

**A CRITICAL ANALYSIS OF THE
MEANING OF *BENEFICIAL OWNER* OF
DIVIDEND INCOME RECEIVED BY A
DISCRETIONARY TRUST**

by
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W.A. Engelbrecht

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A CRITICAL ANALYSIS OF THE MEANING OF *BENEFICIAL OWNER* OF DIVIDEND INCOME RECEIVED BY A DISCRETIONARY TRUST

The term *beneficial owner* is most commonly found in the dividend, interest and the royalty articles of tax treaties (Baker, 2007:15), yet there is still uncertainty surrounding the actual meaning of the term (Du Toit, 2010: 500).

Since Dividends Tax became effective in South Africa as from 1 April 2012, it has become necessary to clarify what the term *beneficial owner* means to correctly apply section 64E of the Income Tax Act No 58 of 1962 ('Act').

Section 64EA(a) of the Act determines that the Dividends Tax liability falls on the "*beneficial owner* of a dividend" [Emphasis added]. Section 64D of the Act does define the beneficial owner as "the person entitled to the benefit of the dividend attaching to the share", the application of this definition to a discretionary trust may be challenging since legal ownership must be distinguished from economic ownership (PWC Synopsis, 2012:6). In the absence of guidance by the South African Revenue Service ('SARS'), the first problem arises as to the interpretation of this term within the context of dividend income received by a discretionary trust (Louw, 2012:1). This leads to a second problem relating to the correct application of section 64G(3)(a)(i) of the Act, which makes provision for a reduced rate of dividends tax.

The purpose of this study is to set parameters for determining who the *beneficial owner* of dividend income within the context of a discretionary trust is, where the dividend is paid in respect of shares held in a resident company, and to the extent that the dividend does not

consist of a distribution of an asset *in specie*. The instances when the reduced rate is applicable in terms of section 64G(3) of the Act will also be clarified.

In order to achieve these objectives, an analysis of factors that should be taken into account to define and determine *beneficial ownership*, was undertaken. Common- and civil law definitions were investigated. The Organisation for Economic Co-operation and Development's ('OECD') Model Tax Conventions (MTCs) and its Commentaries provided possible factors to assist in identifying the *beneficial owner*. In the absence of a decision by a South African court, the judgements in the five international court cases were consulted. Four steps were formulated to reach a conclusion.

In terms of these steps, the trust beneficiary remains the *beneficial owner* of dividend income received by a trust in the case of the income having been distributed by the trustees in having exercised their discretion in terms of the trust deed. In the case of contingent beneficiaries it is suggested that the trust, with the trustees, acting in their official capacity on behalf of the trust, would be seen as the *beneficial owner* of the dividend income.

In terms of section 64G(3) of the Act, where a foreign trustee or a foreign trust beneficiary has been identified as the *beneficial owner(s)* of a dividend, the rate at which Dividends Tax is withheld could be reduced as a result of the application of a double tax agreement.

‘N KRITIESE ONTLEDING VAN DIE BETEKENIS VAN *UITEINDELIK GEREGETIGDE* VAN DIVIDENDINKOMSTE SOOS ONTVANG DEUR ‘N DISKRESIONÊRE TRUST

Die begrip *uiteindelik geregetigde* kom mees algemeen voor in die dividende, rente en die tantième artikels van dubbel belasting ooreenkomste (Baker, 2007:15), tog is daar steeds onsekerheid oor die werklike betekenis van hierdie begrip (Du Toit, 2010: 500).

Nadat Dividendbelasting op 1 April 2012 in Suid-Afrika in werking getree het, het dit noodsaaklik geword om die betekenis van die begrip *uiteindelik geregetigde* vas te stel ten einde artikel 64E van die Inkomstebelastingwet Nr. 58 van 1962 ('die Wet') korrek toe te pas.

