

South African tax court upholds exemption from dividend withholding tax under most favored nations clause of a treaty with South Africa

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Executive summary

On 12 June 2019, the Tax Court of South Africa (the Court) ruled¹ in favor of the taxpayer on the application of the dividends article in the tax treaty between the Netherlands and South Africa (the NL-SA Treaty).

Per article 10 of the NL-SA Treaty, corporate dividend distributions are generally subject to a dividends tax of 5% (subject to certain conditions). However, the Court has ruled that an exemption from dividends tax is available by application of the "most favored nation clause" (MFN) included in this dividend article. This judgment emulates the outcome of a recent judgment of the Dutch Supreme Court on 18 January 2019.²

South African taxpayers should review whether they have paid dividends tax on dividends paid to Dutch shareholders after 1 January 2016. South African taxpayers should furthermore consider the impact of this judgement on any historic, and future dividend distributions.

Since South Africa is renegotiating tax treaties that provide for 0% withholding tax on dividend distributions, the window of applicability may be limited.

Detailed discussion

Background

The NL-SA Treaty was concluded in 2005 and limits the taxation of dividends at source to 5% if the recipient qualifies as the beneficial owner and holds more than 10% of the shares in the entity paying the dividend. In addition, the MFN clause in this treaty (amended by a Protocol in 2008) provides for an automatic application of a lower dividend withholding tax rate if South Africa and a third country conclude a tax treaty which provides for a lower dividend withholding tax rate or an exemption. However, this MFN provision is only applicable if the more beneficial tax treaty is concluded after the date of the NL-SA Treaty, i.e., after the latest amendment by the 2008 Protocol.

The tax treaty between South Africa and Sweden (SA-SW Treaty) was signed in 1995 and amended through a Protocol in 2012. The 2012 Protocol introduced an MFN clause that does not contain any limitation regarding the date on which the more beneficial tax treaty with a third state was concluded.

In this respect, the tax treaty concluded between South Africa and Kuwait (K-SA Treaty), which entered into force in 2006, provides for an exemption of dividend withholding tax. Since the Protocol to the SA-SW Treaty does not contain a limitation in time with respect to the date of conclusion of the referenced treaty with a third state (i.e., the K-SA Treaty in this case), this automatically resulted in a full exemption under the SA-SW Treaty. This position has been confirmed in South Africa through the issuance of several advance tax rulings by the South African Revenue Service (SARS) providing for the exemption of dividends tax on dividend payments from South African companies to Swedish residents who hold more than 10% of the share capital of those South African companies.

The Court's ruling

Following the position outlined above, the Court ruled that the Protocol to the SA-SW Treaty was a treaty concluded after the date of the NL-SA Treaty within the meaning of the MFN clause, and dividends would therefore be exempt from dividend withholding tax.

Although this judgment does not add to the jurisprudence on treaty interpretation, several other important aspects are worth noting in the development of international tax jurisprudence in South Africa.

First, by virtue of the force of statute held by treaties, the Court approached the interpretation of these treaties under domestic legal principles, noting that interpretation of treaties under principles of international private law should only be undertaken as a secondary measure and where contextually appropriate. To this end, the Court made a single reference to the judgment of the Dutch Supreme Court handed down on 18 January 2019, which dealt with identical (albeit inverted) facts, noting that it was not considered in this instance. This reiterates the importance of approaching treaties in South Africa through the lens of South African domestic legal principles.

Secondly, the Court interpreted these treaties under South African law of contract as opposed to ordinary statutory principles which has not been seen in higher South African courts.

Finally, the Court dismissed the notion of an "intention" being read into the NL-SA Treaty, argued on the basis that the MFN clause had not been intended to be triggered by MFN clauses in treaties concluded thereafter, making reference to the SA-SW Treaty. The Court chose instead to rely on the plain meaning of the words contained in the treaty.

Impact

This ruling provides an opportunity to apply a dividends tax exemption under the NL-SA Treaty if the corporate shareholder holds at least 10% of the capital of the company paying the dividends. It also provides an opportunity to apply for a refund of dividends tax paid on or after 1 January 2016 under the NL-SA Treaty refund mechanism.

It is important to note that South Africa has renegotiated treaties with 0% withholding tax on dividend distributions in order to apply a 5% dividend withholding tax rate, like it did in the Protocol amending the tax treaty between South Africa and Cyprus (2015). This Protocol also contained a provision based on which the adjustments will be retroactively applied from 1 April 2012 (the date of introduction of withholding

taxation on dividends in South Africa). In principle, this judgment should remain valid unless it is overturned on appeal in a higher South African court, and as long as the SA-SW Treaty provides for a dividend withholding tax exemption, which in turn relies on the K-SA Treaty providing for a dividend withholding tax exemption.

Accordingly, South African taxpayers should: (i) review whether they have paid South African dividend withholding tax after 1 January 2016; and (ii) consider the impact of this judgment on future dividend distributions.

Endnotes

1. *ABC Proprietary Limited v Commissioner: South African Revenue Services* (Case No. 14287) Tax Court of South Africa (Held at Cape Town) - Unreported at date of publication.
2. *Hoge Raad* dated 18 January 2019, case number 17/04584, appealed from Hof Den Bosch dated 17 August 2017, case number 15/01361.

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