The Interpretation and Application of the Principal Purpose Test in South Africa

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Johannesburg, 2021

ABSTRACT

The introduction of the Principal Purpose Test (PPT) in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) is widely regarded as the most significant change to international tax policy in the past 100 years. As a signatory to the MLI, South Africa has indicated that it intends to adopt the PPT.

By examining the historical development of the PPT and the principles of statutory interpretation in South Africa, this report will analyse the PPT and consider how it is to be interpreted and applied in a South African context. The PPT's interaction with the South African domestic General Anti-avoidance Rule will be examined and whether the broad and vague provisions of the PPT align with the principle of legal certainty as enshrined in the Constitution.

Key Words: Multilateral Instrument, MLI, Principal Purpose Test, PPT, BEPS, Anti-Avoidance, Treaty Shopping, OECD, GAAR, Rule of Law, Legal Certainty

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 of examination at any other university.

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Robyn Killoran
November 2021

Acknowledgements

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

The author would like to thank her husband and her family for all their encouragement and support, as well as her friends and colleagues at Werksmans Attorneys. The author would also like to thank Michael Honiball and Ernest Mazansky for their daily guidance and training and to her supervisor, Professor Alwyn de Koker.

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Abbreviations and acronym

BEPS	Base Erosion and Profit Shifting
CTA	Covered Tax Agreement
DTA	Double Taxation Agreement
GAAR	General Anti-avoidance Rule
MLI	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
OECD	Organisation for Economic Co-operation and Development
PPT	Principal Purpose Test
SARS	South African Revenue Service
UK	United Kingdom
US	United States of America

1 CHAPTER 1: INTRODUCTION

1.1 Background

> 'In a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes is more than ever a priority. Tax avoidance, harmful practices and aggressive tax planning have to be tackled.'[1]

These words were spoken in Saint Petersburg, Russia in 2013 at the G20 Summit, as the world was emerging from the 2008 financial crisis. As the world faces 'the deepest global recession in decades'[2] due to the impact of the COVID-19 pandemic, they are as poignant in South Africa in 2021 as they were in Russia some 8 years prior. Now, possibly even more than in September 2013, the world is facing severe fiscal consolidation and social hardship.

As countries embark on the journey of economic recovery, global co-operation and co-ordination will become more important than ever, with multinational enterprises and ultra-high net worth individuals being expected to either contribute to the efforts, or at the very least, not erode them, through their tax planning.

The term 'tax avoidance' came to the fore following the financial crisis in 2008 and the response to aggressive tax planning.[3] Despite its proliferation in the tax lexicon, it is a term that is difficult to define, as it is a well-established principle of tax law, both domestically and internationally, that taxpayers are entitled to order their affairs so as to pay the least tax.

In 1935 the US Supreme Court held that '[t]he legal right of a taxpayer to decrease the amount of what would otherwise be his taxes or altogether avoid them, by means which the law permits, cannot be doubted.'[4] In the same year the UK House of Lords held that '[e]very man is entitled if he can to order his affairs so that the tax

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1 G20, '*G20 Leaders' Declaration of 6 September 2013*', G20 Information Centre, available at http://www.g20.utoronto.ca/2013/2013-0906-declaration.html#:~:text=1.,2. (accessed 30 August 2020).

2 The World Bank, (8 June 2020), '*The Global Economic Outlook During the COVID-19 Pandemic: A Changed World*', available at https://www.worldbank.org/en/news/feature/2020/06/08/the-global-economic-outlook-during-the-covid-19-pandemic-a-changed-world.print (accessed on 18 July 2020).

3 Bergedahl C, (2018) '*Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1*' Bulletin for International Taxation, IBFD, p11.

4 Gregory v Helvering 293 US 465 (1935) at 469.

attaching under the appropriate Acts is less than it otherwise would be.'[5] The South African Supreme Court of Appeal (SCA) has confirmed that '[w]ithin the bounds of any anti-avoidance provisions… a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner.'[6]

Unlike tax evasion, which typically includes some element of fraud or overt law-breaking, tax avoidance techniques in a cross-border environment do not violate the law of any state, but often simply exploit differences in the domestic laws of two states.[7] Tax avoidance is commonly achieved by taxpayers relying on the tenuous connecting factors that establish a jurisdiction's right to tax in order to exploit the benefits of favourable tax treaties.[8] Lord Nolan of the UK House of Lords noted that 'the hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability'.[9]

Tax treaty abuse primarily affects the state of source[10] and arises as a result of a taxpayer improperly invoking the benefits of a tax treaty to avoid a liability to tax under a domestic tax provision.[11] The two most common forms of circumvention are treaty shopping and rule shopping. Treaty shopping occurs when a taxpayer circumvents the residence article by benefiting from a tax treaty between two contracting states, even though the taxpayer is not a resident of either.[12] This is typically achieved by interposing an entity in a contracting state that has a beneficial tax treaty with the source state. Rule shopping, on the other hand, refers to the practice of re-characterising an income stream so that it benefits from a more favourable distributive rule in the same tax treaty.[13]

Tax treaties have traditionally been regarded as a means to prevent double taxation as opposed to tools to counter tax avoidance[14] and so there has historically been a

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5 Duke of Westminster v CIR, (1985) 19 TC 490 at 520.

6 CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd), 61 SATC 391 at 1.

7 Mason R, (2020) '*The Transformation of International Tax'*, American Journal of International Law, Vol. 114, 3, p362.

8 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p11.

9 IRC v Willoughby, (1997) UKHL, STC 995.

10 Danon R, (2020) *'The PPT in Post-BEPS Tax Treaty Law: It Is a GAAR but Just a GAAR'*, Bulletin for International Taxation, Vol 74, IBFD, p243.

11 De Broe and Luts, (2015) *'BEPS Action 6: Tax Treaty Abuse'* 43 Intertax 2, p125.

12 Watson G, (2014) *'Treaty Shopping and Base Erosion and Profit Shifting Action 6'*, 62 Canadian Tax Journal, p1093.

13 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p19.

14 Idem, p11.

degree of uncertainty regarding the proper role of tax treaties in countering tax avoidance. This is due, in part, to the lack of a single, comprehensive provision in the substantive text of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital (OECD Model) that directly addresses the improper use of a tax treaty.[15]

According to the Commentary on Article 1 of the OECD Model (OECD Model Commentary) (2017), the 'principal purpose of tax treaties is to promote, by eliminating double taxation, exchanges of goods and services, and the movement of capital and persons.'[16] As a seemingly secondary consideration, the OECD Model Commentary (2017) adds that 'it is also part of the purposes of tax conventions to prevent tax avoidance and evasion'.[17]

The OECD Model contains several specific anti-abuse measures in the distributive rules in Chapter III, which deny limited source taxation in certain circumstances. These provisions do not, however, deny treaty benefits but rather preserve the full-extent of the source-state's taxing right.[18] The residence-state is still required to grant relief for tax suffered in the source-state by way of an exemption or credit.[19]

The lack of a general anti-abuse provision in the OECD Model has historically curtailed the OECD's anti-abuse efforts. This was exacerbated by the diverse positions adopted by states in respect of the need and convenience for a general anti-abuse provision, as well as the uncertainty surrounding the interrelationship between domestic anti-abuse provisions and tax treaties.[20] The result was an uncoordinated approach on the part of states. The OECD attempted to rectify this by way of guidance in the Commentary on Article 1 of the OECD Model. The Commentary on Article 1 of the OECD Model (2003) introduced the so-called guiding principle, which states that

15 Idem, p12.

16 OECD Model Convention on Income and on Capital: Commentary on Article 1, (21 November 2017) Treaties and Models, IBFD, para 54.

17 Ibid.

18 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p13.

19 Ibid.

20 Idem, p18.

> '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.'[21]

According to Danon, the nature and function of the guiding principle is unclear and controversial.[22] Due to the non-binding nature of the OECD Model Commentary, the OECD's attempt to introduce uniform application of the guiding principle through the OECD Model Commentary was not an effective solution.[23] The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) was developed as part of the Base Erosion and Profit Shifting (BEPS) Project and gave the OECD the chance to effectively codify the guiding principle in the substantive text of bilateral tax treaties with the introduction of the principal purpose test (PPT). The OECD Model Commentary (2017) explains that the PPT is intended to expressly confirm the guiding principle into the treaty text.[24]

1.2 Objective of the research

By drawing on the principles of statutory interpretation in South Africa and the guidance provided by the OECD and foreign courts, this research seeks to dissect the constituent elements of the PPT in order to determine how the PPT will be applied in South Africa, both in isolation, and in the context of the South African domestic general anti-avoidance rule (GAAR), while still respecting the constitutional framework.

1.3 Research Question

How should the PPT be interpreted and applied in South African law?

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21 OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 (15 July 2014), Treaties and Models, IBFD, para 19.

22 Danon R, (2018) *'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principle Purpose Test for MNE Groups'*, Bulletin for International Taxation, IBFD, p36.

23 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p18.

24 OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 (2017), op.cit., para 61.

1.4 Research Sub-questions

What is the background to the PPT and why was it introduced?

How should the PPT be interpreted and applied in South Africa?

How does the PPT interact with South Africa's domestic GAAR?

Is the PPT in conflict with the principle of legal certainty as rooted in the rule of law doctrine in the Constitution?

1.5 Significance of the study

The introduction of a general anti-avoidance rule in South Africa's tax treaty regime is a new concept and, as such, there is limited academic literature on the interpretation and application of the PPT in a South African context. The South African context is unique as South Africa is not a member of the OECD, but bases its treaties on the OECD Model, it is not a signatory to the Vienna Convention on the Law of Treaties[25] (Vienna Convention), but accepts certain articles as customary international law, and it is a Constitutional administration which requires that the interpretation and application of any legislation or international agreement be done within the confines of the Constitution of the Republic of South Africa[26] (Constitution) as the supreme law.[27]

This research report aims to contribute to the body of academic literature by providing an examination of the PPT and its interpretation and application in South Africa.

1.6 Delimitations of the research

As explained in section 3.1 below, South Africa has not yet deposited its Instrument of Ratification, Acceptance or Approval of the MLI. As such, the MLI has not yet

25 United Nations, Vienna Convention on the Law of Treaties, (23 May 1969), entered into force on 22 January 1974.
26 The Constitution of the Republic of South Africa Act 108 of 1996.
27 Idem, s2.

entered into force to amend South Africa's Covered Tax Agreements (CTA). Accordingly, any analysis of the provisions of the MLI that will apply to South Africa's CTAs is purely academic at this stage.

The MLI contains a wide variety of anti-abuse provisions, both specific and general. This research report only considers the anti-abuse provision encompassed in the PPT and as such focuses on tax avoidance in the form of treaty shopping as opposed to rule shopping.

This research report only considers the PPT as contained in the MLI in the context of the guidance provided by the OECD and the OECD Model Commentary. It does not consider the United Nations Model Convention and the MLI's interaction with CTAs based on such model.

This research report does not consider the PPT in the context of the doctrines of 'sham' or 'substance over form'. The study contained in this research report is based on the assumption that the parties to transactions did not intend to create rights and obligations dissimilar to those apparent from the form of the transaction as implemented.

1.7 Research Methodology

A qualitative research methodology has been employed in the preparation of this research report. The author approaches the subject matter systematically, using the collated literature in the form of legislation, court judgments, official publications, academic texts and opinion pieces to systematically analyse the subject matter starting with the application of enacted law and binding precedent, followed by persuasive guidance and finally considered opinions.

1.8 Chapter Overview

Chapter two will examine the development of BEPS Action 6 and Action 15. This will be followed by a look at the implementation of the recommendations under BEPS Action 6 through Articles 6 and 7 of the MLI and Article 29 of the OECD Model (2017), taking into account South Africa's list of notifications and reservations at the time of signing the MLI.

Chapter three will commence with a synopsis of the principles of interpretation in South African law, in order to establish the tools to be used when interpreting the PPT. This will include a discussion of the principles laid out by the court in the seminal case of Natal Joint Municipal Pension Fund v Endumeni Municipality (Endumeni Case),[28] the Constitutional requirement to consider international law, the guidelines in the Vienna Convention, the status of the OECD Model Commentary and foreign case law.

Chapter three will continue by considering each element of the PPT, with particular focus on the phrases 'one of the principal purposes', 'reasonable to conclude' and 'the object and purpose of the treaty' and conclude with considering guidance from the courts of Canada, the UK and the US.

In Chapter four the South African GAAR will be analysed. Consideration will be given as to how the PPT and the GAAR will interact and whether the two anti-abuse provisions can be synthesized to apply in harmony.

Chapter five will look at the PPT through a Constitutional lens and specifically consider whether the vague and broad nature of the PPT, as well as the broad discretionary powers granted to officials of the South African Revenue Service (SARS) to deny treaty benefits compromises the constitutionally enshrined doctrine of the rule of law.

Chapter six will summarise the findings of the research, provide concluding remarks and propose areas requiring further research.

28 2012 4 SA 593 (SCA).

2 CHAPTER 2: THE DEVELOPMENT OF THE PRINCIPAL PURPOSE TEST

2.1 Introduction

The term 'international tax' is a misnomer, as international tax laws do not exist.[29] The right to tax forms part of a state's sovereign powers and so there are no tax laws which are applicable to all states.[30] For the past century, international tax has consisted of a collection of isolated domestic tax regimes, connected on a piecemeal basis by bilateral tax treaties that predominantly follow a model drafted by a small set of OECD member countries (the OECD Model).[31]

The OECD is an international organisation established in 1960 that works to establish international standards and provide policy solutions to social, economic and environmental challenges.[32] South Africa is not a member of the OECD but in 2007 it became a key partner of the OECD. As a key partner of the OECD, South Africa participates in the OECD's work by participating in committee meetings, adhering to OECD instruments and sharing information.[33]

The Group of Twenty, commonly known as the G20, is a forum for international economic cooperation.[34] The G20 originated in 1999 as a forum for Finance Ministers and Central Bank Governors to gather for high-level discussions on macro-financial issues.[35] In the wake of the 2008 global financial crisis, the G20 was elevated to include the leaders of member countries.[36] Collectively, G20 member countries represent approximately 80% of the world's economic output, two thirds of the global population and three quarters of international trade.[37] South Africa is a member of the G20.

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29 Olivier and Honiball, (2011) *International Tax A South African Perspective* 5th Ed, SiberInk, p1.

30 Ibid.

31 Mason R, *'The Transformation of International Tax'*, op.cit., p354.

32 https://oecd.org/about/.

33 http://www.oecd.org/global-relations/partnershipsinoecdbodies/#d.en.194382.

34 https://g20.org/en/about/Pages/whatis.aspx.

35 Ibid.

36 Ibid.

37 Ibid.

The G20 and the OECD have a very close working relationship, with the OECD acting as a strategic advisor to the G20 by participating in all G20 Working Group meetings and providing data, analytical reports and proposals on specific topics.[38]

The recognition by the G20 and OECD member countries that

> '[d]omestic rules for international taxation and internationally agreed standards are still grounded in an economic environment characterized by a lower degree of economic integration across borders, rather than today's environment of global taxpayers'[39]

led to the launch of the BEPS Project in 2013. BEPS refers to international tax planning strategies that use gaps and mismatches in tax rules to artificially shift profits to low or no-tax jurisdictions, where there is little or no economic activity, resulting in tax avoidance.[40] No single rule or provision can be identified as the cause of BEPS because what generates BEPS is the interplay among different rules.[41]

The goal of the BEPS Project was to revise the rules of the international tax system and align them to developments in the world economy in order to ensure that profits are taxed where economic activities are actually carried out and where value is created.[42] The impetus for the BEPS Project was the perception of certain jurisdictions that they were suffering from the tax practices of other jurisdictions. This was particularly so for France, Germany and the UK in respect of structures employed by multinationals predominantly headquartered in US.[43]

The BEPS Action Plan was published in July 2013 and identified 15 Actions that were necessary to restore balance to the international tax system.[44] The 15 Actions follow three key themes: (i) introducing coherence in the domestic rules that affect

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38 https://www.oecd.org/g20/about/.

39 OECD, (2013) *Addressing Base Erosion and Profit Shifting,* OECD Publishing, p5, available at https://read.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page1 (accessed 15 November 2020).

40 German Federal Ministry for Economic Cooperation and Development, (2018) *'Implementing the OECD/G20 BEPS Package in Developing Countries'*, IBFD, p3.

41 Saint-Amans and Russo, (2016) *'The BEPS Package: Promise Kept'* Bulletin for International Taxation, IBFD, p236.

42 Ibid.

43 Hatting J, (2018) *'The Impact of BEPS Multilateral Instrument on International Tax Policies'* Bulletin for International Taxation, IBFD, p235.

