A COMPARATIVE STUDY OF DOUBLE TAX AGREEMENTS BETWEEN SOUTH AFRICA, MAURITIUS AND CHINA

by

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ENGLISH SUMMARY

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Mauritius has, in recent years, become one of the preferred financial centres owing to its business-friendly economy, preferential tax regime, wide tax treaty network and solid infrastructure. The Mauritian economy and people have greatly benefitted from the country's success as a financial centre. One benefit offered by the Mauritian tax regime is the ability and ease with which a person can gain residency to access the preferential tax rates that the country offers. South Africa has recently re-introduced a headquarter tax regime, which will make it a competitor with Mauritius for channelling international trade and foreign direct investment.

Previous research focuses on the elements of international taxation and highlights some of the benefits that a company could enjoy by using Mauritius as an offshore base. One of the key elements of a successful headquarter company regime is that of a wide tax treaty network which offers preferential terms for taxing certain income classes.

The aim of this study is to provide a theoretical construct for the comparison of double tax agreements, with the goal of identifying those that provide preferential terms for the taxation of certain income classes and the elimination of double taxation. This study focuses on the double tax agreements between South Africa, Mauritius and China, highlighting some of the deficiencies of the South African agreement with China and

comparing those with Mauritius's agreement with China. These deficiencies and the preferential tax regime that Mauritius offers will inevitably provide multi-national companies with tax saving opportunities if they use Mauritius as an offshore base. This study will point out some of the areas where possible tax saving opportunities could be identified.

The study further aims to provide a platform from which the South African headquarter company regime can be assessed and analysed. This is specifically important if South Africa is to compete with Mauritius.

Keywords:
Double tax agreements
International headquarter company
Tax saving opportunities
Preferential tax regime

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AFRIKAANSE OPSOMMING

’N VERGELYKENDE STUDIE VAN DIE DUBBELBELASTINGOOREENKOMSTE TUSSEN SUID-AFRIKA, MAURITIUS EN SJINA

deur

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STUDIE LEIER: ME. H DU PREEZ

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Mauritius het in onlangse jare een van die gekose finansiële sentrums geword as gevolg van hul besigheidsvriendelike houding, voordelige belasting regime, hul wye netwerk van dubbelbelastingooreenkomste en gevestigde infrastruktuur. Die ekonomie van Mauritius en Mauritius se bevolking het baie voordeel getrek uit die sukses van Mauritius se finansiële dienste sektor. Een van die voordele wat Mauritius se belasting regime bied is die gemaklikheid waarmee inwonerstatus bekom kan word en ‘n persoon toegang tot Mauritius se voordelige belastingkoerse kan kry. Suid-Afrika het soortgelyks verlede jaar ‘n internasionale hoofkantoor regime bekendgestel wat Suid-Afrika dus ‘n mededinger met Mauritius gaan maak ten opsigte van die kanalisering van internasionale fondse en buitelandse belegging.

Vorige navorsing fokus op die beginsels van internasionale belasting en identifiseer voordele wat maatskappye kan geniet indien hulle van Mauritius gebruik maak as hul buitelandse basis. Een van die belagrike elemente van ‘n suksesvolle hoofkantoor maatskappy regime is dat die regime ‘n wye netwerk van dubbelbelastingooreenkomste bied en dat die dubbelbelastingooreenkomste voordelige terme vir die belasting van sekere inkomste klasse bied.

Hierdie studie se doelwit is om ‘n teoretiese platform te vestig vir die vergelyking van dubbelbelastingooreenkomste met die oog om dubbelbelastingooreenkomste te

identifiseer wat voordelige terme bied vir die belasting van sekere inkomste klasse en die eliminering van dubbele belasting. Hierdie studie fokus op die dubbelbelastingooreenkomste tussen Suid-Afrika, Mauritius en Sjina in 'n poging om sekere van die tekortkominge van die dubbelbelastingooreenkoms tussen Suid-Afrika en Sjina uit te wys wanneer dit met die dubbelbelastingooreenkoms tussen Mauritius en Sjina vergelyk word. Hierdie tekortkominge en die voordelige belasting regime wat Mauritius bied sal multi-nasionale maatskappye die geleentheid bied om belastingvoordele te ontgin indien hulle van Mauritius gebruik maak as 'n buitelandse basis. Hierdie studie sal van die areas identifiseer waar 'n maatskappy moontlik belasting kan bespaar.

Die studie poog ook om 'n platform te bewerkstellig vir die analise en evalueering van die Suid-Afrikaanse hoofkantoor regime. Hierdie analise en evalueering is spesifiek belangrik indien Suid-Afrika met Mauritius wil meeding.

Sleutelwoorde:
Dubbelbelastingooreenkomste
Internasionale hoofkantoor maatskappy
Geleenthede vir belastingbesparing
Voorkeur belasting regime

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1 CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

Chinese economic growth and expansion is currently a hot topic in social and economic discussions. In 2009 South Africa imported goods and services to the value of R70.8 billion from China, and exported goods and services to the value of R48.7 billion to China. China as a trading partner of South Africa is ranked first for both imports and exports, comprising 15.2% of South African imports and 10.6% of South African exports (Department of Trade and Industry, 2010:1).

Despite the magnitude and importance of the trade relationship between South Africa and China (as evidenced by the trade data), the current double tax agreement (hereinafter referred to as a "DTA") entered into on 7 January 2001 is not comprehensive. It applies only to South African normal tax and secondary tax on companies (hereinafter referred to as a "STC") and Chinese individual income tax and income tax for enterprises with foreign investment and foreign enterprises (South African Revenue Service, 2001:2). In contrast, the DTA between Mauritius and China, entered into on 1 August 1994, applies to taxes on Chinese local income tax in addition to the Chinese taxes dealt with in the DTA between South Africa and China (Mauritius Revenue Authority, 1996:2). Furthermore, the DTA between Mauritius and China applies also to capital gains tax (Mauritius Revenue Authority, 1994:2).

The Mauritian economy is one of substance and transparency. Mauritius has a wide network of DTAs, a lack of exchange controls and preferential tax rates. The country has been criticised in economic and investment forums for portraying characteristics associated with tax havens. However, Mauritius is not classified as a tax haven by the Organisation of Economic Co-Operation and Development (hereinafter referred to as an "OECD") and is a member of the OECD's "white list" of countries. This is largely because of Mauritius implementing internationally-agreed tax standards, participating in various OECD initiatives to eliminate harmful tax practices and adopting the model exchange of information agreement issued by the OECD in 2002 (Gowrea, 2009:1).

Previous research has indicated that Mauritius is fast becoming the offshore base for multi-nationals operating in South Africa, and that certain tax advantages can be gained on, for instance, royalty and interest payments (Honiball, 2009:1). However, this research is limited and focuses on tax opportunities offered by Mauritius as an offshore base. Lawless and Murray (2008:1), on the other hand, identified the Irish holding company regime as a gateway for investment into China owing to the tax advantages it offers. In both cases, the research conducted focuses only on tax advantages that arise owing to the preferential tax regimes of the respective countries. A critical comparison and analysis of the DTAs was never performed. Furthermore, a comprehensive search of the UPetd database and relevant EBSCO HOST databases has revealed that a comparison of DTAs has never been carried out.

1.2 PROBLEM STATEMENT

A critical analysis and subsequent comparison of DTAs has never been carried out. Previous research conducted focused on tax opportunities arising from the use of Mauritius as an offshore base (Honiball, 2009:1) and was not comprehensive. In addition, the research did not highlight the deficiencies in the current DTA between South Africa and China when compared with the DTA between Mauritius and China. Furthermore, this illustration is critical in determining whether the South Africa headquarter regime is in a position to compete against the Mauritian tax regime.

1.3 PURPOSE STATEMENT

The main purpose of the study is to critically analyse the DTAs between South Africa, Mauritius and China and compare the results in order to illustrate the deficiencies that exist in the DTA between South Africa and China when compared with the DTA between China and Mauritius.

1.4 RESEARCH OBJECTIVES

- To critically analyse the DTAs between:

  - o South Africa and Mauritius;
  - o South Africa and China; and
  - o China and Mauritius;

  and to establish the theoretical construct for this and further study.

- To critically compare the DTAs between South Africa, Mauritius and China in order to provide a platform from which conclusions can be reached regarding possible tax advantages which can be gained by using the theoretical construct as underpin.

1.5 IMPORTANCE AND BENEFITS OF THE STUDY

A critical comparison of the DTAs between South Africa, Mauritius and China will be of great value from both the academic and business points of view. The proposed study will extend previous research conducted by providing a platform from which possible tax saving opportunities could be identified for trade between South Africa, Mauritius and China. It will also provide a platform for further research into DTAs by providing a methodology for comparing and analysing any three DTAs.

From a practical point of view, the study aims to identify areas where possible tax saving opportunities could exist for South African companies actively trading with Chinese counterparts, by virtue of the theoretical construct as underpin. Furthermore, the study will provide a platform from which the South African headquarter company regime could be analysed and assessed.

Lastly, the proposed study will be of academic and practical relevance, as it will provide the South African tax authorities with a base on which to assess the need to review and renegotiate the current DTA with China.

This study is comprised of six chapters. Chapter 1 provides background information and establishes the research objectives. Chapter 2 provides a review of relevant literature and will give an overview of international taxation principles applicable to cross-border trade. Chapter 3 provides a critical analysis of the Model Tax Convention and the DTAs between South Africa, Mauritius and China. Chapter 4 provides a comparison of the DTAs between South Africa, Mauritius and China, conclusions reached based on the comparison and tax planning opportunities identified. Chapter 5 provides an overall conclusion. Lastly, a discussion of the research approach is included in the Chapter 6.

1.6 DELIMITATIONS

The study will focus specifically on a comparison of the following DTAs:

- The DTA between South Africa and Mauritius;
- The DTA between South Africa and China; and
- The DTA between China and Mauritius.

The study will focus specifically on the following Articles contained in the DTAs listed above:

- Article 2 – Taxes covered;
- Article 10 – Dividends;
- Article 11 – Interest;
- Article 12 – Royalties;
- Article 13 – Capital gains;
- Article 23A – Exemption method; and
- Article 23 B – Credit method.

1.7 ASSUMPTIONS

Leedy and Ormond (2005:5) define an assumption as “a condition that is taken for granted”. The proposed study is based on the following assumptions:

- The DTAs that form part of the study will not change materially in the near future on account of renegotiation between Contracting States.
- There are no material differences of interpretation between the Chinese version and the English version of the Income Tax Act of the People’s Republic of China.

1.8 DEFINITION OF KEY TERMS

The main terms used in this study are defined in this section.

Beneficial owner: The term beneficial owner is used in the common sense of the word and refers to the actual person who benefits from the ownership of a specific receipt, for instance, dividends. The definition requires a look-through approach in situations where conduit companies act as intermediaries to the receipt (IBFD, 2011).

Controlled Foreign Company: Section 9D(1) of the South African Income Tax Act (58/1962) (hereinafter referred to as the South African Income Tax Act) defines a controlled foreign company as a company situated in a foreign country where 50% of the total participation rights of that company are held, directly or indirectly, by a resident of South Africa.

Hybrid financial instruments: A hybrid financial instrument is defined as an instrument which has characteristics of both equity instruments and debt instruments (Honiball & Olivier, 2008:576).

Intermediary holding company: A company incorporated in a foreign country that holds the controlling shares in one or more companies situated outside that foreign country so that they form part of the same group of companies (Honiball & Olivier, 2008:297).

Risk rating: Risk ratings or credit ratings are provided by organizations such as Standard & Poor's, Moody's or Fitch Ratings and express these organization's opinion about the ability and willingness of a corporation, state or government to meet its financial obligations in full and on time (Standard and Poor's, 2011a:1).

Treaty shopping: Treaty shopping is a problem identified by the OECD whereby a company or other tax person gains access to the benefits of a Contracting State without being a resident of that Contracting State (Honiball & Olivier, 2008:581).

White listed by the OECD: A country which is part of the OECD's white-listed countries and as such has instituted measures to eliminate harmful tax practices.

Table 1: Abbreviations used in this document

Abbreviation	Meaning
CFC	Controlled Foreign Company
DTA	Double Tax Agreement
MTC	Model Tax Convention
OECD	Organisation for Economic Co-Operation and Development
SARS	South African Revenue Services
STC	Secondary Tax on Companies
SARB	South African Reserve Bank

2 CHAPTER 2: LITERATURE REVIEW

2.1 INTRODUCTION

A critical analysis and subsequent comparison of DTAs are not explicitly available in academic literature. This study will focus on analysing and comparing the DTAs entered into between China and Mauritius, South Africa and Mauritius and South Africa and China. In performing a study of this nature, a thorough understanding of international tax principles is essential. The purpose of this chapter is twofold:

- to provide the reader with an overview of the principles that form the cornerstones of international tax. This will provide a conceptual framework within which the study will be conducted;
- to present the reader with an integrated overview of previous research conducted in order to establish the basis for this study.

The agreements entered into between the aforementioned countries are based on the OECD's Model Tax Convention with respect to income and capital, or the model tax agreement, as it is more commonly referred to. As part of the publication of the model tax agreement, the OECD provides commentary on each article detailed in the agreement. The commentary provides interpretation and implementation guidelines for the Model Tax Convention and is crucial to obtaining a thorough understanding of the underlying principles contained in the Model Tax Convention (OECD, 2008:7). The proposed literature review will incorporate (where applicable and relevant to purposes of the study) the commentary and non-members' positions on the Model Tax Convention, as published by the OECD.

Tax opportunities arise from a combination of factors. A thorough understanding of the principles that form the cornerstones of international tax is a prerequisite to identifying tax opportunities arising from the use of offshore bases.

In the sections that follow, the principles of international tax required for a full understanding of the study will be discussed in more detail. The principles to be discussed are the intermediary holding company (hereinafter referred to as an "IHC") and its role in international tax planning, tax relief measures, limiting factors and withholding taxes. In addition, previous research conducted on the subject matter will be reviewed and the application of the previous research and underlying principles on the countries covered by this study will be provided.

2.2 THE ORGANISATION OF ECONOMIC CO-OPERATION AND DEVELOPMENT

In order to critically analyse and compare the DTAs of South Africa, Mauritius and China, it is necessary to understand the role of the OECD and the principles on which the Model Tax Treaty is based.

> "The OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalisation. The OECD is at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies" (OECD, 2008:2).

The OECD publishes the Model Tax Convention with respect to taxes on income and capital, in an effort to standardise and clarify a common solution for its members and their taxpayers who are involved in trading activities in other countries. Furthermore, the convention provides a common means of settling problems arising as a result of juridical double taxation (OECD, 2008:7). Furthermore, the OECD strives to eliminate harmful tax practices, and promote transparency and the exchange of information.

