

**DETERMINING THE IMPACT OF THE 2014 OECD UPDATE TO  
BENEFICIAL OWNERSHIP IN EQUITY DERIVATIVES AND FINANCIAL  
INSTRUMENT TRANSACTIONS**

by

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For Barry and Emma – with thanks.

## ABSTRACT

### **Determining the impact of the 2014 OECD update to beneficial ownership in equity derivatives and financial instruments transactions**

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Beneficial ownership can be distinguished from legal ownership and is the cornerstone for the granting of treaty benefits under the income articles of the Organisation of Economic Cooperation and Development (OECD) Model Tax Convention (MTC). Until recently, beneficial ownership was determined with reference to the domestic laws of states contracting bilateral tax treaties. Foreign case law provided further information on the meaning of the term.

In updating the Commentary to the 2014 MTC, the OECD defined beneficial ownership as having the right to use and enjoy the income unconstrained by any contractual or legal obligation to distribute that income further to another party. In the financial industry, where banks and brokers routinely trade or hedge risk, financial instruments written over equities typically shift economic risks and rewards to contracting parties. As a consequence, the holder of the equity shares is divested from all or selected rights, obligations, risks and rewards that are ordinarily associated with ownership. The question then arises whether the holder of the equity share is the beneficial owner of that share or of the dividend that it produces.

This study aims to determine beneficial ownership of equities and dividends where risk offsets have been concluded. It comprises a doctrinal research study that formulates the

rule of law in respect of beneficial ownership and then applies it to a selection of transactions involving equity derivatives and financial instruments.

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## DEFINITION OF KEY TERMS

**Table 1: Definition of key terms used in this document**

<u>Key term</u>	<u>Definition</u>
Financial Instrument	A financial instrument is any contract that gives rise to a financial asset of one contracting party and a financial liability of another contracting party. A financial asset is any contract with a right to receive cash or another financial asset. Conversely, a financial instrument is a financial liability where an obligation exists to deliver cash or another financial asset (Bessis, 2010:257). In most countries, the accounting and reporting of financial instruments are determined by IFRS, specifically IAS 32 and 39. IFRS 9 replaces IAS 32 and IAS 39 for annual reporting periods commencing on or after 1 January 2018.



Derivative	A derivative can be defined as a financial instrument whose value depends on the value of some underlying asset or other factor such as a stock price, an interest rate or an exchange rate (CFA, 2009). Examples of derivatives include options and futures. In most countries, financial accounting and reporting of derivatives are determined by IFRS, specifically IAS 32 and 39. IFRS 9 replaces IAS 32 and IAS 39 for annual reporting periods commencing on or after 1 January 2018.
Hedging	A general strategy, usually considered to be a reducing, if not an eliminating risk (CFA, 2009)
Equity hedge	A risk mitigation strategy whereby equity is acquired or sold as a means to hedge exposure under a derivative that references equity-
Total return equity swap	A derivative whereby one party agrees to pay another the return on an equity share, calculated as the capital appreciation in share price (as from the time of concluding the swap) plus dividends in return for a fixed or variable payment (CFA, 2009)-
Dividend reclaim	In certain countries the difference between the domestic tax rate and the preferential treaty rate is only refunded on application by the taxpayer to the revenue authorities. This is known as a dividend reclaim. The preferential treaty rate is therefore not automatically applied at source, i.e. at the time of and by the person making the payment. This allows revenue authorities to assess on a case-by-case basis whether treaty benefits should be granted and allows revenue authorities to identify instances of treaty abuse.
International law	The legal systems and principles that are binding upon states in their relations with each other (Olivier & Honiball, 2011:302)





Customary international law	Rules that are generally accepted, often tacitly, by most countries as binding when they enter into international relations, also referred to as 'common law' of public international law (Olivier & Honiball, 2011: 301)
Domestic law	South African statute law, case law common law, international customary law and international law (Olivier & Honiball, 2011:303). From an income tax perspective, domestic tax law includes practice notes, but excludes interpretation notes ( <i>ITC 1675 62 SATC 219</i> ) and is likely to include binding rulings (Olivier & Honiball: 2011:300).
Dividend	Defined in Section 64D of the Income Tax Act No 58 of 1962 as an amount distributed by a resident company for a shareholder. Article 10(3) defines a dividend as "income from shares ... or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident" (OECD 2014: 30). Stuck and Pinetz (2015:7) argue that the decisive criterion under this definition is the existence of a corporate right. A corporate right can be contrasted to a contractual right.
Dividend equivalent payment or manufactured dividend	A contractual right to an amount equalling a dividend. It should be distinguished from a corporate right, such as a right to a dividend. The Explanatory Memorandum to the Securities Transfer Tax Bill 2007 issued by National Treasury confirms that the right to manufactured dividends is not a right to a dividend, but a right to an amount equal to a dividend (National Treasury, 2007:6). By definition the recipient of a manufactured dividend can therefore not be the beneficial owner of a "dividend", as defined. In a securities lending transaction, the term manufactured dividend is commonly used.

Tax evasion	An action by the taxpayer to escape legal obligations by fraudulent or other illegal means (Olivier & Honiball, 2011:509)
Tax avoidance	A legitimate means used by taxpayers to arrange their tax affairs so as to pay the minimum amount of tax ( <i>IRC v Duke of Westminster</i> , 1936, AC 1 at 19)
Impermissible tax avoidance	This term refers to a scenario where income tax is avoided and a tax advantage is derived from an arrangement whereby a liability to tax is reduced without a corresponding loss, expenditure or reduction of income ( <i>ICR v Challenge Corporation Ltd</i> , 1987, AC 155 at 168E).

## LIST OF ABBREVIATIONS AND ACRONYMS

Table 2: Abbreviations and acronyms used in this document

Abbreviation/Acronym	Meaning
CFA	Chartered financial analyst
OECD	Organisation for Economic Cooperation and Development
BEPS	Base erosion and profit shifting
MTC	Model Tax Convention on Income and Capital
IBFD	International Bureau for Fiscal Documentation
IFRS	International financial reporting standards
IAS	International accounting standards
OTC	Over the counter
DTA	Double taxation agreement



# CHAPTER 1

## INTRODUCTION

### 1.1 BACKGROUND

The separation of legal and beneficial ownership has long been recognised by the Organisation for Economic Cooperation and Development (OECD). Under the distributive rules of the OECD Model Tax Convention (MTC) and in terms of Articles 10, 11 and 12 relating to dividends, interest and royalties respectively, the state of residency has unlimited taxing rights. The state of source has limited taxing rights (typically between 5 and 15%), provided that the income is paid to a resident of a contracting state who is also the beneficial owner of such income (OECD 2010:28-30). If the beneficial owner does not reside in the other treaty state, the source state may subject the income to taxation in full, according to its domestic laws, and need not apply any exemption or reduced rate of withholding afforded by the tax treaty (Foster, 2015:75). The MTC thus makes provision for a scenario where the recipient of income is not the beneficial owner thereof. It is therefore intended for use as a treaty anti-avoidance mechanism (OECD 2014:63).

Commercial transactions are being challenged by revenue authorities, on the grounds of beneficial ownership, as a mechanism to prevent treaty abuse<sup>1</sup>. Transactions under scrutiny may involve, for example, the use of derivatives to hedge or mitigate risk, or the conclusion of loan sub-participations to comply with single obligor limits. Such risk mitigation strategies may be required by the internal or external regulatory frameworks within which the entity operates. Effectively, these derivative or financial instrument agreements shift legal and economic rights and entitlements from one contracting party to another in such a way that, by virtue of the contractual arrangement concluded between parties, the ultimate recipient,

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<sup>1</sup> A treaty abuse arrangement through which a person who is not a resident of a Contracting State (i.e. a resident of a non-treaty country) may attempt to obtain treaty benefits that are ordinarily available to residents of the Contracting States only (Davis Tax Commission: 2014,1). For case law on beneficial ownership refer to *Velcro Canada v Her Majesty The Queen*, 2012 TCC 57; *Queen v Prevost Car Inc*, 2009 FCA 57; and *Indofood International Finance Ltd v JP Morgan Chase Bank*, 2006 EWCA civ 158 STC.

as opposed to the legal owner of the asset, is beneficially entitled to the income that the referenced asset produces.

“Beneficial ownership” is one of the well-known, undefined treaty terms and its meaning in terms of international tax lends itself to debate (Du Toit, 2010:2). According to Vallada (2015:39), changes in the meaning of the term “beneficial ownership” have historically taken place to a greater extent in the Commentary to the MTC than in the Articles of the OECD MTC. It therefore remains undefined in the OECD MTC. Previously, contracting parties relied on Article 3(2) of the MTC, which allows Contracting States to determine the meaning of a treaty term that is undefined in the treaty itself by consulting their own domestic laws. However, the update to the OECD MTC 2014 confirms that the term should adopt an international, as opposed to a domestic meaning. In addition, the update specifies the test of beneficial ownership as one having “the right to use and enjoy the income unconstrained by contractual or legal obligation to pass the payment received to another person” (OECD, 2014:189).

In the absence of clarity on how beneficial ownership should be interpreted, financial transactions could be challenged by revenue authorities under commercial scenarios where income-producing assets are contractually hedged, or where there is a separation of legal and beneficial ownership. Should the term be domestically defined, caution must be exercised to ensure consistent results when transactions are concluded between two South African residents, in which instance the term will adopt a domestic meaning, compared to the same transaction being concluded cross-border, when the term will assume an international meaning. Practices by revenue authorities to deny treaty benefits in commercial scenarios by assigning different interpretations to the term – especially in a cross-border scenario – could harm bona fide international business transactions in an industry where margins are thin, and could therefore be contrary to the objectives of the treaty.

## **1.2 PROBLEM STATEMENT (OR RATIONALE FOR THE STUDY)**

Despite the recent update to the OECD MTC 2014 to clarify the OECD’s interpretation of beneficial ownership, the term remains controversial and lends itself to debate. In the

absence of guidance on how beneficial ownership should be interpreted and applied in South Africa, in a domestic and cross-border context (and the weight that will be assigned to the 2014 update to the Commentary), uncertainty exists as to how domestic revenue authorities will interpret and apply the term. Such uncertainty is prevalent in the financial sector where transactions that shift economic rights and entitlements to contracting parties are routinely concluded.

### **1.3 PURPOSE STATEMENT (OR RATIONALE FOR THE STUDY)**

The purpose of this study is to investigate the 2014 update of the OECD Commentary and the impact it has had on the interpretation of beneficial ownership, as evidenced by case law, statute and other authoritative guidance. The impact will be investigated by applying the guidelines issued by the OECD to selected financial transactions in order to conclude where beneficial ownership resides, and whether this is contrary to any outcome that would have existed prior to the OECD update. The aim of the study is to highlight considerations when the OECD 2014 update is applied in a domestic and cross-border context.

### **1.4 RESEARCH OBJECTIVES**

The research objectives of this study are:

- To identify the determinants of beneficial ownership through a review of literature. This will include an investigation of the OECD 2014 update to the Commentary.
- To determine the practical implications of applying the criteria of beneficial ownership identified above to selected financial transactions.

## **5. IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY**

Domestic tax statute defines beneficial ownership only in the context of Dividends Withholding Tax, or with regard to the “transfer” of a security as defined in Section 1 of the Securities Transfer Tax Act No. 25 of 2007. Since Article 3(2) of the OECD MTC 2010 and 2014 provides that the domestic definition should be considered only where the context so requires, it is questionable whether the domestic definitions are sufficiently comprehensive

to allow for the application of the beneficial ownership clause in complex derivative and financial arrangements, especially in cross-border transactions.

Following the release of the 2013 Base Erosion and Profit Shifting (BEPS) initiatives by the OECD, the 2014 Commentary to the OECD and the 2014 Davis Tax Committee Interim Report in South Africa, it has become important to clarify the meaning of beneficial ownership. Revenue authorities and taxpayers should be cognisant of what the tax outcome would be in both the domestic and cross-border context if an international meaning were to be applied to the term.