44 OECD, (2013) *'Action Plan on Base Erosion and Profit Shifting'*, OECD Publishing, Paris, available at https://www.oecd-ilibrary.org/taxation/action-plan-on-base-erosion-and-profit-shifting_9789264202719-en (accessed 15 November 2020).

cross-border activities,[45] (ii) reinforcing substance requirements in the existing international standards,[46] and (iii) improving transparency and certainty.[47] The BEPS Action Plan identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns.[48] Action 6 (Prevention of Treaty Abuse) addresses these issues.

2.2 Action 6: Prevention of Treaty Abuse

The OECD holds the view that secure, treaty-based anti-abuse clauses are crucial to ensuring effective source-state taxation.[49] The OECD Action Plan was followed up by a Discussion Draft in 2014 which lead to a Deliverable in 2014 and finally, the Action 6: 2015 Final Report Preventing the Granting of Treaty Benefits in Inappropriate Circumstances[50] (Action 6 Final Report). The Action 6 Final Report addresses three areas identified as critical to curbing treaty abuse: (i) the development of model treaty provisions and the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances; (ii) a clarification to the effect that tax treaties are not intended to be used to generate double non-taxation; and (iii) the identification of tax policy considerations that states should consider before deciding to conclude a tax treaty.[51] The Action 6 Final Report states that the recommendations aim to reach a common goal of ensuring that '[s]tates incorporate in their treaties sufficient safeguards to prevent treaty abuse, in particular as regards treaty shopping.'[52]

The Action 6 Final Report distinguishes between cases of abuse of a tax treaty and abuse facilitated by a tax treaty. Abuse of a tax treaty occurs when a taxpayer attempts to circumvent the rules that are specific to a tax treaty and so domestic law provisions will be ineffective in addressing this.[53] Abuse facilitated by a tax treaty occurs when a taxpayer attempts to circumvent the provisions of domestic

45 Idem, p15.

46 Idem, p18.

47 Idem, p21.

48 Idem, p18.

49 Ibid.

50 OECD, (2015) *'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report'*, OECD Publishing, Paris, available at http://dx.doi.org/10.1787/9789264241695-en (accessed 7 April 2020) (hereafter 'Action 6 Final Report').

51 Idem, p13.

52 Idem, p14.

53 Idem, p17.

tax law by invoking a tax treaty.[54] Such cases cannot be addressed exclusively through treaty provisions and require domestic anti-abuse rules.[55]

The Action 6 Final Report recommends a three-pronged approach to address treaty shopping. The first is an explicit statement in a tax treaty that the contracting states, when entering into a tax treaty, wish to counter tax avoidance and to avoid creating opportunities for treaty shopping.[56] The second is the inclusion in a tax treaty of a limitation-on-benefits (LOB) provision that is a specific anti-abuse rule that will target treaty shopping situations based on the legal nature, ownership in, and general activities of, residents of a Contracting State.[57] The third and final prong is the inclusion of a PPT, which is a more general anti-abuse rule, based on the principal purpose of arrangements that will catch abusive arrangements not caught by the objective tests of a LOB clause.[58]

Recognising the need to 'level the playing field', all G20 and OECD member countries committed to consistent implementation in several areas of the BEPS Project, including the preventing of treaty shopping.[59] Certain minimum standards were agreed upon in order to deal with issues where no action by some countries would negatively impact others, for example adverse impacts on competitiveness.[60] In order to meet the minimum standard in respect of treaty shopping, countries must include in the preamble to their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.[61] In addition to this, countries must implement at least one of the following (i) a PPT alone; (ii) a PPT and either a simplified or detailed LOB rule; or (iii) a detailed LOB rule supplemented by a mechanism that can deal with conduit arrangements not already dealt with in tax treaties.[62] The Action 6 Final Report acknowledges that the LOB and PPT rule each have their own 'strengths and weaknesses' and shows a preference for a

54 Ibid.

55 Idem, p78.

56 Idem, p19.

57 Ibid.

58 Ibid.

59 Saint-Amans and Russo, *'The BEPS Package: Promise Kept' op.cit.*, p237.

60 Ibid.

61 OECD *'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report'*, op.cit.,p9.

62 Idem, p19.

combination of the two. The PPT is, however, recommended as the default choice as the OECD has stated that it is the only option that, by itself, can meet the minimum standard.[63] The PPT is favoured among states because it is not only the easiest way for a signatory to the MLI to meet the minimum standard, it is also preferable to the signatories because it gives their tax authorities more discretionary power than the detailed and complex LOB rule.[64]

The BEPS Action Plan set out extensive measures to counter BEPS practices at treaty level, domestic law level and through best practices. With regard to the measures recommended at treaty level, the OECD acknowledged the logistical futility of attempting to renegotiate the more than 3000 tax treaties currently in force.[65] Accordingly, in order to 'swiftly implement' the tax treaty measures developed during the BEPS Project, the final action point, Action 15, was the development of a multilateral instrument that could be signed by all participating jurisdictions in order to modify their existing bilateral tax treaties.[66]

2.3 Action 15: The Multilateral Instrument

The goal of Action 15 was to streamline the implementation of the tax treaty-related BEPS measures through a single instrument.[67] On 7 June 2017, 68 countries and jurisdictions, including South Africa, signed the MLI at the Multilateral Convention Ceremony in Paris. By January 2021, a further 27 countries had signed the MLI, bringing the total number of signatories to 95, with another four having expressed their intent to sign.[68] Although various precedents for modifying bilateral treaties

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63 OECD, (2016) *'Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting'*, OECD Publishing, Paris, para 90 available at http://www.oecd.org/tax/treaties/explanatory-statement-multilateral-conventionto-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf (accessed 9 August 2020) (hereafter 'Explanatory Statement').

64 Kuzniacki B, (2018) *'The Artificial Intelligence Tax Treaty Assistant: Decoding the Principal Purpose Test'* Bulletin for International Taxation, IBFD, p530.

65 OECD, (2015) *'Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 -2015 Final Report'*, OECD Publishing, Paris, p16 available at https://www.oecd-ilibrary.org/docserver/9789264241688 en.pdf?expires=1605422312&id=id&accname=guest&checksum=E6386AB8427F105B596EE71F502733C9 (accessed 15 November 2020).

66 OECD, (2015) *'Action 15: A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS'*, OECD Publishing, Paris available at https://www.oecd.org/tax/beps/beps-action-15-mandate-for-development-of-multilateral-instrument.pdf. (accessed 15 November 2020).

67 Saint-Amans and Russo, *'The BEPS Package: Promise Kept'*, op.cit., p240.

68 OECD, (2021) *'Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting',* Status as at 15 January 2021, available at http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf (accessed 22 January 2021).

with a multilateral instrument exist in many areas of public international law, there is no exact precedent in the international tax domain.[69]

The Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting[70] (Explanatory Statement) was prepared as a form of commentary to the provisions of the MLI and is not intended to deal with the underlying BEPS measures.[71] It elaborates on the method by which reservations, options, notifications and mismatches are to be resolved.

The Explanatory Statement explains the intended relationship between the MLI and the bilateral tax treaties it is intended to modify (CTAs) in Article 2(1)(a). It states that the MLI

> 'will not function in the same way as an amending protocol to a single existing treaty, which would directly amend the text of the [CTA]: instead, it will be applied alongside existing tax treaties, modifying their application in order to implement the BEPS measures.'[72]

On its own, the MLI does not aim to achieve the avoidance of double taxation, nor does it allocate taxing rights.[73] The MLI is primarily a procedural instrument which enables jurisdictions to implement the measures developed during the BEPS Project by amending bilateral tax treaties[74] and is thus best characterised as a framework agreement for the modification of bilateral treaties.[75] The MLI is not intended to be read as an autonomous text but rather the MLI and CTAs are intended to co-exist and must be interpreted side-by-side.[76]

69 Saint-Amans and Russo, *'The BEPS Package: Promise Kept'*, op.cit., p240.

70 OECD, Explanatory Statement, op.cit.

71Idem, para 12.

72 Idem, para 13.

73 Haslehner W, (2020) *'A Multilateral Interpretation of the Multilateral Instrument (and Covered Tax Agreements)?'* Bulletin for International Taxation, Vol 74, IBFD, p222.

74 OECD, Explanatory Statement, op.cit., para 2.

75 Haslehner W, *'A Multilateral Interpretation of the Multilateral Instrument (and Covered Tax Agreements)?'* op.cit., p222.

76 Bravo N, (2020) *'Interpreting Tax Treaties in the Light of Reservations and Opt-Ins under the Multilateral Instrument'*, Bulletin for International Taxation, Vol 74, IBFD, p235.

The outcome of the Action 6 Final Report is contained in Part III of the MLI, and is probably the item of the MLI that will have the most significant practical impact in years to come.[77] The clauses required to meet the minimum standard with respect to the prevention of treaty abuse are contained in Article 6 and Article 7 of the MLI.

2.4 Article 6: The Preamble

The preamble to a treaty is intended to record the reasons why two jurisdictions chose to enter into the treaty. Article 6(1) of the MLI states that a CTA shall be modified to include the following preamble text:

> 'Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions).'

South Africa has indicated that it also intends to adopt Article 6(3) which will include the following wording in the preamble of South Africa's CTAs: 'Desiring to further develop their economic relationship and to enhance their co-operation in tax matters…'[78]

The preamble establishes the object and purpose of the treaty, which is relevant in the application of the PPT as contained in Article 7, in so far as determining whether granting treaty benefits would be in accordance with the object and purpose of the treaty.

2.5 Article 7: The Principal Purpose Test

Article 7(1) of the MLI reads as follows:

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77 Danon R, *'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups'* op.cit.,p31.

78 Dept. of National Treasury, Republic of South Africa, (2017) *'Status of List of Reservations and Notifications at the Time of Signature',* p21, available at http://www.oecd.org/tax/treaties/beps-mli-position-south-africa.pdf (accessed 24 August 2020) (hereafter 'South Africa's MLI Positions').

> '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.'

Article 7(2) is a compatibility clause which defines the relationship between the MLI, the PPT and CTAs.[79] It provides that the PPT shall apply 'in place of or in the absence of' provisions of a CTA that deny all or part of the benefits of a CTA where one of the principal purposes was to obtain the benefit of the CTA. As such, if a signatory to the MLI does not expressly opt out of the PPT, it will apply to their CTAs irrespective of whether or not a CTA has (i) a pre-existing, narrower rule (e.g. a sole or main purpose general anti-abuse rule), (ii) a pre-existing general anti-abuse rule contained in a particular article or (iii) no pre-existing general anti-abuse rule.[80]

As required by Article 7(17)(a) read with Article 7(2) of the MLI, South Africa has listed 13 bilateral treaties which it considers to contain provisions that deny all or part of the benefits that would otherwise be provided under the CTA where one of the principal purposes of an arrangement or transaction was to obtain those benefits.[81] The CTAs listed by South Africa do not contain a single, general anti-avoidance provision in the form of a PPT. Rather, each article dealing with dividends (Article 10), interest (Article 11) and royalties (Article 12) has a provision that denies the benefits of the DTA in respect of that item of income if the main, or one of the main purposes was to take advantage of the benefit of that Article.[82] In terms of the notification required by Article 7(17)(a), if both contracting states make such a notification, the PPT will replace the respective provisions. In all other cases, Article 7(17)(a) stipulates that the PPT will supersede the provisions of the CTA only to the extent that those provisions are incompatible with the PPT.

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79 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'* op.cit., p24.

80 Idem, p25.

81 Australia, Brazil, Bulgaria, Chile, Hong Kong, Japan, Netherlands, Nigeria, Oman, Qatar, Singapore, United Arab Emirates and the UK, Dept. of National Treasury, *'South Africa's MLI Positions'*, op.cit., p27.

82 With the exception of Japan which has a general article that refers to a taxpayer becoming a resident of a contracting state to primarily enjoy the benefits of the DTA and the Netherlands which only has a PPT in Article 10.

Article 7(4) of the MLI provides a mechanism by which the competent authority of a Contracting State may, upon a request by the taxpayer, exercise its discretion to grant treaty benefits to a taxpayer, despite the principal purpose of the arrangement or transaction being to obtain treaty benefits. The competent authority has the discretion to grant the benefits if, after considering all the relevant facts and circumstances, it determines that the taxpayer would have been entitled to those benefits in the absence of the transaction or arrangement. The competent authority that is requested to exercise its discretion and grant the treaty benefit under Article 7(4) is required to consult with the competent authority of the other contracting state before rejecting the request. South Africa has indicated that it does not intend to adopt Article 7(4)[83] and so the South African Revenue Service (SARS), as South Africa's competent authority, will have no discretion to hear requests to grant treaty benefits where such benefits are denied by application of the PPT.

2.6 Insertion of the PPT in the OECD Model

While the MLI will amend all the CTAs of a signatory to include the PPT for those signatories that have chosen to adopt the PPT, countries will continue to negotiate and revise bilateral double tax agreements in the ordinary course. As an official observer of the OECD, South Africa's double taxation agreements are primarily modelled on the OECD Model. In line with BEPS Action 6, the OECD Model was updated in 2017[84] (OECD Model 2017) to include, among other BEPS-inspired changes, the new preamble and the PPT in a new Article 29(9).

2.7 Conclusion

Tax competition and corporate tax avoidance represented collective-action problems that no one state could tackle unilaterally without driving out valuable productive factors such as jobs and capital.[85] The BEPS Project was an attempt to identify and address weaknesses in the current international tax rules that created opportunities for BEPS through three common pillars – coherence, substance and transparency. The signing of the MLI represented an 'unprecedented shift to a more

83 By not notifying the Depository of its choice to apply it (i.e. South Africa has not opted-in, so it assumes the default position of opting-out of Article 7(4)). Dept. of National Treasury, *'South Africa's MLI Positions'*, op.cit., p27.

84 OECD, (2017) Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing, Paris.

85 Mason R, 'The Transformation of International Tax', op.cit., p360.

multilateral tax treaty policy'.[86] Further, the introduction of the PPT is the first time in the history of international tax policy that a treaty GAAR has been proposed at an international level by way of a multilateral agreement.[87] As a member of the G20, a key partner of the OECD and a signatory to the MLI, South Africa has indicated that it will adopt the PPT to its CTAs. South Africa will not, however, adopt the discretionary relief provisions that would allow SARS to exercise its discretion to grant treaty benefits despite the provisions of the PPT. This means that it is critical that taxpayers that intend to rely on any of the South Africa's CTAs have a clear understanding of the scope and application of the PPT, as there is no mechanism to claim relief if its provisions are met.

86 Danon and Schon, (2020) *'Foreword: Tax Treaty Interpretation after BEPS'*, Bulletin for International Taxation, Vol 74, 4/5 IBFD, p159.

87 Kuzniacki B, *'The Artificial Intelligence Tax Treaty Assistant: Decoding the Principal Purpose Test'* op.cit., p530.

3 CHAPTER 3: ANALYSIS OF THE PRINCIPAL PURPOSE TEST

3.1 Introduction

Despite signing the MLI on 7 June 2017, South Africa has not yet deposited its Instrument of Ratification, Acceptance or Approval.[88] Until this is done, the MLI will not apply to amend any of South Africa's bilateral tax treaties. Even after South Africa deposits its Instrument of Ratification, Acceptance or Approval, the MLI will only apply to a bilateral treaty if the other country has also deposited its Instrument of Ratification, Acceptance or Approval. South Africa has 79 tax treaties in force and listed 74 of them as CTAs when it signed the MLI.[89]

South Africa's provisional list of expected reservations and notifications lodged at the time of signing the MLI indicates that South Africa intends to apply the PPT and so it is imperative for SARS officials, taxpayers, tax advisors and judicial officers to have an understanding of how the PPT should be interpreted and applied in South Africa. To this end, this chapter commences with a synopsis of the principles of interpretation in South African law, in order to establish the tools to be used when interpreting the PPT. The process of interpretation will then be applied to the PPT in order to ascertain the meaning of the provision and its intended application.

3.2 Interpretation of tax treaties

Internationally, tax treaties are in effect both international contractual agreements and forms of legislative enactment.[90] This dual status makes the interpretation of tax treaties complex because they are international agreements that must be interpreted by domestic courts within a domestic legislative framework.[91] The Australian tax court has noted that tax treaties by their nature are unlike other international agreements because they also confer rights and obligations on parties

88 http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf. Before signing the MLI, the Davis Tax Committee noted in the Final Report on BEPS in South Africa, Annexure 12, p2 that South Africa should adopt a 'wait and see' approach to gauge how the MLI will address the interests of capital importing developing countries whose DTAs are generally based on the UN Model. By signing but not depositing its instrument of ratification, South Africa can be seen to be pro-active with the developed countries but not actually implement the MLI yet.