Artikel 64EA(a) van die Wet bepaal dat die aanspreeklikheid vir Dividendbelasting op die "*uiteindelik geregetigde* van 'n dividend namate die dividend nie 'n uitkering van 'n bate *in specie* uitmaak nie" [klem bygevoeg] val. Artikel 64D van die Wet as "die persoon geregetig op die voordeel van die dividend verbonde aan 'n aandeel", nogtans kan die toepassing hiervan in 'n diskresionêre trust uitdagend wees, aangesien wettige eienaarskap onderskei moet word van ekonomiese eienaarskap (PWC Synopsis, 2012:6). In die afwesigheid van leiding deur die Suid-Afrikaanse Inkomstediens ('die SAID'), ontstaan die eerste probleem weens die interpretasie van die begrip binne die konteks van dividend inkomste ontvang deur 'n diskresionêre trust (Louw, 2012:1). Dit lei tot 'n tweede probleem wat verband hou met die korrekte toepassing van artikel 64G(3)(a)(i) van die Wet, wat voorsiening maak vir 'n verminderde koers Dividendbelasting.

Die doel van hierdie studie is om grense af te baken vir die bepaling van die *uiteindelik geregtigde* van dividend inkomste binne die konteks van 'n diskresionêre trust, waar die dividend betaal word ten opsigte van aandele gehou in 'n maatskappy wat 'n inwoner is, tot die mate dat die dividend nie bestaan uit 'n uitkering van 'n bate *inspecie* nie. Die gevalle waar die verminderde tarief van toepassing is ingevolge artikel 64G(3) van die Wet, sal vasgestel word.

Ten einde hierdie doelwitte te bereik, is 'n ontleding van die faktore wat in ag geneem moet word om die *uiteindelik geregtigde* te definieer en te bepaal, onderneem. Gemeenskaplike regs-definisies is ondersoek. Die '*Organisation for Economic Co-operation and Development's ('OECD') Model Tax Conventions (MTCs)*' en sy kommentare verskaf moontlike faktore om te help in die identifisering van die *uiteindelik geregtigde*. In die afwesigheid van 'n besluit deur 'n Suid-Afrikaanse hof, word die besluite in die vyf internasionale hofsake geraadpleeg. Vier stappe is geformuleer om 'n slotsom te bereik.

In terme van die stappe, bly die trustbegunstigde die *uiteindelik geregtigde* van die dividendinkomste ontvang deur die trust, in die geval waar die inkomste uitgekeer word deur die trustees nadat hul diskresie uitgeoefen is in terme van die trustakte. In die geval van voorwaardelike begunstigdes, word dit gestel dat die trust, met die trustees wat in hul amptelike hoedanigheid namens die trust optree, gesien word as die *uiteindelik geregtigde* van die dividend inkomste.

In terme van artikel 64G(3), waar 'n buitelandse trustee of 'n buitelandse trustbegunstigde as die *uiteindelik geregtigde(s)* van 'n dividend geïdentifiseer is, kan die koers waarteen

Dividendbelasting weerhou word, verminder word as gevolg van die toepassing van 'n dubbelbelastingooreenkoms.

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CHAPTER 1

INTRODUCTION

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1.1 Background and problem statement

The South African Government announced its intent to replace the Secondary Tax on Companies ('STC') with a new Dividends Tax in 2009 (National Treasury, 2009:31). STC was officially repealed effective from 31 March 2012 and the new Dividends Tax came into effect as from 1 April 2012 (National Treasury, 2012:14).

Dividends Tax is regulated by Part VIII of the Income Tax Act No. 58 of 1962 ('Act'). Section 64E(1) of the Act determines that Dividends Tax should be levied at a rate of 15% on the amount of any dividend paid by any company. The dividend for purposes of Dividends Tax is defined as follows per section 64D: any dividend paid by a company resident in the Republic of South Africa ('resident company') or foreign dividend paid by a non-resident company. In the case of the non-resident company, the share in respect of which the foreign dividend is paid, has to be a listed share on a South African securities exchange ('non-resident listed company') (section 64D (b)). The foreign dividend will only be a dividend for purposes of Dividends Tax to the extent that it does not consist of a distribution of an asset *in specie* (section 64D(b)).