In the light of the introduction of Dividend Withholding Tax on 1 April 2012 and Interest Withholding Tax on 1 March 2015, the meaning of beneficial ownership (as a prerequisite for limiting tax on income in the source state) and the application thereof in practice to equity derivative strategies and financial instruments require analysis. Uncertainty as to whether treaty benefits will apply will raise the cost of equity derivative transactions by requiring contracting parties to price in the maximum domestic tax rate and disregard preferential treaty rates. Alternately, contracting parties will insist on the inclusion of indemnification clauses for taxes where revenue authorities have denied treaty benefits to a contracting party.

## **6. LIMITATIONS AND ASSUMPTIONS**

### **6.1. Limitations of the study**

The study considers beneficial ownership in financial transactions concluded by banks and brokers only. Financial transactions concluded by collective investment schemes in securities, properties and hedge funds are excluded from the ambit of the study. The tax consequences of investment vehicles, whereby funds are pooled, depend on their legal form and touch on matters that fall outside the scope of this study. A trust-like investment structure is therefore not considered and reference to the term “person” for purposes of Article 3 is limited to corporates only.

The focus of this study is the transfer of the economic risks and rewards of dividend-yielding equities by means of financial instruments. It does not consider the transfer of risks and

rewards associated with, for example, commodity assets, foreign exchange, intangible assets that produce royalty income and debt-instruments that yield interest. Case Law and publications on beneficial ownership regarding royalty income and interest is considered only to establish principles that can be applied to determine beneficial ownership in dividend-yielding equity transactions.

## **6.2. Assumptions**

The following assumptions underpin this study:

- That contracting parties are situated in treaty partner states, i.e. that the states in which contracting parties are tax residents have concluded double taxation treaties
- That bilateral treaties are modelled on the OECD MTC and Commentary, and that the study is therefore conducted in accordance with the principles contained therein
- That transactions are concluded for commercial purposes and not solely or mainly for obtaining any tax benefit
- That neither contracting party is resident in a tax haven country as the involvement of a tax haven can weaken the commercial substance argument
- That the contracting parties are residents of contracting states that are subject to tax and would otherwise meet all the set criteria to be eligible for treaty benefits, bar eligibility for treaty benefits based on the beneficial ownership criteria, which form the basis of this study
- That investors are portfolio investors that do not hold a substantial equity shareholding. Special treaty rates and domestic law provisions apply to investors with substantial shareholdings, such that the domestic withholding tax rate is even further reduced or exempted. It is therefore assumed that such treaty rates do not apply.

## **7. RESEARCH METHOD**



The research method used in this study can be described as legal doctrinal research. Doctrinal research is research into the law and legal concepts (Hutchinson & Duncan, 2012:85). It addresses an alleged lack of coherence, a disputed issue of application or a normative shortcoming in a defined area of law (Roux, 2014:182). Doctrinal research is a qualitative analysis technique and involves analogical reasoning and the use of both deductive and inductive logic (Chenoweth, 2008:37). Legal reasoning is often deductive as the general rules are determined by, for example, legislation and case law (sources of law). From the rules of law one can therefore deduce an objective reality, i.e. a statement of law encapsulated in legislation or an entrenched common law principle (Hutchinson & Duncan, 2012:110). By comparison, inductive reasoning uses a process of arguing from specific cases to a more general rule (Hutchinson & Duncan, 2012:111). It involves the development of a theory as a result of an observation (Saunders, 2012:672). Finally, analogy involves locating similarities and then arguing that similar cases should be governed by the same principles and should have similar outcomes (Hutchinson & Duncan, 2012:111).

Doctrinal research involves a two-part process: (i) Locating the sources of law and interpreting and analysing the text to determine the rule of law or principle by means of deductive reasoning; and (ii) interpreting and analysing the law or rule within a specific context (Hutchinson & Duncan, 2012:110). The result of the second phase may assist in formulating a theory, or highlight considerations for the formulation of a theory or the adaptation of the general rule by applying inductive logic. Doctrinal research includes a critical literature review comprising a detailed and justified analysis of and commentary on the merits and faults of the literature within a chosen area, which demonstrates familiarity with what is already known about the research topic (Saunders, 2012:668).

Within common law jurisdictions legal rules are to be found in statutes and cases (Chenoweth, 2012: 29). Supplementary sources can be found in guidance notes, such as publications, academic journals and textbooks on the topic, published both domestically and internationally. A critical review of literature will assist with the identification and analysis of the sources of law for purposes of establishing the general rule of law on beneficial ownership, i.e. the fundamental elements or logical assumptions that are required for beneficial ownership to exist. Sources of law will be located by consulting databases such as LexisNexis, WestLaw, Sabinet References and HeinOnline.

The selection of cases will be based on their economic and legal characteristics, determined by means of a review of market standard legal agreements. A search for academic publications may facilitate the identification of areas for further consideration with regard to legal principles or rules on beneficial ownership.

The second phase of this study will involve applying the logical assumptions that underpin beneficial ownership to a selection of market-standard derivative and/or financial transactions concluded by South African banks and brokers. The results will be analysed to determine whether the legislation achieves what it is intended to achieve, and whether it achieves consistent results. The outcome of such analysis may assist in highlighting items for further consideration with regard to the formulation of a definition for beneficial ownership.

## **8. STRUCTURE OF THE MINI-DISSERTATION**

### **8.1. Chapter 1: Introduction**

Chapter 1 provides an introduction and background to the research study and outlines the research objectives. The importance and benefits of the study are discussed, the assumptions and limitations are explained and the research design and method are briefly summarised.

### **8.2. Chapter 2: Doctrinal analysis**

Chapter 2 discusses the interpretation and authority of treaties, including the authority of the MTC and OECD, in South Africa. The chapter provides a discussion of the history of beneficial ownership and recent amendments by the OECD, which is then supplemented by a discussion of decisions reached by foreign courts. Each requirement of beneficial ownership is considered independently. Finally, South African law on beneficial ownership is consulted for definitions, references or interpretational aids. The chapter concludes with a summary of the essential constituents of beneficial ownership.

### **8.3. Chapter 3: Research design and methods**

In Chapter 3, three transactions are selected for testing the rule of beneficial ownership, as determined in Chapter 2. Transactions are representative of those that are routinely concluded by banks and brokers in the financial industry. The focus of all three transactions is on equity-related transactions yielding dividend income flows. The characteristics of each of the selected transactions are discussed and reasons are given for their selection. The characteristics of beneficial ownership that were identified in Chapter 2 are then applied to each of the transactions to determine where beneficial ownership resides.

### **8.4. Chapter 4: Conclusion**

Chapter 4 summarises the conclusions reached for each of the research objectives identified in Chapter 1 and presents the concluding remarks of the study.

## **CHAPTER 2**

### **DOCTRINAL ANALYSIS**

#### **1. INTRODUCTION**

The purpose of this study is to investigate beneficial ownership of income and assets in financial transactions. Such an analysis can be made only once the meaning of beneficial ownership has been determined. To assist the achievement of the first research objective, which is to determine the meaning of beneficial ownership, this chapter contains a review of current literature related to this topic. This literature consists of statutes, case law, interpretational aids and literature published both internationally and locally. Hutchinson (2012:110) argues that the literature review is the first phase of a two-phased approach in a legal doctrinal research study as it determines the general rule of law or the fundamental elements for the existence of beneficial ownership. The second phase involves the interpretation and analysis of the rule of law within a specific context, which is addressed in Chapter 3 of this study.

This chapter commences with a discussion of the interpretation of treaties in South Africa in order to determine the authority of a bilateral treaty and therefore the beneficial ownership criteria contained therein, and includes a discussion of the authority of interpretational aids, such as the Commentary to the MTC published by the OECD. Following this, a background is provided to the use or importance of beneficial ownership in Double Taxation Agreements (DTAs) and details of the developments in the interpretation of the term by the OECD are discussed. To supplement the meaning assigned to the term by the OECD, authoritative foreign case law and domestic statute are discussed. The chapter concludes with a summary of the common features of each of the identified sources of law and establishes the general rule for the existence of beneficial ownership.

#### **2. THE INTERPRETATION OF TREATIES IN SOUTH AFRICA**

## **2.1. The authority of bilateral treaties in South Africa**

Treaties are international agreements, and we are bound to such agreements by Section 231 of the Constitution of the Republic of South Africa, 1996 (hereafter referred to as “the Constitution”). The Constitution is the supreme law of South Africa and the question that arises is whether treaties enjoy special legal status in South Africa in that they automatically outrank domestic law. The legal framework of a country determines the authority of, and the relationship between domestic law and international tax agreements (Vogel, 1997: 30).

In South Africa, treaties are enacted and form part of domestic tax legislation by virtue of Section 108(1) of the Income Tax Act, No. 58 of 1962 (hereinafter referred to as “the Income Tax Act”), which allows the National Executive to enter into an agreement with the government of any other country with a view to the prevention, mitigation and discontinuance of the levying of tax (under the laws of the Republic and any such other country) in respect of the same income, profits and gains. Under Section 108(2) of the Income Tax Act, legislative enactment occurs once Parliament has approved the agreement and notification has been published in the Government Gazette. In South Africa, due to their enactment into the Income Tax Act, treaties rank equally with domestic tax law and enjoy no special legal status in that a treaty does not automatically override or take precedence over domestic law<sup>2</sup>. Where the treaty provisions are in conflict with domestic law<sup>3</sup>, the treaty provisions will prevail, but there is no automatic treaty override (Olivier & Honiball, 2011:306). The judgment in *CSARS v Tradehold Ltd*, 2012 132/11 ZASCA 61 confirmed that treaties modify domestic law and apply in preference to domestic law to the extent that there is conflict.

## **2.2. The authority of the OECD MTC and Commentary in interpreting treaties in South Africa**

In negotiating bilateral treaties, South Africa adopts the OECD MTC and Commentary. Although not an OECD member state, South Africa does have observer status. The OECD

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<sup>2</sup> Confirmed in the International Fiscal Association report at 723.

<sup>3</sup> In the event of conflict an attempt must be made to reconcile international and domestic law (Olivier & Honiball, 2011:-302).

is not a law-making body and the MTC and Commentary are not binding, not even on OECD member states, except to the extent to which it is a source of customary international law.

The Vienna Convention on the Law of Treaties 1969 (hereafter referred to as “the Vienna Convention”) regulates international treaties and how they should be interpreted. Although South Africa is not a signatory to the Vienna Convention, it is bound by it under Section 232 of the Constitution to the extent that the Convention codifies customary international law. In the Australian case of *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338, the High Court held that international interpretative rules are relevant and take precedence over domestic rules of interpretation where there is conflict between the two. Therefore, to the extent that South African courts accept and apply the Vienna Convention’s rules of interpretation when interpreting treaties, it becomes customary international law and South African courts are bound by it, except when it is inconsistent with an Act of Parliament (Olivier & Honiball, 2011: 398, 302, 308).

The General Rule of Interpretation is contained in Article 31(1) of the Vienna Convention and, in the light of the objectives and purpose of the treaty, requires a treaty to be interpreted in good faith and in accordance with the ordinary meaning of a term. In this case “ordinary meaning” does not refer to the ordinary meaning of the term in everyday use, but rather the internationally uniform legal meaning (Amatucci, 2006:157), which may differ from its domestic statutory meaning. The context is determined in particular by the intention of the parties at the time of signing the agreement (Olivier & Honiball, 2011:300). The preamble to the treaty determines its objectives, which include the avoidance of double taxation and the prevention of fiscal evasion.

Article 32 of the Vienna Convention allows the use of supplementary means of interpretation in order to confirm the ordinary meaning, as determined under Article 31, or where the ordinary meaning achieves a result that is ambiguous or obscure, or leads to a result that is manifestly absurd or unreasonable. Supplementary means of interpretation include the OECD Commentary and publications.