89 OECD, (2019) *'Prevention of Treaty Abuse – Peer Review Report on Treaty Shopping: Inclusive Framework on BEPS: Action 6'*, OECD Publishing, Paris, p216 available at https://read.oecd-ilibrary.org/taxation/prevention-of-treaty-abuse-peer-review-report-on-treaty-shopping_9789264312388-en#page3 (accessed 31 December 2020).

90 Schwarz J, (2011) *'Schwarz on Tax Treaties'* 2nd Ed, Wolters Kluwer (UK) Limited, p61.

91 Ibid.

other than those to the double tax agreement (i e the taxpayers).[92] In South Africa, s 231 of the Constitution provides that an international agreement becomes law in the Republic when it is enacted into law by national legislation. Section 108 of the Income Tax Act, No 58 of 1962 (Income Tax Act) is the national legislation that enacts tax treaties into domestic law upon publication in the Government Gazette. Accordingly, once published in the Government Gazette, a tax treaty has the same effect as any other provision in the domestic Income Tax Act and does not have a special or privileged status under South African law.[93] As such, Olivier and Honiball submit that domestic rules of interpretation should be the starting point when interpreting tax treaty provisions in South Africa.[94]

In 2012 the SCA handed down judgment in the Endumeni Case.[95] The principles set down in the Endumeni Case were recently endorsed by the Constitutional Court of South Africa, thus solidifying its place as the locus classicus of interpretation in South African common law.[96] The court in the Endumeni Case held that words must be afforded their ordinary grammatical meaning, having due regard to the context and purpose. The SCA endorsed the approach in which the context and language are considered together from the outset, with neither predominating over the other.[97] Paragraph 18 of the judgment succinctly sets out the process to be followed when attempting to interpret a contract or a piece of legislation:

> '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 un-business like results or undermines the apparent purpose of the document**.' (emphasis added)

92 Olivier and Honiball, *(2011) 'International Tax: A South African Perspective'* 5th Ed, SiberInk, p305, referring to the judgment in Lamesa Holdings BV 199735 ATR 239 ,

93 Olivier and Honiball, *'International Tax: A South African Perspective'* op.cit., p303.

94 Idem, p304.

95 (2012) 2 All SA 262 (SCA).

96 Airports Company South Africa v Big Five Duty Free (Pty) Ltd 2019 (2) BCLR 165 (CC) at 29.

97 Endumeni Case (2012) at 18.

In his commentary on the judgement he penned, Wallis JA stated that

> '[c]ontext must be apparent from the material placed before the court or matters in regard to which it is legitimate to take judicial notice, that is, matters of relatively common knowledge… So in making use of context the judge must be sure that the context on which reliance is to be placed is of this character, not a matter of personal belief, experience, predilection or prejudice.'[98]

While domestic rules of interpretation are the starting point in the interpretive process, international rules must also be considered, and in fact preferred, to the extent that such rules are not inconsistent with domestic laws. Section 232 of the Constitution provides that customary international law is law in South Africa unless it is inconsistent with the Constitution or an Act of Parliament. As stated in section 2.1 above, there is no international compulsory judicial system and so the consent of states to a customary rule must be inferred from their conduct.[99] A rule is accepted as a rule of customary international law if it is settled practice in a state (usus) and the state has a sense of obligation to be bound by the rule (opinio juris).[100]

The Vienna Convention is an international multilateral convention on the interpretation and application of the law of treaties. South Africa is not a signatory to the Vienna Convention, and thus it is, prima facie, not bound to apply the provisions of the Vienna Convention when interpreting tax treaties. Large portions of the Vienna Convention are, however, accepted as reflecting and codifying international customary law.[101] As such, although South Africa is not a signatory to the Vienna Convention, to the extent that the provisions of the Vienna Convention reflect customary international law, in terms of s 232 of the Constitution, South Africa is bound by it.

In terms of s 233 of the Constitution, when interpreting any legislation, every court must prefer any reasonable interpretation that is consistent with international law

98 Wallis M, (2019), *'Interpretation Before and After Natal Joint Municipal Pension Fund v Endumeni Municipality 2012 4 SA* 593 (SCA)', PER/PELJ p21.

99 Dugard, (2011) *'International Law: A South African Perspective'* 4th Ed, Juta, p26.

100 Idem, p29.

101 Olivier and Honiball, *'International Tax: A South African Perspective'*, op.cit., p308

over any alternative interpretation that is inconsistent with international law. This includes customary international law. Since both the main articles dealing with interpretation of treaties (Article 31 and 32) of the Vienna Convention are regarded as customary international law, South African courts must apply these principles when interpreting provisions of a tax treaty.

Article 31(1) of the Vienna Convention sets out the general rule of 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 the light of its objects and purpose.' The domestic method of interpretation laid down in the Endumeni Case is thus consistent with the customary international law embodied in the Vienna Convention.

Article 31(2) of the Vienna Convention specifies that, for the purposes of interpretation of a treaty, the context of a treaty shall comprise the text, the preamble, any annexures to the treaty and any ancillary agreements or instruments relating to the conclusion of the treaty. Article 31(3) stipulates that, together with the context, subsequent agreements regarding the interpretation of the treaty, subsequent practices in respect of the application of the treaty by the parties and relevant rules of international law must be taken into account in the interpretation of the treaty.

Article 32 allows consideration to be given to supplementary means of interpretation to confirm the interpretation under Article 31 or when the application of Article 31 results in a meaning that is 'ambiguous or obscure' or leads to a 'result which is manifestly absurd or unreasonable'. Such supplementary means of interpretation are prescribed by Article 32 as including the preparatory work of the treaty and the circumstances of its conclusion.

Some debate exists as to precisely how the OECD Model Commentary and the OECD Model should be fitted into the above-mentioned general scheme of the Vienna Convention. One possibility is to consider it part of the preparatory work of each model-based convention, in which case it carries relatively little weight. Another possibility is to interpret the OECD Model and the OCED Model Commentary as a part of the 'context' of each convention to the extent that it is based on such a model.

In South Africa, the Appellate Division (now the SCA) has confirmed that when interpreting a treaty, South Africa is bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on concepts utilised in the OECD Model, as South Africa has adopted the OCED Model for its tax treaties.[102] Olivier and Honiball submit that the OECD Model Commentary should be regarded as customary international law in South Africa on the basis of its acceptance in South African case law (opinio juris) and its use as an interpretative aid in interpreting tax treaties (usus).

As mentioned previously, the Explanatory Statement was prepared as a form of commentary to the MLI and states that 'it reflects the agreed understanding of the negotiators with respect to the [MLI]'.[103] Haslehner is of the view that, for the 99 states involved in the preparation of the Explanatory Statement, it qualifies as context as it is an 'agreement relating to the treaty which was made between all the parties in connection with the conclusion of a treaty' as per Article 31(2)(a) of the Vienna Convention.[104] He submits that, for states that were not involved with its preparation but that have since adopted it, the Explanatory Statement should also constitute context as it is accepted by parties that were not a party to the instrument, as being an instrument related to the treaty.[105] Bravo agrees with Haslehner that the Explanatory Statement constitutes context as it was agreed by all parties that concluded the MLI and it relates to its conclusion, with subsequent signatories to the MLI implicitly accepting the Explanatory Statement as an instrument related to the MLI.[106] Bergedhal does not distinguish between states that were involved in the drafting of the Explanatory Statement and those that were not but agrees that it is reasonable to conclude that the Explanatory Statement could constitute context.[107]

102 CIR V Downing 37 SATC 249 at 255.

103 OECD, *'Explanatory Statement'* op.cit., para 11.

104 Haslehner W, *'A Multilateral Interpretation of the Multilateral Instrument (and Covered Tax Agreements)?*' op.cit., p228.

105 Ibid.

106 Bravo N, *'Interpreting Tax Treaties in the Light of Reservations and Opt-Ins under the Multilateral Instrument'*, op.cit., p236.

107 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p22. Although outside the scope of this report, Hattingh (*The Relevance of BEPS Materials for Tax Treaty Interpretation*, 2020, Bulletin for International Taxation, Vol 4, IBFD, 179 at p181) submits an interesting supposition that the answer to whether BEPS materials are relevant for tax treaty interpretation depends on the interpretive community (legislative drafters, tax advisors, educators and academics, judges, taxpayers, etc.).

When considering the BEPS Action Plan's use as an interpretive tool, Bergedahl submits that it does not constitute context,[108] while Haslehner holds the view that it should 'at the very least' be regarded as supplementary material under Article 32 of the Vienna Convention.[109] As far as the Action 6 Final Report is concerned, Bravo is doubtful that it can be considered to be part of the context of the MLI.[110] This is because the BEPS Final Reports were agreed in a different forum from the MLI. The BEPS Final Reports were agreed by the members of the BEPS Project which was a smaller group than the ad hoc group of states that negotiated the MLI.[111] In so far as portions of the BEPS Final Reports are included in the Explanatory Statement, they can be accepted as context to the MLI.[112]

The Explanatory Statement confirms that '[t]he commentary that was developed during the course of the BEPS project and reflected in the Final BEPS Package has particular relevance' when interpreting the substance of BEPS treaty-related measures.[113] As such, the BEPS Final Reports should have the status of supplementary material.[114] Hattingh is of the view that the fact that the Explanatory Statement was formally adopted at the same time as the text of the MLI indicates the intention that it should form part of the context of the MLI for signatory states who were members of the ad hoc group.[115] For all other states, Hattingh submits that it is a supplementary means of interpretation under Article 32 of the Vienna Convention.[116] Hattingh agrees with the other commentators referred to above that the BEPS Action 6 Report is not binding context.[117]

South Africa was a member of the ad hoc group that negotiated and signed the MLI. As such, the accepted view of leading commentators as set out above, and with which the author agrees, is that the Explanatory Statement constitutes context for

108 Ibid.

109 Haslehner W, *'A Multilateral Interpretation of the Multilateral Instrument (and Covered Tax Agreements)?'* op.cit., p229.

110 Bravo N, *'Interpreting Tax Treaties in the Light of Reservations and Opt-Ins under the Multilateral Instrument'*, op.cit., p237.

111 Ibid.

112 Ibid.

113 OECD, *'Explanatory Statement'* op.cit., para 12.

114 Bravo N, *'Interpreting Tax Treaties in the Light of Reservations and Opt-Ins under the Multilateral Instrument'*, op.cit., p237.

115 Hattingh J, (2017) *'The Multilateral Instrument from a Legal Perspective: What May Be the Challenges?'*, Bulletin for International Taxation, Vol 71, IBFD, para 6.3.

116 Ibid.

117 Ibid.

the purposes of interpretation of the MLI in South Africa and must form part of the interpretation process from the outset.

The MLI contains its own interpretation clause in Article 2(2) that mirrors the one in Article 3(2) of the OECD Model (2017), with any term that is not defined having the meaning that it has at that time under the relevant CTA, unless the context otherwise requires. Accordingly, first it must be determined if a term is defined in the MLI. If the term is not defined in the MLI, the second step is to determine if the term can be determined out of the context of the MLI. The third step is to determine the term's meaning in the relevant CTA. If the term is defined in the CTA, that definition will apply for purposes of applying the MLI. If the term is not defined in the CTA, but it is nevertheless used in the CTA, the definition of the term must be derived from the relevant definition in domestic law, unless the context requires otherwise (assuming the CTA includes an article similar to Article 3(2) of the OECD Model).

If, however, the term in question is not used in the CTA, no reference can be made to domestic law and the term must be determined with reference to the general rules of interpretation in the Vienna Convention.[118] Where, however, the relevant term to be interpreted forms part of a substantive provision of the MLI, i.e. one that aims to modify the CTA, the term inevitably forms part of the CTA at the time of application as the modification effectively makes the term part of the CTA.[119]

3.3 The Text of the Principal Purpose Test

Article 7 of the MLI commences by establishing the scope of the PPT and the phrase 'notwithstanding the other provisions' puts it beyond doubt that the PPT can be used in addition to any specific anti-abuse measures in the CTA.[120] The PPT rule is applicable when it is

118 Haslehner W, *'A Multilateral Interpretation of the Multilateral Instrument (and Covered Tax Agreements)?'* op.cit., p227.

119 Idem, p228.

120 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p23.

'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.'

Thus, in order for the PPT to apply to deny treaty benefits, the following two elements must be present:

(i) It must be **reasonable to conclude**;

(ii) That one of the **principal purposes** was to obtain a benefit.

If the above two tests are met, the PPT will apply to deny treaty benefits, unless granting the benefit is in accordance with the **object and purpose** of the relevant provision of the CTA. These three tests will be considered in detail below.

3.3.1 The Reasonableness Test

Although the tests of reasonableness and principal purpose are separate elements, they are inextricably linked and must be applied together.[121] Including a reasonableness test in an anti-avoidance provision objectifies the subjective intention under consideration.[122] In order to determine whether the subjective intention of the taxpayer was to obtain a tax benefit, an objective analysis must be undertaken of the facts and circumstances.[123]

The Oxford English Dictionary defines 'reasonable' to mean 'within the limits of what it would be rational or sensible to expect'. In its effort to provide guidance on the reasonableness test, the suggested commentary on Article X in the Action 6 Final Report[124] (the Suggested Commentary) is somewhat unhelpful as it essentially simply restates the PPT:

121 Weber D, (2017) *'The Reasonableness Test of the Principal Purpose Test Rule in OECD Beps Action 6 (Tax Treaty Abuse) versus the EU Principal of Legal Certainty and the EU Abuse of Law Case Law',* Erasmus Law Review, p49.

122 Ibid.

123 Ibid. The author notes that this is not unfamiliar in a South African tax context as a similar analysis is required in determining whether a natural person is ordinarily resident under the definition of 'resident' in s 1 of the Income Tax Act. The subjective intention of the taxpayer is determined with reference to objective facts.

124 Article X in the Action 6 Final Report was translated into Article 7(1) of the MLI.

> 'It is not necessary to find conclusive proof of the intent of a person concerned with an arrangement or transaction, but it must be reasonable to conclude, after an objective analysis of the relevant facts and circumstances, that one of the principal purposes of the arrangement or transaction was to obtain the benefits of the tax convention.' [125]

The intended scope of the examination is broad as the Suggested Commentary states that determining whether or not one of the principal purposes of a person is to obtain a tax benefit requires an 'objective analysis of the aims and objects of **all persons involved** in putting that arrangement or transaction **in place or being a party to it**'[126] (emphasis added). The Suggested Commentary thus submits that it is not only the motives of the taxpayer who is a party to the transaction or arrangement that must be considered, but the motives of all persons who were involved in implementing the transaction. Thus, for example, if an arrangement calls for the establishment of a trust, the aims and objects of the professional trust company engaged to administer the trust must be considered.

The Suggested Commentary cautions that it 'should not be lightly assumed' that obtaining a tax benefit was one of the principal purposes of the arrangement and that 'merely reviewing the effects of an arrangement will not usually enable a conclusion to be drawn about its purposes.'[127] In other words, just because an arrangement results in a tax benefit, does not mean that obtaining the benefit was one of the principal purposes.

Similarly, a taxpayer 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. All of the evidence must be weighed to determine whether it is reasonable to conclude that an arrangement or transaction was undertaken or arranged for such purpose.'[128]

125 OECD, *'Action 6 Final Report'*, op.cit., p57.

126 Ibid.

127 Idem, p58.

128 OECD, *'Action 6 Final Report'*, op.cit., p58. The author notes that the notion that 'evidence must be weighed' was employed by the South African SCA in the Tradehold case (see ftnt 235).

Weber submits that the use of the word 'weighed' indicates that the tax authority applying the PPT must provide reasons in their assessment as to how the facts and circumstances that were considered relate to each other.[129] Lang, however, is of the view that tax authorities do not need to provide full evidence to support their assessment as the test only requires the conclusion to be reasonable, as opposed to compelling.[130]

The Suggested Commentary states that the determination as to whether or not the principal purpose of an arrangement was to obtain a tax benefit requires reasonableness, which suggests 'that the possibility of different interpretations of the events must be objectively considered.'[131]

In further use of circular explanation, the Suggested Commentary submits that where an arrangement 'can only reasonably be 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 the benefit.'[132]

It is only possible to draw conclusions regarding subjective criteria by relying on external facts, because true motives can never be verified.[133]

3.3.2 One of the principal purposes

The most contentious aspect of the PPT from the taxpayer's point of view is the relatively low threshold for tax authorities to claim that abuse exists as obtaining a tax benefit need only be one of the principal purposes of the arrangement in question.[134]

Commencing with the ordinary meaning of the words, the Oxford English Dictionary defines the word 'principal' as '[F]irst or highest in rank or

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129 Weber D, *'The Reasonableness Test of the Principal Purpose Test Rule in OECD Beps Action 6 (Tax Treaty Abuse) versus the EU Principal of Legal Certainty and the EU Abuse of Law Case Law'* op.cit., p50.