Thus, both cash and *in specie* dividends declared by resident companies, and only cash dividends declared by non-resident listed companies may be subject to Dividends Tax.

Dividends Tax is distinguished from STC in respect of the liability for the tax. STC was a company-level tax. This meant that the liability for paying the tax rested on the company declaring the dividend (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks &

De Swardt, 2012:544). Section 64EA of the Act determines that the Dividends Tax liability falls on any of the following persons:

- (a) *beneficial owner* of a dividend, to the extent that the dividend does not consist of a distribution of an asset *in specie*, or
- (b) company that is a resident that declares and pays a dividend to the extent that the dividend consists of a distribution of an asset *in specie*.

[Emphasis added]

The Act defines a *beneficial owner* as the “person entitled to the benefit of the dividend attaching to the share” (section 64D). Dividends Tax per section 64EA(a) of the Act focuses only on the beneficial owner and not on the registered owner of the share. Furthermore, the “dividend” definition was also amended in section 1 of the Act. This change has led to the removal of the “shareholder” definition. The Explanatory Memorandum on the Taxation Laws Amendment Bill (2011:35) explains the reason behind removing the shareholder definition by stating that the shareholder definition encompasses both the share register and beneficial ownership, which could lead to misunderstanding “since the person named in the share register is not necessarily the beneficial owner of the share.”

The concept of *beneficial ownership* thus is a new concept in South African Tax legislation and needs to be clarified.

Locally and internationally, the meaning of *beneficial owner* is still debated. Oliver, Libin, Van Weeghal and Du Toit (2000:310) stated that “there seem to be a number of possibilities or even just uncertainties as to what meaning, or meanings, it [beneficial owner] might have”. Du Toit (2010:500) investigated the development of

the term beneficial ownership within the context of international taxation and confirmed that there is still much debate about its exact meaning.

Two recent Canadian court cases provide valuable guidance as to the interpretation of the meaning of the term *beneficial ownership* (PWC Synopsis, 2012:4), *Velcro Canada Inc v The Queen* (2012 TLC 57 (TC)) being one and *Prévost Car Inc v The Queen* (2008 TCC 231 (TC)) the other. These cases are discussed in Chapter 2 of this study. Although interpretation was given in the context of double tax agreements ('DTAs'), the Canadian approach is considered rationally sound and South Africa could adopt a similar view when applying the interpretation of the concept *beneficial owner* (Louw, 2012:3). *Velcro Canada Inc v The Queen* analysed commentary made by the Organisation for Economic Co-operation and Development ('OECD') for purposes of interpreting the meaning of *beneficial owner*. The OECD's Model Tax Conventions ('MTCs') forms the cornerstone of the majority of DTAs and therefore the OECD's opinions and interpretations are considered highly persuasive (PWC Synopsis, 2012:4).

The concept of beneficial ownership may be particularly important for trusts. In South Africa, two types of trusts are recognised, namely the *bewind* trust and the ownership trust (Louw, 2012:1). In the case of a *bewind trust*, ownership of the trust assets vests in the beneficiaries and the trustees are only responsible for the administration thereof (Stiglingh *et al.*, 2013:804). In contrast, the ownership trust transfers ownership of the trust assets to the trustees and the rights of the beneficiaries are further determined by the trust deed (Louw, 2012:1).

The discretionary trust is one of the two types of ownership trusts commonly recognised in South Africa. In a discretionary trust, the trustees are the legal owners of the shares (Louw, 2012:1). The distribution of the dividend income and shares to the trust beneficiaries is dependent on the trust deed and may be within the discretion of the trustees (Honiball & Olivier, 2009:6).

