.

[317] *Starr International Co Inc v. United States of America* op.cit., p.7.

[318] ibid.

[319] ibid.

was also moved to Ireland.[320] In 2005 the taxpayer began contemplating relocation, claiming that Ireland was not a suitable jurisdiction for non-tax reasons, such as regulatory restrictions on charitable distributions and litigation risk.[321]

The decision making process that the taxpayer employed in deciding where it would relocate to was summarized in a so called 'decision matrix'.[322] The decision matrix was created in 2009 in an effort to demonstrate for the Competent Authority the analysis of factors considered for purposes of relocation. The decision matrix illustrated that in 2005, four factors were considered for purposes of deciding on a new location. These factors included U.S. taxes, local taxes, litigation risk and charities regulations.[323] The taxpayer noted that its intention was to locate itself and the charitable trust to the same jurisdiction as keeping these entities together would provide 'the strongest level of legal protection' in the event of a legal challenge.[324]

Initially, there were eleven jurisdictional options, which were later reduced to five, being Bermuda, the UK, the Netherlands, Switzerland or remaining in Ireland.[325]

It was considered that Switzerland was ideal for three of the four considered factors. The exception was the 'local tax' category as relief under the 1996 U.S.-Switzerland tax treaty was based on application to the competent authority for discretionary relief. Tax treaty relief applied automatically under the tax treaties with the U.S. and the UK and the Netherlands, notwithstanding this stated disadvantage, the taxpayer and the charitable trust were relocated to Switzerland in 2006.[326]

[320] ibid p.9.
[321] ibid.
[322] ibid, p.11.
[323] ibid.
[324] ibid.
[325] ibid.
[326] ibid, p.12.

The taxpayer made an application to the U.S. competent authority in 2007 for discretionary relief under Article 22(6) of the U.S.-Swiss tax treaty. The taxpayer conceded that it was not entitled to benefits under the LOB tests set out in Article 22 of the U.S.-Swiss tax treaty, however, the discretionary relief was sought primarily on the grounds that its move to Switzerland was motivated by charitable considerations, not tax concerns.[327] In addition, the taxpayer noted that it chose to bear the risk of not obtaining relief under Article 22(6) of the U.S.-Swiss tax treaty because it believed that Switzerland was a better jurisdiction that the available alternatives from which to achieve the company's charitable objectives, even though it was less desirable that the available alternatives from a U.S. withholding tax perspective. In addition, the taxpayer submitted that its request was 'within the spirit of the objective criteria' of Article 22(2) of the U.S.-Swiss tax treaty.[328]

During 2010, the U.S. competent authority however disallowed tax treaty relief because it considered that obtaining treaty benefits was one of the principal purposes of moving the taxpayer’s residence, to Switzerland. In summary, the U.S. competent authority provided the following reasons for disallowing the tax treaty benefit:[329]

1. the original incorporation in Panama and its management and control in Bermuda suggested the structure was developed with a tax avoidance motive and / or with a purpose of avoiding the provision of information on the taxpayer's activities to the IRS;[330]

2. the circumstances of relocation to Ireland and its movement of management out of Bermuda a relatively short time before the payments of dividends to the taxpayer suggested that the reason was to benefit from the Ireland-U.S. tax treaty;[331]

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327 Ibid.

328 ibid.

329 ibid, p.13.

330 ibid, p.14..

331 ibid.

3. the transitory nature of residency in Ireland and subsequent move to Switzerland further suggested an intention to organize in a jurisdiction where treaty reduced rates of dividends would be available;[332] and

4. the taxpayer was largely controlled by U.S. individuals and affording treaty benefits would not accord with 'U.S. policy on acceptable corporate ownership' for LOB purposes.[333]

4.4 The *Starr* case dispute

In casu, the taxpayer challenged the IRS's denial of treaty benefits as being arbitrary and capricious under the Administrative Procedure Act (APA).[334] The taxpayer's primary contention was that the aim of the U.S.-Swiss tax treaty's PPS is designed to prevent treaty shopping and that the IRS applied an erroneous definition to that term in concluding that the company's relocation to Switzerland was largely tax driven.[335]

The court found that there was nothing arbitrary or capricious in the competent authority's application of the PPS and finding that 'at least one of the principal purposes for moving the taxpayer’s management and therefore its residency to Switzerland' was to obtain tax benefits under the U.S.-Swiss Tax Treaty.[336] Accordingly, it was found that by applying the correct legal standard to a host of indisputable relevant facts, the competent authority satisfied its obligation under the APA to 'examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made.'[337]

4.5 The application of the PPS

The taxpayer contended that the competent authority's determination was arbitrary and capricious. In essence the taxpayer alleged that there was fault in

332 ibid.