130 Lang M, (2014) *'BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties'*, Tax Notes International, Vol. 74, p658.

131 OECD, *'Action 6 Final Report'*, op.cit., p58.

132 Ibid.

133 Lang M, (2020) *'The Signaling Function of Article 29(9) of the OECD Model – The "Principal Purpose Test",* Bulletin for International Taxation, Vol 74, IBFD, p264.

134 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p23.

importance; that is at the head of all the rest; of the greatest account or value; foremost.'

In ITC 1569[135] the court was called upon to consider the phrase 'one of the principal shareholders'. The court held that ''one of the principal shareholders' envisages that there are more principal shareholders than one… If one shareholder held more shares than any of the others he would…be the "main shareholder". If shareholders each held an equal number of shares they would be the "principal shareholders".'[136]

The Suggested Commentary makes it clear that the PPT was not intended to be restrictive:

> '[t]he reference to "one of the principal purposes"…means that obtaining the tax 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.'[137]

The explanation offered by the Suggested Commentary as to when a purpose is not a principal purpose is 'confusing and recursive'[138] as according to the OECD, a purpose is not a principal purpose when obtaining a benefit was not a principal consideration for the transaction.[139]

One of the key factors in deciding whether treaty benefits ought to be granted is whether an arrangement is 'inextricably linked to a core commercial activity'.[140] The question must be asked whether the benefit obtained under the treaty 'justified' entering into the arrangement.[141] Any prudent businessperson would be motivated to some extent by the tax cost on an enterprise. Even in perfectly legitimate transactions, taxpayers will naturally

135 56 SATC 86 (C).

136 Idem, p90.

137 OECD, *'Action 6 Final Report'*, op.cit., p58.

138 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p23.

139 OECD, *'Action 6 Final Report'* ,op.cit., p58.

140 Ibid.

141 Ibid.

choose the option that is most tax efficient.[142] Business acumen cannot be quantified or measured objectively, but the language of the PPT indicates that this is the standard required to assess whether a tax benefit was a key driver for the transaction under review.[143]

3.3.3 The object and purpose

If, after performing an objective analysis of the facts and circumstances, it is reasonable to conclude that the principal purpose of an arrangement was to obtain a benefit, the taxpayer can still escape being denied treaty benefits if obtaining the benefit was in accordance with the object and purpose of the relevant provisions of the treaty.

The OECD Model Commentary (2017) states that the preamble is important for determining the object and purpose of the relevant provisions of a tax treaty and Article 29(9) must be read in the context of the preamble.[144]

The new preamble contained in Article 6(1) of the MLI states that the object and purpose of the treaty is to eliminate double taxation without creating opportunities for tax avoidance. Importantly, the preamble of South Africa's CTAs also includes as a purpose of the treaty, the enhancement of economic relations.

Schwartz expresses the view that, although Article 6(1) of the MLI purports to be preamble text, its status is unclear due to the relationship between the MLI and CTAs, which makes its role in the interpretation of CTAs uncertain.[145] As explained in section 2.3 above, the MLI is not the same as an amending protocol to a treaty and is intended to apply alongside a CTA. It is this peculiar status that forms Schwartz's view that the MLI is not part of the context of a CTA within Article 31(2) of the Vienna Convention, nor is it a subsequent agreement made by the parties in connection with the conclusion of a CTA,

142 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p23.

143 Ibid.

144 OECD, (2017) *'Model Tax Convention on Income and on Capital: Condensed Version'* OECD Publishing, Paris, para 173 (hereafter 'OECD Model Commentary').

145 Schwartz J, (2020) *'The Impact of the New Preamble on the Interpretation of Old and New Treaties and on the Policy of Abuse Prevention'* Bulletin for International Taxation, Vol 74, IBFD, p175.

within Article 31(3)(a) of the Vienna Convention.[146] The consequence, according to Schwartz, is that Article 6(1) of the MLI is not a preamble to the MLI itself nor to a CTA, but it is 'preamble-like' to the extent that the MLI modifies a CTA.[147] Thus, Schwartz concludes, it forms part of the context in interpreting the provisions of the MLI that modify a CTA, such as Article 7(1).[148]

The analysis requires the determination of the object and purpose of the relevant provisions, and not simply the object and purpose of the tax treaty in general.[149] The 'relevant provisions' are those provisions in the tax treaty on which the requested treaty benefits are based. These will usually be the treaty residence article (Article 4 of the OECD Model) together with the applicable distributive rule (Articles 6 to 22 of the OECD Model), and, as the case may be, the relief provisions (Article 23A or 23B of the OECD Model).[150]

Danon expresses the view that when determining the object and purpose of the relevant provisions of the treaty in question, the policy objectives pursued by the two contracting states must be considered.[151] The application of the PPT cannot be disconnected from the intention of the contracting states and 'simply assessed against an abstract multilateral benchmark'.[152] This is in line with Canadian case law, discussed in section 3.4.2 below.

The OECD Model Commentary (2017) states that the general objective of tax conventions is to provide benefits in order to encourage cross-border investment.[153] If this is the objective and purpose of tax treaties, the question must be asked why it is not stated in the preamble?[154]

146 Idem, p176.

147 Ibid.

148 Ibid.

149 Idem, p258.

150 Ibid.

151 Danon R, *'The PPT in Post-BEPS Tax Treaty Law: It Is a GAAR but Just a GAAR'*, op.cit., p246.

152 Ibid.

153 OECD, *OECD Model Commentary* on Article 29(9) (2017), para 181.

154 Hatting J, (2020) *'The Relevance of BEPS Materials for Tax Treaty Interpretation'*, Bulletin for International Taxation, IBFD, p195.

The Suggested Commentary provides ten examples that are intended to 'illustrate the application' of the PPT.[155] In Example C,[156] a company that is resident of State R (RCo) is rapidly expanding its business of producing electronic devices. In order to benefit from lower manufacturing costs, RCo is considering establishing a manufacturing plant in a developing country. Locations in three countries are identified, all of which provide similar economic and political environments. As State S is the only one of the three countries that has a tax treaty with State R, RCo makes the decision to build the manufacturing plant in State S.

The conclusion provided is that the PPT will not deny treaty benefits to RCo because 'it is clear the principal purpose 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'.[157] The explanation goes further to state that 'it cannot reasonably be considered that one of the principal purposes for building the plant is to obtain treaty benefits.'[158] The drafters conclude with the justification that encouraging cross-border investment is a general objective of tax treaties and so obtaining the benefits of the State R-State S treaty for the investment in the plant is in accordance with the object and purpose of the provisions of the convention.[159]

Hattingh criticises the analysis of the facts of Example C. His criticism is based on the apparent emphasis of the principal purpose of the construction of the plant (i.e. the transaction) as opposed to the consideration of 'any and all principal purposes without privileging any particular type' as is required by the language of the PPT.[160] Hattingh asks the question that, if the cost of manufacturing is equally low in the three jurisdictions, and RCo's choice is based solely on the presence of a tax treaty, how can RCo's choice not have as its principal purpose, the obtaining of treaty benefits? Hattingh comments

155 OECD, *'Action 6 Final Report'*, op.cit., p59.

156 Idem, p60.

157 Ibid.

158 Ibid.

159 Ibid.

160 Ibid.

that, if this is not the meaning of the PPT, then it is 'very poorly drafted and in serious need of revision.'[161]

Example C is not a typical treaty-shopping scenario as it does not involve a third jurisdiction (a so-called conduit jurisdiction). While technical scrutiny such as that provided by Hattingh is necessary in order to ensure that legislative and treaty provisions are robust, the author submits that an element of pragmatism is also required in such analysis. Example C appears to recognise the so-called choice principle that has been accepted by South African courts (discussed in section 4.3.2 below).

Examples K to M were added to the examples contained in the Suggested Commentary in the OECD Model Commentary (2017) on Article 29(9). The OECD Model Commentary (2017) cautions that the examples 'should not be interpreted as providing conditions or requirements that similar transactions must meet in order to avoid the application of the [PPT].'[162] The analysis of each example explains that it is 'necessary to consider the context in which the investment was made', including the reasons for the investment, the investment functions and other activities carried out in the state of residence being relied on for treaty benefits.[163]

An examination of the examples provided in the Action 6 Final Report and the OECD Model Commentary (2017) reveals that, in addition to the reasonableness and principal purpose tests, the PPT appears to contain an 'unexpressed commercial purpose test'.[164] The wording of the PPT does not refer to the presence or absence of commercial purpose, nor does it make mention of economic investment, however the examples provided seem to favour granting tax treaty benefits in situations involving underlying economic investment.[165] This suggests that the PPT was intended to apply in a business context.[166] The problem with this is that tax treaties do not only apply in a

161 Ibid.

162 OECD, *OECD Model Commentary* on Article 29(9) (2017), para 182.

163 Ibid.

164 Hatting J, *'The Relevance of BEPS Materials for Tax Treaty Interpretation,'* op.cit, p194.

165 Ibid.

166 Ibid.

business context, they also apply to government activity, the employment of individuals and the private affairs of individuals.[167]

For Hattingh, the fact that the scope of the PPT is not included in the substantive text of the PPT but must be derived from supplementary materials such as the OECD Model Commentary (2017) is typical of the OECD's working method.[168] He cautions that the PPT text itself 'requires serious redrafting and elaboration' if the goal is uniform tax treaty interpretation in domestic courts.[169] The lack of clarity in the text of the PPT regarding the assumed commercial purpose test put forward by the examples will, in Hattingh's view, inevitably result in arguments about the legal admissibility and meaning of the PPT examples.[170]

It is also interesting to note that the examples on the application of the PPT in the OECD Model Commentary (2017) repeatedly refer to transfer pricing-type substance.[171] In determining whether the PPT applies to preclude treaty benefits, the examples consider factors such as assumption of risks, capacity to take decisions, exercise of functions, use of assets, and presence of human and financial resources.[172] The examples thus appear to suggest that the carrying out of functions within the meaning of chapter 1 and 6 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017)[173] in a state should provide some protection against the application of the PPT.[174]

3.4 Guidance from foreign jurisdictions

As set out in section 3.2, Article 31(1) of the Vienna Convention requires that a tax treaty should be interpreted 'in good faith' and 'in the light of its object and purpose'. One necessary implication of this is that contracting states

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167 Ibid.

168 Ibid.

169 Ibid.

170 Idem, p196.

171 See examples D, F, G, H, K and L of the OECD Model Commentary on Article 29(9) (2017) at para 182.

172 Jimenez M, (2020) '*Value Creation: A Guiding Light for the Interpretation of Tax Treaties?*' Bulletin for International Taxation, Vol 4, IBFD, p209.

173 OECD, (2017) *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'*, OECD Publishing, Paris.

174 Jimenez M, '*Value Creation: A Guiding Light for the Interpretation of Tax Treaties?*' op.cit., p209.

should endeavour to apply a common interpretation (i.e. an interpretation that is most likely to be accepted in both contracting states). Another necessary implication is that the revenue authorities and courts, in applying a tax treaty, must take into account the merits of relevant decisions made by comparable institutions in the other contracting state. Further, s232 of the Constitution, read with the Vienna Convention, requires that both SARS and the South African courts will need to consider the decisions of foreign courts on the interpretation of the PPT.

3.4.1 **The US**

The use of a PPT to grant treaty relief on a discretionary basis originated in US tax treaty practice.[175] As the language found in the PPT can be traced back to Article 1(4) of the United States Model Income Tax Convention of September 20, 1996,[176] guidance as to its implementation can be taken from US case law.

In a tax treaty context, the US Court of Appeals for the Fifth Circuit has stated that 'the fact that [the taxpayer] was motivated in his actions by the desire to minimize his tax burden can in no way be taken to deprive him of an exemption to which an applicable treaty entitles him.'[177] The US Tax Court has also accepted in the context of a tax treaty that the 'fact that the actions taken by the parties… were taken to minimize their tax burden may not by itself be utilized to deny a benefit to which the parties are otherwise entitled under the convention.'[178]

In the 2017 matter of Starr International Company Inc. v the USA,[179] (Starr Case) the US District Court for Columbia was called upon to review a decision taken by the US competent authority not to grant treaty benefits under the 1996 tax treaty between the US and Switzerland. Under such a review application, the court is called upon to determine if the competent authority considered all the relevant evidence and provided a satisfactory explanation

175 Hattingh J, (2018) *'The Impact of the BEPS Multilateral Instrument on International Tax Policies'*, Bulletin for International Taxation, IBFD, p241.

176 Idem, p237.

177 Ingemar Johansson v US, US Court of Appeals for the Fifth Circuit of 2 September 1964, 336F.2d 809.

178 Aiken Inc. v Comm'r, 56 TC 925, US Tax Court of 5 August 1971.

179 Starr International Co Inc v United States of America Case No 14-cv-01593(CRC), 20 ITLR 94 (hereafter 'Starr v US').

for its decision. If the court concludes that this has not occurred, the court is only entitled to set aside the decision and instruct the tax authority to consider the matter again, the court cannot impose a substantive decision itself. As such, even if the court does not agree with the merits of the tax authority's reasoning, provided that the tax authority can show a rational connection between the facts and the decision, the court will not intervene.[180]

A brief synopsis of the background facts of the Starr Case is necessary to understand the conclusions reached by the court. Starr International Company Inc (Starr) was established in Panama in 1943 by the founder of the US insurance business, AIG, to hold the majority of AIG. In 1970, Starr was relocated to Bermuda and a restructure resulted in the executives of AIG holding the voting rights in Starr and a charitable trust holding the economic value in Starr. Dividends paid by AIG to Starr in Bermuda were subject to US withholding tax at 30%. In 2004, Starr and the charitable trust were relocated to Ireland, which was later determined to be an unfavourable jurisdiction for non-tax reasons such as litigation risk and regulatory restrictions on charitable distributions, thus prompting the consideration of alternative jurisdictions.

From the evidence presented it was clear that four factors were considered in determining an alternative jurisdiction, namely US tax, local tax, litigation risk and the regulation of charitable institutions. Four jurisdictions were considered: Bermuda, the Netherlands, Switzerland and the UK. Treaty relief applied automatically under the treaty between the US and the Netherlands and between the US and the UK, whereas treaty relief was only available under the treaty between the US and Switzerland upon application to the competent authority for discretionary relief.

Despite the fact that Switzerland was less favourable than the UK and the Netherlands in relation to local tax, due to the lack of automatic treaty relief, it was considered to be an ideal jurisdiction in so far as the other three criteria on the decision matrix were concerned. Accordingly, in 2006 Starr and the charitable trust were relocated to Switzerland. In 2007, Starr applied to the Internal Revenue Service (IRS) for discretionary relief under Article 22(6), the

180 Hattingh J, *'The Impact of the BEPS Multilateral Instrument on International Tax Policies',* op.cit., p243.

limitation on benefits clause, of the treaty between the US and Switzerland, which clause effectively required application of the PPT.

The IRS declined the request for relief and phrased its response in the negative by stating that it could not conclude that 'obtaining treaty benefits was not at least one of the principal purposes for moving Starr's management, and therefore its residency, to Switzerland.'[181] In coming to this conclusion, the IRS focused on four issues:

> Starr's original incorporation in Panama and its management and control in Bermuda suggest that the original corporate structure may have been developed with a tax avoidance motive in mind and/or to avoid providing information to the IRS;
>
> Starr's relocation to Ireland and the movement of its management and control out of Bermuda shortly before the receipt of dividends from its subsidiary suggest that Starr was seeking to benefit from the reduced rate of dividends tax imposed by the US under the tax treaty between the US and Ireland;
>
> The short time that Starr was located in Ireland, which location may or may not have been intentionally transitory, followed by its subsequent move to Switzerland, suggested to the IRS Starr's intention of organizing itself in a treaty jurisdiction to avail itself of a reduced rate of withholding tax on US source dividends; and
>
> The control of Starr by predominantly US individuals is not in accordance with the recent development of US policy on acceptable corporate ownership for LOB purposes.