The Davis Tax Committee (2014:36) specifies that South African courts have applied the OECD Commentary and other international guidelines in considering cases involving DTAs. This view is supported internationally as, according to Vallada (2014: 35), the OECD MTC and Commentary carry weight in the interpretation of treaties, especially if a country adopts the OECD MTC and its Commentary in negotiating its bilateral treaties. Recent instances in

foreign case law in which the courts consulted the OECD Commentary include *Indofood International Finance Ltd v JP Morgan Chase Bank*, 2006 EWCA, where the Court of Appeal relied on the Commentary when it adopted an international meaning of beneficial ownership to support its decision to disallow treaty benefits to an intermediary on the basis that it was acting as nominee, agent or conduit. In *Real Madrid F.C. v Oficina Nacional de Inspeccion*, 2006, the Court consulted the Commentary and concluded that “an economic interpretation can be applied to find the ‘real owner’ of the income whereby the legal ownership of income could be disregarded”. The judgement in the Australian case of *Thiel v Federal Commissioner of Taxation*, 1990 171 CLR 338, confirmed that there was no reason for not taking the MTC and Commentary into account when interpreting treaties.

As most clarifications regarding beneficial ownership were made in the Commentary, rather than in the Articles, the authority of subsequent Commentary should be considered when interpreting the meanings of terms used in bilateral treaties. Since the intention of the parties involved creates the context within which treaty terms should be interpreted, the extent to which subsequent amendments accurately reflect the intention of the parties at the time of negotiation of bilateral treaties must be considered.

Vallada (2014: 35) argues that it is not reasonable to assume that future events, such as those embodied in amendments to the Commentary, made after the signing of a treaty can play a role in determining the intention of the parties when negotiating the treaty. Baker (2007:203) supports this view and argues that it is difficult to see how later Commentaries constitute context or serve as a basis for determining the common intention of the negotiators at the time of concluding the treaty. However, he recognises that where subsequent Commentary amplifies existing Commentary, it deserves to be taken in consideration when pre-existing Commentaries are interpreted. This view was confirmed in the case of the *Queen v Prevost Car Inc*, 2009 FCA 57, in which the court found that later Commentary had persuasive value to the extent that it did not contradict the views previously expressed. Later Commentaries can guide treaty interpretation if they are a fair representation and are not in conflict with Commentaries that existed at the time a specific treaty was entered into. In the Swiss Swap Case, the court adopted the view that the concept of beneficial ownership was implicitly included in treaties and was similarly applicable to older treaties that contained the beneficial ownership provision.



According to Vallada (2014:35), these arguments stem from a long-standing disagreement between static and ambulatory treaty interpretation. Arguments in favour of and against both approaches exist (Olivier & Honiball:2011, 301).

The OECD has made it clear that the proposed changes are solely for clarification and do not constitute an amendment (OECD, 2012:16). It is uncertain whether subsequent Commentary achieved the expressed objective of the OECD, which had been to provide clarification on the intention of the parties at the time of signing the agreement. Public comments regarding the 2012 OECD discussion draft indicated a consistent theme, i.e. that the OECD had failed to provide clarity and had instead created uncertainty (OECD 2012). The Capital Markets Tax Committee of Asia (2012) even argued that the update was a deviation from, or a reinterpretation of the meaning of beneficial ownership, as previously explained, in which case the update to the OECD MTC 2014 Commentary can apply only to new treaties concluded. This is in line with the interpretation of treaties as discussed in Chapter 2.

### **3. RELEVANCE OF BENEFICIAL OWNERSHIP IN THE MTC**

#### **2.3.1 The use of beneficial ownership as an income attribution tool**

Under the distributive rules of Article 10 of the MTC on Dividends, the state of source has primary but limited taxing rights, typically 15% of the gross amount of the dividend. The state of residence has unlimited taxing rights and is obliged to grant a tax credit for the foreign tax paid in the source state (OECD MTC 2014:30-31, 37). The provisions of the Article effectively shares or distributes taxing rights between treaty states.

Limited taxing rights in the source state are available only if the recipient of the income is (i) a resident of the contracting state; and (ii) is also the beneficial owner of that income (OECD 2010:28-30). If both conditions have not been satisfied, the source state may subject the income to taxation in full, according to its domestic tax laws, and need not apply the reduced rate of withholding afforded by the DTA (Foster, 2015:75).



### **2.3.2 The use of beneficial ownership as an anti-avoidance mechanism**

Treaty abuse can occur when a resident of a non-treaty country establishes a subsidiary in a treaty country to conclude transactions with another contracting state (referred to for the purposes of this study as the third state) solely or mainly for the purpose of benefiting from the preferential treaty rates that apply between the two contracting states. The income earned by the subsidiary is then on-distributed to the holding company, net of the preferential treaty withholding tax rate. Had the holding company concluded the transaction directly with the third state, it would have been liable to pay the higher domestic withholding tax rate under the domestic laws of the third state.

The use of beneficial ownership as a treaty anti-avoidance mechanism is confirmed by the OECD as it requires, in addition to a factual test, a substance test to be applied when determining beneficial ownership. However, it cautions against the use of beneficial ownership to combat all forms of treaty shopping arrangements and states that its use should not restrict the application of other approaches to address treaty shopping cases (OECD 2014:63,190). It further provides that even where the recipient is the beneficial owner of income, treaty benefits should not be granted in cases of abuse (OECD 2014: 190).

## **2.4 DETERMINING BENEFICIAL OWNERSHIP IN A CROSS-BORDER CONTEXT**

South Africa applies the MTC and OECD in its negotiation of bilateral treaties and as such, the interpretation and application of the term by the OECD is relevant for purposes of this study.

### **2.4.1 The history of the meaning of beneficial ownership as determined by the OECD**

The concept 'beneficial owner' was introduced in the OECD MTC and Commentary in 1977, as amended in 2003, in order to deal with simple treaty shopping situations where income is paid to an intermediary resident of a tax treaty country who is not treated as the owner of the income for tax purposes. The intermediary residents referred to by the OECD are agents, nominees or conduit companies that receive income on behalf of and for the benefit of others (Davis Tax Committee, 2014:3). The Commentary clearly states that it is inconsistent with

the objective and purpose of the MTC for the state of source to grant relief or exemption under domestic statute on the basis that the amount is *paid* to a recipient that is a resident of a contracting state<sup>4</sup> as such recipient must also be the beneficial owner. No double tax arises as the recipient is not treated as the owner of the income under the domestic tax law of the state of residence<sup>4</sup> (OECD 2010:188). The original intention of the OECD with the inclusion of beneficial ownership in the MTC and Commentary was therefore to deny treaty benefits to agents and nominees. This denial was subsequently extended to conduit companies, which are defined as companies that have such narrow powers over the income received by them that they are, in substance, merely acting as fiduciaries or administrators.

Baker (2007:17) points out that the OECD failed to define beneficial ownership, either in the Commentary or in the MTC, and only excluded very obvious cases of treaty shopping. According to Vargas (2004:18-20), respondents to the Commentary mentioned the scarcity of information on the intended meaning of beneficial ownership and pointed out that the OECD came short of completely defining the term. This resulted in contracting parties relying on Article 3(2)<sup>5</sup> of the MTC, which allows contracting states to consult their domestic laws to determine the meaning of a treaty term, where such term is undefined within the treaty as such.

It is doubtful whether reliance on Article 3(2) of the MTC achieves the OECD's objective of contracting states to adopt an autonomous international meaning that is used and understood by all countries that adopt the OECD MTC and Commentary in the negotiation of their bilateral treaties, since domestic laws of Contracting States will assign different meanings to the term. The adoption of an international versus a domestic meaning is further discussed in the section on the interpretation of treaties in Chapter 2.

Historically, clarifications regarding beneficial ownership have been added only to the Commentary and the Articles have remained unchanged. The OECD continued this trend

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4 In terms of Section 1 of the Income Tax Act, income is included in "gross income" when an amount is "received by or accrued to" a person. In *Geldenhuys v CIR*, 1947 (3) SA 256 (C) (14 SATC 419) it was held that only amounts received by a person for his or her own benefit are included in that person's gross income. An amount received by an agent, nominee or conduit that is not for own account and benefit is not included in that person's gross income and is therefore not taxed in that person's capacity as taxpayer.

5 Referred to as the "Renvoi" principle. The reliance on Article 3(2) was demonstrated in *The Queen v Prevost Car Inc*, 2009 FCA 57, in which the domestic meaning of beneficial ownership was consulted by revenue authorities.

in its 2014 update, but did assign a definition to the term as “the right of the recipient to use and enjoy the income without being constrained by a contractual or legal obligation to pass that payment on to another person” (OECD, 2014: 13). It further states that in determining beneficial ownership, a “facts and circumstances” test may be applied to determine whether, in substance, the legal owner is not the beneficial owner.

The OECD confirms that it was never the intention for the term to be interpreted with reference to any narrow technical meaning that it could have had under the domestic law of a specific country<sup>6</sup>, such as the meaning that it has under the trust laws of some common law states. Rather, it should be understood in its specific context and in the light of the objective and purpose of the MTC, including the avoidance of double taxation and the prevention of fiscal evasion and avoidance (OECD, 2010:188,189).

The update to the Commentary stems from the release of two discussion papers on beneficial ownership by the OECD<sup>7</sup>. Public commentary on the proposal updates indicated a consistent theme: (i) the proposals do not provide clarity on the meaning of beneficial ownership; (ii) the reference to a contractual or legal obligation to on-distribute income received creates more uncertainty; and (iii) the OECD provides limited guidance on where an on-payment will be related or unrelated to the income received and the criteria to assess the level of interrelatedness or contractual linkage in order to satisfy or fail the beneficial ownership test.

Concerns were raised by the Capital Markets Tax Committee of Asia and by the Institute of Chartered Accountants in England and Wales (ICAEW) Tax representatives (OECD: 2012) over the nature of the relationship or types of inter-dependencies that would impact beneficial ownership. Examples provided were those of economic and/or legal dependence where payments are dependent upon receipt of income. Alternately, relationships may be time related, e.g. when the entitlement or receipt of income coincides with the obligation or

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<sup>6</sup> The OECD’s view that the term should carry an international meaning was confirmed in *Indofood International Finance Ltd. v JP Morgan Chase Bank NA London*, 2006 EWCA civ 158 STC, in which the court suggested that beneficial ownership has an international meaning that is understood and used by all countries that adopt the OECD MTC in the negotiation of their bilateral treaties (OECD, 2014:188-189).

<sup>7</sup> The first was published in 2011 on the “Clarification of the Meaning of Beneficial Owner in the OECD MTC”. Amendments to these proposals were published in a subsequent discussion paper in 2012: “OECD MTC: Revised Proposals Concerning the Meaning of Beneficial Owner in Articles 10, 11 and 12”.

payment. These concerns were raised within the context of financial transactions that are routinely concluded by financial institutions and involve a level of interrelatedness or dependence. It was noted by public commentators (OECD, 2012) that a general definition for beneficial ownership is not sufficient to provide clarity on its interpretation and application in the financial industry, where transactions are routinely complex. The Capital Markets Tax Committee of Asia (2012) was of the view that the update might have been a reinterpretation of the concept of beneficial ownership, which increases the risk of the Commentary being interpreted inappropriately.

The OECD recognised that the proposed amendment of the MTC 2014 in paragraph 12.4 gave rise to uncertainty and that greater clarity is required to better identify the kind of obligations that affect beneficial ownership, but decided against the inclusion of obvious examples, choosing to remain focused on principles (OECD 2012:9, 15). In the 2014 update to the Commentary, the OECD included the wording of the 2012 discussion draft without the clarification requested by industry participants.

#### **2.4.2 Authoritative foreign case law on beneficial ownership**

In Section 2 of Chapter 2, which deals with the interpretation of treaties, it was concluded that the authority of foreign case law is accepted as having persuasive value, and that South African courts are likely to accept an interpretation that is consistent with foreign case law. The principles established in authoritative foreign case law on beneficial ownership are considered below.

##### ***The United Kingdom case of Indofood International Finance***

In *Indofood International Finance Ltd v JP Morgan Chase Bank*, 2006 EWCA civ 158 STC (hereafter referred to as “Indofood”), the court ruled on beneficial ownership of interest in a cross-border financing arrangement. The facts involved a back-to-back loan structure whereby interest received by a subsidiary was on-distributed to its parent company. Had the parent company raised funding directly in the market, a 20% interest withholding tax rate would have applied under domestic law. By interposing an intermediary as the issuer of loan notes, interest withholding tax was effectively reduced to 10% under a treaty.