333 ibid.

334 ibid, p.3.

335 ibid.

336 ibid.

337 ibid.

the competent authority's analysis on the PPS and the manner in which it applied the PPS. It was submitted by the taxpayer that the competent authority, *inter alia,* overlooked essential information that would have compelled a different result.[338]

For purposes of illustrating how the competent authority went about with its analysis on the PPS, this particular argument is discussed in detail below.

The taxpayer argued that certain evidence clearly demonstrated that obtaining tax benefits under the U.S.-Swiss Tax Treaty was not 'one of its principal purposes' for relocating to Switzerland. According to the taxpayer, its U.S. tax position was not improved by relocating to Switzerland because the most favourable withholding tax rate that it would obtain in Switzerland on dividends paid by AIG was the same rate that the taxpayer was entitled to under the U.S.-Ireland Tax Treaty.[339] In addition, given that this equivalent withholding tax rate was automatic in Ireland but discretionary in Switzerland, the only change that was brought about for the taxpayer on its relocation from Ireland to Switzerland was a less certainty that it would be entitled to a reduction in the withholding tax rate (as a consequence of the reduced rate being a discretionary benefit).[340]

The court stated that the submissions put forward by the taxpayer assumes a much narrower inquiry that is required under the Technical Explanation, which necessitates a competent authority to determine 'whether the establishment, acquisition, or maintenance of a company in the relevant jurisdiction had a principal purpose of obtaining treaty benefits.'[341] Moreover, the court noted that the Technical Explanation does not require a competent authority to merely ask what made a company's current jurisdiction more favourable than its previous one, although that might be part of the analysis, but rather why a company chose to 'establish' or 'maintain' itself where it did.[342] The court found that the question that should be asked is not simply why the taxpayer chose Switzerland

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[338] ibid, p.30.

[339] ibid, p.31.

[340] ibid.

[341] ibid.

[342] ibid.

over Ireland, but rather why the taxpayer chose Switzerland over any other jurisdiction where it could have moved.[343]

Furthermore, the court stated that the language used in the Technical Explanation suggests that the competent authority should engage in a 'historical, totality-of-the-circumstances enquiry in evaluating a company's reasons for choosing a jurisdiction'[344]. This would include analysing the taxpayer's history of relocation and not just the taxpayer's most recent move. In this regard, the competent authority cited the aforementioned four specific facts and circumstances that it considered to be problematic.[345]

The taxpayer argued further that the decision matrix was conclusive proof that obtaining treaty benefits was not of principal concern to the company when deciding to relocate to Switzerland and that Switzerland offered a less favourable tax regime than the other jurisdictions considered such as the Netherlands and UK, both of which guaranteed the taxpayer the low dividends withholding rate that it had in Ireland.[346] Consequently, the taxpayer contended that the decision matrix proved that the tax motive was not a chief concern for its relocation to Switzerland.

The court noted that notwithstanding the decision matrix itself constituting suspect evidence, even if the decision matrix did accurately summarize the taxpayer's decision making process, it can hardly prove that tax benefits were low on the company's priority list.[347] Moreover, 'U.S. Tax' was stated as being one of four key criteria that the taxpayer analysed in deciding on a jurisdiction and consequently illustrated that it constituted a principal consideration. In addition, the court determined that even though it was uncertain how the taxpayer arrived at its list of five final jurisdictions, it is presumed that the process of elimination would have bearing on whether treaty benefits were a

[343] ibid.

[344] ibid, p.32.

[345] ibid.

[346] ibid.