Hence, the trust beneficiaries are not necessarily entitled to the shares or dividend income until such time as a distribution is made by the trust and the beneficiaries consequently have a contingent right to them (Louw, 2012:1). In terms of the new legislation, Dividends Tax may be the liability of the *beneficial owner* of the dividend in certain instances (section 64EA(a)). Thus, it is important to correctly identify the *beneficial owner* and also who would be liable for paying the Dividends Tax. This might be problematic in the case of dividends received by a discretionary trust.

The first problem that arises is the question of how the term *beneficial owner* is interpreted in South Africa. Even though the term *beneficial owner* is specifically defined in section 64D of the Act as “the person entitled to the benefit of the dividend attaching to the share”, a distinct difference remains between the legal ownership and economic ownership of the share (PWC Synopsis, 2012:6). Applying the definition to discretionary trusts might be problematic, as the trustees are the legal owners of the shares who hold the shares on behalf of and for the benefit of the beneficiaries (PWC Synopsis, 2012:6). The beneficiaries, in turn, are the economic owners of the shares (PWC Synopsis, 2012:6). Depending on how *beneficial owner* is interpreted, the person entitled to the benefit of the dividend attached to the share can either be the beneficiary or the trust itself (Louw, 2012:1). The South African

Revenue Service ('SARS') to date has not issued guidance on how Dividends Tax will be applied to trusts as a whole and in particular to discretionary trusts (Louw, 2012:1).

The second problem which arises from the possible differences in interpretation surrounding beneficial ownership is the application of section 64G(3) of the Act. This section makes provision for a company to withhold tax from the payment of the dividend at a reduced rate when the dividend is subject to a double tax agreement. The Dividends Tax can possibly be withheld at the incorrect rate, should a foreign beneficial owner fail to notify the resident company "that the dividend is subject to that reduced rate" (section 64G(3)(a)(i)).

The reference to a DTA in section 64G of the Act necessitated that international literature be scrutinised in an attempt to clarify the meaning of *beneficial owner*. Honiball and Olivier (2008:571) define beneficial ownership as "an English common law concept which means the person who ultimately and substantially enjoys the benefit of the income or the asset in contrast with the registered or nominal owner". This term is used in some DTAs to prevent treaty shopping. Treaty shopping is defined as:

...the situation where a person who is not entitled to the benefit of a tax treaty, makes use – in the widest sense of the word – of an individual or of legal person in order to obtain those treaty benefits that are not available directly.
(Rogers-Glabush, 2005:453)

The purpose of treaty shopping is to avoid tax. The OECD aims to prevent such tax avoidance (Krishna & Gervais, 2009:139).

In the Model Tax Convention on Income and on Capital as issued by the OECD, article 10 refers to the term 'beneficial owner', but no further explanation on the meaning of the term is provided. The OECD issued a discussion draft in 2011 to clarify the meaning of '*beneficial owner*' as used in the OECD Model Tax Convention. The commentary stipulated that "the term beneficial owner is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries), rather, it should be understood in its context". As a footnote, specific reference is made to a discretionary trust (OECD, 2011:3).

Furthermore, Article 3(2) of the OECD model states that the following should be done if a term is not defined in a tax treaty:

As regards the application of the Convention at any time by a Contracting State,¹ any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purpose of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State. (OECD, 2008:23)

Article 3(2) can be interpreted as stating that a domestic law meaning prevails over any other meaning (Meyer, 2010:13). This emphasises the importance of determining the meaning of South Africa's domestic tax law in respect of *beneficial ownership*.

¹ Article 10 of the 2010 OECD MTC explains that a Contracting State is a country (state) that is a party to a DTA.

1.2 Objectives

This study aims to set parameters for determining who the *beneficial owner* of dividend income within the context of a discretionary trust is; where the dividend is paid in respect of shares held in a resident company; and to the extent that the dividend does not consist of a distribution of an asset *in specie*. The rate at which a resident company must withhold Dividends Tax in terms of section 64G(3) of the Act where a dividend is paid to a discretionary trust, is also clarified.