In consulting the 1986 OECD report on conduit companies, it was held that the test of beneficial ownership for tax treaty purposes is economic in nature, and for that reason nominees and agency companies will generally not be the beneficial owners of the income they receive. This endorsed the OECD's approach that conduit companies, due to their narrow powers over the income and assets under their control, will not be beneficial owners. The court ruled in favour of the revenue authorities on the basis that the intermediary was a conduit and had no function other than to receive and on-distribute income. It was also held that the company served no purposes other than a tax purpose.

In arriving at this decision, the court considered the following factors: (i) the interest received by the Mauritian company was identical to that paid; (ii) no margin was retained and the intermediary company exercised no control over funds received; (iii) the timing of payments was only one day apart; and (iv) the loan agreement precluded the recipient from meeting its interest obligations from any source other than the funds received from the payer.

In responding to the *Indofood* case, Baker (2007:15, 16, 26) argues that the purpose of the test is to determine the extent to which the conduit arrangement (for the denial of benefits treaty benefits) is artificial. In his view, the problem posed by the case is not that it confirms the status of the intermediary company as conduit, but lies with the level to which the judgment extends, i.e. which other arrangements will fall foul of the beneficial ownership test.

### ***The Canadian case of Prevoist***

In the Canadian case of the *Queen v Prevoist Car Inc, 2009 FCA 57* (hereinafter referred to as "Prevoist"), beneficial ownership was decided in a tax case involving dividends. The facts of the case involved an intermediate holding company, tax resident in the Netherlands and established for the purpose of holding shares in a Canadian company. The Canadian Revenue Authorities argued that the holding company was not the beneficial owner of dividends received by the Canadian company as dividends received were perfectly matched by dividend payments to its shareholding companies. In their view, it was therefore a conduit or a funnel for dividends. The Canadian Revenue Authorities argued that treaty benefits under the Canadian-Netherlands treaty should be denied on the basis that the holding

company, being the direct recipient of the dividend, was not the beneficial owner of the dividends.

In ruling in favour of the taxpayer, the tax court confirmed the beneficial ownership status of the Netherlands holding company and defined beneficial ownership as being “for the owner’s own benefit”, without any accountability to anyone for how he or she deals with the dividend income<sup>8</sup>. The court rejected the view that the company was a “conduit company”<sup>9</sup> as it did have discretion as to how the funds were to be applied. The court further found that there was no predetermined or automatic flow of funds and that the dividend received by the holding company was not predestined for its shareholders. In ruling on the application of a look-through principle, the court found in favour of the taxpayer and ruled that “one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit”. It considered this principle as “capturing the essence” of the concept of a beneficial owner. Should the company not act as conduit, agent or nominee (therefore having “absolutely no discretion” over the use of the funds) the legal owner is the beneficial owner.

### ***The Canadian case of Velcro***

In *Velcro Canada v Her Majesty the Queen* 2012 TCC 57 (hereinafter referred to as “Velcro”) the Tax Court ruled on the beneficial ownership of income from royalties. The facts were similar to those in *Prevost* and involved the creation of an intermediary holding company, which was tax resident in the Netherlands, to receive royalty income by licensing intellectual property. It was contractually obliged to on-distribute 90% of that income within 30 days of receipt. The court outlined the four elements of beneficial ownership as (i) possession; (ii) use; (iii) risk; and (iv) control. In finding in favour of the taxpayer, the court found that the recipient of the royalty income was the beneficial owner thereof, notwithstanding a contractual obligation to pass on 90% of that royalty income to a company situated in a non-

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<sup>8</sup> The court relied on Article 3(2) and consulted domestic law to interpret beneficial ownership.

<sup>12</sup> Defined in the 1986 OECD Conduit Companies Report as a company with very narrow powers, which render it, in relation to the income it receives on the assets under its control, a mere fiduciary or administrator, acting on account of interested parties. A conduit company cannot normally be regarded as a beneficial owner.

treaty state. The court ruled that the existence of a contractual obligation did not indicate that the recipient company was in substance acting as a conduit, an agent or a nominee. The court confirmed the decision taken in *Prevost* that it was inappropriate to pierce the corporate veil and ignore the separate legal existence of the recipient company unless it can be demonstrated that the recipient was acting as a conduit, agent or nominee with no discretion as to the use or application of the funds. The court confirmed that although the company's discretion may be limited it does exist, and that the contractual obligation does not result in an automatic flow of funds, such that the recipient is not the beneficial owner. In deciding where a treaty resident is a mere conduit, "one must take a close look at where the right to use and the enjoyment and the assumption of risk and control of the payments lie". With regard to the assumption of risk, the court found that the company assumed currency risk as the royalty receipt and payment were denominated in different currencies. The assets were reported on the financial statements of the company, thereby being at risk to creditors in the event of liquidation.

#### **2.4.3 Conclusion regarding the meaning of beneficial ownership**

In determining beneficial ownership, one first has to establish whether the recipient of an amount of income is (in fact or substance) acting as an agent, a nominee or a conduit. Such determination is made by conserving the discretion exercised by the conduit over the use or application of funds. Where the conduit has "absolutely no discretion" as to the use or application of the funds, it will be regarded as a conduit company and will normally not be the beneficial owner of the income. Where the conduit can exercise discretion, albeit limited, it is inappropriate to look through the separate legal existence of the entity in order to determine the ultimate beneficial owner. In this instance the conduit, as the legal owner of the income and/or assets, is the beneficial owner. From foreign case law on beneficial ownership it can be deduced that beneficial ownership comprises the constituents: (i) use; (ii) control; (iii) possession; and (iv) risk. This study considers each of these elements and investigates the result that is achieved in practice when applied to equity derivative transactions that are routinely concluded by financial institutions in international markets.



## 2.5 THE INTERPRETATION OF BENEFICIAL OWNERSHIP IN SOUTH AFRICA

### 2.5.1 Domestic definition and references to beneficial ownership

The JSE Equity Rules (2014:9) define a beneficial owner of equities as the person in whom the benefits of the bundle of rights attaching to equity securities are vested, typically evidenced by one or more of the following: (a) the right or entitlement to receive dividends in respect of those equities; (b) the right to exercise voting rights attaching to those equity securities; and (c) the right to dispose of those equities or any part of a distribution and to be beneficially entitled to the disposal proceeds. The JSE Equity Rules recognise that the definition is untainted by the fact that the securities may be registered in the name of a nominee acting on behalf of the beneficial owner. The Companies Act, No. 71 of 2008 (hereinafter referred to as the “Companies Act”) mirrors this definition.

Beneficial ownership is defined for purposes of Dividends Withholding Tax in Section 64D of the Income Tax Act as being ascribed to “the person entitled to the benefit of the dividend attaching to a share”. The “transfer of a security” is defined in Section 1 of the Securities Transfer Tax Act No. 25 of 2007 (hereinafter referred to as the “Securities Transfer Tax Act”) as referring to beneficial ownership by excluding, for purposes of levying Securities Transfer Tax, a transfer that does not result in a change in beneficial ownership.

Neither the Income Tax Act nor the Securities Transfer Tax Act defines beneficial ownership. The 2007 Explanatory Memorandum to the Securities Transfer Tax Bill explains that beneficial ownership is akin to economic ownership and should be distinguished from legal ownership (National Treasury, 2012:6). It acknowledges that the mere registration of a security in the name of a holder, such as securities registered in the name of a nominee company that holds shares on behalf of shareholders, does not constitute beneficial ownership. Such analysis appears to be consistent with the view of the OECD that agents or nominees in whose name shares are registered are not the beneficial owners of such shares.

The legislative amendment history of the provisions of the Income Tax Act and Securities Transfer Tax Act may provide additional clarification on National Treasury’s interpretation of



beneficial ownership. The Explanatory Memorandum to the Taxation Legislation Amendment Act, which deleted the definition of a “shareholder” in Section 41, provides the following reasons for this deletion: “The shareholder definition focuses on both the share register and beneficial ownership. This duality creates confusion because the person named in the share register is not necessarily the beneficial owner of that share” and that “consistent with the overall philosophy of the Income Tax Act, the focus should solely be on the beneficial owner of the shares.” It was therefore proposed that the definition be deleted as it treats both the registered and beneficial owners of shares as “shareholders”, whereas the focus should always be on the beneficial owner of the shares, i.e. “the holder of the shares” as opposed to the registered owner (National Treasury, 2012:35).

Further guidance may be found in the reasons stated by National Treasury for the amendment to the broker/member exemption on 1 January 2013, to expand the Section 8(1)(q) exemption from Securities Transfer Tax to include transfers to “bank restricted stock accounts”. Prior to 1 January 2013, Section 8(1)(q) allowed for an exemption from Securities Transfer Tax in the case of any transfer of a security where “the person to whom that security is transferred is a member who has purchased the security for that person’s own account and benefit”. A “member” is defined in Section 1 of the Securities Transfer Tax Act as an authorised user providing securities services in respect of the buying and selling of listed securities. In other words, stock exchange brokers were exempt, provided that they were trading *for their own account and benefit*.

On 1 January 2013, National Treasury expanded the member/broker exemption to any member that acquires securities and allocates them to a “bank-restricted stock account”<sup>10</sup>. The amendment was effected to cater for scenarios where brokers conduct equity hedge activities on behalf of associated banking enterprises, illustrated by means of the following example: A bank assumes a risk position by entering into an equity derivative transaction with an independent counterparty. On the instruction of the bank, an associated broker hedges the risk by acquiring the equities in the market. The view of National Treasury is set out in the Explanatory Memorandum to the Draft Taxation Laws Amendment Bill: Where a

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<sup>10</sup> Defined in the JSE Equity Rules as a stock account for transactions or positions in equity securities where the member acquires or sells equity securities for the member’s own account, and where the member does not have the freedom to acquire or dispose of such equity securities due to a restriction placed on the member in respect of the acquisition or disposal of such equity securities by an associated banking entity.

broker conducts equity dealings as a risk offset against derivative positions of associated banking enterprises the broker is not acting “for own account and benefit” (National Treasury, 2012:136). In these circumstances it is doubtful whether the Section 8(1)(q) broker exemption applies as it is questionable whether the broker is actually anything more than an agent in an economic matter. The agency nature of this relationship becomes even more obvious when the broker has no ability to control the disposal of such shares.<sup>11</sup>

The view of National Treasury reinforces the principle that domestically a substance over form approach may be preferred when determining beneficial ownership. This is in line with the OECD recommendations, as contained in the Commentary to the MTC. In the equity hedge transactions discussed above, the broker has no control over the acquisition and disposal of shares, and risk and rewards may be transferred to the bank by means of a derivative.

## **2.5.2 Conclusion regarding the meaning of beneficial ownership in South Africa**

The South African view that a substance over form approach should be preferred is consistent with the OECD view that a “facts and circumstances” test should be applied to determine who the beneficial owner is.

The JSE Equity Rules and the Companies Act do not regard the assumption of equity risk as an essential element of beneficial ownership and are indifferent to whether the equity risk is retained or substantially transferred to another by means of an equity derivative hedge transaction. It is also indifferent with regard to whether the economic benefit of the dividend is transferred to another. This is contrary to the view of National Treasury on the associated broker/bank equity hedge activities, where the assumption of risks and rewards associated with equity are determining factors. It could be argued that the OECD MTC 2014 is consistent with National Treasury’s view in that beneficial ownership exists only if the benefits and risks are enjoyed unconstrained by a contractual obligation to pass the income

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<sup>11</sup> Following consultation with industry on the adverse consequences of raising the cost of equity hedging transactions, the Section 8(1)(q) exemption was expanded to cater for activities of this nature conducted between associated banks and brokers.

on to another. The retention of voting rights is not considered an essential component of beneficial ownership since in the bank/broker scenario the broker retains voting rights.

Each of the elements of beneficial ownership will be considered separately through testing a selection of transactions against both the domestic and international interpretations of beneficial ownership. In all instances, the right or entitlement to dividends is a key element in determining beneficial ownership, which will be further explored in Chapter 3.