Starr challenged the IRS's denial of treat benefits as 'arbitrary, capricious, an abuse of discretion, and otherwise not in accordance with law.'[182] The court held that, in applying the PPT, it was not relevant whether Switzerland was

181 Starr v US, p13, para D.

182 Idem, at 9.

less favourable than the other jurisdictions because treaty relief was not automatic, but rather, it was relevant for the competent authority to ask why the taxpayer established in Switzerland.[183] If the benefits available under the Swiss tax treaty were a consideration, then, the court concluded, it was a purpose for establishment in Switzerland. The court was satisfied that, on the evidence, it was one of the principal purposes as it was a main priority with the other three factors.[184]

In applying the review standard, the court was satisfied that the US competent authority examined relevant evidence and provided a 'satisfactory explanation' that was not arbitrary or capricious and that there was a rational connection between the factual information and the decision to deny the treaty benefits.[185]

3.4.2 **Canada**

Schwartz is of the view that the Canadian case of Her Majesty the Queen v Alta Energy Luxembourg S.A.R.L[186] (Alta Energy Case) is the best current indicator of how the preamble might impact on the interpretation of the PPT.[187] The case involved the restructure of a US investment in a Canadian company in order to interpose a Luxembourg holding company and is described by Schwartz as a 'classic illustration of treaty shopping'.[188] Under the tax treaty between Canada and the US[189] a disposal of the investment would be taxed in Canada whereas if the disposal were made by a Luxembourg resident, Canada would be prevented from taxing under the tax treaty between Canada and Luxembourg.[190] The Canadian domestic law makes its tax treaties subject to Canadian domestic GAAR and the Canadian Revenue Authority sought to

183 Idem, at 119.

184 Idem, at 120.

185 Idem, at 123.

186 2020 FCA 43.

187 Schwartz J, *'The Impact of the New Preamble on the Interpretation of Old and New Treaties and on the Policy of Abuse Prevention'*, op.cit., p176. Schwartz's analysis is based on the judgment of the Canadian Tax Court in 2018, which was upheld by the Canadian Federal Court of Appeal in Her Majesty the Queen v Alta Energy Luxembourg S.A.R.L 2020 FCA 43.

188 Ibid.

189 Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital (26 Sep. 1980) (as amended through 2007), Treaties and Models, IBFD.

190 Convention between the Government of Canada and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital (10 Sep. 1999) (as amended through 2012), Treaties and Models, IBFD.

deny the taxpayer's claim to exemption under the Canada-Luxembourg Treaty on the basis, that, among other reasons, the restructuring was in contravention of the domestic GAAR.

In considering the judgment and the guidance it provides on the interpretation of the PPT, Schwartz highlights that the 'structural similarity between the Canadian domestic GAAR and the PPT are crucial'.[191] The Canadian GAAR has three requirements that must be met before it can be invoked to prohibit tax relief: (i) a tax benefit, (ii) an avoidance transaction, and (iii) an abuse of the provisions of the Canadian Income Tax Act or a treaty. The same criteria are present in the PPT: (i) a benefit under the treaty, (ii) a principal purpose of any arrangement or transaction that resulted directly or indirectly in that benefit, and (iii) that benefit should only be granted if to do so would be in accordance with the object and purpose of the provisions of the treaty (ie an absence of abuse).[192]

The taxpayer conceded that the arrangement resulted in a tax benefit and was an avoidance arrangement, leaving only the question of whether the transaction was abusive to be decided by the court.[193] Under Canadian law, a transaction is abusive for purposes of the GAAR if it frustrates the object, spirit or purpose of the provision.[194] The test for abuse in the PPT is whether granting the benefit is in accordance with the object and purpose of the relevant treaty provision. Thus, Schwartz submits, the analysis is effectively the same for both the Canadian GAAR and the PPT.[195]

The Canadian Federal Court of Appeal considered the preamble of the Canada-Luxembourg Treaty which states that the contracting states desired to 'conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital'.

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191 Schwartz J, *'The Impact of the New Preamble on the Interpretation of Old and New Treaties and on the Policy of Abuse Prevention'*, op.cit., p176.

192 Schwarz J, (2020) *'Alta Energy: Treaty shopping is no abuse'*, Kluwer International Tax Blog, 27 February 2020, available at http://kluwertaxblog.com/2020/02/27/alta-energy-treaty-shopping-is-no-abuse/ (accessed 15 November 2020).

193 At para 72.

194 At para 51.

195 Schwartz J, *'The Impact of the New Preamble on the Interpretation of Old and New Treaties and on the Policy of Abuse Prevention'*, op.cit., p177.

The court noted that the preamble was indicative of the general purpose of the treaty but it was vague regarding the application of specific articles.[196] The court explained that, when performing a GAAR analysis, the rationale underlying the specific articles in question must be identified.[197] It is not sufficient to identify a 'vague policy supporting a general approach to the interpretation of the Treaty as a whole.'[198]

In the light of the Alta Energy judgment, Schwartz considered whether the language of the new preamble contained in Article 6(1) of the MLI would produce a different meaning for any specific articles and concluded that the only article that the new wording would have an impact on is Article 4 (fiscal domicile).[199] Article 4 does not, however, contain any explanation as to when a resident of a contracting state should or should not be denied treaty benefits as a result of treaty shopping.[200] Schwartz agrees with the submission of the court that if preventing treaty shopping is the objective, then a LOB provision that grants benefits only to qualifying residents would give effect to the stated purpose in the preamble in Article 6(1) of the MLI.[201]

A predecessor to the Alta Energy Case was the case of MIL Investments S.A v Her Majesty the Queen[202] which also involved the application of the Canadian domestic GAAR to a treaty shopping structure designed to benefit from the provisions of the Canada-Luxembourg Income and Capital Tax Treaty (1989). The Tax Court of Canada (TCC) held that the 'shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive' because a determination of abuse must look to 'the use of the selected treaty'.[203]

196 Ibid.

197 Ibid.

198 Ibid.

199 Schwartz J, *'The Impact of the New Preamble on the Interpretation of Old and New Treaties and on the Policy of Abuse Prevention'*, op.cit., p177.

200 Ibid.

201 Ibid.

202 18 August 2006, 9 ITLR 25.

203 Idem, at 72.

The TCC stated that the two exemptions under consideration (in Article 13(4) of the treaty) are not found in the OECD Model upon which the treaty is based.[204] As such, it must be 'presumed that Canada had a valid reason to allow Luxembourg to retain the right to tax capital gains in those specific circumstances, for example, the desire to encourage foreign investment in Canadian property.'[205] The TCC went on to state that if Canada was concerned with the preferable tax rates of any of its treaty partners, it should renegotiate the treaty in question rather than seek to apply the GAAR.[206] In this regard, the TCC in the Alta Energy Case held that it is not the role of the court to 'disturb [the] bargain' of States.[207] This is in line with Danon's view as set out in section 3.3.3 that when determining the object and purpose of the relevant provisions of the treaty in question, the policy objectives pursued by the two contracting states must be considered.

The Canadian courts appear to take the position that the object and purpose of the distributive rules is to allocate taxing rights and if the taxpayer satisfies that objective, the transaction is not abusive for purposes of the GAAR.[208]

The OECD Model Commentary (2017) contains an example with a similar fact pattern to that of the Alta Energy Case, but concludes that treaty benefits 'could' be denied:

> '[A] person may sell a property for various reasons, but if before the sale, that person becomes a resident of one of the Contracting States and one of the principal purposes for doing so is to obtain a benefit under a tax convention, [Article 29(9) of the OECD Model (2017)] could apply notwithstanding the fact that there may also be other principal purposes for changing residence, such as facilitating the sale of the property or the re-investment of the proceeds of the alienation.'[209]

204 Idem, at 73.

205 Ibid.

206 Idem, at 74.

207 Alta Energy Luxembourg S.A.R.L v The Queen (2018) TCC 152 at 85.

208 Chand and Eliffe, (2020) *'The Interaction of Domestic Anti-Abuse Rules with Tax Treaties in the Post-BEPS Digitalized World'*, Bulletin for International Taxation, Vol 74, IBFD, p312.

209 OECD, *OECD Model Commentary* on Article 29 (2017), para 180.

3.4.3 **The UK**

Language similar to that contained in the PPT is contained in UK domestic legislation and has been included in UK tax treaties for nearly 30 years.[210] It is thus apposite to look to the decisions of the UK courts for guidance on how to determine if tax avoidance is a purpose of an arrangement. When considering to what extent consideration of tax in deciding on a course of action constitutes avoidance, the UK courts distinguish between 'tax avoidance' and 'tax mitigation'.[211] In Willoughby v IRC[212] the House of Lords held that tax avoidance is a course of action designed to conflict with or defeat the evident intention of Parliament. Tax mitigation, so the court stated, is taking advantage of a fiscally attractive option afforded by the tax legislation, and genuinely suffering the economic consequences that Parliament intended to be suffered by doing so. Schwartz is of the view that this approach is consistent with the PPT and statutory GAARs which permit tax benefits that are in line with the purpose of the relevant tax rule.[213]

During the course of 2019 and 2020, the UK tax tribunals have been charged with considering a series of cases specifically dealing with the 'Transfer of Assets Abroad' legislation. This UK domestic legislation is similar to the South African tax attribution rules found in s 7(8) and paragraph 72 of the Eighth Schedule to the Income Tax Act. It deems the income of a non-UK person to be the income of anyone who is UK resident and transferred assets directly or indirectly to the non-UK person, if the transferor has a 'power to enjoy' the income of the non-UK person arising from the transfer. The income is not attributed to the UK resident taxpayer if the taxpayer can show one of two possible 'motive defences': (i) the purpose of avoiding liability to taxation was not the purpose, or one of the purposes, for which the relevant transactions or any of them were effected; or (ii) the transfer and any associated operations were genuine commercial transactions and were not designed for the purpose of avoiding liability to taxation.[214] Notably, the 'motive defence' has been

210 Schwarz J, (May 2020) '*The eye of the needle: Is one of your purposes tax avoidance?',* Kluwer International Tax Blog, available at http://kluwertaxblog.com/2020/05/26/the-eye-of-the-needle-is-one-of-your-purposes-tax-avoidance/ (accessed 8 July 2020).

211 Ibid.

212 IRC v Willoughby, (1997) UKHL, STC 995.

213 Schwarz J, '*The eye of the needle: Is one of your purposes tax avoidance?' op.cit.*

214 UK Income Tax Act 2007, Part 13, Chapter 2.

narrowed over time as it was previously in line with the current South African GAAR in that provided tax avoidance was not the main purpose of the transaction, the defence would succeed. It now appears to be more in line with the PPT in only requiring 'one of the purposes' of the transaction to be tax avoidance.

In the case of Davies and Others v HMRC[215] three UK resident individuals were involved in the development of UK land by a Mauritian company wholly owned by a Bermuda insurance company. The UK residents each took out a life insurance policy with the Bermuda company, which policies were linked to their respective entitlements in the Mauritian company, which purchased and developed land in the UK. The individuals argued that they did not enter into the arrangements to avoid tax, and did not, in fact avoid tax, as the Mauritian company paid tax in Mauritius on the profits of the development and the life policy arrangements were subject to tax in the UK on the proceeds of the policies.

Their purpose, they submitted, was to find an alternative vehicle for the purchase of the UK land in order to release another company in which they were interested from its commitment to purchase the land without losing its deposit, as well as to make pension plans for themselves. The taxpayers argued that deferral of tax (which may constitute tax avoidance) until payment under the policies must be considered in the context of pension provisions, otherwise all pension planning would constitute tax avoidance. The Upper Tribunal agreed with the First Tier Tribunal's reasoning that consideration of tax is not necessarily tax avoidance because of the distinction between tax mitigation and tax avoidance. The Tribunal held that, while taking out a life policy itself does not constitute tax avoidance, when considered together with the creation of a special purpose vehicle in Mauritius to benefit from the Mauritius-UK DTA, it was for tax reasons.

The case of Hoey v HMRC[216] considered whether a common structure marketed to IT contractors who are engaged by customers on short term

215 (2020) UKUT 67 (TCC).
216 (2019) UKFTT 489 (TC).

contracts for specific periods, was entered into for tax avoidance purposes. The taxpayer was an IT contractor who was introduced to the provider of the scheme by his adviser. Under the scheme, multiple contractors were employed by a single non-UK umbrella company which provided the services of the contractors to the customers. A trust was established for each contractor to receive payments from the umbrella company and in turn, make interest-free loans to the contractors, who had no intention of ever repaying the loans. While the court found that the individual taxpayer's motive was to avoid the complexities of running his own company and not to avoid tax, it held that it is not enough to just look at the purpose of the taxpayer, because the legislation requires the motive of the designer or promoter of an arrangement in question to also be considered. The tribunal held that the establishment of the umbrella company was an acceptable commercial transaction, but the additional transactions of establishing trusts and making loans which were never to be repaid meant that the motive defence would have failed.

In Rialas v HMRC[217] a UK resident individual wanted to buy out his co-shareholder in a UK company. A non-UK resident discretionary trust established for the benefit of the individual's family incorporated a wholly-owned non-UK resident company, which took a loan from an unrelated third party to purchase the shares in the UK company. The loan was repaid using dividends received from the UK company. The taxpayer submitted that his motives were (i) to monetise the value of his holding in the UK company which required him to buy out his fellow shareholder, who was reluctant to sell if he had to keep working in the business; (ii) to borrow the funds required to purchase the shares without personal liability, but retain the upside in the event that the UK company increased in value; (iii) to buy out his co-shareholder in a way that did not introduce a new party in the ownership chain who would require certain UK regulatory approval; (iv) the lender was only prepared to lend on unusually favourable terms to a company based in a jurisdiction which would preserve the privacy they sought; and (v) to hold the shares via an offshore trust to reduce exposure to UK Inheritance Tax. The taxpayer had not taken specific advice on this, but was aware that offshore trusts were generally used for Inheritance Tax purposes. The First Tier

217 (2019) UK FTT 520 (TC).

Tribunal found that all the motives had a commercial purpose, except for the establishment of the trust to prevent the shares from being subject to Inheritance Tax. The Tribunal found that this final motive went beyond tax mitigation and was unacceptable tax avoidance.

Finally, the case of Fisher and others v HMRC[218] is interesting because the Upper Tribunal adopted a pragmatic, business-friendly approach when it identified a qualitative difference between a taxpayer voluntarily entering into a tax avoidance arrangement in order to save tax and a situation in which a taxpayer is effectively forced to restructure in the same tax-efficient way as its competitors in order to secure the survival of the business. In this case, the introduction of betting duty in the UK resulted in all large telephone betting companies moving from the UK to more favourable jurisdictions. The telephone betting business under consideration was sold by a UK resident company owned by a UK resident family to a Gibraltar company owned by the same family. The Upper Tribunal accepted that, if the UK company remained in the UK and subject to the levy, it would be uncompetitive in pricing bets and would go out of business. The Tribunal was satisfied that the commercial transactions were not 'designed for the purpose' of avoidance.[219]

3.5 Conclusion

The ordinary meaning of the word 'principal' suggests that, in the context of purpose or motive, there can only be one principal purpose, being the motive that ranked highest in importance. The process of interpretation laid down by the court in the Endumeni Case, in conjunction with the customary international law contained in Articles 31 and 32 of the Vienna Convention, however, requires the ordinary meaning of words to be considered together with their context, with neither the ordinary meaning nor the context predominating over the other.

When the ordinary meaning of the phrase 'principal purpose' is considered in conjunction with the context provided by the preamble and the Explanatory Statement, together with supplementary means of interpretation in the form of the

218 (2020) UKUT 62 (TCC).

219 Idem, at 146.

Action 6 Final Report and the OECD Commentary, it becomes clear that the phrase is not intended to mean a single, dominant purpose, but rather one of a number of equally important considerations. The subjective intention of the taxpayer as to whether obtaining a tax benefit was a principal purpose of the arrangement must be determined by considering the objective facts and circumstances to arrive at a reasonable conclusion.[220]

A potential investor's decision will depend upon a determination of which investment opportunity provides the best overall net economic return, after taking into account all of the usual investment considerations such as the perceived riskiness of the investment, its liquidity, the timing of any returns, and each investor's own investment objectives, existing portfolio, anticipated cash needs and risk tolerance. The tax treatment of the investment would simply be one factor taken into account by a rational investor in comparing the attractiveness of various investments and making an informed decision. Herein lies the difficulty because when considering the application of the PPT, a tax authority will assess in abstract whether the transaction reflects sound business practice in the absence of the tax benefit.[221]

Baker is concerned that the PPT will undermine the whole system of tax treaty benefits. In this regard, the author must agree with Baker's view that, as a result of the PPT, 'no taxpayer who has given any consideration to the impact of a tax treaty on its transactions or arrangements will be able to rely with any certainty on obtaining the benefit of the tax treaty.'[222]

220 Weber D, *'The Reasonableness Test of the Principal Purpose Test Rule in OECD Beps Action 6 (Tax Treaty Abuse) versus the EU Principal of Legal Certainty and the EU Abuse of Law Case Law'* op.cit., p49.

221 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p23.