The conventions contained in the Model Tax Convention in respect of taxes on income and capital are agreed upon by member countries. Member countries are expected to conform to the conventions and the interpretation of the conventions, as detailed in the commentary provided by the OECD (OECD, 2008:7). Although it is compulsory for member countries to conform to the conventions, non-member countries are also encouraged to adopt them. South Africa, Mauritius and China are not members of the OECD, but they enter into DTAs based on the provisions of the Model Tax Convention and its interpretation contained in the commentary.

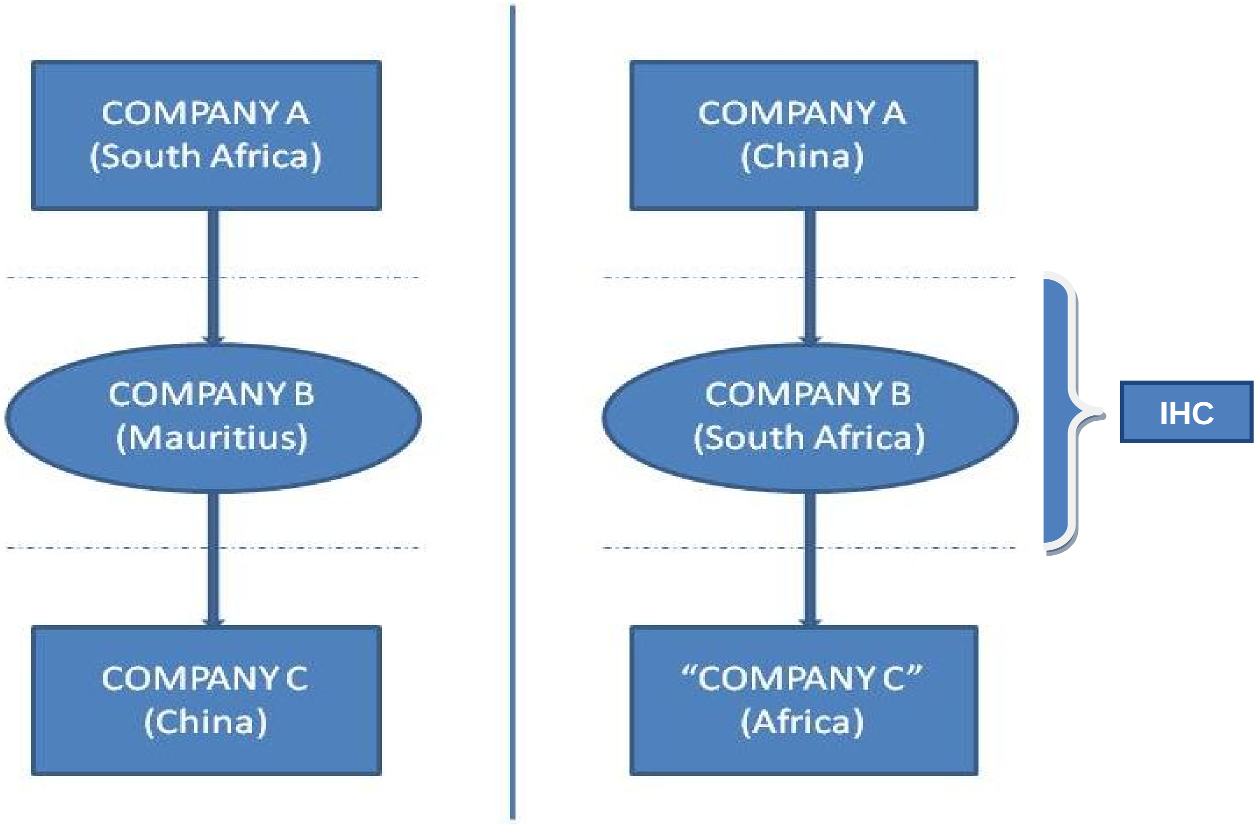
Although Mauritius is commonly seen as a tax haven, owing to its low tax status, it is white-listed by the OECD, as it has substantially adopted the international tax standards issued by the OECD, and has taken an active role in OECD initiatives, adopting the model of exchange of information issued by the OECD in 2002 (Gowrea, 2009:1).

2.3 THE INTERMEDIARY HOLDING COMPANY

An IHC is generally used to acquire, manage or sell investments in domestic or foreign companies (Honiball & Olivier, 2008:297). In practice, the IHC is often situated in a tax haven or low tax jurisdiction, as this provides multinational groups of companies with potential tax saving opportunities. In fact, some countries have developed holding company regimes specifically aimed at attracting foreign investors and investment flows. One such example is Ireland. Ireland received approval for its holding company regime from the European Union in 2004. The introduction of the holding company regime coupled with the introduction of a capital gains tax participation exemption and favourable amendments to foreign dividend repatriation legislation has contributed significantly to making Ireland the jurisdiction of choice for companies wishing to use intermediary holding companies (Lawless & Murray, 2008:1).

Figure 1 below provides two examples of group company structures that are often used by multinational group companies in order to take advantage of favourable IHC regimes. The first structure illustrates an investment in China by using Mauritius as an offshore base. The second structure illustrates an investment in Africa by using South Africa as an offshore base.

Figure 1: Examples of intermediary holding company structures



There are various business reasons for establishing a holding company. The business reasons for establishing a holding company will equally apply to an IHC despite the fact that the primary functions of an IHC are more limited and focused. Holding companies provide a means to centralise the ownership of a group of companies in a specific region or jurisdiction. Furthermore, a group of companies can expect efficiencies, and therefore cost savings, by centralising its business functions, shared services, financing and management functions in a holding company (Legwaila, 2010:25).

Legwaila (2010:56) identifies several primary functions of an IHC. These functions include, inter alia, the managing and selling of investments and the provision of transactional and operational flexibility. In addition, Honiball and Olivier (2008:298) identify several reasons for establishing an IHC. These reasons are classified as either non-tax or tax reasons and are discussed in more detail below.

2.3.1 Non-tax reasons for establishing an IHC

Usually, the real economic benefits of an IHC are non-tax in nature (Rohatgi, 2002:238).

2.3.1.1 *Exchange controls*

Exchange controls are regulations which have been implemented by a country to monitor, permit and restrict the movement of financial assets and financial liabilities into and out of that country (Rohatgi, 2002:432). Exchange controls (or the lack thereof) provide residents with a means to repatriate foreign currency back to their home country and as such prevent its retention offshore (Legwaila, 2010:12-13).

When an investor is situated in a country that imposes exchange controls, for instance South Africa, it is often beneficial for the investor to establish an IHC outside the exchange control area. This prevents a situation of forced repatriation of profits or profit trapping within the exchange control area (Honiball & Olivier, 2008:298).

Currently, South Africa imposes exchange control restrictions on South African residents (both individuals and companies). The following exchange controls are applicable to South African residents:

- Natural persons over the age of 18 years who are tax payers in good standing are allowed to invest R4million abroad.
- Companies may invest up to R500million per calendar year in a direct foreign investment in a subsidiary or branch subject to approval from an Authorised Dealer. Certain criteria should be met before approval can be granted. For instance, the company must obtain at least 10% of the voting rights and the expansion must be in the same line of business of the company's South African operations.
- Institutional investors, for instance, retirement funds or long-term insurers, are allowed to invest a certain percentage of their retail assets under management abroad (Snyckers, 2010:1).

However, recent trends suggest that South Africa is gradually reducing the restrictions imposed on South African residents as part of the process of global reintegration. In the

Mid-Term Budget Speech of 2009 and the Budget Speech of 2010 the South African government introduced significant exchange control relaxation measures. These relaxation measures are specifically aimed at South African banks and South African private equity funds as part of the South African government's broader strategy for becoming the jurisdiction of choice for investment in Africa (Snykers, 2010:1).

From 1 March 2010, South African banks have been allowed to acquire direct and indirect foreign exposure up to 25% of total liabilities in terms of Exchange Control Circular 6/2010. South African private equity funds are allowed to invest in Africa subject to obtaining approval from the Reserve Bank (Snykers, 2010:1). These exchange control relaxation measures will contribute greatly to increasing South Africa's competitiveness in becoming the gateway to Africa.

2.3.1.2 *Raising external finance*

Companies have various forms of financing available, for instance, debentures, bonds, initial public offerings, issue of preference shares, loans, working capital facilities and mortgages. These financing options are categorised as either debt or equity financing.

An investor can use an IHC to obtain a preferential financing rate for its investments. An IHC could potentially secure financing at a preferential rate owing to:

- the reduced country risk of the country in which the IHC is situated; or
- the strength of the IHC's balance sheet, owing to the consolidation of the assets of subsidiary companies (Honiball & Olivier, 2008:298).

The Standard and Poor's country risk ratings for the countries that form part of this study are as follows:

- South Africa – BBB+ (Standard and Poor's, 2011b)
- Mauritius – BB (Standard and Poor's, 2011b)
- China – AA- (Standard and Poor's, 2011b)

China has the best country rating, followed by South Africa and then Mauritius.

2.3.1.3 *Structural consolidation and group reorganisation*

Reorganisation refers to transactions where the legal or economic structure of a company or a group of companies is changed. These transactions typically include mergers, acquisitions, consolidations and recapitalisations (Legwaila, 2010:53). Income tax systems treat reorganisations as taxable when the transferor company is dissolved subsequent to the reorganisation (Vanistendael, in Legwaila, 2010:54).

Intermediary holding companies are located in jurisdictions where reorganisation attracts the least regulatory and tax consequences (Legwaila, 20110:54).

Furthermore, an IHC may be used for purposes of centralising the legal control for a geographical region or consolidating investments under one legal entity (Honiball & Olivier, 2008:299).

2.3.1.4 *Asset protection*

An asset is defined by Paragraph 1 of the Eighth Schedule of the South African Income Tax Act as movable, immovable, corporeal or incorporeal property and excludes currency and coins. Assets are generally income producing in nature and it is therefore critical that assets are protected and kept safe. Common threats to assets are expropriation and the high cost of complying with business regulations (Legwaila, 2010:52-53).

An IHC could be used to reduce the risk of expropriation of assets in an investment country with high political risk (Honiball & Olivier, 2008:299). Tax havens also become attractive for asset protection purposes owing to the availability of corporate forms not available in the investor country and the tax haven's reputation for confidentiality and dependability (Honiball & Olivier, 2008:554). Furthermore, the use of offshore trusts further provides asset protection by breaking the chain of legal ownership between the investment and investor (Honiball & Olivier, 2008:556).

2.3.2 Tax reasons for establishing an IHC

There are various tax reasons for establishing an IHC. In general, intermediary holding companies are established in low tax jurisdictions in order to benefit from the lower tax rates available in these jurisdictions. A multinational group of companies would, for instance, use an IHC as part of its tax planning strategy, as it could derive both non-tax and tax benefits from doing so.

2.3.2.1 *Reducing withholding taxes*

Withholding tax refers to a tax deduction in the source country from the income of non-resident recipients and is an anti-tax avoidance measure. Another form of withholding tax is the deduction that employers make from their employees' salaries which is paid to the relevant tax authority (Worldwide Tax, 2011b). The latter form of withholding tax will not be dealt with in this study.

A country with a wide tax treaty network could potentially have negotiated more favourable withholding tax rates than the investor country (Honiball & Olivier, 2008:301). Withholding taxes are often levied on dividends, interest, royalties and capital gains. Although relief is often available in the form of a tax credit for the withholding tax paid (if granted by the domestic tax laws and if the withholding tax leads to double taxation) an investor could nevertheless obtain benefits from the lower withholding tax rate as a result of:

- an improvement in the investor's cash flow owing to no payment of withholding taxes or payment of withholding taxes at a lower rate; and
- the investor could potentially save a significant amount of interest by retaining the benefit of the money saved as a result of the lower withholding tax paid.

For example, Company A establishes an IHC in Country B in order to invest in Country C. The withholding tax rate applicable to dividends and available to Country A for investments made in Country C is 10%. The withholding tax rate applicable to dividends and available to Country B for investments made in Country C is 5%. If Company C pays a dividend of R100 million, then the withholding tax withheld when payment is made to Company A is R10 million and the withholding tax withheld when payment is made to Company B is

R5 million. Suppose Company A (either directly or indirectly) were entitled to a tax credit for withholding taxes paid in both scenarios. From the perspective of cash flow, Company A's cash flow situation would be improved by R5 million owing to the use of Company B, the IHC. Company A would also derive benefit from obtaining the additional R5 million owing to the time value of money.

2.3.2.2 *Deferring capital gains tax*

Capital gains arise on the disposal of capital assets. A distinction is made between assets that are capital in nature and assets that are income in nature. This distinction is based on the taxpayer's intention with the asset. From a tax perspective, capital gains are in general treated more favourably than revenue (Ault in Legwaila, 2010:61).

An IHC could be used to reduce the capital gains tax arising from the disposal or deemed disposal of investments or from deferring the capital gains tax until a future date. Some jurisdictions, such as the Netherlands, Mauritius and Switzerland, levy minimal or no capital gains tax. In other cases, the use of an IHC could result in the deferral of capital gains tax which would have arisen in the investor country if the investment had been made directly (Honiball & Olivier, 2008:302).

For instance, a number of tax treaties entered into with India provides for the favourable treatment of capital gains. The Indian treaties with Mauritius, Cyprus, Singapore and Netherlands contains a favourable capital gains tax clause and these jurisdictions are preferred for routing investments into India (Faith, 2008:1). This supports the findings made by Honiball and Olivier (2008:302).

2.3.2.3 *Deferring tax on operating income*

No distinction is made between revenue income or operating income for tax purposes. Operating income comprises income or receipts from business activities or from the utilisation of capital assets (Legwaila, 2010:59).

An IHC could be used to accumulate dividends and other income in order to reinvest the income, thereby deferring the tax that would have arisen in the investor country. This is referred to as a dividend trap. However, in many jurisdictions Controlled Foreign Company (hereinafter referred to as a "CFC") legislation has been instituted in order to prevent the abuse of these types of tax deferral (Honiball & Olivier, 2008:302).

CFC legislation entails the taxation of the profits of a CFC in the hands of the resident holding company as if the profits had been earned by the resident holding company. CFC legislation is typically used as an anti-avoidance measure (Legwaila, 2010:60) and its practical application as such a measure is clearly illustrated in this discussion. Should a South African holding company establish an IHC in a foreign jurisdiction, a portion of the IHC's profits would be taxed in South Africa by including the profits in the South African holding company's taxable income.

2.3.2.4 *Optimising tax credits*

The foreign tax credit is intended to reduce the double tax burden that is imposed on income arising in a foreign source which is subject to tax in both the resident country and the foreign country (Taxalmanac, 2007).

The credit method is one tax relief method generally granted by virtue of jurisdictions' domestic tax laws. The credit method provides for the deduction of a rebate from the tax liability, equal to the amount of foreign taxes paid by the resident (Honiball & Olivier, 2008:320). Section 6*quat* of the South African Income Tax Act provides that the rebate can be claimed only up to the amount of the tax payable. A refund of foreign taxes paid in excess of local taxes paid is therefore not possible.