[347] ibid.

principal factor in its ultimate selection.[348] Finally, although Switzerland was labelled as 'bad' for U.S. taxes on the decision matrix, it was at least better than Bermuda and if the taxpayer has been afforded the discretionary relief (which the taxpayer seemed to expect) then Switzerland would have tied for first place in that category along with the other three jurisdictions.[349] Consequently, for these reasons the court held that neither the taxpayer's decision matrix, nor its decision to leave Ireland in favour of Switzerland, inevitably led to the conclusion that treaty benefits were not a 'principal' concern for the company when it chose to relocate and thus the competent authority's finding was not arbitrary or capricious.[350]

4.6 The role of the judiciary

The *Starr* case also illustrates the court's approach to decisions made by competent authorities in relation to determinations made in respect of tax treaty provisions. The court adopted the review standard applicable under administrative law to determine whether there were grounds present to allow the court to interfere with the decision taken by the U.S. competent authority to not grant treaty benefits under the U.S.-Swiss Tax Treaty.[351] The decision taken by the court was premised on the principles of administrative law, which provides that the only power available to the court is to declare a decision taken by a regulator to be invalid and consequently the competent authority would be required to consider the matter afresh. In this regard, the court does not have the power to substitute its own judgment in the place on the decision taken by that regulator.[352] The *Starr* case demonstrates the role of the judiciary in assessing a competent authority or tax regulators findings when exercising its discretion in terms of a tax treaty provision is to ensure that the competent authority correctly examined the relevant information and expressed suitable explanations for its decision, which include a rational connection between the

[348] ibid., p.33.

[349] ibid.

[350] Hattingh PJ, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies', op.cit., pp.10 -11.

[351] ibid.

[352] ibid.

facts at hand and the choices made.[353] The court will generally presume validity and expertise on the part of the competent authority. Furthermore, the court 'should have before it neither more nor less information' that what was available to the competent authority.[354]

4.7 Concluding remarks on the *Starr* case

The *Starr* case provides a useful practical illustration of how a tax authority may approach the application of the PPT and the relevant facts that may be considered by that authority. From the decision it is, however, clear that the 'one of the principal purposes' test is indeed a low threshold and should be simple for the tax authority to meet.

In addition the outcome of the case is indicative of the 'potential extent of transfer of power under a PPT from courts to tax administrators as ultimate arbitrators to grant access to tax treaties.'[355]

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[353] ibid.

[354] ibid.

[355] ibid.

5. **Conclusion**

5.1 **Summarising remarks**

While legal certainty is identified as being one of the key objectives of the BEPS Action Report, it appears that the creation of the PPT is producing an unpalatable outcome due to the extensive wording of the provision and vague guidance provided by the OECD on its interpretation and scope of application.[356]

For example, the 2017 Commentary provides that the phrase 'one of the principal purposes' means that obtaining the benefit under a tax convention need not be the 'sole or dominant purpose' of a particular arrangement or transaction.[357] It is sufficient that at least one of the principal purposes was to obtain the benefit. This explanation leads one to question whether the 'choice principle' developed in *Conhage* and the commercial substance tests established in South African law will be used by SARS when assessing the relevant transaction in the context of tax treaties. In these circumstances, SARS may be of the view that if the eventual decision for entering into a certain type of transaction was tax driven, it is unlikely that obtaining a tax benefit was not one of the key considerations or principal purposes for entering into a specific type of transaction.

Notwithstanding the above, having regard to the OECD's approach to Example C and Example D in the 2017 Commentary, it is not clear that this would be the definitive position and that the 'choice principle' is unworkable. These examples seem to recognise the existence of commercial substance and choice by ultimately concluding that provided that the core transaction was commercially driven, structuring such transaction in a tax efficient manner in order to obtain tax treaty benefits will not in itself necessitate the application of the PPT.

The OECD, however, qualifies that the examples provided in the 2017 Commentary are provided for illustrative purposes only and should not be

[356] Cunha RC, n.d, 'BEPS Action 6: Uncertainty in the Principal Purpose Test Rule', *10th Asia / Africa Conference* available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2796565.

[357] OECD, *2017 Commentary*, op.cit., p.593, paragraph 180 of the commentary on Article 29.

interpreted as providing a clear standard or static requirements which similar transactions must meet in order to avoid application of the PPT. Moreover, the application of the PPT must be determined based on the facts and circumstances on a case-by-case basis.

This contradictory guidance provided by the OECD leaves one in an uncertain position as to how the PPT will be applied in practice. The *Starr* case discussed above, although it does not consider the PPT in the context of Article 7(1) of the MLI (Article 29 of the 2017 Commentary), seems to apply the test in a more rigorous fashion by providing that, in the circumstances, it was relevant for the competent authority to ask why the taxpayer was established in a certain jurisdiction. If the answer was that tax treaty benefits were a consideration, then it was a purpose for establishment in that country and if that consideration featured as a main priority (along with any other considerations), obtaining tax treaty benefits would be considered as 'one of the principal purposes'.