222 Baker P, (2017) *'The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting'*, British Tax Review, Vol 3, p283.

4 CHAPTER 4: INTERACTION BETWEEN PPT AND THE DOMESTIC GAAR

4.1 Introduction

The OECD Model Commentary (2017) on Article 1 recognises that 'many countries have included in their domestic law a legislative anti-abuse rule of general application.'[223] The OECD Model Commentary (2017) acknowledges that this could raise the question of conflicts with tax treaties but, according to the OECD, such a conflict should not arise 'in the vast majority of cases'.[224]

As explained in section 3.2, when a tax treaty is published in the Government Gazette, it attains the status of domestic law. The question that arises is thus what happens when the provisions of a tax treaty conflict with the provisions of domestic law contained in the Income Tax Act? The normal rules of reconciling conflicts between two 'typical' domestic provisions need to be supplemented with additional considerations due to the specific nature of a tax treaty as an agreement between two states.

The Davis Tax Committee (DTC) considered the feasibility of applying the PPT in South Africa in its Final Report on Base Erosion and Profit Shifting (BEPS) in South Africa (DTC Report). The DTC Report states that

> 'the PPT rule requires tax authorities to make a factual determination as to whether the principal purpose (main purpose) of certain creations or assignments on income or property or of the establishment of the person who is a beneficial owner of the income, was to access the benefits of a particular tax treaty.'[225]

In coming to the conclusion that South Africa should implement the PPT, the DTC considered the argument that '[s]ince the [PPT and GAAR] serve a similar purpose… there is no need for South Africa to amend its treaties to include a PPT test.'[226] The DTC Report, however, ultimately recommends inserting the PPT

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223 OECD, *OECD Model Commentary* on Article 1 (2017), para 76.

224 Idem, para 77.

225 Davis Tax Committee (2016) *'Second and Final Report on Base Erosion and Profit Shifting (BEPS) in South Africa'*, Annexure 6, p4 available at https://www.taxcom.org.za/docs/New_Folder3/8%20BEPS%20Final%20Report%20-%20Action%206.pdf (accessed 15 November 2020).

226 Ibid.

because 'there could be concerns of treaty override if South Africa applies its GAAR in a treaty context… [and] South Africa's GAAR may not be exactly worded like a similar provision with its treaty partner.'[227]

4.2 Interaction between domestic law and tax treaties

The issue of the interaction between domestic law and tax treaties is a complex one, particularly when there is a conflict between the two. The Income Tax Act itself provides no guidance as to how such a matter should be dealt with, and case law has provided conflicting answers. While it is outside the scope of this report to perform an in depth analysis of this complex issue, the most prominent cases in this area are discussed briefly below.

In the case of AM Moola Group Ltd v Commissioner for the South African Revenue Service[228] the Tax Court had to consider a conflict between the Customs and Excise Act 91 of 1964 and the Trade Agreement between South Africa and Malawi. Despite concluding that there was no conflict, the court held that if there were a conflict, the Customs and Excise Act 'must, of course, prevail'.[229]

Although not a case in the national revenue sphere, in Glenister v President of the Republic of South Africa[230] the majority judgment of the Constitutional Court stated, with reference to the status of international agreements, that 'the incorporation of an international agreement creates ordinary domestic statutory obligations.'[231] The minority judgment addressed the issue of a conflict between a treaty and domestic legislation and stated that

> 'if there is a conflict between an international agreement that has been incorporated into our law and another piece of legislation, that conflict must be resolved by the application of the principles relating to statutory interpretation and superseding of legislation.'[232]

227 Ibid.
228 (2003) 65 SATC 414.
229 Idem, para 16.
230 (2011) 3 SA 347 (CC).
231 Idem, par 181.
232 Idem, para 100 – 101.

The Western Cape High Court was called upon to decide on the status of a tax treaty in relation to the Income Tax Act in the case of Commissioner for the South African Revenue Service v van Kets.[233] The court held that

> '[g]iven the manner in which the DTA stands to be in terms of section 231 of the Constitution, its provisions must rank at least, equally with domestic law, including the [Income Tax] Act. For this reason, the provisions of the DTA and the [Income Tax] Act should, if at all possible, be reconciled and read as one coherent whole'.[234]

Finally, the SCA in the case of Commissioner for the South African Revenue Service v Tradehold Ltd[235] considered the purpose of a tax treaty, and made it plain that the provisions of a tax treaty modify the provisions of the Income Tax Act:

> 'Double tax agreements… achieve the objective of s 108, generally, by stating in which contracting state taxes of a particular kind may be levied or that such taxes shall be taxable only in a particular contracting state or, in some cases, by stating that a particular contracting state may not impose the tax in specified circumstances. **A double tax agreement thus modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict.**'[236] (emphasis added)

The OECD Model Commentary (2017) states that, in the case of a conflict, the provisions of a tax treaty should generally prevail under the 'pacta sunt servanda' principle.[237] The OECD's view is that if the application of specific domestic anti-abuse rules result in a tax treatment that is not in accordance with the provisions of a tax treaty, this would conflict with the provisions of the treaty and the treaty provisions should prevail under public international law.[238] With regard to domestic general anti-abuse rules, the OECD does not envisage that such a conflict will arise very often.[239] This is premised on the assumption that the main aspects of domestic

233 2012 (3) SA 399 (WC).

234 Idem, para 25.

235 2013 (4) SA 191 (SCA).

236 Idem, para 21.

237 OECD, *OECD Model Commentary* to Article 1 (2017), para 70.

238 Ibid.

239 Idem, para 77.

general anti-abuse rules are 'similar' to the main aspects of Article 29(9) of the OECD Model (2017).[240]

According to the OECD, where the domestic anti-abuse rules are 'similar' to the provisions of Article 29(9), the domestic general anti-abuse rule will apply in the same circumstances in which the benefits of the tax treaty would be denied under the PPT.[241] As will be seen from the analysis below, the South African domestic GAAR may be 'similar' to the PPT, but it's application is considerably different.

4.3 GAAR Overview

The South African GAAR is contained in s 80A – 80L of the Income Tax Act and imposes general limits upon the tax effectiveness of arrangements designed to avoid tax by empowering SARS to reduce, eliminate or neutralise any tax benefit derived from an 'impermissible avoidance arrangement'.

In order for the GAAR to apply, the following requirements must all be satisfied:

There must be an 'arrangement';

The arrangement must result in a tax benefit (the Tax Benefit Requirement);

The sole or main purpose of the arrangement must be to obtain a tax benefit (the Purpose Requirement); and

There must be a lack of commercial substance or an element of so-called abnormality to the arrangement or transaction (the Abnormality Requirement).

It is clear that there are a number of requirements that must be met before an arrangement (being any transaction, operation, scheme, agreement or understanding, including all steps therein or parts thereof) can be construed as an impermissible avoidance arrangement. If any of the four requirements is not satisfied, the GAAR does not apply.

240 Ibid.

241 Ibid.

4.3.1 Tax Benefit Requirement

A 'tax benefit' is defined to include 'any avoidance, postponement or reduction of any liability for tax'.[242] In the author's opinion, the courts are likely to interpret the term 'tax benefit' in s 80L of the Income Tax Act in the same way as they did the requirement in the now repealed s 103(1), that the relevant transaction, operation or scheme had 'the effect of avoiding or postponing liability for the payment of any tax… or of reducing the amount thereof'. Accordingly, the considerations which were taken into account in interpreting that requirement apply equally to the concept of a 'tax benefit' as referred to in s 80L.

In Smith v CIR[243] (Smith Case) (dealing with s 90 of the Income Tax Act 31 of 1941) the court held that '[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 ...' This phrase was quoted with approval by Trollip JA in Hicklin v SIR[244] (Hicklin Case).[245] Thus, Trollip JA held that it is 'a liability for tax that the taxpayer anticipates will or may fall on him in the future.'[246]

It is noteworthy that in the Hicklin Case the court regarded it as sufficient that the taxpayer contemplated the possibility of the tax liability befalling him although it was not established that, if he had not concluded the transaction in question, he would have incurred such liability.

In ITC 1625[247] Wunsh J took a much narrower approach when determining whether a transaction had the effect of avoiding tax. His view was that the courts must apply a 'but for' test. In order to illustrate this test, he gave the following example:

242 S 1 of the Income Tax Act.

243 1964 (1) SA 324 (A).

244 1980 1 SA 481 (A).

245 Idem, par 333E.

246 Idem, par 333G.

247 59 SATC 383.

> 'In order to determine whether the advancing of the loans enabled Respondent to get out of the way of, escape or prevent an anticipated liability for tax one must, I think, ask oneself the question whether, but for the loans, equivalent . . . amounts would probably have been received by Respondent in taxable form, i.e. as salary or dividends.'[248]

The approach of Wunsh J in ITC 1625 is a more compatible test when considered within the context of the GAAR and is thus, in the author's view, preferred to that of Trollip JA in the Hicklin Case. Wunsh J's approach, applying the so-called but for test, accords more closely with the view taken in the Smith Case and in the author's opinion, with the purpose of the relevant provision.

4.3.2 The Purpose Requirement

If the arrangement or any part thereof results in a tax benefit, the question is whether the sole or main purpose of the arrangement, or any step therein or part thereof, was to obtain the tax benefit. Accordingly, the purpose of an arrangement is fundamental to determine whether such arrangement constitutes an impermissible avoidance arrangement.

The GAAR contains a rebuttable presumption that the mere presence of a tax benefit gives rise to the presumption that the avoidance arrangement was designed and entered into solely or mainly to obtain a tax benefit.[249] An issue which has never been considered by the courts is precisely how a 'main purpose' is to be determined. The commercial consequences of a transaction may have both quantitative (numerical) and qualitative (business efficiency) components, whereas the 'tax benefit' to be weighed in the balance is purely quantitative.

SARS take the view that the word 'mainly' should be construed as a purely quantitative measure of more than 50%; conveying the idea of dominant; or more than anything else, for the most.[250]

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248 Idem, p397.

249 S 80G of the Income Tax Act.

250 SARS Legal and Policy Division, '*Draft Comprehensive Guide to the General Anti-Avoidance Rule (GAAR*)', (now deleted), p22.

Due to the lack of case law or guidance on how to determine the purpose of an arrangement, in the author's view, the principles applicable to the 'purpose' requirement in the former s 103(1) of the Income Tax Act should apply equally to the 'purpose' requirement in the new GAAR. In this respect, in relation to the former GAAR, in SIR v Gallagher[251] the court rejected an objective test to determine purpose and held that

> '[a] subjective test … takes as its criterion the purpose which those carrying out the scheme intend to achieve by means of the scheme… [O]f prime importance in determining the purpose of the scheme would be the evidence of [the] respondent ….as to why it was carried out….'[252]

An arrangement can never have a 'purpose' different from the subjective purpose of the person who implemented that arrangement. An arrangement is an inanimate thing, a creation of human ingenuity. It cannot be interrogated to establish its purpose in any ordinary sense. One locates the purpose of an arrangement in the mind and motives of its progenitor. An arrangement has an effect which is objectively ascertainable, but it does not have a mind of its own. To attribute a 'purpose' to an arrangement which is different from the purpose of the person who brought it into effect, is therefore to apply a fiction that is not reconcilable with the ordinary meaning of the word.

Even if a transaction provides for a tax benefit, this in and of itself does not mean that the sole or main purpose of the transaction was to obtain such tax benefit. The principle that a taxpayer may arrange his affairs as he deems fit, whether or not a tax advantage is derived, was confirmed by the SCA in the case of Commissioner for Inland Revenue v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd)[253] (Conhage Case). In this case the taxpayer required funding and obtained the funding through a sale and lease back transaction with a bank. The SCA held that

251 40 SATC 39.

252 Idem, p48 - 49.

253 1999 (4) SA 1149 (SCA).

'[The raising of finance] was the fons et origo of the transactions and it remained the underlying and basic purpose thereof ... **This whole arrangement ... was to achieve the predominant purpose of raising finance but, because of the welcome by-product of the tax benefit, the vehicles chosen were the sale and leaseback transactions**.'[254] (emphasis added)

In broad terms, under the so-called choice principle, provided there is a commercial transaction to be entered into by a taxpayer and the sole or main purpose of the taxpayer is to enter into such transaction, i.e. absent the commercial drivers there would be no transaction then, in terms of the principle set out in the Conhage Case, the taxpayer is entitled to structure such transaction in a tax efficient manner. The choice principle has been endorsed by South African courts on a number of different occasions and was reinforced in CSARS v NWK Ltd[255] (NWK Case) and CSARS v Bosch and Another,[256] where it was stated 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.[257]

4.3.3 Abnormality Requirement

The Abnormality Requirement looks to so-called tainted elements of a transaction or arrangement that are indicative of a lack of commercial substance. Although an avoidance arrangement is impermissible if its sole or main purpose was to obtain a tax benefit, this is not the only requirement. In addition to this (this onus of proof being on the taxpayer), the Commissioner must prove the presence of any one or more of the tainted elements. There are four 'tainted elements' that are independent of one other.[258] Thus, the presence of any one of them is sufficient to satisfy the Abnormality Requirement. On the other hand, the absence of a particular element is irrelevant in determining whether or not any of the other elements may be present.

254 Idem, p14.

255 2011 (2) All SA 347 (SCA).

256 2015 (1) All SA 1 (SCA).

257 Idem, para 40 and NWK Case op.cit., para 42.

258 s 80A of the Income Tax Act.

The 'tainted elements' under the GAAR apply to arrangements:

entered into or carried out in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit (i.e. an element of abnormality);[259]

that lack commercial substance;[260]

that have created rights or obligations that would not normally be created between persons dealing at arm's length;[261] or

that would result in the misuse or abuse of any provision of the Income Tax Act, including the provisions of the GAAR itself.[262]

4.3.3.1 **Abnormality**

In terms of the previous anti-avoidance provision in s 103(1) of the Income Tax Act, the onus rested on SARS to prove that the abnormality requirement is satisfied.[263] The taxpayer in ITC 1712[264] won the case, as SARS was not able to discharge its onus of proof in this regard. In the author's view, this onus is the same in terms of the current GAAR. In ITC 1712, the court held in regard to the abnormality test in the previous anti-avoidance provision that

> 'before the appellant's transaction can be regarded as "normal"… it has to correspond with the hypothetical model of the "normal" transaction [which] is devised by asking how –
>
> businessmen generally (objective yardstick);
>
> with a real/genuine business rationale ("bona fide business purposes");

259 Idem, s 80A(a)(i).

260 Idem, s 80A(a)(ii).

261 Idem, s 80A(c)(i).

262 Idem, s 80A(c)(ii).

263 Conhage Case, op.cit., p398.

264 63 SATC 499.

> without being motivated by any possible tax advantage ("other than the obtaining of a tax benefit") would have structured a corresponding transaction.'

In the absence of any legal precedent in relation to the current GAAR, the author agrees with the interpretation outlined above. Essentially, this means that a transaction or arrangement would be normal in the context of this provision if businessmen generally would have entered into similar transactions in the same manner without the resultant tax benefits.

4.3.3.2 Lack of commercial substance

An avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained but for the provisions of the GAAR.[265] There are three factors that are indicative of a lack of commercial substance,[266] namely (i) round trip financing;[267] or (ii) an accommodating or tax indifferent party;[268] or (iii) elements that have the effect of offsetting or cancelling each other.[269]

The Commissioner is explicitly authorised to treat parties who are connected persons in relation to each other as one and the same person for purposes of applying this test. This general rule regarding lack of commercial substance is not framed as a comparative test. It is, therefore, the author's view that the test must be applied as an absolute, and not by comparison to a hypothetical 'base case' scenario.

4.3.3.3 The creation of rights and obligations that are not arm's length

265 S 80C of the Income Tax Act.

266 Idem, s 80C(2).

267 Idem, s 80C(2)(b)(i).

268 Idem, s 80C(2)(b)(ii).

269 Idem, s 80C(2)(b)(iii).

The term 'arm's length' is not defined in the Income Tax Act. In the Hicklin Case the court held that the phrase 'connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself.'[270] The authors of Silke comment that 'virtually every family arrangement' will fail this test.[271]

4.3.3.4 Misuse or abuse of the Income Tax Act

This particular criterion is made applicable 'in any context' which makes an avoidance arrangement an 'impermissible avoidance arrangement' if it is coupled with the requisite sole or main purpose of obtaining a tax benefit and the avoidance arrangement in question would result directly or indirectly in the 'misuse or abuse' of the provisions of the Income Tax Act (including the provisions of the GAAR).[272]

This concept is new to the GAAR and was not present in the former s 103 of the Income Tax Act. As pointed out in the Explanatory Memorandum to the GAAR, the misuse or abuse test has its inspiration in Canadian and certain European jurisdictions. Although the concept derives from Canadian law, the test is nevertheless implemented somewhat differently in the context of the South African GAAR.

As discussed in section 3.4.2, in Canada the misuse or abuse test involves a two-part inquiry. The first is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose. The second is to examine the factual context of a case in order to determine whether the avoidance arrangement defeated the object, spirit or purpose of the provisions in issue. The first question is one of law that is, as in all cases, ultimately for the courts to decide. The second is generally a mixed question of law and fact, in which the onus is upon the Commissioner to the extent of the factual element.