In order to achieve this objective, consideration is given to the following in an attempt to clarify and substantiate the aim of this study:

- To analyse the factors that should be taken into account to define and determine *beneficial ownership*
- To analyse the proposed meaning of the term *beneficial owner* for Dividends Tax purposes
- To identify who the *beneficial owner* entitled to the benefit of the dividend attaching to shares held by a discretionary trust is
- To identify who the *beneficial owner* is for purposes of obtaining a reduced rate of Dividends Tax in terms of section 64G of the Act

1.3 Research design, methods and scope

This study consists of a literature review using recent local and international sources available on the internet and took the form of a non-empirical approach. This entailed

an extended literature review of government publications, court cases and published articles. The use of international articles and publications are invaluable since guidance has yet to be provided in South Africa on the research questions posed.

International court cases relevant to *beneficial ownership* formed a significant part of the research. The international cases are not binding on the South African courts, but do have persuasive value.

This study focused on setting parameters for determining who the *beneficial owner* of dividend income within a discretionary trust is; where the dividend is paid in respect of shares held in a resident company; and to the extent that the dividend does not consist of a distribution of an asset *in specie*.

1.3.1 Delimitations

This study has the following delimitations:

Section 64D of the Act refers to dividends paid by a company that is a resident and a foreign dividend paid by a non-resident company, where the share in respect of which that foreign dividend is paid, is a listed share on a South African securities exchange and “to the extent that the foreign dividend does not consist of a distribution of an asset *in specie*”. This study does not analyse the *beneficial owner* of such foreign dividends.

Secondly, to the extent that a dividend paid by a resident company consists of a distribution of an asset *in specie*, the liability for Dividends Tax falls on the resident

company (section 64EA(b)). Dividends consisting of a distribution *in specie* fall outside the scope of this study.

Lastly, vested trusts also fall outside the scope of this study. In a vested trust, the ownership of the shares vests in the trustees (Olivier & Honiball, 2009:5). However, the beneficiaries have vested rights to the income derived from the shares, which would be the dividend, and to the capital, the shares, when the trust is terminated (Olivier & Honiball 2009:5). The trust beneficiary therefore automatically is the person entitled to the benefit of the dividend attaching to the shares and liable for any Dividends Tax in terms of section 64EA(a) of the Act.

1.3.2 Assumptions

Currently, more than one legal system is used around the world. South Africa uses the civil law system, which is of Dutch origin, and the common law system, as inherited from the British (Department of Justice and Constitutional Development, 2013:1). For purposes of this study, it must be assumed that there are only two law systems: common law and civil law. For practical purposes, it will not be feasible to analyse the term beneficial owner in terms of Socialist law, Islamic law, or any other legal system around the world.

1.4 Outline of the chapters

A brief outline of each chapter will follow explaining the content of each chapter.

1.4.1 Chapter 2: Analysis of the concept *beneficial ownership*

Chapter 2 provides a detailed analysis of existing literature on the concept beneficial owner; the term currently used in section 64D of the Act. The meaning of the term is analysed by investigating the common-, civil- and international law definitions. MTCs and international case law were also consulted for interpretation of the meaning of the concept.

1.4.2 Chapter 3: The nature of trusts in South Africa

Chapter 3 provides a basic understanding, firstly of the nature of a trust and, secondly, of the rights and obligations of the trustee and beneficiary in terms of the trust property (capital and/or income) in a discretionary trust.

1.4.3 Chapter 4: Determination of the *beneficial owner* of dividend income in a discretionary trust

Based on the factors of *beneficial ownership*, as identified in Chapter 2, together with the discussion of the nature of a trust in Chapter 3, Chapter 4 formulates steps to determine who the beneficial owner of dividend income in a discretionary trust is. This is done on the basis of factors of *beneficial ownership*, as identified in Chapter 2, together with the discussion of the nature of a trust in Chapter 3.