## **CHAPTER 3**

# **DETERMINING BENEFICIAL OWNERSHIP IN A SELECTION OF FINANCIAL TRANSACTIONS**

### **1. INTRODUCTION**

In the previous chapter, the determinants of beneficial ownership were identified by way of a review of foreign and domestic law, international law and international interpretational aids, such as the OECD MTC 2014 and Commentary. The focus of this chapter is to analyse beneficial ownership in a selection of three financial transactions that are routinely concluded by banks and brokers in the normal course of their business. The transactions were selected based on the manner in, and extent to which rights and obligations are transferred contractually to other parties. In each selection, beneficial ownership is determined by consulting domestic law, foreign case law and paragraph 12.4 of the Commentary to the OECD MTC 2014. This chapter highlights considerations that are taken into account when domestic, foreign and international laws on beneficial ownership are considered in combination.

### **2. AMERICAN DEPOSITORY RECEIPTS**

#### **2.1. Characteristics of an American Depositary Receipt**

An American Depositary Receipt (ADR) is a security traded on American Stock Exchanges representing a share of a non-United States (non-US) company. An ADR enables shares of non-US companies to be traded in US markets without the physical share being listed on the US exchange. ADRs are denominated and pay dividends in US dollars, calculated by applying an exchange rate to the currency in which the share (and thus the dividend) is denominated.

The Depository Agreement contractually entitles the holder of an ADR to an interest in an equity share. It is a contractual right against the Depository Banker (hereinafter referred to as a “Depository”) and should be distinguished from a corporate right akin to that which exists between a shareholder and a company. It is not an equity share, as defined in Section 1 for Income Tax purposes<sup>12</sup>.

The Depository is contractually obliged to (i) distribute all dividends or other distributions in connection with those shares to the ADR holder; and (ii) to exercise its voting rights in connection with those shares in accordance with the instruction of the ADR holder. As the market value of the ADR is directly derived from the listed share, the holder of the ADR is fully exposed to the market risk of the listed share. Other than a fee, no risks or benefits accrue to the Depository.

On the creation of an ADR under a Depository Receipt Programme, a broker transfers listed shares, which have been acquired in the market by that broker, to an offshore Depository, who issues an ADR to the investor or transferee of the shares. On cancellation of the Programme, the ADRs settle either in cash or in specie. The former involves the ADR holder receiving a cash settlement equal to the value of the shares at the time of cancellation, while the latter involves the holder receiving the underlying equities.

For the purposes of this study, it is assumed that ADRs reference South African shares. Such assumption is required in order to test whether the transfer of a South African listed share into a Depository Receipt Programme and the transfer on cancellation of such a Programme is a transfer that results in a change of beneficial ownership.

### **3.2.2 The reasons for selecting an American Depository Receipt**

The creation and cancellation of an ADR involves a transfer of a share from the transferee broker to the Depository, but all corporate rights and obligations attaching to those shares are contractually transferred to the ADR holder. Foreign case law, domestic law and

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<sup>12</sup> The Income Tax Act No. 58 of 1962 defines an equity share as a “share in a company”. A “share” is defined as a unit into which the proprietary interest in that company is divided.

paragraph 12.4 of the Commentary to the OECD MTC 2014 will be considered to determine whether such transfer results in a change of beneficial ownership.

## **2.2. Determining the beneficial owner of the share and the dividend**

### *Determining whether the Depository is acting as a nominee, an agent or a conduit*

In Chapter 2 it was confirmed that the separation of legal and beneficial ownership has long been recognised by both the OECD and domestic Tax Law. Legal ownership can be registered in the name of an agent, a nominee or a conduit that controls the assets on behalf of beneficial owners.

The Depository serves no purpose other than to receive and on-distribute the income, i.e. it serves as a conduit or funnel for dividends (*Queen v Prevost Car Inc, 2009 FCA 57*). With regard to the assets under its control, it has no discretion or control over the utilisation of assets or the income that it produces. It may not dispose of the assets and vote independently, and accrues no benefits or risks other than the earning of a fee as a reward for the holding and administration of an asset and the income that it earns for the benefit of another (*Indofood International Finance Ltd v JP Morgan Chase Bank, 2006 EWCA civ 158 STC*). In conclusion, one should look through the corporate existence of the Depository to identify the ultimate beneficial owner (*Queen v Prevost Car Inc, 2009 FCA 57*).

It was concluded that treaty benefits are not available to nominees, agents or conduits. No double tax arises as income will not be attributed to those intermediaries under the domestic laws of their resident states. This analysis is consistent with the principles laid down in *Geldenhuys v CIR, 1947 (3) SA 256 (C) 14 SATC 419*, whereby an amount was received, but had not accrued for “own account and benefit”. In determining whether a recipient is acting as an agent, a nominee or a conduit, one has to consider whether, in substance, the recipient has any discretion, power or control over the funds or assets under its control.

Based on this analysis, the Depository Agreement is no different from a custodian or nominee. Custodians or nominees have the authority to enforce their rights against the company in which they hold the shares, but the benefits of shareholding are vested in the

beneficial owner. These benefits can be claimed from the custodian or nominee by means of a custody agreement concluded between parties. In terms of Section 1 of the Income Tax Act No. 58 of 1962, only the Depository fee will be included in the “gross income” of the Depository.

#### *Withholding Tax on ADR distributions*

Distributions under ADRs are amounts distributed by the Depository to ADR holders and are equal to the dividends declared on the shares held in custody. In practice, the rate of Dividends Withholding Tax applied to the ADR distribution is determined under the domestic jurisdiction of the company’s place of incorporation. The rate may be reduced under a treaty concluded between the contracting states of which the company and the ADR holder are tax residents. The tax residency of the Depository is therefore irrelevant. Market practice thus supports the view that the dividend flows through the Depository and, importantly, *retains its nature* as a “dividend”. Dividends are predestined for the ADR holder and there is an automatic flow-through of funds (*Queen v Prevost Car Inc*, 2009 FCA 57). This practice is consistent with Article 10 of the OECD MTC, paragraphs 1 and 2, in that it is not enough for the direct recipient to be a resident of a contracting state, but that the recipient should also be the beneficial owner of the dividend. Lastly, it is supportive of the 2014 update to the OECD Commentary in paragraph 12.4 in that a person can only be the beneficial owner if he holds “the right to use and enjoy the income unconstrained by contractual or legal obligation to pass the payment received to another person”. The ADR holder is therefore beyond any doubt the beneficial owner of the dividend.

A prevalent point is that the dividend retains its nature as a corporate right, and therefore qualifies for treaty benefits under Article 10, irrespective of the fact that it is effectively a contractual right that exists between the depository banker and the ADR holder. This should be compared to a dividend-equivalent payment, which is discussed under securities lending transactions and equity swaps.

#### *Determining the beneficial owner of the share*

It is an established principle that one can contractually divest oneself of an income right while remaining the beneficial owner of the asset that produces that income. One may argue

that contractual divestment of the income produced by an asset is not sufficient to divest oneself from *all* real or ownership rights attached to the asset.

In *Velcro Canada v Her Majesty the Queen*, 2012 TCC 57, the court ruled on the four elements of beneficial ownership as (i) possession; (ii) use; (iii) risk; and (iv) control. When considered in light of the real rights attached to the asset, the holder of the ADR is entitled to all legal ownership *and* economic (beneficial) ownership rights. On the creation of the ADR, corporate rights are swapped for identical contractual rights. The opposite occurs when an ADR is redeemed. There is therefore a temporary cessation of the existence of corporate rights to enable the share to trade on an offshore exchange without the company being listed on that exchange, which requires adherence to more regulatory requirements. The only difference between the ADR and the equity share is the existence of a corporate versus a contractual right that confers all corporate rights on the ADR holder.

The domestic interpretation of a beneficial owner of a share was discussed in Chapter 2 with reference to the JSE Equity Rules, the Companies Act, No. 71 of 2008 and the Securities Transfer Tax Act, No. 25 of 2007. Beneficial ownership rights were identified as (i) voting rights; (ii) dividend rights; and (iii) disposal rights. As the ADR holder possesses all three, it would be commensurate with corporate law to conclude that the ADR holder is the beneficial owner of the share.

If one argues that the depository banker was acting in the capacity of a trustee, the case of *Braun v Blann and Botha NNO* 1984 (2) SA 850 (A) confirms that the trustee is the owner of the trust property for purposes of the administration of the trust and has no beneficial interest in the trust property. Such beneficial interest lies with the beneficiaries.

The conclusion that beneficial ownership of the share resides with the ADR holder is consistent with the OECD MTC 2014 amendment of the Commentary, paragraph 12.4, as the Depository, as the recipient of the income, does not have the power to enjoy the income unconstrained by a contractual obligation to on-distribute that income. Such unconstrained use and benefit rests with the ADR holder. Although Article 10 of the OECD MTC 2014 aims to determine beneficial ownership in a (dividend) income scenario, i.e. it does not specifically aim to address the beneficial ownership of the asset that produces the income, it is



reasonable to conclude that the transfer of equity shares under a Depository Programme is not a change in beneficial ownership if one has to consider the OECD MTC 2014 Commentary in conjunction with foreign and domestic law.

### **3.2.3 Conclusion**

The Depository acts as an agent, a nominee or a conduit as has no discretion with regard to the use or application of assets or the funds under its control. The Depository is neither the beneficial owner of the dividend, nor that of the underlying shares. The corporate existence of the Depository as an intermediary should be disregarded. The ADR holder is the beneficial owner of the dividend and the underlying shares. Such a conclusion is consistent with foreign law, domestic law and the OECD MTC 2014.

## **3. SECURITIES LENDING TRANSACTIONS**

### **3.3.1 Characteristics of a securities lending transaction**

A securities lending arrangement is characterised by a loan of securities, in this case listed shares, from a lender by a borrower for a specified period, usually against the transfer of collateral. Securities lending transactions enable investors to sell shares that they do not own, but which they borrow by means of share loan transactions referred to as “selling short” or a “short sale”. According to Practice Note 5 of the South African Revenue Services (now withdrawn), such functionality expedites the settlement of equity transactions, improves market liquidity and price efficiency and encourages investment (SARS, 1999:2). A short seller (the share borrower) anticipates that market prices will fall and sells the shares short in the market at the higher current market price. The short seller concludes a share loan to deliver the equities to the market buyer under the short sale. Should the projections be accurate, those shares are subsequently repurchased at a lower future market price and returned to the share lender. The short seller therefore anticipates a trading gain between the higher selling price and lower cost price of the share, net of any securities lending fee. The share lender benefits by earning a securities lending fee, which offers an enhanced yield on equities already in its possession. An example of a typical share lender is a pension fund that holds equities as a hedge against its pension fund liabilities and which may on

occasion conclude share loan transactions in order to earn an enhanced yield on equities. Brokers, banks and other financial institutions are examples of share borrowers.

Irrespective of the legal transfer of ownership, the lender retains all equity market risk since at close-out of the share loan identical shares are returned. Consequently, price risk is retained by the lender. Similarly, the lender retains the *economic* benefit of the dividend as is contractually compensated for dividends declared over the tenor of the loan.

The transaction is governed by a market standard agreement issued by the International Securities Lending Association, known as a Global Master Securities Lending Agreement (hereinafter referred to as a GMSLA). The GMSLA confirms that, notwithstanding the use of expressions such as “borrow” and “lend” within the agreement, full title, right and interest to the shares “borrowed” or “lent” shall pass from the lender to the borrower on condition that the borrower undertakes to return identical shares to the lender, as defined in Section 1 of the Income Tax Act, No. 58 of 1962 (hereinafter referred to as the Income Tax Act), as shares of the same class in the same company. Legal title transfers from the lender to the borrower so that the borrower becomes entitled to all rights attaching to those shares, i.e. dividend, voting and disposal rights, over the tenor of the loan.