An IHC could possibly be used to reduce or eliminate wasted tax credits by pooling the tax credits (being from either a high tax or low tax jurisdiction). In effect, foreign income is pooled in a foreign jurisdiction where this is allowed, and pooled for purposes of foreign tax credits granted by the domestic tax laws (Honiball & Olivier, 2008:302).

2.3.2.5 *Foreign exchange gains or losses*

Foreign exchange gains or losses are used in the broad sense of the definition. South African domestic tax laws provide for a definition of exchange differences which equally applies and are interchangeable with foreign exchange gains or losses. Section 24I of the South African Income Tax Act defines an exchange difference as a foreign exchange gain or loss that arises as a result of the movement in the value of foreign exchange currency due to a movement in foreign exchange rates.

Some countries or jurisdictions impose tax on foreign currency gains and allow a deduction from tax on foreign currency losses. Other countries or jurisdictions do not impose tax on foreign currency gains but do not allow a deduction from tax on foreign currency losses. Another option is the taxation of foreign exchange gains but the disallowance of foreign exchange losses as a deduction. The latter option is however not popular with jurisdictions (Legwaila, 2010:75).

Tax benefits can be obtained or negative tax consequences reduced as a result of the tax rules applicable to foreign exchange gains or losses by using an IHC. This would be subject to the domestic tax laws of the country in which the IHC is located (Honiball & Olivier, 2008:303).

2.3.2.6 *Re-characterisation of income*

Re-characterisation of income refers to those scenarios where the same income is treated differently by different jurisdictions. The first scenario refers to instances where the same income arising in a specific jurisdiction is treated differently by other jurisdictions. The second scenario refers to instances where income arises in one jurisdiction, are received by a resident of another jurisdiction but the income is treated differently in the two jurisdictions (Legwaila, 2010:76).

Where hybrid financial instruments are used for making investments, the use of an IHC could result in a re-characterisation of, for instance, interest as dividends or vice versa. This would be beneficial to the investor company as certain income streams could be exemption from tax. The re-characterisation of income by domestic tax laws could result in the investor company earning exempt income rather than taxable income (Honiball & Olivier, 2008:303).

The most common hybrid financial instrument is redeemable preference shares, whereby the substance of the transaction takes on the form of a loan rather than that of a share. It should, however, be noted that, with the introduction and adoption of International Accounting Statements by countries worldwide, the definition and recognition criteria for hybrid financial instruments have, to a great extent, been standardised. It is therefore improbable that domestic tax laws would differ significantly in the characterisation of income.

2.4 TAX RELIEF MEASURES

Tax can be levied on either a source basis or a residence basis. The domestic tax laws of a country determine which basis is used for taxation purposes, and in practice a country can apply both the income based source and the residence basis. The source basis refers to the taxation on the location (i.e. source) giving rise to that income. The residence basis refers to the taxation of income based on the residence status of the person generating the income (Honiball & Olivier, 2008:50).

The justification for the taxation on a source basis is that taxpayers (both residents and non-residents) each have a share in the running costs of a country and are thus responsible for things like the cost of infrastructure and maintenance, which are used for income-producing activities (Honiball & Olivier, 2008:52). The justification for taxation on a residence basis is that residents enjoy the protection of their country and should therefore contribute to the costs of running and maintaining that country (Honiball & Olivier, 2008:60).

Section 1 of the South African Income Tax Act stipulates that South African residents are taxed on their global income, irrespective of the source of the income, so the residence basis is followed. If, therefore, a South African resident earned rental income from a property situated in Mauritius, the resident would be liable for South African tax on the rental income. In South Africa, non-residents are taxed on any income-producing activity located within the South African territory which gives rise to income. Therefore, if a Mauritian resident earned rental income from a property situated in South Africa, the Mauritian resident would be liable for South African tax on the rental income.

Section 5 of the Mauritius Income Tax Act (1995) (hereinafter referred to as the Mauritian Income Tax Act) provides for a jurisdictional treatment similar to that in South Africa. Residents are therefore taxed on all income earned, whether in Mauritius or elsewhere, and any person deriving income from Mauritius is taxed on that income.

Finally, Article 2 of the China Income Tax Act (2009) (hereinafter referred to as the Chinese Income Tax Act) also provides for the taxation of all income derived from sources within the Chinese territory, irrespective of the residence of the person deriving such income. Income derived by non-residents is, however, treated slightly differently than it would be in South Africa and Mauritius. Article 2 of the Chinese Income Tax Act stipulates that tax on income earned from Chinese sources by a non-resident will be withheld and the taxes paid to the respective sources.

Double taxation can arise as a result of three types of conflict:

- Source versus source conflicts;
- Residence versus residence conflicts; or
- Residence versus source conflicts (Honiball & Olivier, 2008:315).

Rental income earned by a Mauritian resident from a South African source illustrates a typical source versus residence conflict. In this example, the rental income earned by the Mauritian resident would be taxed in South Africa, as the rental income was earned from a source within the South African territory. However, the Mauritian Revenue Authority could also tax the rental income, as the Mauritian Income Tax Act allows for the taxation of income earned by residents, irrespective of where the income was generated. The same income is therefore subject to taxation in both South Africa and Mauritius, thus leading to double taxation.

Relief from double taxation can be obtained:

- unilaterally by virtue of the domestic tax laws; or
- bilaterally by virtue of tax treaty law (Honiball & Olivier, 2008:315).

The tax relief measures available when double taxation arises will be discussed in more detail in the sections that follow.

2.4.1 Unilateral tax relief measures

Domestic tax laws can provide relief from double taxation by means of three methods. These methods are:

- The exemption method;
- The credit method;
- The deduction method (Honiball & Olivier, 2008:315).

Each of these relief measures will be discussed in more detail below as it applies in the South African context.

2.4.1.1 *The exemption method*

Section 10 of the South African Income Tax Act contains the majority of the tax exemptions available to South African residents, and it applies to income earned locally or in a foreign country.

In essence, the exemption method provides for the exemption of certain types of income from inclusion in a person's taxable income. One example of an available exemption is the exemption of foreign dividends. Section 10(1)(k) of the South African Income Tax Act provides for the exemption of foreign dividends under certain circumstances. For instance, dividends that relate to a dividend declaration by a foreign-listed company is exempt by virtue of Section 10(1)(k)(ii)(bb) of the South African Income Tax Act if South African residents collectively hold more than 10% of the equity share capital of the listed company at time of declaration.

It is interesting to note that the exemption method would not succeed in providing relief if withholding tax was deducted from the foreign dividends by the source country.

It should further be noted that when income is exempt then the expenditure incurred to produce that income will not be deductable from the resident's taxable income (Legwaila, 2010:66).

2.4.1.2 *The credit method*

The credit method is the most popular form of unilateral tax relief as it is the most effective and practical method of avoiding double taxation. This stems from the fact that the taxpayer's tax will be limited to the higher of the tax of either the source or resident country (Legwaila, 2010:68).

Section 6*quat* of the South African Income Tax Act provides for a rebate of foreign taxes paid. The rebate is available to residents only and applies to the following categories of income:

- Any income (excluding dividend income) received by or accrued to a resident from a foreign source;
- Any proportional amount as calculated under the CFC rules;
- Any foreign dividend;
- Any capital gain received by or accrued to a resident from a foreign source;
- Any amount deemed to be received by or accrued to a resident in terms of the tax-back provisions of Section 7 of the South African Income Tax Act or capital gain tax-back provisions in terms of the Eighth Schedule; and
- Any capital of a trust which is included in a resident's income (Honiball & Olivier, 2008:320-321).

SARS' Interpretation Note 18 provides a calculation for the purposes of calculating the maximum amount of foreign taxes which can be deducted as a rebate. In practice, the Section 6*quat* rebate is therefore limited to the proportion that foreign income bears to total income as applied to the total normal tax payable (Honiball & Olivier, 2008:323). For example, if Company A earns R10 foreign income, R90 local income and normal tax payable is determined as R30, the maximum amount that may be deducted as a rebate is equal to R3. This is the proportion of normal tax that relates to foreign income.

It is interesting to note that the credit method would certainly succeed in providing relief if withholding tax was deducted from dividends by the source country. In this case, a rebate could be claimed by the South African resident for foreign taxes paid on foreign dividends in terms of Section 6*quat*.

Article 3 of the Chinese Income Tax Act provides for a similar rebate mechanism where a profit-seeking enterprise would be able to deduct the amount of foreign taxes paid from its taxation payable, on condition that certain administrative requirements were met.

Section 77(1) of the Mauritian Income Tax Act also provides for a credit against income tax payable in Mauritius, with income subject to foreign taxes. Section 77(2) of the Mauritian Income Tax Act further provides that in the case of a dividend the credit for foreign taxes should include a credit for foreign taxes paid, which relates to the profit from which the dividend was paid, if applicable.

2.4.1.3 ***The deduction method***

The deduction method is available according to South African domestic law via the application of Section 11C of the South African Income Tax Act, which provides for the specific deduction of foreign taxes. There are several important differences between the Section 11C deduction and the Section 6*quat* rebate. These differences are:

- The rebate available in terms of Section 6*quat* is limited by the availability of domestic tax charges, against which the rebate can be offset. A tax refund can therefore not be created by virtue of the rebate. This often leads to wasted credits, even though the unused Section 6*quat* rebates can be carried forward for seven years. Section 11C contains a similar ring-fencing provision. The ring-fencing is, however, applicable only to foreign dividends;
- The Section 6*quat* rebate can be claimed only by residents, whereas Section 11C does not contain any similar restriction;

- The Section 6*quat* rebate can be claimed only if nobody else has the right to claim back the taxes payable. Section 11C does not contain any similar restriction;
- The Section 6*quat* rebate cannot be claimed if relief is granted by virtue of a DTA. Section 11C does not contain a similar restriction. However, it is unlikely that a Section 11C deduction would be available when relief was granted by a DTA, as Section 11C requires foreign taxes to be proved payable (Honiball & Olivier, 2008:325-326).

2.4.2 Bilateral tax relief measures

Bilateral tax relief measures refer to tax relief measures granted by DTAs. It follows that two Contracting States should have entered into a DTA before the relief measures were available to residents of the Contracting States. The OECD Model Tax Convention (hereinafter referred to as a "MTC") provides for the following relief methods:

- Exemption method per Article 23A
- Credit method per Article 23B (Honiball & Olivier, 2008:328).

These two bilateral relief measures will now be discussed in more detail with reference to both the rule contained in the Articles and the commentary on the Articles.

2.4.2.1 *Article 23A exemption method*

The exemption method provides that foreign income should be exempt from tax by the local Contracting State. This article does not apply to dividends or interest. Furthermore, the Contracting State is under no obligation to grant an exemption from tax if the foreign Contracting State used the treaty to exempt the person from foreign taxes (Honiball & Olivier, 2008:328).

The commentary to Article 23A indicates that OECD members believe that the exemption method is the most practical way of providing tax relief, as it does not burden the country of residence with the need to investigate the tax practices in the country of source (Honiball & Olivier, 2008:329).

2.4.2.2 *Article 23B credit method*

The credit method provides that where a foreign Contracting State taxes a person based on income generated within the territory of that foreign Contracting State, then the local Contracting State is obliged to allow that person a deduction from his local taxes equal to the foreign taxes paid. Article 23B further provides that the amount to be deducted may not exceed the amount of local tax (Honiball & Olivier, 2008:329).

It can be concluded that the credit method is similar for the purposes of both unilateral and bilateral tax relief measures. The credit method contained in Article 23B provides relief similar to that of Section 6*quat* of the South African Income Tax Act, Article 3 of the Chinese Income Tax Act and Section 77 of the Mauritian Income Tax Act as can be evidenced above. The only exception is that the Mauritian Income Tax Act does not explicitly limit the amount of foreign tax deductible to the amount of local taxes payable, although this might be the case in practice.

From the above it is therefore clear that, even if the tax treaties did not provide for the deduction of foreign taxes paid from local taxes due and payable, then the domestic tax laws of South Africa, China and Mauritius would have provided relief. An important question is therefore whether a person should rely on the relief provided by the tax treaty or on the relief provided by the domestic tax laws.

The general rule of thumb is that a person would elect the relief provided by the tax treaty only if it provided more beneficial relief. Another factor for consideration is that the treaty would provide relief only for categories of income covered by the tax treaty. Similarly, the domestic tax laws provide relief only for categories of income explicitly covered by the tax laws. For example, the Section 6*quat* rebate available to South African residents is available only for the categories of income mentioned in part 2.4.1.2 above (Honiball & Olivier, 2008:325).

However, it is unclear whether it is possible to obtain, for certain categories of income, relief from domestic laws and, for other categories of income, relief from the tax treaty. It is further unclear whether a person should apply tax relief measures consistently from one year to the next.

2.5 LIMITING FACTORS

Limiting factors refers to steps taken by Contracting states (through domestic law) or the OECD (through tax treaty provisions) to prevent the abuse of tax conventions or to limit the benefits that a person can obtain from international tax structures, preferential tax regimes or low tax jurisdictions.

2.5.1 Limiting factors arising from domestic laws

A tax jurisdiction has various means of preventing the abuse of tax conventions. These means are as follows:

- Controlled Foreign Company legislation;
- Imposing limits on tax credits for foreign taxes paid;
- Exchange control; and
- Anti-avoidance measures (Honiball & Olivier, 2008:306-307).

2.5.1.1 *CFC legislation*

The ultimate aim of CFC legislation is to prevent the accumulation of income in a company situated in a foreign country where the tax rates are substantially lower than the rates of the local country (Honiball & Olivier, 2008:306) and to prevent the deferring of tax in the resident country on income earned in a foreign country (Legwaila, 2010:143). CFC legislation basically provides for the inclusion of income earned by the foreign country in the local holding company's taxable income.

CFC legislation therefore prevents the abuse of tax treaty conventions, preferential tax regimes or low tax jurisdictions by placing a tax burden on the income of the CFC. It is important to note that the CFC income included in the local company's income is generally calculated in accordance with the tax rules of the local country rather than with those of the foreign country (Legwaila, 2010:100). Section 6*quat* of the South African Income Tax Act specifically includes the CFC proportional amount in the categories of income that qualify for the foreign tax credit.

It should further be noted that, from the South African perspective, CFC legislation provides certain exemptions. For example, interest, royalties or rentals paid to a CFC by a company from the same group of companies are exempt from the provisions of CFC legislation. These exemptions provide South African companies with a deferral benefit and ensure that the South African companies can compete internationally (Honiball & Olivier, 2008:306).

It should further be noted that the effectiveness of CFC legislation depends on the extensiveness with which the CFC definitions are applied. The most important definition being the CFC definition and the exclusions and exemptions which accompany it, for instance the business establishment exemption (Legwaila, 2010:144).

2.5.1.2 *Limits on tax credits*

Some countries impose a restriction on the tax credits which may be claimed. This could be done, for instance, based on percentage shareholding. A company may only be entitled to claim credits if the company holds 20% or more of the participation rights of the foreign company (Honiball & Olivier, 2008:307).