1.4.4 Chapter 5: Conclusion

Chapter 5 provides a summary of the research as well as the author's findings and conclusion with regard to the stated objectives.

CHAPTER 2

ANALYSIS OF THE MEANING OF THE CONCEPT *BENEFICIAL OWNERSHIP*

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2.1 Introduction

Following the introduction of Dividends Tax in South African Income tax legislation, the concept of *beneficial ownership* has become relevant for both local and international dividend transactions (SARS, 2012:3).

A statement repeatedly made in studies pertaining to the meaning of *beneficial ownership*, is that of the continuing uncertainty surrounding the actual meaning of the term. This is surprising when taking into consideration the high volume and value of transactions emanating from the international flow of interest, royalties and dividends and the fact that the term has been used for over thirty years (Du Toit, 2010:500).

The concept of *beneficial ownership* is unfamiliar in South African common law and the term *beneficial owner* has also not been comprehensively defined in the Act (Honiball & Olivier, 2011:540). Furthermore, no guidelines indicating how to use the term *beneficial ownership*, or the meaning thereof in the context of dividends paid have been issued by SARS (Honiball & Olivier, 2011:540).

The term *beneficial owner* is most commonly found in the dividend, interest and the royalty articles of tax treaties. These articles provide for a decreased level of withholding tax in the particular category of income if the *beneficial owner* of the dividends, interest or royalties is a resident of the state which is a party to the treaty. The use of beneficial ownership was introduced to counter treaty shopping and to place a constraint on the use of this decreased tax rate (Baker, 2007:15). However, the term beneficial ownership is also not clearly defined in tax treaties, although

guidance can be gained from the Commentaries to the tax treaties of the OECD, or the OECD MTC.

In this chapter, the concept of beneficial ownership is analysed. The purpose of the analysis is to identify components of the concept of beneficial ownership. This may assist in determining who is liable for Dividends Tax in terms of section 64EA(a) of the Act, or who will qualify for a reduced rate of the withholding tax in terms of section 64G(3).

The OECD MTC and its Commentaries are investigated and used as guidance in the analysis. Before this, however, the domestic law meanings of beneficial ownership are scrutinised. Finally, a study of relevant case law will add to the analysis.

2.2 Domestic law meanings of *beneficial owner*

Due to differences in legal systems and approaches in defining the ownership concept, the concept beneficial ownership is not applied consistently internationally. The most significant differences exist between the common and civil law jurisdictions (Vitko, 2011:4).

The concept of ownership is fundamental in both common law and civil law states (Greyling, 2011:72). The most important difference between these legal systems, for the purpose of this chapter, is that the common law states allow for a segregation of ownership between legal ownership and beneficial ownership, whereas the civil law

states do not. The question of ownership is a legal one and assesses the nature of the rights held by different persons (Greyling, 2011:72).

South Africa is a member of the Commonwealth of Nations, but is not generally regarded as a common law state. This is due to its legal system being based primarily on the Roman Dutch legal system with aspects of English law influencing trust and company law (Honiball & Olivier, 2011:542).

2.2.1 Common law jurisdictions

In common law jurisdictions, the concept of *beneficial rights* originates from trust law. In accordance with trust law, property interests can be divided into legal and beneficial interests. Equitable (beneficial) rights are assigned to the beneficiary and legal rights to the trustee. The title to the trust property rests with the trustee. In essence, the beneficiary does not own trust property, but has the right to put into force the terms of the trust deed – which may provide that this beneficiary eventually acquires final ownership of the trust property (Krishna & Gervais, 2009:140).

The starting point thus is an investigation into the nature and extent of ownership rights or ownership attributes as held by different parties. A person can be the legal owner of an object, yet have no right to deal with the object as his own and not carry any risk related to the object. This person will not be the beneficial owner (Olivier, *et al.*, 2000:319).

Olivier *et al.* (2000:319) define beneficial owner as: “...the person whose ownership attributes outweighs that of any other person.”