The GMSLA requires the borrower to compensate the lender for dividends received over the loan period. Such compensation is effected by means of a manufactured dividend, i.e. an amount *equal* to the dividend declared. The parties typically agree to manufacture a dividend that restores the lender to the same economic after-tax position in which it would have found itself had the share loan not been concluded. The amount manufactured is therefore a post-tax amount, taking into account the Dividends Withholding Tax rate that would have applied to the share lender had the share loan not been concluded. The net manufactured dividend is taxable as gross income in the hands of the share lender. In a cross-border context, such rate will be determined by the domestic tax rate of the company declaring the dividend, taking into account any Double Tax Agreement concluded between the tax jurisdiction of the company and that of the share lender.

The above can be illustrated by a scenario in which a dividend is declared on a South African share over the tenor of a share loan and both the share lender and borrower are South

African tax residents. Assuming that the share lender is a Pension Fund, the borrower (as the registered shareholder) is contractually obliged to manufacture the gross dividend to the lender as Section 64F(1)(f) exempts South African pension funds from Dividends Tax. Should the share borrower hold the share over dividend date and the share borrower's tax status is such that Dividends Withholding Tax will be withheld on the dividend, it will receive the dividend net of 15% Dividends Withholding Tax. It will nevertheless be required to compensate the lender for the gross dividend as the lender would have been exempt from Dividends Withholding Tax. In a cross-border context, the borrower will manufacture an amount taking into account the lender's right to a reduced rate or an exemption under a treaty concluded between the lender and the company that declares the dividend. The obligation to compensate the lender for dividend declared over the tenor of the loan exists contractually, regardless of whether the borrower has received the dividend or not.

### **3.3.2 Reason for selecting securities lending transactions**

Securities lending transactions were selected as a comparison to American Depositary Receipts (ADRs) whereby all dividend, voting and disposal rights are contractually transferred. All economic risks and rewards associated with beneficial ownership are also contractually conferred to the ADR holder. In the previous section it was concluded that no change occurs in beneficial ownership when the share is transferred to the Depository Banker, who issues an ADR to the transferee of those shares. It was also concluded that the Depository Banker acts as a conduit with no discretion as to the use or application of the funds or the assets under its control. As a result, no Securities Transfer Tax should be levied on the transfer of shares under the Securities Transfer Tax Act, No. 25 of 2007 (hereinafter referred to as the Securities Transfer Tax Act) as the transfer does not result in a change in beneficial ownership.

Although a securities lending transaction transfers full legal title from the lender to the borrower, the lender retains price and dividend risk. The borrower obtains voting, disposal and corporate dividend rights, but sacrifices economic benefits as dividends are passed on to the lender (albeit by means of an amount equivalent to the dividend) and risk, as equity price risk, remains with the lender. In fact, the lender is therefore entitled to all economic risks and rewards associated with the shares out on loan, but legal title rests with the borrower.

### 3.3.3 Tax consequences of securities lending transactions and manufactured dividends

Section 1 of the Securities Transfer Tax Act defines a share loan transaction as a “lending arrangement” in terms of which:

- a) “A lender lends a listed security to a borrower in order to enable that borrower to deliver those shares within 10 business days after the date of the original transfer;
- b) The borrower contractually agrees to deliver an identical listed security to the lender within 12 months from the date of the original transfer;
- c) The borrower is contractually required to compensate the lender for any distributions in respect of the listed security which that lender would have been entitled to receive during that period had the arrangement not been entered into; and
- d) The arrangement does not affect the lender’s benefits or risks arising from fluctuations in the market value of the listed security.”

The Securities Transfer Tax Act disregards the fact that equity and dividend risk substantially remain with the lender, i.e. the retention of economic risk and rewards is not considered an essential element of beneficial ownership – rather, the holding of the legal ownership rights will determine beneficial ownership. This approach is consistent with legal form, as opposed to an economic substance.

In the case of *CIR v Genn & Co (Pty) Ltd*, 1955 (3) SA 293 (A) (20 SATC 113), it was confirmed that borrowing for use differs from borrowing for consumption. In the case of borrowing for use, the borrower does not become the owner of the thing borrowed and must return it in specie, while in the case of borrowing for consumption the borrower does become the owner and is only obliged to return what is similar. For present purposes there would appear to be no difference between the two, because at the moment when the borrower is given possession of the securities he falls under an obligation to repay dividends and return identical securities. If that which is borrowed is consumable, there is, according to *law*, a change of ownership.

By levying Securities Transfer Tax on securities lending transactions that have not satisfied the requirements for specific dispensation, the Securities Transfer Tax Act confirms that the borrower is the legal and beneficial owner. It can thus be concluded that, under domestic law, the entitlement to a manufactured dividend carries no weight in determining beneficial ownership. This view is mirrored in Practice Note 5 (now withdrawn), where it is stated that a manufactured dividend under a share loan transaction is not a dividend and must not be treated as a dividend for purposes of the Income Tax Act by either the lender or the borrower (South African Revenue Services, 1999:5, 6). The manufactured dividend receipt will be included in the gross income of the lender and deducted under Section 11(a), provided that the requirements for deductibility under that section are satisfied. The Explanatory Memorandum to the Securities Transfer Tax Bill 2007 issued by National Treasury confirms that the right to manufactured dividends is not a right to a dividend, but a right to an amount equal to that dividend (National Treasury, 2007:6). By definition, the recipient of a manufactured dividend can therefore not be the beneficial owner of a “dividend”, as defined. Section 64F of the Income Tax Act does not levy dividends withholding tax on manufactured dividends.<sup>13</sup>

### **3.3.4 Securities ending transactions in a cross-border context**

Where the share lender and share borrower are tax residents of two different tax jurisdictions, the domestic Dividends Withholding Tax rate applicable to the company that declares the dividend, taking into account the tax status of the share borrower, will apply. This rate may be reduced by a Double Taxation Agreement (DTA) concluded between these two tax jurisdictions. The amount manufactured under the GMSLA by the borrower will restore the lender to the after-tax position in which it would have found itself had the share loan not been concluded. The manufactured dividend will therefore be net of tax, taking into account any reduction or exemption from Dividends Withholding Tax in the DTA concluded between the tax jurisdictions of the company that declares the dividend and the share lender.

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<sup>13</sup> There is a specific scenario whereby manufactured dividends do attract Dividends Withholding Tax under Section 64EB of the Income Tax Act. It involves security lending transactions concluded with dividend exempt counterparts post dividend declaration date, but before payment of that dividend. The lender of the shares, who would have been subject to Dividends Withholding Tax, receives a manufactured dividend which is not subject to any Dividends Withholding Tax. The Income Tax Act considers these arrangements to be abusive and levies a Dividends Withholding Tax on the manufactured payment.

The functioning of treaty benefits in a cross border securities lending arrangement can be illustrated as follows:

Assume that a dividend is declared on a share issued by a company tax resident in Switzerland. The domestic withholding rate on dividends declared on shareholdings in Swiss companies is currently 35%. The DTA concluded between Switzerland and its treaty partner countries typically reduce this rate to 15%. A borrower of shares that is tax resident of a treaty partner country should qualify for the reduced treaty rate and should similarly be obliged to manufacture an amount equal to only 85% of the dividend, provided the share lender is situated in a treaty partner country. Where an exemption applies to the share lender, the borrower is obliged to manufacture the equivalent of the gross dividend and will be short 15% of the dividend, which the borrower will have to fund by means other than the dividend receipt.

In line with Article 10 of the OECD MTC definition of a “dividend”, the manufactured dividend is not a “dividend”, but is a payment made under a derivative contract. Depending on the nature of the borrower and the lender’s enterprise activities, manufactured payments under derivatives are classified either as “Business Profits” under Article 7, or as “Other Income” under Article 21 of the Model Tax Convention. Both these Articles typically allow only the state of residence to tax, i.e. the source state has no right to withhold tax. It is therefore only the dividend that could potentially be subjected to Dividends Withholding Tax under Article 10, provided that the domestic jurisdictions impose a Dividends Withholding Tax under its domestic tax laws. The equivalent amount manufactured as such does not attract a withholding tax, although the amount manufactured is an after-tax equivalent.

Paragraph 12.4 of the update of the Commentary to the MTC 2014 denies treaty benefits where the recipient of the dividend does not hold the right to enjoy the dividend unconstrained by an obligation to pass the benefit to another, either legally or in substance. Where, according to the interpretation of revenue authorities, the Commentary applies to a securities lending transaction in a cross-border context, they may argue that the lender remains the beneficial owner of the dividend as the borrower does not have the right to enjoy the dividend unconstrained as the benefit is contractually passed onto another. Treaty benefits may be denied to the share borrower on the basis that beneficial ownership in

Article 10(2) has not been satisfied as the registered owner of the shares and direct recipient is not entitled to the unconstrained enjoyment of the dividend. In the event that treaty benefits are denied to the share borrower, the question arises as to who the beneficial owner is, if indeed anyone. If treaty benefits are denied to the borrower on the basis that the borrower is not the economic beneficiary, could it be argued that the lender is the beneficial owner? Since a manufactured dividend is not a corporate, but rather a contractual right, this view is contrary to the definition of a “dividend” in Article 10, which requires the existence of a corporate right. Such results may lead to the conclusion that there is no beneficial owner of the dividend.

In a similar example, but one in which revenue authorities deny treaty benefits to the borrower under the application of paragraph 12.4 of the Commentary of the OECD MTC 2014, the maximum domestic rate of 35% will apply. The borrower will nevertheless be required to manufacture an amount that restores the share lender to the after-tax position in which it would have found itself had the share loan not been concluded, which will create an economic shortfall of either 20% or 35% (where the lender qualified for a complete treaty exemption as opposed to only a reduction). The economic shortfall is a cost to the taxpayer, which requires funding from monies other than the dividend receipt and may erode the trading profit to the extent that the trade becomes economically unviable. The taxpayer has three options to resolve this, namely (i) to contractually negotiate to price in the maximum domestic withholding tax of 35% on the manufactured dividend, which is contrary to international best practice and is unlikely to be accepted by the lender; (ii) to price in a treaty rate, but with an indemnity clause in the event that the share borrower is challenged by revenue authorities; or (iii) to close out all share loan positions before the dividend record date, thereby avoiding the need to manufacture an amount equivalent to the dividend.

In all three instances, the cost of securities lending transactions is increased – either as a result of an increase in the withholding taxes (and reduced returns), or due to the administrative cost of monitoring and closing out positions over dividend periods. In the last scenario, the lender (having a preference for a dividend at a preferential Dividend Withholding Tax rate) may recall the shares borrowed, which would result in a lack of availability in the market of those shares. Should the shares become illiquid in the market, borrowers may default on their obligations to return shares at the request of the lenders.



A counter-argument to Revenue Authorities seeking to deny treaty benefits by applying paragraph 12.4 of the Commentary to the OECD MTC 2014 is that the contractual obligation to pay a manufactured dividend exists independently of whether a dividend is received, which is, in itself, sufficient to contradict the pass-through nature. In share loan transactions, the borrower is required to compensate the lender for any dividend received over the tenor of the loan, irrespective of whether a dividend was physically received. The borrower, having sold the shares short in the market would have delivered the shares to the buyer under the short sale, re-acquiring those shares only once market prices have declined. The share loan will therefore remain open and dividends may be declared over that period. The borrower would have to compensate the share lender for an amount equivalent to value of the dividend without having received an actual dividend. Economically, treaty benefits can only be denied if the dividend is received by the borrower, but the fact that the GMSLA requires the payment of a dividend equivalent, irrespective of the receipt of a dividend should, in itself, be sufficient to counter-argue the application of paragraph 12.4 of the Commentary to the OECD MTC 2014. In other words, even if the borrower receives the dividend, the contractual nature of the arrangement is such that it falls foul of the pass-through scenario described in paragraph 12.4 and the borrower retains beneficial ownership status.