2.5.1.3 *Limits due to exchange controls*

Countries implement exchange controls in order to regulate the balance of payments, and therefore the amount of money that enters and leaves the country. Certain countries may impose exchange controls that place a burden on a person to repatriate profits to the home country (Honiball & Olivier, 2008:307).

2.5.2 Limiting factors arising from tax treaties

The OECD is aware that the establishment of double tax conventions provides tax payers with opportunities to construct artificial legal structures in order to benefit from the relief provided by certain tax jurisdictions. This increases the risk of abuse of the tax conventions (OECD, 2008:1). Furthermore, it is of particular interest to the study, as the critical analysis and comparison of the DTAs between South Africa, Mauritius and China will aim to identify possible opportunities for reducing a multi-national company's tax burden, by establishing, for instance, an IHC. It is important to identify these opportunities within the ambit of tax practices which are not harmful as defined by the OECD.

The OECD addresses two separate problems, amongst others, which could result in the abuse of tax conventions, which is relevant to this study. The first problem identified by the OECD is that of structures involving conduit companies or, more specifically, the problem of treaty shopping. The second problem identified by the OECD is that of entities benefiting from preferential tax regimes (OECD, 2008:48).

The OECD details an approach to dealing with the problem of treaty shopping, aimed at limiting the benefits which a person could derive from a convention without being a resident of either of the Contracting States. The approaches stipulated by the OECD and contained in the commentary to Article 1 of the MTC provide that a person must qualify for residency of either Contracting State in order to access the benefits afforded by the conventions. In order to qualify for residency of a Contracting State, a person must meet the criteria for becoming a qualified person (OECD, 2008:50). The Mauritian tax system provides clear guidelines for companies wishing to obtain tax residency.

2.6 THE SOUTH AFRICAN HEADQUARTER COMPANY TAX REGIME

The South African government is currently in the process of introducing (or rather reintroducing) the headquarter company tax regime in the hope of reinforcing South Africa's credentials as the preferred gateway into Africa (Knight, 2010:1).

The draft Taxation Laws Amendment Bill of 2010 contains a proposal to include a definition for "headquarter company", which will effectively introduce the headquarter company regime into the South African domestic tax laws. In terms of the proposed definition, a multinational group of companies could incorporate a headquarter company in South Africa and take advantage of the preferential tax terms available for the current year of assessment if:

- Each shareholder of the company holds a minimum of 20% of the equity share and voting rights in that company for the entire year of assessment and all previous years of assessment;
- At least 80% of the base cost of the assets of the company as at the end of the year of assessment and all previous years of assessment consist of equity interests in and loans and advances to foreign companies; and
- At least 80% of the total receipts and accruals of the company during the year of assessment consists of investment income, for instance, dividend income, interest income, royalties, management fees received and capital gains on the disposal of an equity investment (National Treasury, 2010:10).

Until 2003, South Africa offered a headquarter company regime, with limited success. The headquarter company regime was made possible by the inclusion of a definition for an international headquarter company in Section 1 of the South African Income Tax Act. On 1 June 2004, the headquarter company regime was abolished by deleting the definition of an international headquarter company. Further, an international headquarter company was deemed to be to a non-resident owing to its exclusion from the definition of a resident (Honiball & Olivier, 2008:310-311).

The failure of the original South African headquarter company regime can be attributed largely to, inter alia, the following:

- The tax regime did not offer the foreign investor any tax privileges, as income sourced or deemed to be sourced in South Africa remained taxable in South Africa at the ruling tax rate;

- As the international headquarter company was not a South African resident, the international headquarter company did not have access to South Africa's treaty network, as DTAs apply only to residents; and
- In certain circumstances the international headquarter company would still be subject to the South African exchange control regulations, which limits the freedom with which such international headquarter company can repatriate profits (Honiball & Olivier, 2008:311-312).

The reintroduction of the headquarter company regime into South African tax legislation will attempt to overcome the limitations as described above by:

- Excluding international headquarter companies from the ambit of exchange control regulations. This will provide foreign investors the opportunity of moving funds freely between the target country and the investor's home country;
- Providing taxpayers with an exemption from tax for dividends received from an international headquarter company;
- Providing international headquarter companies with an exemption from South African CFC legislation and its administrative burden; and
- Providing investors in an international headquarter company with a capital gain exemption for the disposal of certain interests in that international headquarter company (Knight, 2010:2).

It should, however, be noted that the international draft Taxation Laws Amendment Bill of 2010 once more provides for the exclusion of an international headquarter company from the definition of a resident (National Treasury, 2010:71). It therefore appears that foreign investors will, once more, not gain access to South Africa's tax treaty network and will not qualify for the tax relief measures provided by Section 6*quat* of the Income Tax Act. Furthermore, there is currently no indication that international headquarter companies will be offered any tax privileges, for instance, preferential tax rates.

Knight (2010:2) is of the opinion that the introduction of the headquarter tax regime, combined with South Africa's solid banking, accounting and legal system, ease of communication and skilled workforce will make South Africa attractive to multinational groups of companies for establishing a headquarter company. However, the fact that the foreign investor will not gain access to South Africa's tax treaty network nor receive tax privileges contradicts the characteristics established by Honiball and Olivier (2008:311-312) for creating a successful headquarter tax regime.

A further factor to consider is whether the South African headquarter company regime is positioned to compete with the Mauritian holding company regime. In contrast with the proposed South African model, the Mauritian holding company regime offers multi-national companies the opportunity of becoming residents of Mauritius. These companies will therefore gain access to the Mauritius tax treaty network and will also qualify for the preferential tax rates that Mauritius offers.

2.7 INTERNATIONAL TAX PLANNING

Low tax jurisdictions and/or tax havens are often used by multi-national companies to establish intermediary holding companies in an attempt to reduce their tax burden. One such low tax jurisdiction is Mauritius. The advantages for multi-national companies (specifically South African companies) in using Mauritius as an offshore base were first published by Honiball (2009:1).

Honiball (2009:1) highlights the following advantages of using Mauritius as an offshore base:

- Mauritius combines a low tax jurisdiction with a wide double tax treaty network that includes a large number of African countries;
- The Mauritian system accommodates anti-tax haven legislation, which has proven a stumbling block for multi-national companies in international tax planning;
- The Mauritian system is superior to that of most tax havens, as it provides a clear guideline for companies wishing to obtain residency for tax treaty purposes; and
- Mauritius has a developed infrastructure system and a skilled labour force.

Apart from discussing the advantages of Mauritius as an offshore base, Honiball further provides examples of sources of income on which South African multi-national companies could possibly expect tax savings when locating their holding company in Mauritius. Possible areas for specific tax savings in relation to income sources will be discussed in more detail in later sections of the study.

The development of Mauritius as an offshore centre was first considered with opportunities in South Africa in mind. However, owing to the South African exchange control restrictions and resistance by international institutional investors, trading activity between the two countries initially did not increase to the levels expected (Joory & Lala, 1994:1).

The recent relaxation of exchange controls by the South African Reserve Bank (hereinafter referred to as a “SARB”) will give South African companies the necessary freedom to use the opportunities that exist as a result of the DTA between South Africa and Mauritius. This will especially be true for countries which do not have a DTA with South Africa (Joory & Lala, 1994:1). Similarly, opportunities will exist for South African companies in relation to trade countries which do not have a comprehensive DTA with South Africa but do have a comprehensive DTA with Mauritius, for instance, China.

Although the focus of the study is limited to South Africa, Mauritius and China, other low-tax jurisdictions exist which could provide equal tax planning and tax saving opportunities. Ireland is one such country. Ireland’s holding company regime was approved by the European Union in 2004, and Ireland has an ever-increasing double tax treaty network. More importantly, Ireland has a favourable tax treaty with China, and a company could, for instance, expect significant capital gain savings by routing its capital investment through a holding company in Ireland (Lawless & Murray, 2008:1).

2.8 CONCLUSION

In this chapter the principles of international tax were discussed in detail. Of specific importance are the IHC and its use as a tax planning mechanism. The literature review provides an overview of the tax and non-tax reasons for establishing an IHC. This highlights the characteristics associated with a country or tax regime that provides a suitable environment for the establishment of an IHC. For instance, the Mauritius tax regime offers no exchange controls, an opportunity to defer capital gains, an opportunity to reduce withholding taxes, an opportunity to gain access to a wide treaty network and an opportunity to optimise tax credits. As a result Mauritius provides a suitable environment for the establishment of an IHC.

In comparison, the South African headquarter company regime imposes exchange controls, does not provide an opportunity to reduce withholding taxes, does not offer access to its tax treaty network and does not provide an opportunity to defer capital gains. Therefore, South Africa does not provide a suitable environment for the establishment of an IHC and is not in a position to compete with Mauritius as the preferred channel for African investment.

Some countries or jurisdictions have taken steps to prevent the abuse of tax conventions or to limit the benefit that a resident can derive from preferential tax regimes. One example of such a limiting factor is CFC legislation. Limiting factors play an important role in understanding the extent of the benefit that can be derived from utilising an IHC structure but potentially also limits possible tax planning opportunities. These factors therefore play an important role in the context of this study.

One pivotal aspect that directly impacts double taxation and therefore DTAs is the extent of bilateral and unilateral tax relief measures available to the tax payer. Not only do tax relief measures provide tax planning opportunities but these measures also prevent possible double taxation of income.

In the chapter that follows an analysis of the DTAs between South Africa, Mauritius and China will be performed.

3 CHAPTER 3: A CRITICAL ANALYSIS

3.1 INTRODUCTION

In Chapter 2 the various principles of international tax, international tax planning and headquarter tax regimes were discussed. An understanding of these principles and concepts is imperative in performing a critical analysis and comparison of DTAs. In this chapter an analysis of DTAs will be performed.

In performing a critical analysis and comparison for purposes of this study, focus will be on the following Articles of the MTC:

- Article 2 – Taxes covered
- Article 10 – Dividends
- Article 11 – Interest
- Article 12 – Royalties
- Article 13 – Capital gains
- Article 23A – Exemption method
- Article 23B – Credit method

These Articles will first be analysed as they apply to the MTC and then as they apply to the DTAs between:

- South Africa and Mauritius;
- South Africa and China; and
- China and Mauritius.

3.2 A CRITICAL ANALYSIS OF THE MODEL TAX CONVENTION

The OECD describes the purpose of the MTC in respect of taxes on income and capital as the elimination of double taxation, the promotion of trade activities and the prevention of tax avoidance and tax evasion (OECD, 2008:48).

3.2.1 Article 1

Article 1 of the MTC details the scope of the tax conventions. It states that the conventions will apply to the residents of either one or both of the Contracting States. Further, the commentary to Article 1 provides guidance in dealing with the abuse of tax conventions (discussed in section 2.4.2).

3.2.2 Article 2 – taxes covered

The OECD (2008:64) describes the intention of this article:

- To provide a standardised terminology which is acceptable and precise;
- To widen the scope of the taxes to be covered by the Convention within the framework of the domestic tax laws; and
- To avoid the necessity of changing the Convention every time domestic taxes and/or tax laws are changed.

Paragraph 1 of Article 2 defines the scope of the taxes to be covered by the tax conventions (OECD, 2008:64). The remaining paragraphs of the Article provide a clear and concise view of the taxes to be covered by the tax conventions.

Paragraph 2 of Article 2 provides a definition of taxes on income as applicable to the DTA (OECD, 2008:64). These taxes could include those on income and elements of income, taxes on capital and gains from capital appreciation. Paragraph 2 is important in the context of the study, as it will determine whether the DTA is comprehensive in nature and thus provides for the inclusion of a broad spectrum of taxes.

As previously mentioned, paragraph 3 of the Article provides a list of taxes in force at the time of signature of the DTA and also the list of taxes covered by the DTA (OECD, 2008:65).

Paragraph 4 of the Article provides that the conventions will also apply to taxes similar to those declared in paragraph 3 (OECD, 2008:65).

3.2.3 Article 10 - dividends

Paragraph 1 of Article 10 provides that dividends will be taxed in the country in which the receipt is made (OECD, 2008:28). Therefore, if a company in South Africa pays a dividend to a person in Mauritius, that dividend is subject to tax in Mauritius.

Paragraph 2 of Article 10 further provides for situations in which the person receiving the dividend is a significant shareholder in the company paying the dividend and is also the beneficial owner of the dividend (OECD, 2008:28). These situations result in the taxation of the dividend in the Contracting State where the dividend originated.

Paragraph 3 of Article 10 aims to provide a definition for the term dividends as the term applies for purposes of the tax conventions. Owing to the significant differences between the definitions of dividends in countries worldwide, paragraph 3 aims to provide a list of applications found in the majority of the OECD's member countries. The list is, however, not exhaustive (OECD, 2008:154).

Paragraphs 4 and 5 of Article 10 of the MTC further provide for situations in which a dividend is received by a resident of a Contracting State from a permanent establishment in the other Contracting State (OECD, 2008:29). The intention of these provisions is demonstrated as follows:

> "The paragraph [paragraph 4] merely provides that in the State of source the dividends are taxable as part of the profits of the permanent establishment there owned by the beneficiary which is a resident of the other State..." (OECD, 2008:156).

3.2.4 Article 11 - interest

Paragraph 1 of Article 11 provides for the taxation of interest received in the recipient's Contracting State (OECD, 2008:170).

Paragraph 2 of Article 11 further provides for situations in which the Contracting State from which the payment of interest is made reserves the right to tax the interest payment. The MTC makes provision for the taxation of interest in the Contracting State from which the interest originates if the beneficial owner of the interest is situated in the recipient's Contracting State. Per the MTC, the maximum rate at which interest may be taxed in the Contracting State where the interest originated is 10% (OECD, 2008:170).

Paragraph 3 of Article 11 of the MTC defines the scope of interest as applicable for purposes of the tax conventions. In the commentary provided by the OECD (2008:175), it is noted that items that form part of the definition of interest per paragraph 2 of Article 11 cannot form part of the definition of dividends per paragraph 3 of Article 10. This provision aims to avoid the possibility of overlap between the different categories of income dealt with in Article 10 and Article 11 (OECD, 2008:175).

The list of items that qualify as interest, as defined by paragraph 3 of Article 11, is exhaustive, as it covers all the possible definitions of interest in the domestic laws of the OECD's member countries (OECD, 2008:176).

Paragraph 4 of Article 11 in the MTC deals with situations in which the payment of interest is made by a permanent establishment situated in a Contracting State other than the one in which the recipient is a resident. This paragraph states that the provisions of paragraphs 1 and 2 of Article 11 do not apply to the interest payment. Instead the provisions of Article 7 and, where applicable, Article 14 will apply to these types of payments (OECD, 2008:30).

Paragraph 5 of Article 11 in the MTC provides that interest will arise in the Contracting State in which the payer of the interest is a resident. It further provides for situations in which a permanent establishment pays interest in connection with a debt incurred by that permanent establishment. In such situations the interest is deemed to arise in the Contracting State in which the permanent establishment is a resident (OECD, 2008:30).