The ownership attributes referred to above include the “right to possess, use or manage the income, the capital (including the power to alienate and the ability to consume, waste or destroy), etc.” (Olivier *et al.*, 2000:319). The beneficial owner also carries the risk in connection with dividend distribution in the case of shares held (Olivier *et al.*, 2000:319).

According to Du Toit (Olivier *et al.*, 2000:319), there is a strong notion that the OECD borrowed the concept beneficial owner from the common law states. The OECD MTC Article 3(2) governing general definitions is used as the basis of this argument.

It states that:

As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Du Toit (Olivier *et al.*, 2000:320) supports his own opinion by stating that the drafters of the OECD Model, who considered the issue over a number of years and had various other options available to them, opted for this strange wording, wording with a very specific legal meaning and not known outside the common law states. Du Toit thus is of the opinion that the drafters of the OECD Model intended this legal meaning to apply.

2.2.2 Civil Law Jurisdictions

Civil law is distinguishable from common law in that it does not formally recognise segregated ownership. Thus a person holds a legal title in accordance with the Civil Code, but this is subject to rights and obligations in respect of other persons. The third party has an enforceable and personal right against the person holding the legal title and not against the whole world. Thus, notwithstanding the formal exclusion of segregated ownership from civil law, this approach means that the same effect is achieved as that in the common law (Olivier *et al.*, 2000:319)

In the absence of a clear definition of the concept of beneficial ownership under domestic law, guidance is often taken from the application of the concept under the OECD MTC and its Commentaries.²

2.3 Beneficial ownership in the latest OECD Documentation

The possible meaning of beneficial ownership will now be discussed in light of OECD documentation.

² The Commentaries to the OECD MTC are regarded as a supplementary means of interpretation. In this respect, the Commentaries may be used only to confirm a meaning already ascertained, or to establish a meaning to prevent absurdities and abnormalities. In practice, the OECD Commentaries are taken into account in interpreting MTCs. This is due to the OECD MTC having been used in numerous treaties entered into by Contracting States. Subsequently, the OECD Commentaries provided Contracting States with reliable material to enable them to interpret the meaning of the provisions of the treaty. It can also be said that the Commentaries helped to develop a common body of international tax law and to provide a degree of certainty to both taxpayers and administrators. However the Commentaries are regarded as a supplementary means of interpretation only and are not binding on OECD member states (Van Raad, 1984:166).

2.3.1 Background

The OECD released the Eighth Edition of its MTC on Income and Capital in July 2010 (OECD, 2010:3). The main purpose of the OECD MTC is to provide a consistent basis to solve problems that repeatedly arise in the area of double taxation (OECD, 2010:7).

The term beneficial owner first appeared in articles of the OECD MTC in 1977. No explicit definition was provided and Commentaries of the OECD gave limited reference to this term (Olivier *et al.*, 2000:310). The term has become widely used in tax treaties, yet very little information is available on the history of this term and the exact reasons why it was incorporated into the OECD MTC (Oliver *et al.*, 2000:311).

2.3.2 Interpretation of the concept *beneficial owner* in the Commentaries to the 2010 OECD MTC

The Commentary begins its explanation of beneficial ownership by excluding agent or nominee relationships:

Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purposes of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State (OECD, 2010:188).

The Commentary also excludes conduit companies:

It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies” concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary³ or administrator acting on account of the interested parties (OECD, 2010:188).

During April 2011, the OECD issued a public discussion draft, namely the “Clarification of the meaning of ‘beneficial owner’ in OECD Model Tax Convention” (‘Discussion Draft’). Due to the differing interpretations by courts and tax administrations in applying the concept of beneficial owner in the Articles of the OECD MTCs, this Discussion Draft was aimed at clarifying the interpretation thereof (OECD, 2011:2).

The Discussion Draft addressed, inter alia, whether the concept of beneficial ownership should be used in its autonomous treaty meaning or in its domestic law meaning.