270 Hicklin v SIR, op.cit., p195.

271 AP de Koker et al, (2020) *'Silke on South African Income Tax'*, (Online), Lexis Nexis, at para 19.39.

272 S 80A(c)(ii) of the Income Tax Act.

SARS in the DRAFT Guide on GAAR states that

> 'The introduction of the misuse or abuse concept is intended to reinforce the emerging trend in South Africa (which mirrors similar trends in other jurisdictions) towards a contextual and purposive approach to tax statutes—in order to find a meaning that harmonises the wording, object and spirit and purpose of [their] provisions.'[273]

If a taxpayer's actions are within the scope of a provision of the Income Tax Act, the question that arises is that in what sense could those actions ever be an 'abuse' or 'misuse' of the kind that s 80A(c)(ii) seems to contemplate? Or does the intent of an Act extend beyond its language? Does the inquiry into the 'abuse' or 'misuse' of the Income Tax Act turn on the subjective intent of the taxpayer or is it a purely objective test?

It was held in the New Zealand case of Glenharrow Holdings Ltd v C of IR[274] that a provision of a statute has been defeated where an arrangement was structured so as to avoid tax in a manner that was 'outside the purpose and contemplation of the relevant statutory provisions'.

In Her Majesty the Queen v Canada Trustco Mortgage Company held that[275]

> 'a finding of abuse is only warranted where the … conclusion – that the avoidance transaction was consistent with the object, spirit or purpose of the provisions of the Act that are relied on by the taxpayer – cannot be reasonably entertained. In other words, the abusive nature of the transaction must be clear. The GAAR will not apply to deny a tax benefit where it may reasonably be considered that the transactions were carried out in a manner consistent with the object, spirit or purpose of the provisions of the Act, as interpreted textually, contextually and purposively'.

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273 SARS Legal and Policy Division, '*Draft Comprehensive Guide to the General Anti-Avoidance Rule (GAAR)*', (now deleted), p44.

274 (2009) 24 NZTC 23 at 236.

275 Her Majesty the Queen v Canada Trustco Mortgage Company 2005 SCC 54 (2005) 2 S.C.R. 601 at 628..

> There is a considerable number of cases in which it has been held that 'a court was not entitled to do otherwise than expound [the] words in their ordinary and natural sense.'[276] In other words, if words of a taxing provision are clear and unambiguous, the court cannot depart from their ordinary meaning just because such meaning permits tax avoidance.[277] Silke notes, however, that under South Africa's new constitutional dispensation, statutory provisions are interpreted more in line with their purpose, even where there is no ambiguity in the language used.[278]

4.4 The PPT and the GAAR

The DTC Report sets out the DTC's understanding of the application of the PPT by comparing it to the domestic GAAR. According to the DTC

> 'the factual determination required under the "principal purpose test" is similar to that required to make an "avoidance transaction" determination under the GAAR… 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...'[279]

This statement of the DTC is lacking in one crucial respect. It makes reference to the analysis under the PPT being similar to that under the GAAR in that one must determine 'the' primary purpose, in other words, a single primary or principal purpose. While a primary purpose and a principal purpose may be interchangeable in ordinary English language, the difference lies in the consideration of 'the' principal purpose and 'one of the' principal purposes.

Unlike South Africa's domestic GAAR which looks to the existence of one main purpose (with all other purposes, by implication, being only ancillary or secondary), the PPT implies that it is possible for a number of principal purposes to exist.[280] Whereas under the GAAR, once the main purpose has been determined, the other

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276 AP de Koker, 'Silke on South African Income Tax', op. cit., para 19.39.

277 Ibid.

278 Ibid.

279 Davis Tax Committee, (2016) *'Second and Final Report on Base Erosion and Profit Shifting (BEPS) in South Africa'*, op. cit., p4.

280 PwC (2017) Synopsis Tax Today, *'A South African perspective on the Multilateral Instrument's principal purpose* test' August 2017, available at https://www.pwc.co.za/en/assets/pdf/synopsis-august-2017.pdf (accessed 9 August 2020).

secondary considerations are not relevant, under the PPT, considerations that would be secondary (and thus inconsequential) under the GAAR can be elevated to being a co-principal consideration, and thus result in treaty benefits being denied. The DTC appears to have missed this critical point in its comparison of the two.

As discussed in section 4.3.2, the court in SIR v Gallagher rejected the objective test in relation to determining the purpose of an arrangement under the former GAAR and there is no case law under the current GAAR from which to draw guidance. When determining the purpose under the PPT on the other hand, the OECD has made it clear that the analysis required is an objective one (see section 3.3.2 above).

With regard to the burden of proof, the Suggested Commentary explains the OECD's intended burden of proof under the PPT by unhelpfully simply restating the wording of the PPT:

> 'it is not necessary to find conclusive proof of the intent of a person concerned with an arrangement or transaction, but it must be reasonable to conclude, after an objective analysis of the relevant facts and circumstances, that one of the principal purposes of the arrangement or transaction was to obtain the benefits of the tax convention.'[281]

Although conceding that the standard of proof under the PPT is vague, Bergedahl is of the view that, under the PPT, the burden of proving that a benefit was one of the principal purposes is incumbent on the tax authorities.[282] Korving and van Hulten, on the other hand submit that the PPT shifts the burden of proof regarding treaty abuse to the taxpayer.[283] Danon also holds the view that under the PPT the onus of proof has shifted to the taxpayer.[284]

The taxpayer bearing the onus of proof is questionable from a policy perspective.[285] As stated above, the misuse or abuse element of the South African GAAR was

281 OECD, *'Action 6 Final Report'*, op.cit., p57.

282 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1',* op.cit., p24.

283 Korving and van Hulten, (12 December 2018), *'MLI: Testing the 'principal purpose*', International Tax Review, available at https://www.internationaltaxreview.com/article/b1f7n2f6tqcfyx/mli-testing-the-principal-purpose (accessed 17 August 2020).

284 Danon R, (2020) *'The PPT in Post-BEPS Tax Treaty Law: It Is a GAAR but Just a GAAR'*, op.cit., p254.

285 Ibid.

largely based on the Canadian GAAR.[286] Canadian courts have confirmed that once a taxpayer has shown compliance with the wording of a provision, he or she should not be required to disprove that the object, spirit or purpose of the provision has been violated.[287] The Supreme Court of Canada explained why it makes sense for the onus of proof to rest with the tax authority and not the taxpayer:

> 'It is for the Minister who seeks to rely on the GAAR to identify the object, spirit or purpose of the provisions that are claimed to have been frustrated or defeated… [t]he Minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue.'[288]

The South African GAAR provides for a rebuttable presumption that an arrangement has obtaining a tax benefit as its sole or main purpose if the effect of the arrangement is a tax benefit. In other words, as soon as a tax benefit exists, the GAAR imposes the burden of proof on the taxpayer to show that the sole or main purpose was not to obtain that tax benefit. The PPT contains no such rebuttable presumption and, the Suggested Commentary explicitly states that it should not be 'lightly assumed' that obtaining a tax benefit was a principal purpose.

The rebuttable presumption in the GAAR therefore appears to be more punitive than that in the PPT. The rebuttable presumption is, however, not as severe as it may first appear, bearing in mind that under the GAAR, the taxpayer need only prove that obtaining the tax benefit was not the sole or main purpose, as opposed to one of a number of important considerations. Therefore, it is submitted that it is easier for the taxpayer to rebut such a presumption under the South African GAAR than it would be if a similar presumption existed under the PPT.

The examples in the Suggested Commentary and the OECD Model Commentary (2017) appear to recognise, albeit not expressly, the 'choice principle' that is an

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286 RSA National Treasury, Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006 p63 available at https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-2006-01-Explanatory-Memorandum-Revenue-Laws-Amendment-Bill-2006.pdf (accessed 15 November 2020).

287 Her Majesty the Queen v. Canada Trustco Mortgage Company, op.cit., at 629.

288 Ibid.

accepted principle of South African courts in tax avoidance matters (see section 4.3.2 above). In ITC 1625[289] the court held that

> '[i]f a taxpayer has a commercial or a family purpose for entering into an agreement which is not itself a tax avoidance purpose and chooses a method to achieve his or her objective which is tax effective, that does not convert the transaction into one for the avoidance, reduction or postponement of tax.'[290]

This accords with the Suggested Commentary that one cannot simply look at the effect of an arrangement to determine if it was entered into to avoid tax (see section 3.3.1 above).

The court in ITC 1625 went on to state that

> 'I have always understood our courts to have adopted the approach of the House of Lords in IRC v Brebner [1967] 1 All ER 779 at 784:
>
> '. . . when a genuine commercial transaction is considered and there are two ways of carrying it out, one that involves paying more tax than the other, **it is quite wrong to draw the inference, as a necessary consequence, that in adopting the course which involves paying less tax, one of the main objectives is to avoid tax.**'[291] (emphasis added)

Example C of the Suggested Commentary (discussed in section 3.3.3 above) recognises that RCo sought to invest in a manufacturing plant in a 'low-cost' jurisdiction and was entitled to choose the jurisdiction that would provide the most beneficial tax outcome. This is in line with the principle confirmed by the court in ITC 1625 above.

According to Hattingh, the most significant difference between the domestic GAAR and the PPT is that the domestic GAAR sets out detailed circumstances that may give rise to 'impermissible' avoidance (the so-called tainted elements), whereas the PPT gives no guidance as to when avoidance is impermissible or abusive.[292] South

289 59 SATC 383.

290 Idem, at 398.

291 Ibid.

292 Hattingh J, (2017) *'The Multilateral Instrument from a Legal Perspective: What May Be the Challenges?'*, op.cit., p73.

Africa's statutory GAAR is also accompanied by detailed procedural safeguards, provisions regulating up-front disclosure of presumed avoidance transactions and detailed practical application guidance.[293] The lack of such elements leads Hattingh to conclude that much attention is required to synthesize the PPT with the domestic GAAR.[294]

4.5 Conclusion

The PPT and the GAAR share many similarities, but also some crucial differences, the most notable of which are that the GAAR looks at whether obtaining a tax benefit was the sole or main reason for the arrangement whereas the PPT looks at whether it was one of a number of important reasons. As it is an anti-abuse provision, the GAAR provides guidance in the form of the 'tainted elements' as to when abuse is present whereas the PPT's scope of application is broad and uncertain. It is the author's view that the differences do not, however, result in a conflict between the two provisions.

On an application of the decision of the SCA in the Tradehold Case, the PPT should prevail over the GAAR only to the extent that there is a conflict. As the PPT will form part of domestic law when it comes into force in South Africa under the MLI, the author submits that, as the PPT and GAAR both seek to serve the same purpose, that of preventing impermissible tax avoidance, by adopting a purposive approach, it is possible to follow the recommendation set forth by the High Court in the Glenister Case in terms of which the PPT and the GAAR can 'be reconciled and read as one coherent whole'.

In this regard, it is submitted that the 'tainted elements' of the GAAR were included in the Income Tax Act because the legislature was of the view that the presence or absence of such elements is indicative of abuse. In attempting to reconcile the PPT and the GAAR, the author submits that the 'tainted elements' contained in the GAAR should be used as guidance in determining whether one of the principal purposes was to obtain a tax benefit under the PPT.

293 Hattingh J, *'The Impact of the BEPS Multilateral Instrument on International Tax Policies'* op.cit., p239.
294 Ibid.

5 CHAPTER 5: LEGAL CERTAINTY AND THE RULE OF LAW

5.1 Introduction

> 'The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.' Adam Smith, 1776[295]

Although upheld by the OECD as the only approach that independently meets the minimum standard, the proposal and introduction of the PPT garnered significant adverse reaction. The general consensus expressed by stakeholders through the public commentary process was a concern over the lack of certainty inherent in a rule based on such broad terminology.[296]

The International Monetary Fund/OECD Report for the G20 Finance Ministers and Central Bank Governors: Update on Tax Certainty echoed this concern:

> '[t]he implementation of PPT rules in bilateral treaties, while effective in reducing aggressive tax planning, is perceived as potentially increasing tax uncertainty. Various stakeholders have in fact expressed concerns on the implementation of the PPT.'[297]

The PPT is 'a vague measure by design',[298] the effect of which is to introduce a cross-border bilateral general anti-avoidance rule, which will apply predominantly to foreign inbound investments.[299] This is of particular relevance to South Africa as a country that relies on foreign investment. In 2018, President Cyril Ramaphosa appointed a team of business and finance experts to secure USD100 billion in investment to boost the ailing South African economy. The balance between the need to attract foreign investment, but also adhere to the progressions of the international tax framework was consider by the DTC, which cautioned that

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295 Smith, A (1776) *'An Enquiry into the Nature and Causes of the Wealth of Nations'* p452.

296 OECD, (11 April 2014) *'Comments Received on Public Discussion Draft BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances',* Appendix B, p2, available at https://www.oecd.org/tax/treaties/comments-action-6-prevent-treaty-abuse.pdf (accessed 29 January 2021).

297 Para 2.1.2, p 12 (IMF/OECD July 2018) available at www.oecd.org/ctp/tax-policy/tax-certainty-update-oecd-imf-report-g20-finance-ministers-july-2018.pdf (accessed 10 January 2021).

298 Hattingh J, *'The Impact of the BEPS Multilateral Instrument on International Tax Policies'* op.cit., p238.

299 Idem, p244.

> 'as much as it is important for South Africa … to be associated with the BEPS initiatives, protection of South Africa's economic interests in light of its special circumstances as [a] developing country is of paramount importance.'[300]

In addition to its status as a developing country, South Africa is a constitutional democracy, which requires that all laws adhere to the principles protected by the Constitution. This chapter thus considers the PPT through the lens of the constitutional principles of the rule of law and legal certainty.

5.2 The Rule of Law

No tax can be levied without the authority of law and such a law cannot be in violation of the basic principles enshrined in the Constitution. One such principle is adherence to the rule of law, which includes in its ambit certainty in application and implementation of the law. The principle of the rule of law is essentially the notion that no person is above the law. When considering this principle, the Tax Court in the case of Pienaar Brothers (Pty) Ltd v CSARS[301] referred with approval to the writing of Beinart:[302]

> 'Several of the attributes or tendencies of law… are not only its natural consequences which explain why the Rule of Law that is preferable to the rule of discretion; they at the same time indicate what are the desirable features in the formulation of legal rules. To these attributes legal rules should therefore as far as possible conform, and if they do not, then, even if they have been lawfully enacted, they would infringe the principles of the Rule of Law.
>
> Of such features the prime one is that of certainty; which has rightly been addressed by modern authors... It is an element of certainty which enables persons to know and predict their rights, and therefore the Rule of Law postulates that law should not be formulated in wide general term but should be reasonably clear and precise; otherwise a decision by discretion is imported.'

300 Davis Tax Committee (2016) *'Second and Final Report on Base Erosion and Profit Shifting (BEPS) in South Africa'*, Annexure 12, p19 available at https://www.taxcom.org.za/docs/New_Folder3/14%20BEPS%20Final%20Report%20-%20Action%2015.pdf (accessed 15 November 2020).

301 (2017) 4 All SA 175 (GP) at 200.

302 Beinart B, (1962*) 'The Rule of Law'*, Acta Juridica 99 at 106.

The pillars of the rule of law, as applied to tax law, are as follows: (i) tax law should be clear and precise; (ii) tax law must be accessible and reasonably intelligible for all users; (iii) tax law must be disputed openly in public courts; and (iv) tax law should be subject to express and clear legal safeguards to protect taxpayer's rights.[303]

The SCA has confirmed that '[t]he doctrine of vagueness, which is founded on the rule of law, is a foundational value of our constitutional democracy.'[304] The SCA did, however, clarify that the doctrine 'requires laws to be written in a clear manner, with reasonable certainty and not perfect lucidity.'[305] The question is thus whether the wording of Article 7(1) of the MLI, despite being 'broad and vague',[306] meets the threshold of 'reasonable certainty'. In order to answer this question, the pillars of the rule of law will be applied to the PPT. For purposes of the examination which follows, the first and second pillars will be considered together and the third and fourth pillars will be considered together.

5.2.1 **Clear, precise, accessible and reasonably intelligible**

Danon comments that the broad terms of the PPT will result in its meaning becoming very far-reaching as soon as it is detached from the OECD Model Commentary (2017), which will lead to 'uncertainties and increased tax treaty disputes around the globe'.[307]

Kuzniacki submits that the OECD has incorporated an ambiguous concept of treaty abuse in an ambiguous way, thereby resulting in additional complexity and a lack of legal certainty that make the PPT very difficult to apply, if foreseeable at all.[308] According to Kuzniacki, in practice at least, at the level of tax authorities, the PPT is capable of everything.[309]

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303 Hattingh J, *'The Multilateral Instrument from a Legal Perspective: What May Be the Challenges?'*, op.cit., para 2.