Paragraph 6 of Article 11 in the MTC places a restriction on the provisions concerning the taxation of interest where interest is held to be excessive as a result of a special relationship between the payer and the beneficial owner or another person (OECD, 2008:179-180). In such situations the interest determined to be excessive will be taxed in accordance with the domestic tax laws of the Contracting State of the payer (OECD, 2008:30).

3.2.5 Article 12 - royalties

Paragraph 1 of Article 12 of the MTC provides that royalties will be taxed in the country in which the beneficial owner of the Royalties is a resident (OECD, 2008:30).

The requirement for beneficial ownership was introduced by the OECD in order to give the Contracting State in which the royalties originated the right to tax the royalties in situations where the recipient of the royalty is an intermediary (OECD, 2008:182). It should further be noted that Article 12 does not deal with cases in which the royalty originated in a country other than the two Contracting States (OECD, 2008:183).

According to a critical analysis of the commentary provided by the OECD, the OECD purposefully deleted the reference to scientific, industrial and commercial equipment in paragraph 2 of the 2008 version of the MTC in order to ensure that such income would be taxed in accordance with the provisions of Article 5 and Article 7, which relate to the taxation of business profits (OECD, 2008:185).

Paragraph 3 of Article 12 of the MTC provide for situations in which the recipient of the royalties has a permanent establishment in the Contracting State in which the royalties arise and the permanent establishment is connected to the underlying asset which produces the royalty (OECD, 2008:30).

In such cases the royalty income will not be dealt with in terms of the provisions of paragraphs 1 and 2 but rather as business profits, as defined by Article 7 of the MTC (OECD, 2008:30).

Paragraph 4 of Article 12 in the MTC places a restriction on the provisions concerning the taxation of interest where interest is held to be excessive, when compared to an arm's length transaction, as a result of a special relationship between the payer and the beneficial owner or another person (OECD, 2008:193). In such situations the royalties determined to be excessive will be taxed in accordance with the domestic tax laws of the Contracting State of the payer (OECD, 2008:30-31).

3.2.6 Article 13 – capital gains

Paragraph 1 of Article 13 of the MTC provides that the capital gains arising from the alienation of immovable property, as defined in Article 6, will be taxable in the Contracting State in which the alienation takes place (OECD, 2008:31).

Paragraph 2 of Article 6 of the MTC stipulates that the term “immovable property” will be applicable as it is defined by the domestic law of the country in which the immovable property is situated (OECD, 2008:26).

Immovable property is purposefully defined with reference to the domestic law in which it is situated in order to avoid difficulties in interpreting whether or not an asset can be classified as immovable property. However, paragraph 2 of Article 6 specifically includes certain assets which will always be classified as immovable property regardless of the definition in the domestic law (OECD, 2008:117).

It should further be noted that the term “alienation” is used in the context of the domestic law definition of the Contracting State in which the asset is situated (OECD, 2008:199). In order to provide a comprehensive comparison of the tax treatment of capital gains, a comparison of the definition of “alienation” (as applied in Article 6 of the MTC) according to the domestic laws of South Africa, China and Mauritius is appropriate.

It is important to note that the application of Article 13 of the MTC as it applies to the DTAs which form part of this study will be largely dependent on the treatment of capital gains in the respective Contracting States which are bound by the DTAs in question. In order to clearly identify possible opportunities for saving tax, a comparison of the rate of tax on capital gains in each country is required.

3.2.7 Articles 23A and 23B – exemption method and credit method

According to the OECD Model Tax Treaty, these articles deal with situations in which juridical double taxation applies to income or capital earned by the same person but taxed in more than one State (OECD 2008:258).

Further, the OECD describes three scenarios in which international juridical double taxation may arise:

- A person is taxed by two Contracting States on his worldwide income or capital;
- A resident of a Contracting State is taxed by another Contracting State on income or capital in that other Contracting State; and
- A person is taxed on income or capital by two different Contracting States, in neither of which is he a resident (OECD 2008:258).

These three scenarios described by the OECD correspond to the conflicts described in section 2.4. For instance, if a resident of a Contracting State were taxed by another Contracting State on income or capital derived in that other Contracting State, then double taxation as a result of a source versus residence conflict would arise.

The OECD Model Tax Treaty makes provision for the elimination of double taxation based on:

- The principle of elimination; or
- the principle of credit (OECD 2008:261).

3.3 A CRITICAL ANALYSIS OF DOUBLE TAX AGREEMENTS

3.3.1 Introduction

Article 1 of the MTC was discussed in section 3.2.1 above. Although the discussion of this Article is not comprehensive, the comparison between the DTAs will not include any further reference to this Article, as the focus of Article 1 vests mainly in the identification of harmful tax practices, the abuse of tax conventions and the processes, approaches and procedures for identifying and eliminating these harmful tax practices.

The following sections provide an analysis of the Articles that form the subject to this study. The DTA between South Africa and Mauritius is discussed in section 3.3.2, the DTA between South Africa and China is discussed in section 3.3.3 and the DTA between China and Mauritius is discussed in section 3.3.4.

3.3.2 South Africa and Mauritius

3.3.2.1 *Article 1*

The DTA between South Africa and Mauritius adopt the exact wording of Article 1 of the MTC (Mauritius Revenue Authority, 1996:2).

3.3.2.2 *Article 2 – taxes covered*

The content of paragraph 1 of Article 2 of this DTA is similar to the MTC (Mauritius Revenue Authority, 1996:2).

Table 2 below contains extracts from Article 2 of the DTA between South Africa and Mauritius with reference to the corresponding paragraphs in the MTC.

Table 2: Extracts from Article 2 of the SA and Mauritius DTA

Paragraph	Extracts of Article 2 paragraph 2 and 3
2	"There shall be regarded as taxes on income all taxes imposed on total income or on elements of income" (Mauritius Revenue Authority, 1996:2).
3	The DTA applies to Mauritian income tax and South African normal tax and STC (Mauritius Revenue Authority, 1996:2).

Even though the DTA between South Africa and Mauritius does not cover taxes on gains from the alienation of immovable property and taxes on gains from capital appreciation, this should be interpreted with reference to the domestic tax laws in force. At the time of signature of the DTA in 1996, neither Mauritius nor South Africa had introduced capital gains tax into their domestic tax laws. However, on 1 October 2001, South Africa introduced capital gains tax into its domestic tax laws. The effect of the introduction of capital gains tax into the South African system and possible opportunities which could arise as a result of the provisions of the DTA between South Africa and Mauritius will be discussed in greater detail during the analysis and comparison of Article 13 (refer to section 4.3.6).

The content of paragraph 4 of Article 2 of this DTA is similar to the MTC (Mauritius Revenue Authority, 1996:2).

3.3.2.3 *Article 10 - dividends*

The content of paragraph 1 of Article 10 of this DTA is similar to the MTC (Mauritius Revenue Authority, 1996:9).

Previous research does not deal with possible tax saving opportunities for South African companies when it comes to the receipt of dividends. It should be noted that this could possibly be owing to the South African tax treatment of dividends. Currently the receipts of local dividends are exempt from income tax according to Section 10(1)(k)(i) of the South African Income Tax Act, but companies paying dividends are liable to the South African Revenue Service ("SARS") for the payment of STC. Furthermore, the receipts of foreign dividends are exempt from income tax according to Section 10(1)(k)(ii) of the South African Income Tax Act subject to certain provisions (also refer to section 2.4.1.1). However, in recent years SARS has indicated via budget speeches and legislation proposals that dividends should no longer be exempt from tax and that STC should be abolished. Proposals furthermore suggest that a withholding tax will be instituted regarding dividends (National Treasury, 2011:6).

Paragraph 2 of Article 10 further provides for the taxation of dividends in the Contracting State in which the company paying the dividends is a resident. However, in the event that the recipient is the beneficial owner of the dividends the tax charged will be limited based on the level of shareholding of the beneficial owner in the company paying the dividends. If the beneficial owner holds 10% of the shares or more then the tax charged may not exceed 5% of the gross dividends. If the beneficial owner holds less than 10% of the shares then the tax charged may not exceed 15% of the gross amount of dividends (Mauritius Revenue Authority, 1996:9).

Paragraph 3 of Article 10 of this DTA defines a dividend as income from shares, profit participations or rights but excludes income from debt claims (Mauritius Revenue Authority, 1996:9).

The content of paragraphs 4 and 5 of Article 10 of this DTA is similar to the MTC and provide for situations in which a dividend is received by a resident of a Contracting State from a permanent establishment in the other Contracting State (Mauritius Revenue Authority, 1996:9).

3.3.2.4 *Article 11 - interest*

Previous research indicates that there are certain situations in which it will be more appropriate to locate in Mauritius a finance company earning interest income in South Africa. A special exemption is available to recipients of interest income if a recipient is controlled and managed abroad (Honiball, 2009:2).

A slight variation of paragraph 1 of Article 11 is found in the DTA between South Africa and Mauritius as, for purposes of this DTA, the receipt will be taxable only in the Contracting State of the recipient if the recipient is the beneficial owner of the interest (Mauritius Revenue Authority, 1996:10).

The DTA between South Africa and Mauritius does not include a paragraph similar to paragraph 2 of Article 11 of the MTC. This paragraph has been deleted from the DTA.

Paragraph 2 of Article 11 of the DTA between South Africa and Mauritius is mostly similar to paragraph 3 of Article 11 of the MTC. This paragraph defines interest as income from debt-claims but explicitly excludes items which are treated as dividends in terms with Article 10 (Mauritius Revenue Authority, 1996:10).

Paragraphs 4 and 5 of the MTC, and the corresponding paragraphs in this DTA are similar in nature and no material differences were identified (Mauritius Revenue Authority, 1996:10).

3.3.2.5 *Article 12 - royalties*

Previous research indicates that tax saving and tax planning opportunities relating to royalty income exist for South African companies. Royalties paid by a South African resident to a Mauritian person are taxable only in Mauritius. The taxation of royalties in Mauritius rather than in South Africa will result in a decreased tax charge owing to the difference in the corporate tax rate of these two countries. It is therefore possible for foreign companies operating in South Africa to route their investment in South Africa through Mauritius in order to qualify for the reduction in the tax charge (Honiball, 2009:1).

The content of paragraph 1 of Article 12 of this DTA is similar to the MTC. It provides for the taxation of royalties in the resident state assuming that the receiver of royalties is the beneficial owner (Mauritius Revenue Authority, 1996:10). It is therefore assumed that the source state will have the right to tax the royalties in the event that the recipient of the royalty income is not the beneficial owner.

The content of paragraph 2 of Article 12 of this DTA is similar to the MTC and provides the scope of the term “royalties” as applicable to this Article (Mauritius Revenue Authority, 1996:10).

The content of paragraph 3 of Article 12 of this DTA is similar to the MTC and provide for situations in which royalties are received by a resident of a Contracting State from a permanent establishment in the other Contracting State. The royalties will be subject to the provisions of Article 7 or Article 14 (Mauritius Revenue Authority, 1996:11).

The content of paragraph 4 of Article 12 of this DTA is similar to the MTC (Mauritius Revenue Authority, 1996:11).

3.3.2.6 *Article 13 – capital gains*

Previous research indicates that possible tax saving opportunities exist for South African companies as a result of Mauritius being used as an offshore base. The research indicates that, in accordance with the Mauritian domestic laws, no taxes are levied on capital gains. The research further suggests that South African companies can lessen the tax burden on capital gains by placing their investments in China via Mauritius. This is because the tax treaties into which Mauritius has entered with the People's Republic of China provide for the taxation of capital gains only in the Contracting State of the seller (Honiball, 2009:2).

The content of paragraph 1 of Article 13 of this DTA is similar to the MTC and provides that the capital gains arising from the alienation of immovable property, as defined in Article 6, will be taxable in the Contracting State in which the alienation takes place (Mauritius Revenue Authority, 1996:11). It should further be noted that Article 6 of this DTA is similar to that of the MTC (Mauritius Revenue Authority, 1996:6).

The content of paragraph 2 of Article 13 of this DTA is similar to the MTC and provides that the capital gains arising from the alienation of movable property of a permanent establishment will be taxable in the Contracting State in which the alienation takes place (Mauritius Revenue Authority, 1996:11).

The content of paragraph 3 of Article 13 of this DTA is similar to the MTC and provides that the capital gains arising from the alienation of ships or aircrafts will be taxable in the place of effective management (Mauritius Revenue Authority, 1996:11).

Paragraph 4 of Article 13 of this DTA provides for the taxation of gains from the alienation of property (other than property referred to in paragraphs 1 to 3 of this Article) in the Contracting State of the seller. It follows that this paragraph is not applicable to:

- Immovable property as referred to in Article 6 of the DTA (paragraph 1);

- Movable property which forms part of the business property of a permanent establishment (paragraph 2); and
- Ships, aircraft and movable property relating to the operation of ships and aircraft (paragraph 3) (Mauritius Revenue Authority, 1996:11).

The above exceptions are taxable in the country in which the capital gain from alienation of the immovable or movable property arises (Mauritius Revenue Authority, 1996:11).

According to Article 10 of the Eighth Schedule of the South African Income Tax Act, the taxable capital gain of a natural person is 25% and of a company is 50%. Section 26A of the South African Income Tax Act states that the taxable income of a person shall include the taxable capital gain. The effective tax rate applicable to taxable capital gains are therefore the product of the inclusion rate according to Article 10 above and the tax rates applicable to either natural persons or companies.

For the 2011 year of assessment the tax rate applicable to natural persons ranges from 0% to 40% depending on the natural person's level of income (South African Revenue Services, 2011:1). The effective tax rate applicable to natural persons can therefore be determined as a percentage between 0% and 10% depending on the natural person's level of income.

The current corporate tax rate is 28% (Wikipedia, 2011). The effective tax rate applicable to a corporate can therefore be determined as 14%.

3.3.2.7 *Articles 23A and 23B – exemption method and credit method*

A critical analysis of the DTA between South Africa and Mauritius reveals the following:

- The elimination of double taxation is applicable only to income. This is because Mauritian residents are not subject to capital gains tax, so double taxation can therefore not arise from capital gains;

- Mauritian residents may credit the South African tax paid on income earned in South Africa against the Mauritius tax imposed on those residents and which applies to the same profits or income. This credit is, however, subject to Section 77 of the Mauritius Income Tax Act (Mauritius Revenue Authority, 1996:15);
- When a Mauritius resident earns dividends from a South African source, bilateral tax relief via the abovementioned credit will be granted only to tax paid in additional to the taxes on profit from which the dividend was paid (Mauritius Revenue Authority, 1996:15). Practically speaking, this relief will apply only to any STC paid when dividends are declared according to the current treatment of tax on dividends. Should STC be replaced with a withholding tax, this relief will apply to the withholding tax;
- Article 23(a)(iii) of the DTA between South Africa and Mauritius further stipulates that credit will be granted to a Mauritius resident relative to the South African tax paid on profits from which dividends are paid. This provision will, however, apply only if the Mauritius resident controls at least 10% of the capital of the company paying the dividend (Mauritius Revenue Authority, 1996:16);
- In section 2.4.1.2 of this study, it is also stated that Section 77(2) of the Mauritius Income Tax Act provides for unilateral tax relief in the form of credit for tax paid on the profits from which dividends are paid;
- South African residents may deduct from their South African taxes the Mauritius tax paid on income earned and taxable in Mauritius. The amount of the deduction is, however, limited to the ratio that the underlying income bears to the total income as applied to the total South African tax liability (Mauritius Revenue Authority, 1996:16); and
- The amount deductable by South African residents from their South African taxes is further deemed to include the amount of tax that the resident would have paid in Mauritius if the tax had not been subject to preferential tax rates (Mauritius Revenue Authority, 1996:16).