Banks and/or brokers applying the principles established in Chapter 2 under foreign case law typically do have discretion regarding the use or application of the dividend income. The dividend is not pre-destined for the stock lender as the manufactured dividend may be funded out of a general pool of funds available to the bank and/or broker – there is no automatic flow of funds. The argument is further strengthened by the fact that the dividend does not automatically flow through the share borrower, but changes in nature from a dividend to a manufactured dividend. It has been legally established that the manufactured dividend is not a dividend for purposes of Income Tax and does not bear the legal characteristics and consequential tax implications of a dividend. The manufactured dividend takes into account the tax status of the lender, and even though the timing of the dividend and manufactured dividend may coincide, the amount involved may not. It cannot be said that the borrower is funnelling dividends or acting as a conduit as dividend income is aggregated within a pool of funds that can be set aside for many purposes, including further investment, payment of operating expenditure or making a manufactured payment. The



corporate existence of the stock borrower should therefore remain intact and a look-through principle should not be applied in determining the beneficial owner of the dividend. The view is therefore that, in adhering to the principles established in foreign case law, the existence of a contractual obligation to pass on the dividend (by means of a manufactured payment or otherwise) cannot in itself taint the beneficial ownership status of the borrower for purposes of Article 10.

### **3.3.5 Conclusion**

In conclusion, the fact that a contractual obligation exists to transfer the economic benefit of a dividend to a share lender is not sufficient for domestic law to regard the lender as the beneficial owner of the dividend. Section 3.3.4 of this study concluded that such a result is also not inconsistent with the principles of foreign case law, as discussed in Chapter 2. The reasons can be summarised as follows: (i) The obligation to manufacture a dividend exists irrespective of whether an actual dividend is received or not, therefore there is no causal link between any dividend received and the manufactured dividend paid. (ii) The dividend received is not predestined for the lender as the payment of the manufactured dividend can be funded from various entity funds that are controlled by the borrower. (iii) The recipient has full control over the use or application of the dividend received as it can be applied for many purposes, including the settlement of operating or business expenditures, reinvestment, etc.

In the ADR scenario it was concluded that, owing to the contractual conferral of all corporate legal and beneficial ownership rights and entitlements, the ADR holder is the beneficial owner of the equity share. In a securities lending arrangement, the holder of the equity share is the beneficial owner as a result of an entitlement to all ownership and beneficial ownership rights, except for the assumption of equity risk which, in substance, resides with the lender. In the next section, a pure substance over form approach will be applied in an equity swap scenario to demonstrate that the foreign courts have relied solely on this type of approach, for which National Treasury has also expressed a preference.

## **3.4 EQUITY TOTAL RETURN SWAPS**

### **3.4.1. Characteristics of Equity Total Return swaps**

A swap is a derivative contract in terms of which the contractual parties agree to swap future cash flows, either by means of a series of future cash flows or in one lump sum. Equity total return swaps (hereinafter referred to as “equity swaps”) link the cash flows to the variability in price of a referenced equity share plus the amount of any dividend declared over the tenor of the total return swap. In return, that party pays its counterpart a fixed or variable rate of interest over the term of the contract. A contracting party can assume either a long or a short equity swap position. The holder of a long position will benefit from an increase in the underlying share price. Such a return is enhanced by any receipt of an amount equalling a dividend. Conversely, the long position holder will suffer a loss if the price of the referenced equities decreases, which loss may be compensated (partially or in full) by any dividend-equivalent payment. The holder of the short position will benefit from a decrease in the equity share price (which return may be reduced by the obligation to make payment of a dividend equivalent) and suffer a loss in the event of an increase in the equity share price (which loss may be increased by any dividend-equivalent amount).

### **3.4.2 Reason for selecting equity total return swaps in determining beneficial ownership**

Equity swaps, whereby equity exposure and dividends are transferred, are commonly used as a hedging mechanism between associated banks and brokers. In Chapter 2, the legislative amendment history of the Securities Transfer Tax Act was discussed and reference was made to the Explanatory Memorandum to the introduction of the bank restricted stock account on 1 January 2013 (National Treasury, 2012:136). The expansion of the existing broker exemption was introduced to allow brokers to conduct equity hedges on behalf of associated banking enterprises while still qualifying for Securities Transfer Tax exemption. The reason for the amendment was that National Treasury was of the view that brokers were not acting “for own account and benefit”, but rather for the account and benefit of the associated banking enterprises. The view of National Treasury was that in effect the bank (and not the broker) was the beneficial owner of the shares as risks and rewards associated with equities were transferred to the bank under an equity derivative. It considered the broker as a mere agent acting on behalf of and for the benefit of the bank. It

is clear that in this instance, legal or real rights were disregarded and a substance over form approach was applied. Substance was determined by the level and nature of risk and benefits assumed versus transferred and, in the case of equity derivatives, such risks and rewards materialises as dividend and equity risk (National Treasury 2012:136).

### **3.3.3 Determining beneficial ownership in equity total return swaps**

On 5 May 2015, the Swiss Federal Supreme Court ruled on a case (Case No. A-6537/2010, hereinafter referred to as the “Swiss Swap Case”) involving beneficial ownership where banks concluded equity swaps over Swiss equities, having acquired the referenced equities as a hedge. The Court ruled that the Danish banks were not the beneficial owners of the dividends received on the equity shares.

The holder of the equity shares, held as a hedge against the equity swap, made payment of a dividend-equivalent payment under the equity swap to the swap counterpart equalling 100% of the dividend received. At the time, the treaty between Switzerland and Denmark exempted any dividend received from a Swiss source by a Danish beneficial owner. The domestic Swiss Dividends Withholding Tax rate of 35% is reduced under a treaty on application to the Swiss revenue authorities to refund the difference between the domestic and treaty Dividends Withholding Tax rate, i.e. the treaty rate is not applied at source. On application by the Danish taxpayers to refund the 35% Dividends Withholding Tax, the Swiss revenue authorities denied the application on the basis that the Danish recipients of the dividend were not its beneficial owners.

In concluding that the Danish taxpayers had relinquished beneficial ownership status, the court considered the following:

- That the dividends are substantially passed on to contractual counterparts and that the recipient has therefore given up the unconstrained right to use, enjoy and dispose of the dividend received.

- That by concluding an equity derivative, equity risk is hedged and the holder of the equity share does not assume any risk as this has been transferred to the derivative counterpart.
- That at the time of concluding and terminating, the derivative contracts perfectly matched the acquisition and disposal of the equity shares. The derivative contracts and equities were also perfectly matched in terms of amount, i.e. the price exposure, being the risk that the equity value would decrease, was perfectly matched with a return under the derivative. The holder of the equity is relieved from any equity and dividend risk.
- That as a result of these combined factors, the risks and rewards are in substance borne by the derivative counterpart and not by the holder of equity shares, with the Danish taxpayers retaining only a small margin on market-making activities, which was considered a risk-free return, i.e. the net of the interest transferred under the equity swap and the dividend equivalent payment.
- As per the judgment delivered, (i) the achievement of the income is therefore dependent upon the obligation to forward such income; and (ii) the obligation to forward the income must depend on the achievement of that income, i.e. there was a clear interdependence between the earning of the dividend and the distribution thereof under the derivative.

The judgement delivered in the Swiss Swap Case is contentious and can be counter-argued as follows:

- The existence of interdependence between the receipt of the dividend and the payment of an amount equalling a dividend is arguable. The amount received is a dividend and the amount paid is calculated with reference to the dividend and has therefore lost its nature. The payer is contractually obliged to make payment of the dividend *irrespective of whether he has received one*. A counterpart is free to choose the method of hedging, i.e. by acquiring the equity or concluding an opposite position under another derivative such as an equity future, which may or may not involve the receipt of a dividend equivalent. In the event that a taxpayer chooses to hedge by acquiring an equity future, no dividend equivalent will be received.

- The dividend received is not pre-destined or specifically set aside for on-distribution, i.e. there is no automatic flow of funds. The funds are intermingled or pooled at an entity or business unit level and may be applied for many purposes, such as reinvestment or business expenditure. This pool of funds and the use and application thereof is under the control of the entity or business unit. The recipient therefore has control over the use or application of the dividend income.
- It is questionable whether the recipient of the dividend is still free to dispose of the dividend. Should the taxpayer choose to dispose of the equity or the dividend right, such disposal does not absolve the taxpayer from the contractual obligation to make a payment equalling the amount of the dividend.
- The court took into consideration the timing and value of the hedge, i.e. it regarded full and contemporaneous hedging as tainting beneficial ownership status. Banks and brokers are typically hedged, which implies that if a substantial portion of the risk is hedged at the same time the bank is exposed to that risk. It is doubtful that full and simultaneous hedging in a financial environment is an indication of improper use of a treaty or of abusive dividend-stripping schemes. Should this factor be a prerequisite for beneficial ownership, banks and brokers will rarely be considered to be beneficial owners of dividends.
- Banks and brokers typically trade or hedge risk retaining only a small profit margin, which is the reward that accrues to them. The judgement statement that no benefit accrues to the Danish bank is not accurate. In *Velcro Canada v Her Majesty the Queen*, 2012 TCC 57, it was held that the retention of 10% of the royalty payment was sufficient for the recipient to qualify as the beneficial owner.

Other factors to be taken into account include the following:

- Would the court have reached a different conclusion if the mechanics of the equity swap was amended to provide for only one termination settlement cash flow? If yes, such a result would seem obscure, since the same economics are achieved. In other words, in the absence of a cash flow that perfectly matches the amount and timing of any dividend over the tenor of the contract, the holder of the equity shares may retain beneficial

ownership status. Such result seems obscure as the decision on where beneficial ownership resides should be a question of fact.

- Similarly, if the derivative is settled in a different currency as that of the equity, would a different outcome be achieved? In *Velcro Canada v Her Majesty The Queen*, 2012 TCC 57, the assumption of currency risk in relation to royalty payments was deemed sufficient for the recipient to qualify as the beneficial owner.
- With reference to the Commentary to the OECD MTC 2014, the Swiss Swap Case raises the question as to whether beneficial ownership is retained in the event of partial hedging, i.e. whether the owner has to hold the *full* right to use and enjoy the benefit unconstrained. The Commentary merely refers to the right to the unconstrained use and enjoyment of the benefit. Partial hedging, i.e. hedging only a portion of the full exposure or, alternately, hedging only selected categories of risks, is frequently undertaken by banks and brokers. This leaves the question regarding the extent and nature of the risk that must be assumed, unanswered.
- The court applied a substance over form test to determine beneficial ownership. A similar approach is followed by National Treasury, where brokers conclude an equity risk offset against an associated bank's equity derivative positions. However, National Treasury does not apply this approach in securities lending transactions. The borrower assumes no equity risk and on-distributes the economic benefit of the dividend while the borrower remains the beneficial owner of the share. The so-called "economic test" of beneficial ownership is therefore not consistently applied by South African legislators. It is possible that National Treasury preferred the substance over form test in the broker/associated bank hedging strategy as parties were connected, although such context is not expressly stated in the Explanatory Memorandum (National Treasury, 1012:136).

### **3.3.4 Conclusion**

According to Hermann (2015:1), the decision reached by the court in the Swiss Swap Case challenges the generally agreed upon tax principle that there is always a person who is the beneficial owner of the (dividend) income. If the court denies beneficial ownership status to

the shareholder, the recipient of the dividend equivalent amount cannot be the beneficial owner as he does not receive a “dividend”, as defined in Article 10 of the OECD MTC 2014.

The extent to which the court relied on the OECD MTC 2014 and Commentary in reaching its decision is not clear. According to Hermann (2015:3), “the OECD must reconsider the 2014 amendments to the Commentaries on the meaning of beneficial ownership” as the judgment delivered in the Swiss Swap Case “results in an interpretation that is hardly reconcilable with the proper meaning of beneficial ownership” and “implies that nobody is the beneficial owner of the Swiss dividend”.

### **3.5 CONCLUSION**

It is the nature of bank and broker entities to fully hedge exposures (or even trade risk positions) and retain only a profit margin on market-making activities. Such market-making activities are concluded in the ordinary course of business and for commercial purposes. If the Swiss Swap Case sets the precedent for how revenue authorities are likely to interpret beneficial ownership, especially in light of the 2014 update to the Commentary of the MTC, banks and brokers will rarely qualify for treaty benefits under Article 10 of the OECD MTC 2014.