From the above, it is notable that in practice the circumstances and considerations surrounding transactions and arrangements are a great deal more intricate and the considerations affecting the implementation of certain structures are not always clear cut. The OECD's examples are standard scenarios that do not deal with actual scenarios where there are copious factors to be considered and weighed up. In addition, the explanation provided by the OECD that accompanies the application of the PPT and outcome is brief and ambiguous.

Although the principles and doctrines established in South Africa for interpreting and applying the South African GAAR could potentially be of relevance in understanding the operation of the PPT which has been dubbed as a form of treaty GAAR, it is essential to note that that although the wording in the GAAR provisions and the PPT test seem to be *prima facie* substantially similar, the slight differences and nuances may result in two different tests with independent requirements that will not necessarily yield the same outcome. In addition, the principles developed by the South African courts should only be relied on for supplementary guidance, given that tax treaty provisions must be interpreted in accordance with the ordinary principle of tax treaty interpretation, more specifically, in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.

The lack of comparative material available regarding the direction and approach that other jurisdictions are considering taking towards integrating the PPT into domestic rules seems indicative that tax authorities are uncertain about how these rules will operate in practice. In addition, the wide discretionary powers that tax authorities will be entitled to exercise when applying the PPT should be subject to certain domestic checks and balances to ensure that the application strikes a balance between deterring treaty abuse without impeding on cross-border investment and business activities. Another concern that arises in terms of the wide discretion afforded to tax authorities is capacity constraints and corruption in government departments.

It is too early to assess how the introduction of the MLI and PPT will influence the international tax environment and whether these proposed changes will be positive developments in curbing tax treaty abuse or whether the effect of its operation will discourage cross border investment and curb international expansion for multinational corporations.

From a practical corporate tax governance perspective, it is advisable that multinational enterprises are informed in advance about the range of scope that is given to the PPT by the jurisdictions in which they operate and whether the interpretation of the PPT by the relevant jurisdictions is in line with the OECD's guidance and interpretation.[358] This will be of particular importance for the initial implementation phase of the PPT.[359]

The practical effects of adopting the PPT in South Africa must be determined with reference to non-residents wishing to invest in South Africa, as well as South African corporates investing offshore. Provision should be made in South Africa to adopt and implement the PPT in domestic legislation and for procedural safeguards to be established to accompany the application of the

[358] Chand V, 'The Principal Purpose Test in the Multilateral Convention: An in-depth Analysis', loc.cit.
[359] ibid.

PPT. South African legislators should also consider following Canada's lead by implementing an independent advisory panel that is responsible for the application of the PPT to certain arrangements or transactions that are suspected of abusing the provisions of tax treaties. Lastly, the role of the judiciary in reviewing decisions taken by SARS to disallow treaty benefits should also be clearly defined.

5.2 Limitations and areas for future research

It is considered appropriate to note that this research report is focussed solely on the main characteristics and criticisms levied on specific aspects of the PPT that have brought about the most controversy and academic debate among international tax scholars worldwide. This research report is inherently limited insofar as it does not fully critically assess each feature of the PPT or its practical operation. There is a wide range of scope for comprehensive studies to be performed into the nature and shortfalls of the PPT in its entirety, especially once this rule evolves and develops over time. In addition, this research report has not attempted to discuss the contemporaneous operation of the PPT with a simplified or detailed LOB provision nor does it consider how the mechanics of the PPT will integrate with other special anti-avoidance rules.

This research report briefly compares the approach taken by Canada, and to a lesser extent the UK, for the implementation of the PPT and how it might operate alongside domestic GAARs that are currently in place to deal with abusive or impermissible avoidance transactions. Unfortunately, a full study on this issue was not possible given a shortage of commentary and academic information available in these jurisdictions. This comparative enquiry should be expanded upon once tax authorities in these jurisdictions (as well as others) initiate drafting domestic guidance for the application and operation of the PPT in those specific jurisdictions.

The author notes that this research report makes an important theoretical contribution to assessing how the PPT could potentially be interpreted and applied in South Africa. Given the lack of guidance provided by the OECD, coupled with National Treasury and SARS' silence to date, this assessment is purely speculative in nature and expresses the author's own opinions and views. Consequently, there is scope for a comprehensive discussion on the topic once SARS and National Treasury issue draft legislation, explanatory memoranda, guidelines and other information on how the PPT will function in South Africa.

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