3.3.3 South Africa and China

3.3.3.1 *Article 1*

The DTA between South Africa and China adopt the exact wording of Article 1 of the MTC (South African Revenue Service, 2001:2).

3.3.3.2 *Article 2 – taxes covered*

The content of paragraph 1 of Article 2 of this DTA is similar to the MTC (South African Revenue Service, 2001:2).

Table 3 below contains extracts from Article 2 of the DTA between South Africa and China with reference to the corresponding paragraphs in the MTC.

Table 3: Extracts from Article 2 of the SA and China DTA

Paragraph	Extracts of Article 2
2	The DTA does not include paragraph 2 of Article 2 of the MTC.
3	The DTA applies to Chinese individual income tax and income tax for Chinese enterprises with foreign investment or foreign enterprises and South African normal tax and STC (South African Revenue Service, 2001:2).

It can be concluded that the exclusion of paragraph 2 of the MTC from the DTA between South Africa and China indicates that the DTA entered into between these two countries is not comprehensive. It could also possibly lead to confusion about the interpretation of the remaining articles of the DTA as a definition of the taxes covered is not provided. Nevertheless, a complete list of taxes in force at the time of signature of the DTA is provided in paragraph 2 of the Article (South African Revenue Service, 2001:2).

The content of paragraph 3 of Article 2 of this DTA is similar to paragraph 4 of the MTC (South African Revenue Service, 2001:3).

3.3.3.3 *Article 10 – dividends*

The content of paragraph 1 of Article 10 of this DTA is similar to the MTC and provides for the taxation of dividends in the Contracting State of the recipient (South African Revenue Service, 2001:8).

Paragraph 2 of Article 10 further provides for the taxation of dividends in the Contracting State in which the company paying the dividends is a resident. However, in the event that the recipient is the beneficial owner of the dividends the tax charged may not exceed 5% of the gross dividend (South African Revenue Services, 2001:8).

Article 3-1 of the Chinese Income Tax Act suggests that dividends received from a profit-seeking enterprise may be deducted from the income tax liability of the shareholder or member receiving such dividends.

However, Article 3-1 of the Chinese Income Tax Act does not apply to dividends distributed to individuals who do not reside within the territory of China or to public-seeking enterprises with their head office outside the territory of China. For such payments, and according to Article 88 of the Chinese Income Tax Act, tax should be withheld by the tax withholder and treated in accordance with the withholding processes. The amount withheld will be calculated according to the rates described in Table 8.

The content of paragraph 3 of Article 10 of this DTA is similar to the MTC in most respects. Paragraph 3 defines a dividend as income from shares, profit participations or rights but excludes income from debt claims (South African Revenue Service, 2001:9).

The content of paragraphs 4 and 5 of Article 10 of this DTA is similar to the MTC and provide for situations in which a dividend is received by a resident of a Contracting State from a permanent establishment in the other Contracting State (South African Revenue Service, 2001:9).

3.3.3.4 *Article 11 - interest*

The content of paragraph 1 of Article 11 of this DTA is similar to the MTC and provides for the taxation of interest in the Contracting State of the recipient (South African Revenue Service, 2001:9).

Paragraph 2 of Article 11 further provides for the taxation of interest in the Contracting State in which the company paying the interest is a resident. However, in the event that the recipient is the beneficial owner of the interest the tax charged may not exceed 10% of the gross amount (South African Revenue Service, 2001:9).

The DTA between China and South Africa include a paragraph which does not form part of the provisions of the MTC. Paragraph 3 of the DTA reads as follows:

> "Notwithstanding the provisions of paragraph 2, interest arising in a Contracting State and derived by the Government of the other Contracting State, a political subdivision, a local authority and the Central Bank thereof or any financial institution wholly owned by the Government of that other State, or by any other resident of that other State with respect to debt-claims indirectly financed by the Government of that other State, a political subdivision, a local authority and the Central Bank thereof or any financial institution wholly owned by the Government of that other State, shall be exempt from tax in the first-mentioned State" (South African Revenue Service, 2001:10).

Paragraph 4 of Article 11 of the DTA between South Africa and China is similar to paragraph 3 of the MTC. This paragraph defines interest as income from debt-claims (South African Revenue Service, 2001:10).

Paragraph 5 of Article 11 of the DTA between South and China is similar to paragraph 4 of the MTC. This paragraph provides for situations where the beneficial owner of the interest carries on business through a permanent establishment in the Contracting State of the company paying the interest. The interest will be dealt with in accordance with Article 7 or Article 14 of this DTA (South African Revenue Service, 2001:10).

Paragraph 5 of the MTC, and the corresponding paragraph in this DTA are similar in nature and no material differences were identified (South African Revenue Service, 2001:10).

Paragraph 7 of Article 11 of the DTA between South Africa and China is similar to paragraph 6 of the MTC (South African Revenue Service, 2001:10).

3.3.3.5 *Article 12 - royalties*

Paragraph 1 of Article 12 of this DTA differs from that of the MTC. This DTA makes provision for the taxation of royalties in the country in which the royalties are received, regardless of whether or not the recipient is the beneficial owner of the royalties (South African Revenue Service, 2001:10).

Paragraph 2 of Article 12 further provides for the taxation of royalties in the Contracting State in which the company paying the royalties is a resident. However, in the event that the recipient is the beneficial owner of the royalties the tax charged will be limited to 10% of the gross amount (South African Revenue Service, 2001:11).

A significant variation on the MTC is found in this DTA. Paragraph 3 of Article 12 of the DTA, read with paragraph 2, provides that royalties earned on the use or right of use of scientific, industrial or commercial equipment are subject to taxation in the Contracting State in which the royalties originated at a rate of 10% as applied to the adjusted amount. The adjusted amount is determined as 70% of the gross royalty payment (South Africa 2001:11).

Despite the fact that the reference to scientific, industrial and commercial equipment in paragraph 2 of the 2008 version of the MTC was deleted (OECD, 2008:185), the provisions of paragraph 3 of Article 12 of the DTA between South Africa and China will remain valid until the DTA is renegotiated and changes are made to align the agreement with the provisions of the 2008 version of the MTC.

The content of paragraph 4 of Article 12 of this DTA is similar to paragraph 3 of the MTC. This paragraph provides for situations in which royalties are received by a resident of a Contracting State from a permanent establishment in the other Contracting State. The royalties will be subject to the provisions of Article 7 or Article 14 (South Africa Revenue Service, 2011:11).

Paragraph 5 of Article 12 of this DTA provides that royalties will arise in the Contracting State in which the payer of the royalties is a resident. It further provides for situations in which a company pays royalties in connection with a liability incurred by a permanent establishment. In such situations the royalties are deemed to arise in the Contracting State in which the permanent establishment is a resident (South Africa Revenue Service, 2011:11).

The content of paragraph 6 of Article 12 of this DTA is similar to paragraph 4 of the MTC (South Africa Revenue Service, 2011:11).

3.3.3.6 *Article 13 – capital gains*

The content of paragraph 1 of Article 13 of this DTA is similar to the MTC (South African Revenue Service, 2001:12). It should further be noted that Article 6 of this DTA is similar to that of the MTC (South African Revenue Service, 2001:6).

The content of paragraph 2 of Article 13 of this DTA is similar to the MTC and provides that the capital gains arising from the alienation of movable property of a permanent establishment will be taxable in the Contracting State in which the alienation takes place (South African Revenue Service, 2001:12).

Paragraph 3 of Article 13 of this DTA provides that the capital gains arising from the alienation of ships or aircrafts will be taxed in the Contracting State of the enterprise disposing of the ships or aircrafts (South African Revenue Service, 2001:12).

Paragraph 4 of Article 13 of this DTA provides that the capital gains arising from the alienation of property shares will be taxed in the Contracting State in which the alienation takes place (South African Revenue Service, 2001:12).

However, a slight variation regarding Article 13 of this DTA is found when it is compared with the MTC. This DTA includes a paragraph providing for the taxation of shares, other than property shares, in the Contracting State in which the company selling the shares is resident. This provision will be available only in the event that the company selling the shares has a minimum shareholding of at least 25% (South African Revenue Service, 2001:12).

Paragraph 6 of Article 13 of this DTA provides for the taxation of gains from the alienation of property (other than property referred to in paragraphs 1 to 5 of this Article) in the Contracting State of the seller. It follows that this paragraph is not applicable to:

- Immovable property as referred to in Article 6 of the DTA (paragraph 1);
- Movable property which forms part of the business property of a permanent establishment (paragraph 2);
- Ships, aircraft and movable property relating to the operation of ships and aircraft (paragraph 3);
- Shares in companies where the property of those companies principally consist of immovable property either directly or indirectly (paragraph 4); and
- Shares in companies, other than the shares referred to above, which represents a minimum shareholding of 25% in that company (paragraph 5) (South African Revenue Service, 2001:12).

The above exceptions are taxable in the country in which the capital gain from alienation of the immovable or movable property arises (South African Revenue Service, 2001:12).

3.3.3.7 *Articles 23A and 23B – exemption method and credit method*

A critical analysis of the DTA between South Africa and China reveals the following:

- The elimination of double taxation is applicable only to income. This is consistent with the provisions of Article 2, which stipulates that the DTA will not apply to tax on capital gains (South African Revenue Service, 2001:2);
- Chinese residents may credit the South African tax paid on income earned in South Africa against the Chinese tax imposed on that resident. The amount of the credit is, however, restricted to the amount of Chinese tax that the resident would have paid if the income had been derived in China and the income was subject to taxation per the Chinese Income Tax Act (South Africa Revenue Service, 2001:16); and
- South African residents may deduct from their South African taxes the Chinese tax paid on income earned and taxable in China. The amount of the deduction is, however, limited to the ratio that the underlying income bears to the total income as applied to the total South African tax liability (South Africa Revenue Service, 2001:16).

3.3.4 <u>Mauritius and China</u>

3.3.4.1 *Article 1*

The DTA between South Africa and China adopt the exact wording of Article 1 of the MTC (Mauritius Revenue Authority, 1994:1).

3.3.4.2 *Article 2 – taxes covered*

The content of paragraph 1 of Article 2 of this DTA is similar to the MTC (Mauritius Revenue Authority, 1994:1).

Table 4 below contains extracts from Article 2 of the DTA between China and Mauritius with reference to the corresponding paragraphs in the MTC.

Table 4: Extracts from Article 2 of the Mauritius and China DTA

Paragraph	Extract of Article 2 paragraph 2
2	"There shall be regarded as taxes on income all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of movable or immovable property, as well as taxes on capital appreciation" (Mauritius Revenue Authority, 1994: 1).
3	The DTA applies to Chinese individual income tax, income tax for Chinese enterprises with foreign investment or foreign enterprises and local income tax and South African normal tax and STC (Mauritius Revenue Authority, 1994:1-2).

The content of paragraph 4 of Article 2 of this DTA is similar to the MTC (Mauritius Revenue Authority, 1994:2).

3.3.4.3 *Article 10 - dividends*

The content of paragraph 1 of Article 10 of this DTA is similar to the MTC and provides for the taxation of dividends in the Contracting State of the recipient (Mauritius Revenue Authority, 1994:8).

Paragraph 2 of Article 10 further provides for the taxation of dividends in the Contracting State in which the company paying the dividends is a resident. However, in the event that the recipient is the beneficial owner of the dividends the tax charged may not exceed 5% of the gross dividend (Mauritius Revenue Authority, 1994:8).

The content of paragraph 3 of Article 10 of this DTA is similar to the MTC in most respects. Paragraph 3 defines a dividend as income from shares, profit participations or rights but excludes income from debt claims (Mauritius Revenue Authority, 1994:8).

The content of paragraphs 4 and 5 of Article 10 of this DTA is similar to the MTC. These paragraphs provide for situations where the beneficial owner of the dividends carries on business through a permanent establishment in the Contracting State of the company paying the dividend. In these situations the Contracting State of the company paying the dividends may not impose tax (Mauritius Revenue Authority, 1994:8-9).

3.3.4.4 *Article 11 - interest*

The content of paragraph 1 of Article 11 of this DTA is similar to the MTC and provides for the taxation of interest in the Contracting State of the recipient (Mauritius Revenue Authority, 1994:9).

Paragraph 2 of Article 11 further provides for the taxation of interest in the Contracting State in which the company paying the interest is a resident. However, in the event that the recipient is the beneficial owner of the interest the tax charged may not exceed 10% of the gross amount (Mauritius Revenue Authority, 1994:9).

The DTA between China and Mauritius include a paragraph which does not form part of the provisions of the MTC. Paragraph 3 of the DTA reads as follows:

> "Notwithstanding the provisions of paragraph 2, interest arising in a Contracting State and derived by the Government of the other Contracting State, a local authority and the Central Bank thereof or any financial institution wholly owned by that Government, or by any other financial institution agreed upon by the competent authorities of the Contracting States, or by any other resident of that other Contracting State with respect to debt-claims indirectly financed by the Government of that other Contracting State, a local authority, and the Central Bank thereof or any financial institution wholly owned by the Government, or by any other financial institution agreed upon by the competent authorities of the Contracting States shall be exempt from tax in the first-mentioned Contracting State" (Mauritius Revenue Authority, 1994:9).

Paragraph 4 of Article 11 of the DTA between Mauritius and China is similar to paragraph 3 of the MTC. This paragraph defines interest as income from debt-claims (Mauritius Revenue Authority, 1994:9).

Paragraph 5 of Article 11 of the DTA between Mauritius and China is similar to paragraph 4 of the MTC. This paragraph provides for situations where the beneficial owner of the interest carries on business through a permanent establishment in the Contracting State of the company paying the interest. The interest will be dealt with in accordance with Article 7 or Article 14 of this DTA (Mauritius Revenue Authority, 1994:9).

Paragraph 5 of the MTC, and the corresponding paragraph in this DTA are similar in nature and no material differences were identified (Mauritius Revenue Authority, 1994:9-10).

Paragraph 7 of Article 11 of the DTA between Mauritius and China is similar to paragraph 6 of the MTC (Mauritius Revenue Authority, 1994:10).

3.3.4.5 *Article 12 - royalties*

Paragraph 1 of Article 12 of this DTA is different from that of the MTC. This DTA makes provision for the taxation of royalties in the country in which the royalties are received, regardless of whether or not the recipient is the beneficial owner of the royalties (Mauritius Revenue Authority, 1994:10).