304 City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others 2018 (4) SA 71 (SCA) at para 35.

305 Ibid.

306 Goel A, (2 May 2019) *'Does the Principal Purpose Test (PPT) Throw Tax Certainty to the Winds*?', Kluwer International Tax Blog, available at http://kluwertaxblog.com/2019/05/02/does-the-principal-purpose-test-throw-tax-certainty-to-the-winds/ (accessed 15 November 2020).

307 Danon R, (2018) *'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principle Purpose Test for MNE Groups'*, op.cit., p32.

308 Kuzniacki B, *'The Artificial Intelligence Tax Treaty Assistant: Decoding the Principal Purpose Test'* op.cit., p530.

309 Ibid.

The US-Sweden Income Tax Treaty (1994)[310] contains a PPT and the US Committee on Foreign Relations commented that it may be 'applied leniently (so that any colourable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them).'[311]

The narrow or lenient application of the PPT will depend on the tax authority called upon to apply it, with such application influenced by the fiscal interests of its state.[312] Consequently, Kuzniacki warns, the PPT could easily become a legal conundrum.[313] The variation in adoption and application of the PPT by different jurisdictions can exacerbate the defragmentation of a common approach to the interpretation and application of tax treaties, despite their ultimate purpose being the same – to enhance international commerce by eliminating double taxation.[314] The increase in disputes between taxpayers engaged in cross-border activities and revenue authorities denying them treaty benefits may endanger the appropriate functioning of tax treaties. Ultimately, tax treaties may give rise to more uncertainty than foreseeability for taxpayers involved in cross-border business.[315] Baker goes so far as to say that the unpredictable interpretation and application of the PPT by the tax authorities has the potential to undermine the entire global system of tax treaty benefits.

The author agrees with the views of the commentators set out above and submits that the wording of the PPT is neither clear nor precise and as such, its application is uncertain. As can be seen from the analysis of the PPT in Chapter 3, the phrase 'one of the principal purposes' has sparked much debate amongst commentators due to its ambiguity. Furthermore, the object and purpose of a treaty provision also cannot be determined with certainty

310 Convention between the Government of Sweden and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (1 September 1994), Treaties IBFD.

311 Committee Comments on Treaty Shopping (1995), Committee on Foreign Relations report to the ratification of the US-Sweden Income Tax Treaty, 104th Congress Exec. Rept. Senate 1st Session 104-4, p12 available at https://www.govinfo.gov/content/pkg/CRPT-104erpt4/html/CRPT-104erpt4.htm (accessed 30 August 2020).

312 Kuzniacki B, *'The Artificial Intelligence Tax Treaty Assistant: Decoding the Principal Purpose Test'* op.cit., p531.

313 Idem, p530.

314 Idem, p531.

315 Ibid.

without access to the negotiating history between the jurisdictions, which is not publicly available. With regard to the accessibility of the PPT, the MLI does not contain a mechanism to produce consolidated or annotated texts for CTAs. The result will be that CTAs will not be 'accessible as reasonably intelligible law for all users.'[316] The author is, therefore, of the view, that the PPT does not meet the first two pillars of the rule of law in that it is not clear and precise and it is not reasonably accessible.

5.2.2 Disputed openly in public courts, express and clear procedural safeguards to protect the rights of the taxpayer

The Suggested Commentary to the PPT only makes one suggestion regarding the procedural application of the PPT which is that contracting states may wish to establish a form of administrative process that would ensure that the PPT is only applied after approval at a senior level within the administration.[317] Neither the Suggested Commentary, nor the PPT itself provides for any up-front disclosure to taxpayers of a proposed denial of treaty benefits or a mechanism through which a taxpayer may make representations.

The PPT not only affords significant discretionary power to SARS, but in fact appropriates power by SARS away from domestic courts.[318] Apart from providing insight into the interpretation of the PPT, the Starr Case discussed in section 3.4.1 above shows the potential extent of transfer of power under a PPT from courts to tax administrators in the ultimate determination of granting access to tax treaty benefits.[319]

If an administrative law approach is taken, the court is limited to only assessing whether the competent authority followed due process and reached a plausible outcome.[320] Unless the legislature intervenes to grant courts the necessary powers, courts will not be able to interfere with the merits of a case or the justness of the outcome.[321] The OCED's justification for this transfer of

316 Hattingh J, *'The Multilateral Instrument from a Legal Perspective: What May Be the Challenges?'*, op.cit., p72.

317 OECD, *'Action 6 Final Report'* op.cit., p64.

318 Hattingh J, *'The Impact of the BEPS Multilateral Instrument on International Tax Policies'* op.cit., p239.

319 Idem, p243.

320 Ibid.

321 Ibid.

discretionary powers is found in the preamble to the MLI which recognises 'that governments lose substantial corporate tax revenue because of aggressive international tax planning…'[322] For Hattingh, this is a 'fundamental alteration of who ultimately decides whether taxpayers may access tax treaty benefits' and raises rule of law concerns.[323]

The PPT lacks procedural safeguards to protect the taxpayer's rights in the event of it being invoked by SARS to deny treaty benefits. This is, in the author's view, exacerbated by the fact that South Africa did not elect to include the discretionary relief provision in Article 7(4) of the MLI. The transfer of power away from the courts to SARS will result in disputes regarding the PPT being held outside of the realm of the public court space, with judgments not being published and accessible to the public. As such, the author is of the view that, if the PPT is implemented in its current form, without intervention from the legislature in the domestication process, it will violate the third and fourth pillars of the rule of law.

5.3 The PPT in South Africa, Practical Considerations

The PPT provides far broader discretion to SARS than the South African domestic GAAR, with the criterion of 'one of the principal purposes' providing authorities 'extensive room to manoeuver'.[324] Hattingh submits that in a constitutional democracy such as South Africa, parity in procedural safeguards should be guaranteed because there is no legal justification for maintaining less robust procedures when addressing tax avoidance involving bilateral treaties.[325]

Safeguarding procedural law in the application of the PPT will assure foreign investors that their reliance on South Africa's tax treaty network will not be jeopardized through administrative discretion or without due process.[326] The importance of this was explained by the Supreme Court of South Africa's fellow BRICs member, India, in the case of Vodafone International Holdings v Union of India:

322 Ibid.

323 Ibid.

324 Lang M, *'The Signaling Function of Article 29(9) of the OECD Model – The "Principal Purpose Test",* op.cit., p266.

325 Hattingh J, *'The Multilateral Instrument from a Legal Perspective: What May Be the Challenges?'*, op.cit., p73.

326 Ibid.

> '[Foreign direct investment] flows towards locations with strong governance infrastructure which includes enactment of laws and how well the legal system works. Certainty is integral to rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner.'[327]

In June 2020 the South African Tax Ombud issued his report titled 'Tax Ombud's Systemic Investigations Report'[328] (Ombud's Report) which was divided into two parts. Part II dealt with the failure by SARS to adhere to the dispute resolution timeframes prescribed by the TAA and the rules promulgated under s 103 thereof.

In considering the issue of the 'raising of non-meritorious additional assessments', the Ombud's Report stated that following:

> 'In total, SARS conceded 70% of all appeals finalised. Taking into account that a concession results in the entire additional assessment being revised to the original, this is a very high number of assessments found to be incorrect. Leaving aside appeals withdrawn by taxpayers and looking only at cases where the merits of the assessment are actually reconsidered, the proportion of matters in which SARS concedes in full increases to 92.14%. **This is rather concerning as it means that in 92% of the matters that reach appeal, there was no merit in the assessments**.'[329] (emphasis added)

As a country that is plagued by capacity constraints and corruption, the South African legislator should be 'circumspect in awarding great swathes of uncircumscribed discretionary power' to public officials.[330]

As can be seen from the analysis of the PPT in Chapter 3, applying the PPT rule requires an in-depth study of all the facts and circumstances.[331] This requires

327 (2012) 6 SCC 613, at para180.

328 Issued in terms of section 16(1)(b) of the TAA, available at http://www.taxombud.gov.za/Documents/SYSTEMICINVESTIGATIONREPORT2020.pdf (accessed 30 January 2021) (hereafter 'Ombud's Report').

329 Idem, para 38.2.

330 Hattingh J, *'The Impact of the BEPS Multilateral Instrument on International Tax Policies'* op.cit., p239.

331 Weber D, *'The Reasonableness Test of the Principal Purpose Test Rule in OECD Beps Action 6 (Tax Treaty Abuse) versus the EU Principal of Legal Certainty and the EU Abuse of Law Case Law'* op.cit., p50.

substantial resources which SARS simply does not have. The Ombud's Report repeatedly refers to 'capacity constraints' as being a reason why SARS fails to adhere to the prescribed dispute resolution timelines, despite acknowledging that it is 'not acceptable for SARS, which is the administrator of tax legislation, to be non-compliant with the very legislation it administers.'[332]

The OECD recognises that the provisions of the LOB rule are based on objective criteria that provide more certainty than the PPT rule, whereas the PPT requires a case-by-case analysis based on reasonableness.[333] This raises the question why a tax administration that is severely under-resourced, would choose to implement a test that requires a case-by-case analysis as opposed to the simple application of objective, undisputable facts. Clear and certain application of the PPT is not only important from a theoretical point of view, the ability to discern the application of the PPT to an arrangement has important practical implications. The clearer the application of the PPT is to an arrangement, the less manpower is required by SARS to consider whether it should be applied to deny treaty benefits.

5.4 **Conclusion**

Tax law must be accessible and ought to be expressed in precise terms since it imposes a burden, even more so when a measure affords discretionary power to address tax avoidance.[334] Not only does the PPT afford tax administrators substantial discretionary power, it appropriates the discretionary power away from domestic courts to tax administrators.[335] The uncertainty of the PPT cannot be reconciled with the tenets of legal certainty and the rule of law.

The OECD itself acknowledges that '[t]he actions implemented to counter BEPS cannot succeed without…certainty and predictability for business' and 'mechanisms should be implemented to provide businesses with the certainty and predictability they need to make investment decisions.'[336]

332 Ombud's Report (2020), op.cit., p47.

333 OECD, *'Action 6 Final Report'* op.cit., p19.

334 Hattingh J, *'The Multilateral Instrument from a Legal Perspective: What May Be the Challenges?'*, op.cit., p76.

335 Hattingh J, *'The Impact of the BEPS Multilateral Instrument on International Tax Policies'* op.cit., p238.

336 OECD, *'Action Plan on Base Erosion and Profit Shifting'*, op.cit., p14.

As unilateral double tax relief is often available to residents, tax treaties are largely concerned with reducing source taxing rights. Practically then, the PPT's main field of operation will be in respect of source tax relief for inbound investments by non-residents.[337] The practical application of the PPT should be aligned to the entire legal framework governing the application of South Africa's domestic GAAR to safeguard the country's constitutional standards of just administrative action and to ensure equal treatment of resident taxpayers and foreign investors.[338]

The lack of procedural safeguards in the MLI for the exercise of discretionary power by fiscal authorities will require national legislators to address this issue through the domestication process.[339] In a country that is governed by a constitution that protects procedural fairness and the rule of law, this should be given due consideration by the South African legislature.

The Ombud's Report clearly shows a tendency of SARS officials towards arbitrary aggression without proper legal grounds. It follows that, when faced with the task of determining whether to deny treaty benefits or not, the so-called default position will be to deny the treaty benefits. The Ombud's Report also makes it clear that, once a non-meritorious denial of benefits has been imposed, a taxpayer objecting to such denial cannot rely on the statutorily prescribed time-limits within which to have its objection resolved, either positively or negatively. This again speaks to the uncertainty not only in the legal provisions, but in their practical implementation in the South African context.

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337 Hattingh J, *'The Impact of the BEPS Multilateral Instrument on International Tax Policies'* op.cit., p239.

338 Ibid.

339 Hattingh J, 'The Multilateral Instrument from a Legal Perspective: What May Be the Challenges?', op.cit., p73.

6 CHAPTER 6: CONCLUSION

6.1 Summarising remarks

The fundamental problem with the international tax system is the mismatch between the globalised nature of modern-day business and the lack of cooperation between states in respect of taxation. This allows companies operating globally to take advantage of the fact that countries compete for investment and exploit mismatches between different domestic tax systems.[340]

International tax relations have traditionally been co-ordinated through bilateral double taxation conventions.[341] The MLI is the only recent multilateral convention relating to substantive tax matters.[342] The MLI is a new form of instrument in international tax relations and so there is no precedent to rely on as to its application or interpretation.[343] Given the PPT's status as a common minimum standard, as well as its wide-scale adoption, there has never been a more pressing need for clear guidance to facilitate uniform application of the rule.[344]

This research report has sought to provide a concise analysis of the BEPS Action 6 points as they apply to South Africa. Further, by referencing the work of the OECD, academic literature and case law, it has attempted to set out the practical application of the PPT in a South African context. A comparison of the PPT and the South African domestic GAAR shows that the two provisions, although different, do not result in a conflict, and can be interpreted coherently. The PPT is not, however, in line with the constitutional principles of legal certainty and the rule of law due to its broad and vague application and the lack of procedural safeguards mandated for implementation.

In 1776, Adam Smith, the 'Father of Economics' cautioned that '[t]he uncertainty of taxation encourages the insolence and favours the corruption of an order of men

340 Myszkowski A, (May 2016) *'Mind the Gap: The Role of Politics and the Impact of Cultural Differences on the OECD BEPS Project'*, Bulletin for International Taxation, IBFD, p282.

341 Baker P, *'The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting'*, op.cit., p281

342 Ibid.

343 Idem, p282.

344 Bergedahl C, *'Anti-Abuse Measures in Tax Treaties Following the OECD Multilateral Instrument – Part 1'*, op.cit., p24.

who are naturally unpopular, even where they are neither insolent nor corrupt.' This sentiment still holds true in 2021, with Stewart noting that the difficult judgements that competent authorities will be required to make under the PPT is 'likely to cause contested issues to be hidden in a non-transparent process that carries risks for administrative abuses of power and also for corruption and capture…'[345] By signing the MLI and selecting the PPT as the means of meeting the minimum standard to combat treaty abuse, South Africa will be able to comply with the required minimum standard quickly. As a tax administration that is crippled with systemic corruption and severe lack of resources, it remains to be seen whether SARS will be able to apply the PPT in a consistent and correct manner. Failure to do so will have dire consequences for an economy that relies heavily on the confidence of foreign investors, now so possibly more than ever before.

6.2 Limitations and areas for further research

In order to address some of the concerns raised by the author in this report around investor confidence, legal certainty and arbitrary exercise of excessive power by SARS, consideration should be given to the establishment of an advisory panel within SARS to facilitate the interpretation and application of the PPT. Advisory panels have served a valuable role in the interpretation and application of legal standards internationally and domestically.[346] In order to promote overall consistency in the application of the PPT, the OECD Model Commentary (2017) suggests that states consider establishing an administrative process to ensure that the PPT is only applied 'after approval at a senior level' within the tax authority.[347]

In Australia, an advisory panel staffed by representatives from the Australian Tax Office and non-governmental professionals was established in 2000 to facilitate the interpretation of the Australian GAAR.[348] The primary aim of the panel is to ensure consistent interpretation of the legislation.[349] A similar panel was established in the UK in 2013 in order to support interpretation of the UK GAAR, but is staffed only by non-governmental members, despite being part of Her Majesty's Revenue and

345 M Stewart, (2015) *'Abuse and Economic Substance in a Digital BEPS World'*, Bulletin for International Taxation, vol 69, 6/7, IBFD, p407.

346 Myszkowski A, *'Mind the Gap: The Role of Politics and the Impact of Cultural Differences on the OECD BEPS Project'*, op.cit., p284.

347 OECD Model Commentary (2017), op.cit., para 183.

348 ATO Practice Statement Law Administration 2005/24 (updated 28 May 2020) para 18 – 27, available at https://www.ato.gov.au/law/view/document?docid=PSR/PS200524/NAT/ATO/00001#P1 (accessed 15 November 2020).

349 Id.

Customs.[350] The research required in respect of the establishment of such a panel in South Africa would be academic, economic and practical in nature. The contribution of similar panels to legal certainty and uniform application of the law, coupled with the feasibility of establishing such a panel in a tax administration that is already under-resourced would need to be determined.

350 HMRC, (2018) 'General Anti-abuse Rule (GAAR) Advisory Panel: Terms of Reference', available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/723704/GAAR_Advisory_Panel_-_Terms_of_Reference__2018_.pdf (accessed 19 April 2021).

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