Many categories of risk exist in financial markets, such as market risk, credit risk, interest rate risk, operational risk and currency risk. Case law does not provide sufficient guidance on the level and category of risk to be assumed or transferred to satisfy or fail the beneficial ownership test. Should the courts consider the assumption of meaningful economic risk as one of the main determinants of beneficial ownership, banks and brokers would rarely be considered the beneficial owners of equity shares and of dividend income. A complication also arises when banks and brokers deconstruct an instrument into various risk categories and hedge out only selected categories. This leads to the question: What level and category of risk should be assumed in order for the risk to be considered meaningful?

From the selection of financial transactions, it is not clear when and under what circumstances a substance over form approach should be preferred. From foreign case law and domestic law, one can conclude that there are instances where revenue authorities may



be more likely to succeed in challenging beneficial ownership of equity shares held as a hedge against equity derivatives. These include instances of full and simultaneous hedging or transactions involving related parties. Another factor that may be considered is whether the terms and conditions are comparable to those ordinarily concluded in the market (i.e. governed by market-standard agreements) and whether transactions are over the counter (OTC) or exchange traded. The timing of the derivative conclusion and termination compared to the dividend cycles of equities could indicate whether entities are concluding arrangements for the avoidance of Dividends Withholding Tax, in which case treaty benefits could be denied on the basis that it constitutes treaty abuse. Finally, the substance of the entity holding the equities and the nature and volume of transactions and similar transactions undertaken by that entity in the ordinary course of business could be considered by revenue authorities. However, in the Swiss Swap Case the court disregarded the fact that the Danish bank had a considerable local presence, i.e. 61 employees, and regularly concluded swap agreements with numerous counterparts as part of its normal business.

The OECD is silent on contractual obligations that are calculated *with reference to* income received, i.e. payments that are equivalent to the income that the asset produces or is expected to produce over its lifetime. Payments may be made at regular intervals or at maturity of a contract. Payments may either assume the nature of identifiable cash flows, or can be made as a lump sum upfront or at maturity of the contract. It is uncertain whether a manufactured dividend or dividend equivalent payment will qualify as a constraint on the enjoyment of the dividend income under paragraph 12.4 of the Commentary to the OECD MTC 2014.

As a consequence of the uncertainty of the interpretation and application by revenue authorities with regard to beneficial ownership, the market will factor the maximum domestic Dividends Withholding Tax rate into the price of derivatives and disregard any preferential treaty rate, thereby increasing the cost of concluding derivatives. As an alternative, the treaty rate may be used, but with indemnity clauses whereby the equity holder has recourse to the derivative counterpart in the event of challenge by revenue authorities for specified periods after the termination of contracts. However, since the success of a dividend reclaim can be long outstanding and could even result in litigation or settlement, this may not be practical. The uncertainty that exists with regard to Dividends Withholding Taxes, coupled with the increased cost, is likely to harm bona fide financial transactions where entities rely on a high



volume of transactions as profit margins are thinly spread. Such consequences may be contrary to the objectives of treaties, which are to avoid double tax and encourage international trade.

## **CHAPTER 4**

### **CONCLUSION**

#### **4.1 INTRODUCTION**

The purpose of this study was to investigate the Organisation for Economic Cooperation and Development's (OECD) update of the Model Tax Convention (MTC) and Commentary, and the impact this has had on the interpretation of the term "beneficial ownership" as evidenced by case law, statute and other authoritative guidance. Specifically, the study was guided by two research objectives, namely (1) to identify the determinants of beneficial ownership by way of a literature review; and (2) to determine the practical implications of applying the criteria of beneficial ownership by investigating selected financial transactions. This chapter concludes the study.

#### **4.2 SUMMARY OF RESEARCH OBJECTIVE 1**

By way of legal doctrinal research, this study first reviewed the authoritative literature in order to determine the essential characteristics of beneficial ownership. Literature sources included foreign case law, domestic tax law and international publications and interpretation aids, specifically the OECD MTC 2014 and Commentary. The second part of the study involved the application of these characteristics to a selection of three financial transactions, routinely concluded in the financial industry, in order to determine whether principles were consistently applied and to highlight areas for further consideration by taxpayers and revenue authorities. The outcome of the first phase, comprising the literature review phase, is outlined below.

Only those recipients of dividend income that are beneficial owners of that income qualify for treaty benefits under Article 10 of the OECD MTC 2014. As a result, recipients of income that are not also the beneficial owners of that income will be subjected to the domestic tax

rate of the source state. Beneficial ownership was initially included in the OECD MTC in 1977 as an anti-treaty abuse mechanism to combat simple treaty shopping scenarios involving agents and nominees who receive income on behalf of others. The application was subsequently extended to include conduit companies with such narrow powers that, in substance, they received the income *on behalf of* the beneficial owners. Nevertheless, the term found application in situations of real or perceived treaty abuse which is consistent with the OECD MTC and Commentary in that treaty benefits should not be awarded cases of treaty abuse.

Consistent with Article 3(2) of the OECD MTC, and prior to 2014 update to the Commentary, contracting states relied on their domestic laws for a definition of beneficial ownership. The update to the Commentary, however, clearly states that the term should take on an international meaning, as opposed a narrow domestic meaning, and should be understood in the light of the context and objectives of the treaty. Paragraph 12.4 of the Commentary to the MTC 2014 has defined the term as having the right to use and enjoy the income unconstrained by contractual or legal obligation to pass the payment received to another person and states that a facts-and-circumstances test may be applied to identify the beneficial owner.

Foreign case law has confirmed that subsequent Commentary is likely to be considered by interested parties where it amplifies existing Commentary, as opposed to contradicting it, even in the case of treaties that were in force prior to the amended Commentary. The OECD has confirmed that the changes made in the Commentary with regard to beneficial ownership are merely clarifications and not amendments.

South Africa adopts the OECD MTC and Commentary in negotiating bilateral tax treaties. The OECD is not a law-making body and countries are not bound by the MTC or its Commentary unless and to the extent that it is considered a source of customary international law. Therefore, to the extent that South African courts accept and apply the rules of interpretation of the Vienna Convention (which accepts the use of supplementary means of interpretation such as the OECD MTC and Commentary in interpreting treaties) it becomes customary international law and South African courts are bound by it. As the South African courts have relied on the OECD MTC and Commentary for the interpretation of

treaties, it is a source of customary international law and, unless a reservation is expressed, it is considered binding in South Africa. Furthermore, South Africa is bound by international tax treaties under Section 231 of the Constitution of the Republic of South Africa. Tax treaties are enacted as part of our domestic tax law by virtue of Section 108 of the Income Tax Act, No. 58 of 1962 and rank equally with domestic tax law, except in the event of conflict, in which case the treaty will override domestic tax law.

Foreign case law has distilled the elements of beneficial ownership as (i) possession; (ii) use; (iii) risk; and (iv) control. Such criteria were considered against the requirement of substance, i.e. whether the transaction was artificially arranged with the main objective of obtaining a tax benefit. Foreign case law has established that beneficial ownership can be satisfied irrespective of the existence of a contractual or legal obligation to pass the income received on to another. Only where it can be demonstrated that the recipient is an agent, a nominee or a conduit should the separate corporate existence of the recipient be disregarded and a look-through principle applied. Where a company can exercise some discretion, albeit limited, it is not an agent, a nominee or a conduit company.

Domestic corporate law defines beneficial ownership as the possession of dividend, voting and disposal rights. Tax law defines beneficial ownership only within the context of Dividends Withholding Tax, as the person who is beneficially entitled to the dividend attaching to the share, and refers to the term in the Securities Transfer Tax Act by levying Securities Transfer Tax only on a transfer of a share that results in a change of beneficial ownership. Explanatory Memoranda to the Securities Transfer Tax Act confirm the test for beneficial ownership as economic in nature and clearly distinguishes between legal and beneficial ownership. The legislative amendment history of the Securities Transfer Tax Act provides further clarity as to the extent to which a substance over form approach should be adopted in interpreting the term. In clarifying the reasoning for the amendments to the Section 8(1)(q) broker/member exemption, National Treasury expressed the view that where a broker concluded equity dealings as a risk offset against derivative positions concluded between associated banking entities and third parties, the broker was acting merely as agent on behalf of the bank. National Treasury argued that the bank was the beneficial owner as it was in substance entitled to all equity risk and dividend compensation.

irrespective of the fact that the broker retained all voting and disposal rights attached to the shares.

### **4.3 SUMMARY OF RESEARCH OBJECTIVE 2**

Three financial transactions were selected to test the elements of beneficial ownership, as determined under domestic, foreign and international law. The outcome of this selection is outlined below:

In the Depository Receipt scenario it was concluded that the holder of the American Depository Receipt was the beneficial owner of the dividend income and the equity share as the Depository Banker was purely a nominee, an agent or a conduit in whose name the equity shares were registered on behalf of the beneficial owner, who was the holder of the American Depository Receipt. Such conclusion is consistent with foreign case law and the 2014 OECD MTC and Commentary update in that the Depository Banker had absolutely no discretion as to the use or application of the dividend received or the equity shares that produced the dividend income.

The second transaction was a securities lending transaction. The Securities Transfer Tax Act confirms that a transfer of an equity share under a securities lending transaction results in a change in beneficial ownership. The borrower acquires voting, disposal and dividend rights while the lender retains all equity risk. Under the Securities Transfer Tax Act, the obligation to manufacture an amount equivalent to any dividend declared over the tenor of the loan (coupled with the retention of equity risk) is not sufficient for the lender to remain the beneficial owner of the dividend or the equity share. It is uncertain whether paragraph 12.4 of the Commentary to the OECD MTC 2014 will taint the beneficial ownership status of the share borrower as a result of the contractual obligation to manufacture the benefits across to the share lender. It could be argued that paragraph 12.4 is unlikely to apply as the manufactured dividend is not dependent upon the receipt of the dividend by the borrower – the obligation to compensate the lender for dividends declared exists irrespective of whether the borrower received the dividend. The amount on-distributed by the borrower has changed its nature from a “dividend”, as defined in Article 10 of the MTC, to a dividend-compensating payment. There is no interrelatedness or dependency between the amount received and the

amount paid. Based on the principles established in foreign case law, beneficial ownership should be afforded to share borrowers on the basis of the existence of control over the use and/or application over the income received – there is no automatic flow of funds – coupled with the right to vote, receive dividends and dispose of those equity shares.

This position should be contrasted to the decision reached by the Swiss Revenue Authorities in the Swiss Swap Case, the third transaction investigated. Under the equity swap scenario, the holder of the shares transfers all benefits and risks attached to the equities and the benefit of the dividend to the equity swap counterpart, retaining only disposal rights of the equities and voting rights. Similarly, the obligation to compensate the long position holder under the swap contract exists irrespective of whether the holder of the equity shares received the dividend or held the share. The Swiss courts considered the holding of the risks and benefits attaching to the equity shares sufficient for the holder to be considered the beneficial owner of those equity shares. The judgment delivered in the Swiss Swap Case may have created more ambiguity than clarity as the courts applied a substance over form approach in determining beneficial ownership based on equity risk and dividend entitlements. The Securities Transfer Tax Act favours such an approach in an associated banking/broker relationship using derivatives as a risk offset.

#### **4.4 CONCLUDING REMARKS**

Foreign case law has identified the elements of beneficial ownership as (i) possession; (ii) use; (iii) risk; and (iv) control. Foreign case law is consistent in respect of the original intention of the inclusion of beneficial ownership in the Model Tax Convention by the OECD in that treaty benefits should not be granted to agents, nominees or conduit companies. The confirmation by the OECD that beneficial ownership should adopt an international, as opposed to a domestic meaning, is welcomed. It is, however, uncertain whether the definition of beneficial ownership of paragraph 12.4 of the Commentary to the OECD MTC 2014 has provided the clarity required. For example, it is not clear in what manner and to what extent economic risk and rewards, including dividend entitlements, should be retained or transferred in order to satisfy or fail the beneficial ownership test. It could be argued that an economic substance over form approach should be preferred where the transaction seems artificially arranged mainly in order to avoid or postpone tax. However, when

interpreting and applying the update to the Commentary to the MTC 2014, paragraph 12.4 should be interpreted in a manner that reconciles to, as opposed to contradicts, the principles established in foreign case law.







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