The requirement for beneficial ownership introduced by the OECD was discussed in section 3.3.3.5 with reference to the relevant literature. The principles presented in section 3.3.3.5 will equally apply to this section. Therefore, the Contracting State in which royalties originate obtains the right to tax the royalties if the beneficiary is an intermediary.

A significant variation on the MTC is found in this DTA. This DTA provides for the taxation of the royalties in the country in which they originated. The DTA between China and Mauritius provides for the taxation of royalties at a maximum rate of 10% if the recipient is the beneficial owner of the royalties (Mauritius Revenue Authority, 1994:10).

The content of paragraph 2 of Article 12 of this DTA is similar to the MTC and provides the scope for the term “royalties” as applicable to this Article. However, industrial, commercial or scientific equipment are also included in the scope of the term “royalties” (Mauritius Revenue Authority, 1994:10).

The content of paragraph 4 of Article 12 of this DTA is similar to paragraph 3 of the MTC. This paragraph provides for situations in which royalties are received by a resident of a Contracting State from a permanent establishment in the other Contracting State. The royalties will be subject to the provisions of Article 7 or Article 14 (Mauritius Revenue Authority, 1994:10).

Paragraph 5 of Article 12 of this DTA provides that royalties will arise in the Contracting State in which the payer of the royalties is a resident. It further provides for situations in which a company pays royalties in connection with a liability incurred by a permanent establishment. In such situations the royalties are deemed to arise in the Contracting State in which the permanent establishment is a resident (Mauritius Revenue Authority, 1994:10).

The content of paragraph 6 of Article 12 of this DTA is similar to paragraph 4 of the MTC (Mauritius Revenue Authority, 1994:10).

3.3.4.6 *Article 13 – capital gains*

The content of paragraph 1 of Article 13 of this DTA is similar to the MTC (Mauritius Revenue Authority, 1994:11). It should further be noted that Article 6 of this DTA is similar to that of the MTC (Mauritius Revenue Authority, 1994:6).

The content of paragraph 2 of Article 13 of this DTA is similar to the MTC. This paragraph provides that the capital gains arising from the alienation of movable property of a permanent establishment will be taxable in the Contracting State in which the alienation takes place (Mauritius Revenue Authority, 1994:11).

Paragraph 3 of Article 13 of this DTA provides that the capital gains arising from the alienation of ships or aircrafts will be taxed in the Contracting State of the enterprise disposing of the ships or aircrafts (Mauritius Revenue Authority, 1994:11).

Paragraph 4 of Article 13 of this DTA provides that the capital gains arising from the alienation of property shares will be taxed in the Contracting State in which the alienation takes place (Mauritius Revenue Authority, 1994:11).

Paragraph 5 of Article 13 of this DTA provides for the taxation of gains from the alienation of property (other than property referred to in paragraphs 1 to 4 of this Article) in the Contracting State of the seller. It follows that this paragraph is not applicable to:

- Immovable property as referred to in Article 6 of the DTA (paragraph 1);
- Movable property which forms part of the business property of a permanent establishment (paragraph 2);
- Ships, aircraft and movable property relating to the operation of ships and aircraft (paragraph 3); and
- Shares in companies where the property of those companies principally consist of immovable property either directly or indirectly (paragraph 4) (Mauritius Revenue Authority, 1994:11).

The above exceptions are taxable in the country in which the capital gain from alienation of the immovable or movable property arises (Mauritius Revenue Authority, 1994:11).

Capital gains received by natural persons and arising in China will be taxed at a rate of 20% of the net capital gain. Capital gains received by companies will be taxed at a rate of 25% and included in the company's normal tax. However, withholding tax of 10% will apply for non-resident persons or companies (Worldwide, 2011).

Capital gains arising from the alienation of real estate will be taxed at a rate between 20% and 60% of the capital gain depending on the size of the capital gain (Worldwide, 2011).

3.3.4.7 *Articles 23A and 23B – exemption method and credit method*

A critical analysis of the DTA between China and Mauritius reveals the following:

- The elimination of double taxation is applicable to income alone. This is because Mauritius residents are not subject to capital gains tax, so double taxation can therefore not arise from capital gains;
- Chinese residents may credit the Mauritius tax paid on income earned in Mauritius against the Chinese tax imposed on them. The amount of the credit is, however, restricted to the amount of Chinese tax that the resident would have paid if the

income had been derived in China and the income was subject to taxation per the Chinese Income Tax Act (Mauritius Revenue Authority, 1994:15);

- A credit will be granted to a Chinese resident relative to the Mauritius tax paid on profits from which dividends are paid. This provision will, however, apply only if the Chinese resident controls at least 10% of the capital of the company paying the dividend (Mauritius Revenue Authority, 1994:15);
- Mauritius residents may credit the Chinese tax paid on income earned in China against the Mauritius tax imposed on that resident. The amount of the credit is, however, restricted to the amount of Mauritius tax that the resident would have paid if the income had been derived in Mauritius and the income was subject to taxation per the Mauritian Income Tax Act (Mauritius Revenue Authority, 1994:15);
- A credit will be granted to a Mauritius resident relative to the Chinese tax paid on profits from which dividends are paid. This provision, however, applies only if the Mauritius resident controls at least 10% of the capital of the company paying the dividend (Mauritius Revenue Authority, 1994:15); and
- The amount of the credit as it applies to both Chinese and Mauritius residents is deemed to include the tax that the relevant person would have paid if preferential tax rates had not applied owing to the promotion of economic development (Mauritius 1994:15-16).

In this chapter an analysis of the DTAs between South Africa, Mauritius and China was performed with specific reference to the Articles discussed in this study. In the following chapter this analysis will be used as a platform to compare the DTAs between South Africa, Mauritius and China.

4 CHAPTER 4: A COMPARATIVE STUDY

4.1 INTRODUCTION

In this chapter a comparative study of the DTAs between South Africa, Mauritius and China will be performed based on the analysis provided by chapter 3. The DTAs will first be compared to the MTC after which a comparison of the Articles which forms the subject of this study will be performed. Chapter 5 provides the overall conclusions drawn from the comparative study.

4.2 A COMPARISON WITH THE MODEL CONVENTION

The DTAs entered into between South Africa, Mauritius and China are based on the MTC published by the OECD. A critical comparison of the DTAs would therefore be incomplete without a comparison of the DTAs with the MTC. Areas in which the Contracting States, as applicable, moved away from the specific provisions of the MTC will also be identified. Table 5 below provides a summary of the Articles contained in the MTC and indicates whether the specific DTAs compare in all material respects with the MTC.

Table 5: The MTC and its inclusion in double tax agreements

		Contracting States of double tax agreements		
Article number	**Article heading**	**SA and Mauritius**	**SA and China**	**China and Mauritius**
1	Persons covered	✔	✔	✔
2	Taxes covered	🛇	🛇	🛇
3	General definitions	🛇	🛇	🛇
4	Resident	🛇	🛇	🛇
5	Permanent establishment	🛇	🛇	🛇
6	Income from immovable property	✔	✔	✔
7	Business profits	🛇	✔	✔
8	Shipping and transport	🛇	🛇	🛇
9	Associated enterprises	✔	✔	✔
10	Dividends	🛇	🛇	🛇
11	Interest	🛇	🛇	🛇

Article number	Article heading	SA and Mauritius	SA and China	China and Mauritius
12	Royalties	⃠	⃠	⃠
13	Capital gains	⃠	⃠	⃠
14	[Deleted]	X	X	X
15	Income from employment	✔	⃠	⃠
16	Directors' fees	✔	✔	✔
17	Artists and sportsmen	⃠	⃠	⃠
18	Pensions	⃠	⃠	⃠
19	Government service	✔	✔	✔
20	Students	✔	⃠	⃠
21	Other income	✔	✔	✔
22	Capital	X	X	X
23A	Exemption method	⃠	⃠	⃠
23B	Credit method	⃠	⃠	⃠
24	Non-discrimination	⃠	⃠	⃠
25	Mutual agreement procedure	⃠	⃠	⃠
26	Exchange of information	⃠	⃠	⃠
27	Assistance in the collection of taxes	X	X	X
28	Members of diplomatic missions	✔	✔	✔
29	Territorial extension	X	X	X
30	Entry into force	✔	✔	✔
31	Termination	✔	✔	✔
Legends				
✔	The DTA agrees in all material respects with the MTC.			
X	The Article per the MTC is not included in the DTA.			
⃠	The Article per the DTA was modified according to the applicable principle, taxing authority or rate.			

4.2.1.1 *Conclusion from comparison with the Model Tax Convention*

It is clear from this comparison of the selected DTAs with the MTC that DTAs are not similar. There are various reasons for this, including the following:

- Countries' domestic tax laws differ, and DTAs are tailored and negotiated in order to accommodate the domestic tax laws;
- DTAs are dependent on the specific trade relationship of the two Contracting States; and

- the economic prerogatives of the Contracting States are encapsulated in the DTAs, subject to negotiation (Honiball & Olivier, 2008:14-15).

The fact that DTAs are not similar provides entities with opportunities to implement tax planning initiatives and, in doing so, lessen their tax burden.

In the following sections a detailed comparison of selected Articles in the DTAs that form the subject of this study will be performed. The detailed comparison will further highlight some of the differences between DTAs and will provide insight into possible tax planning opportunities.

4.3 A COMPARISON OF DOUBLE TAX AGREEMENTS

4.3.1 Introduction

In chapter 3 a detailed analysis of the DTAs that form the subject of this study was performed. In the sections that follow, a summary of the findings of the analysis will be presented in a comparative format. In chapter 3 the content was discussed in great detail with reference to the literature and the reader is referred to the sections on which the comparison is based.

4.3.2 A comparison of Article 2

Table 6 below provides a matrix of the defined scope of taxes on income and capital covered per the relevant DTA.

Table 6: Summary of defined scope of taxes per DTA in Article 2

Taxes defined	SA and Mauritius	SA and China	China and Mauritius
Income	Total income; or elements of income	N/A	Total income; or elements of income
Capital	N/A	N/A	Capital gains; or capital appreciation

Source: Refer to sections 3.3.2.2, 3.3.3.2 and 3.3.4.2

Table 7 below provides a matrix of each Contracting State's taxes covered per the relevant DTA.

Table 7: Summary of specific taxes covered per Contracting State in Article 2

Contracting State's taxes in question	South Africa	Mauritius	China
South Africa		Normal tax; STC	Normal tax; STC
Mauritius	The income tax		The income tax
China	Individual income tax; Tax on foreign income	Individual income tax; Tax on foreign income; Local income tax	

Source: Refer to sections 3.3.2.2, 3.3.3.2 and 3.3.4.2

4.3.2.1 *Conclusion from Article 2 comparison*

Based on a critical review of the extracts contained in Tables 6 and 7 above, it is clear that the three DTAs do not provide the same tax coverage. The following observations demonstrate this:

- The DTA between South Africa and Mauritius are applicable only to taxes on income and does not include any reference to taxes on capital, taxes on gains of alienation of immovable property or taxes on capital appreciation;
- the DTA between China and Mauritius is comprehensive, as taxes on gains from alienation of immovable property and taxes on capital appreciation are included in the scope of the DTA; and thus
- the DTA between China and Mauritius provides more comprehensive coverage of taxes than does the DTA between South Africa and China.

It is clear in the comparison of the DTAs pertaining to this Article that the only difference between the taxes covered in respect of the various DTAs are the extent to which Chinese taxes are covered. Firstly, the Mauritian agreement provides for a wider scope of tax coverage as the definition of taxes on income includes taxes on capital gains and capital appreciation.

Secondly, the Mauritian agreement provides additional coverage, as local income tax is also included in the list of taxes covered by the agreement. This in itself is not necessarily significant, as the definition of the taxes as defined in the specific domestic laws must first be studied in order to clearly identify the scope of application in domestic terms and the practical impact of this.

4.3.2.2 *Tax planning opportunities*

The above results indicate that greater tax coverage is offered to Mauritius than to South Africa when comparing their DTAs with China. It further indicates the possibility of tax savings, specifically the avoidance of double taxation on local income tax and taxes on capital gains in China.

4.3.3 A comparison of Article 10

All the DTAs that form the subject of this study provide for the taxation of dividends in both the Contracting State of the recipient and the Contracting State of the company paying the dividends. However, paragraph 2 of Article 10 of the DTAs limit the rate of tax that the Contracting State of the company paying the dividends can charge if the recipient of the dividends is the beneficial owner.

Table 8 below provides a comparison of the tax rates applicable to dividends based on the level of shareholding that the beneficial owner holds in the company paying the dividends. The domestic tax laws of the Contracting State of the company paying the dividends will apply to all situations where the recipient of the dividends is not the beneficial owner.

Table 8: Comparison of tax rates per shareholding threshold

Shareholding threshold	Model tax convention	SA and Mauritius	SA and China	China and Mauritius
Tier 1 shareholding	>=25%	>=10%	All cases	All cases
Tier 1 tax rate	5%	5%	5%	5%
Tier 2 shareholding	All other cases	All other cases	N/A	N/A
Tier 2 tax rate	15%	15%	N/A	N/A

Source: Refer to sections 3.3.2.3, 3.3.3.3 and 3.3.4.3

4.3.3.1 *Conclusion from Article 10 comparison*

Table 8 illustrates the difference between the applications of paragraph 2 of Article 10 to the DTAs that form the subject of this study. However, it is not possible to draw conclusions based solely on the comparison provided in Table 8. In order to reach meaningful conclusions, Article 10 should be taken into consideration as it applies in practice, while the provisions of the domestic laws should be considered as they apply to dividends.

It is clear from the analysis and comparison of Article 10 that dividends received by either a Mauritian or a South African counterpart from a Chinese profit-seeking entity will be subject to withholding tax at the rates specified in Table 8.

4.3.4 A comparison of Article 11

For purposes of this section and the sections that follow, resident state refers to the Contracting State of the recipient of dividends, interest, royalties or capital gains and source state refers to the Contracting State from which the dividends, interest or royalties are paid or the capital gain arises.

Table 9 below provides a comparison of the paragraphs of Article 11 and the underlying principles contained in these.

Table 9: Taxation of interest

Principle	SA and Mauritius	SA and China	Mauritius and China
Right to tax	Resident state	Resident state; and Source state	Resident state; and Source state
Tax rate at source	N/A	10%	10%
Interest earned by Government entities	N/A	Exempt at source	Exempt at source
Scope	Income on debt-claims excluding dividends	Income on debt-claims	Income on debt-claims
Permanent establishments	Provisions of Article 7 or Article 14 shall apply	Provisions of Article 7 or Article 14 shall apply	Provisions of Article 7 or Article 14 shall apply
Deemed source	N/A	Similar to MTC	Similar to MTC
Special relationships	Similar to MTC	Similar to MTC	Similar to MTC

Source: Refer to sections 3.3.2.4, 3.3.3.4 and 3.3.4.4

4.3.4.1 *Conclusion from Article 11 comparison*

The comparison of paragraph 2 as included in the DTAs provides for the following conclusions to be drawn:

- The DTAs between China and South Africa and China and Mauritius provide for the taxation of interest in both Contracting States; and
- The DTA between Mauritius and South Africa provides for the taxation of interest only in the Contracting State of the recipient of the interest income. However, this applies only if the beneficial owner of the interest and the recipient of the interest are one and the same person.

It is also clear from the inclusion of paragraph 3 in the DTAs entered into with China that the Chinese provides for situations in which interest income is received by a Government entity. In such circumstances, the interest income would be exempt from taxation in the Contracting State where it originated.

The explicit exclusion of dividends from the scope of interest as noted in the DTA between South Africa and Mauritius has no practical implications as it is the OECD's intention to avoid overlaps between the income dealt with in Article 10 and Article 11 (OECD, 2008:175).

4.3.4.2 *Tax planning opportunities*

From the conclusions drawn in section 4.3.4.1 it is clear that tax planning opportunities exist by using Mauritius as an offshore base. For instance, a Chinese company can establish a company in Mauritius for purposes of investing in South Africa similar to the IHC structure illustrated in Figure 1. The Chinese company provides funding in the form of a loan to the South African company via Mauritius. Interest arising from the loan will be subject to taxation in Mauritius as the DTA between South Africa and Mauritius provides for the taxation to occur in the resident country. The Chinese company can therefore expect a tax saving as Mauritius offers preferential corporate tax rates. It should further be noted that potential tax advantages may be limited by the factors highlighted in section 2.5.

In the above example, if the Chinese company invests directly in South Africa then the interest earned from the loan is subject to taxation in both the source and the resident state.

4.3.5 A comparison of Article 12

Table 10 provides a comparison of the taxation principles of Article 12 as they apply to the respective DTAs that form part of this study.

Table 10: Taxation of royalties

Principle	SA and Mauritius	SA and China	China and Mauritius
Right to tax	Resident state	Resident state; and Source state	Resident state; and Source state
Tax rate at source	N/A	10%; or 7% on equipment	10%
Scope	Similar to MTC	Similar to MTC; and Industrial, commercial or scientific equipment.	Similar to MTC; and Industrial, commercial or scientific equipment.
Permanent establishment	Provisions of Article 7 or Article 14 shall apply	Provisions of Article 7 or Article 14 shall apply	Provisions of Article 7 or Article 14 shall apply
Deemed source	N/A	Contracting State of: • Payer; or • Permanent establishment	Contracting State of: • Payer; or • Permanent establishment
Special relationship	Similar to MTC	Similar to MTC	Similar to MTC

Source: Refer to sections 3.3.2.5, 3.3.3.5 and 3.3.4.5

4.3.5.1 *Conclusion from Article 12 comparison*

The DTA between South Africa and Mauritius provides for the taxation of royalties in the resident country. In comparison, the DTAs between South Africa and China and Mauritius and China allows for taxation of royalties in both the source and resident country. Royalties will be subject to withholding tax of 10% in the source country. However, industrial, commercial and scientific equipment will be subject to a withholding tax deduction of 7% in terms with the DTA between South Africa and China.

Until changes are made to the DTA between South Africa and China to align paragraph 3 of Article 12 with paragraph 2 in the MTC of 2008, the possibility exists that opportunities for tax savings can be identified. This will, however, require further analysis, specifically with reference to the articles that deal with the double taxation of business profits and in light of the domestic laws applicable to the taxation of royalties and business profits.

Although the DTAs with China provides for the taxation of royalties in the resident and source country, double tax relief is provided by virtue of Article 23 and unilateral relief measures.

4.3.5.2 *Tax planning opportunities*

From the conclusions drawn in section 4.3.5.1 it is clear that tax planning opportunities exist for South African residents by using Mauritius as an offshore base. For instance, a South African company can establish a company in Mauritius and transfer its copyrights, patents and trademarks to this company. Royalties arising from the use of these intangible assets in South Africa will be subject to taxation in Mauritius as the DTA between South Africa and Mauritius provides for taxation in the resident country. The South African company can therefore expect a tax saving as Mauritius offers preferential tax rates. This confirms the results obtained in the previous research by Honiball (2009:1). It should further be noted that potential tax advantages may be limited by the factors highlighted in section 2.5.

4.3.6 A comparison of Article 13

Table 11 provides a comparison of the rate of taxation applicable to capital gains as defined in the domestic laws of the countries which forms part of this study.

Table 11: Capital gains tax rates

Category	South Africa	Mauritius	China
Individual	0% to 10%	N/A	Residents – 20% Non-residents – 10%
Company	14%	N/A	Residents – 25% Non-residents – 10%
Real estate	Individual – 0% to 10% Company – 14%	N/A	20% to 60%

Source: Refer to sections 3.3.2.6, 3.3.3.6 and 3.3.4.6

Table 12 provides a comparison of the taxation principles of Article 13 as they apply to the respective DTAs which form part of this study. To this end the comparison indicates the country in which the capital gains arising from the alienation of property can be taxed.

Table 12: Taxation of capital gains arising from the alienation of various asset classes

Asset class	Model tax convention	SA and Mauritius	SA and China	China and Mauritius
Immovable property	Source state	Source state	Source state	Source state
Business property	Source state	Source state	Source state	Source state
Ships and aircrafts	Source state	Source state	Source state	Source state
Shares of property companies	Source state	Resident state	Source state	Source state
Other shares (>25% holding)	Resident state	Resident state	Source state	Resident state
Other shares (<25% holding)	Resident state	Resident state	Resident state	Resident state
All other property	Resident state	Resident state	Resident state	Resident state

Source: Refer to sections 3.3.2.6, 3.3.3.6 and 3.3.4.6

4.3.6.1 *Conclusion from Article 13 comparison*

The following conclusions can be drawn from the comparison performed in Table 11:

- Mauritius does not impose tax on capital gains;
- Capital gains of foreigners arising from the alienation of Chinese assets will be taxed at a rate of 10%;
- The rate of capital gains tax for individuals and companies is significantly higher in China than in South Africa; and
- The rate of capital gains tax for real estate is significantly higher in China than in South Africa.

The following conclusions can be drawn from the comparison performed in Table 12:

- The DTA between South Africa and Mauritius provides for the taxation of capital gains arising from the disposal of shares held in a property company to take place in the country of the recipient. The other DTAs that form part of this study does not provide for the same; and
- The DTA between South Africa and China provides for the taxation of capital gains arising from the disposal of shares of a company in which the recipient holds a 25%

share to take place in the country of source. The other DTAs that form part of this study does not provide for the same.

4.3.6.2 *Tax planning opportunities*

From the conclusions drawn in section 4.3.6.1 it is clear that certain tax planning opportunities exist for South African persons who intend to invest in China. These tax planning opportunities arise as Mauritius does not impose capital gains tax and the DTA between Mauritius and China is more advantageous than the DTA between South Africa and China for certain asset classes.

The IHC structure illustrated in Figure 1 where Mauritius is used as an offshore base can therefore be used to reduce potential capital gains taxes arising from the disposal of assets in China. For instance, a South African company can utilise a Mauritius IHC to purchase a 25% shareholding in a Chinese company. Should the South African company dispose of these shares (via the Mauritius company) on a future date, then Mauritius will have the right to tax the capital gains. As Mauritius does not impose capital gains tax the South African company can therefore expect a tax saving of 10%.

4.3.7 A comparison of Articles 23A and 23B

Table 13 provides a comparison of the taxation principles of Article 23 as they apply to the respective DTAs that form part of this study.

Table 13: Elimination principles of Article 23

Principle	SA and Mauritius	SA and China	Mauritius and China
Coverage	Income only	Income only	Income only
Method of elimination	Credit method	Credit method	Credit method
Limitation on credit	Limited to tax calculated per domestic tax laws	Limited to tax calculated per domestic tax laws	Limited to tax calculated per domestic tax laws
Dividends	STC credit for Mauritius	N/A	N/A
>10% shareholding	Credit for Mauritius for taxes on profit from which dividend is paid	N/A	Credit for Mauritius and China for taxes on profits from which dividends are paid

Principle	SA and Mauritius	SA and China	Mauritius and China
Preferential rates	Preferential rates ignored for SA credit calculation	N/A	Preferential rates ignored for China credit calculation

Source: Refer to Sections 3.3.2.7, 3.3.3.7 and 3.3.4.7

4.3.7.1 *Conclusion from Article 23 comparison*

A critical comparison of Article 23 as contained in the DTAs that form part of this study reveals considerable variation when it comes to the MTC.

The DTAs between South Africa, China and Mauritius only grants bilateral relief in the form of the credit method.

The unilateral tax relief offered by Section 77(2) of the Mauritian Income Tax Act is more beneficial than the bilateral tax relief offered by Article 23 of the DTAs with South Africa and China, as there is no limitation on the percentage control held by a Mauritius resident (also refer to section 2.4.2.2).

Tax relief is not available to South African residents for tax paid on capital gains. This is because the DTA between South Africa and China does not cover capital gains tax.

More beneficial tax relief may potentially exist owing to the provisions for the adjustment of the amount of the credit as a result of preferential tax rates on account of economic development programs. This benefit is not offered unilaterally.

4.3.7.2 *Tax planning opportunities*

One of the benefits of utilising an IHC was demonstrated in section 2.3.2.4. An IHC can be used to pool tax credits and to eliminate wasted tax credits. From the comparison performed in section 4.3.7.1 above it is clear that all the countries that form part of this study rely on the credit method for bilateral tax relief and as such are in a position to pool tax credits or eliminate wasted tax credits.

Capital gains in China are subject to a withholding tax of 10% (refer to Table 11). The comparison in section 4.3.7.1 further demonstrates that South African residents who receive capital gains from a source in China can not rely on bilateral tax relief for purposes of eliminating the double tax burden. These tax payers will have to rely on unilateral tax relief measures. However, Section 77(2) of the Mauritian Tax Act provides for more beneficial unilateral relief than is available in South Africa. This provides tax payers with a tax planning opportunity.

5 CHAPTER 5: CONCLUSION

5.1 INTRODUCTION

In the previous chapter a comparative study of the DTAs between South Africa, Mauritius and China was performed. The DTAs were also compared to the MTC. This chapter summarises the conclusions drawn from the comparative study and will address the purpose statement, problem statement and research objectives in chapter 1.

5.2 A COMPARATIVE STUDY OF DOUBLE TAX AGREEMENTS

In chapter 1 the purpose of this study was defined as the illustration of deficiencies in the DTA between South Africa and China when compared to the DTA between Mauritius and China. South African companies trading with Chinese counterparts are potentially at a tax disadvantage as a result of these deficiencies. Honiball (2009:1) suggested that Mauritius is ideal for establishing an offshore base due to its preferential tax regime, wide treaty network and lack of exchange controls. This study proposes that Mauritius could be used as an offshore base in an IHC structure as a tax planning initiative for South African and Chinese companies who trade and invest in the Afro-China corridor.

In chapter 2 the tax concepts and principles applicable to international taxation and more specifically DTAs, intermediary holding companies and international tax planning were discussed in detail. This discussion provided a platform from which a critical analysis and comparative study of the MTC and the DTAs between South Africa, Mauritius and China can be performed.

In chapter 3 a critical analysis of the MTC and the DTAs between South Africa, Mauritius and China was performed. It was noted that DTAs are not always identical to the MTC. It was further noted that DTAs vary according to the economic circumstances underlying the DTA. There are clear opportunities for saving tax based on the different treatments of certain cash flows and income by each respective DTA.

In chapter 4 a comparative study of the MTC and the DTAs between South Africa, Mauritius and China was performed. The conclusions reached from this comparative study confirm that tax planning opportunities exist for both South African and Chinese residents if they utilise Mauritius as an offshore base.

5.3 TAX PLANNING OPPORTUNITIES

It is evident that, given the high level of trade between South Africa and China, South African and Chinese companies are at a disadvantage from the taxation perspective because the current DTA with China is not comprehensive and does not apply to capital gains tax.

The comparative study illustrated that tax advantages can be gained for the taxation of royalties, interest and capital gains. In the comparison of Article 11 it was concluded that the DTA between South Africa and Mauritius provides for the taxation of interest in the resident country. It was further illustrated that Chinese companies can utilise Mauritius as an offshore base and by so doing gain a tax advantage as a result of the preferential corporate tax rates that apply to residents of Mauritius. Furthermore, Chinese companies can avoid possible double taxation scenarios arising from the right to tax interest in both the resident and source states.

In the comparison of Article 12 it was concluded that the DTA between South Africa and Mauritius provides for the taxation of royalties in the resident country. This will provide tax advantages similar to the advantages which were identified from the comparison of Article 11. Furthermore, the comparison confirmed the opportunities which were identified by Honiball (2009:1).

Article 13 clearly illustrates that tax advantages can be gained for certain asset classes if Mauritius is used as an offshore base. The current DTA between South Africa and China does not cover taxation arising from capital gains tax. Establishing an IHC in Mauritius provides an ideal opportunity to manage the tax consequences for South African companies with investments in China.

The re-introduced South Africa headquarter regime is not in a position to compete with the Mauritius tax regime for trade and investment flow. The South Africa headquarter company regime does not provide investors with residency and they will not gain access to South Africa's network of DTAs. The conclusions reached in this study further illustrates that deficiencies exist in the DTA between South Africa and China when compared to the DTA between Mauritius and China. This could potentially also apply to countries other than China. Furthermore, even if investors gain access to South Africa's network of DTAs they might still be at a disadvantage due to the deficiencies which were identified in this study.

Furthermore, Mauritius provides preferential tax rates which South Africa is unlikely to match.

6 CHAPTER 6: RESEARCH DESIGN AND METHODS

6.1 DESCRIPTION OF INQUIRY STRATEGY AND BROAD RESEARCH DESIGN

The proposed study compares the DTAs between South Africa, Mauritius and China in an effort to identify tax planning opportunities for South African companies. The most appropriate strategy for inquiry is that of a literature review of secondary data. The secondary data is represented by the relevant DTAs as concluded, approved and implemented between South Africa and Mauritius, China and Mauritius, and China and South Africa.

The proposed study has the following core research characteristics:

- *Non-empirical:* The study is non-empirical in nature as the research conducted compares the conceptual principles of DTAs between different countries.
- *Exploratory:* The study is exploratory in nature, because a comparison between DTAs has not yet been carried out. Further, the study aims to identify tax planning and tax saving opportunities by virtue of the results obtained from the critical comparison between the DTAs.
- *Type of data:* The data to be studied is textual in nature.
- *Secondary data:* Existing DTAs will be studied.

DTAs are subject to review and renegotiation on an *ad hoc* basis. The conclusions reached by virtue of the research conducted could be made redundant in whole or partially as a result of changes made to a DTA subsequent to the study. However, decades may pass during which no review is conducted unless it is warranted by specific economic circumstances.

7 CHAPTER 7: LIST OF REFERENCES

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