³ The fiduciary duty is a responsibility to conduct trust administration prudently and in utmost good faith (Du Toit, 2002:67).

2.3.2.1 Autonomous treaty meaning versus domestic law meaning

It is clear from the Discussion Draft that the term beneficial owner should not be used in a “narrow technical sense” with reference to the meaning that it has “under the trust law of common law countries”. However, it goes on to explain that the domestic law meaning should not be ignored in terms of the interpretation of the concept of beneficial owner. It may still be used, provided that it is consistent with the broad-spectrum guidance in the Commentaries of the OECD (OECD 2011:3). Hence, according to the International Bureau of Fiscal Documentation (‘IBFD’) (2011:1), the term is to be interpreted in a tax treaty context.

Dividends are one of the classes of income that may be subjected to limited taxation (OECD, 2010:12) and Article 10 (‘Article’) of the OECD MTC governs the international taxation of dividends between Contracting States. Paragraph 2 of the Article limits the tax charged on a dividend paid by referring to the beneficial owner of the dividend (OECD, 2010:28). In the Discussion Draft specific mention is made of the example of a discretionary trust where the trustees do not exercise their discretion in distributing dividends earned. In this scenario, the trustees or the trust could be the beneficial owners of the dividend income for purposes of Article 10, despite the fact that trust law might differentiate between legal and beneficial ownership (OECD, 2011:3).

2.3.2.2 Placement of the concept of the *beneficial owner* within the OECD MTC

As stated earlier, the OECD MTC and its Commentaries do not define beneficial ownership, but merely attempt to describe its character (Krishna & Gervais, 2009:140). The Discussion Draft intends to supplement the Commentaries by expanding on the beneficial ownership concept. It has been contended that countries have been reluctant to accept the concept as set out in the Discussion Draft as they may wish to reserve the possibility of interpreting the term beneficial owner in a broader sense, namely, in light of their own anti- (treaty) abuse doctrines (IBFD, 2011:2).

2.3.3 Factors to determine the meaning of the concept *beneficial owner*

Based on the explanations provided in the OECD Commentaries, possible factors to assist in identifying the beneficial owner will be analysed in the next section(s). These factors are:

- (i) Intermediate recipients;
- (ii) Ownership of the underlying assets;
- (iii) Technical meaning;
- (iv) Trustees.

2.3.3.1 Intermediate recipients

Paragraph 12.4 of the Discussion Draft stipulates that an agent, nominee, conduit company acting as a fiduciary or administrator as the recipient of the dividend is not the beneficial owner (OECD, 2011:4).

The reasons given for such a recipient not being the beneficial owner are as follows:

- (i) That recipient does not have the full right to use and enjoy the dividend that it receives and this dividend is not its own, and
- (ii) The powers of that recipient over that dividend are indeed constrained in that the recipient is obliged (because of a contractual, fiduciary or other duty) to pass the payment received to another person. (OECD, 2011:4)

Therefore, the recipient of a dividend is the beneficial owner of that dividend where that party has the “full right to use and enjoy” the dividend, unrestricted by a contractual or legal obligation to pass the dividend received to another person. The obligation can originate from relevant legal documents. Facts and circumstances may also show the substance of the transaction and indicate clearly that the recipient does not have the “full right to use and enjoy” that dividend (OECD, 2011:4).

In the case of a conduit company, a practical test was formulated which looks at the relationship and role of the conduit company. This test examines the governance model and composition of the conduit company’s parent board and its actual duties of corporate management. The greater the degree of legal responsibilities of the conduit’s boards of management, the greater the likelihood that the conduit is both the legal and beneficial owner of its subsidiary’s shares and the associated income (Krishna & Gervais, 2009:141).

2.3.3.2 Ownership of the underlying assets

In determining who the beneficial owner is, formal or legal ownership of the shares is not the decisive factor if that party has narrow powers in relation to the income derived from the share (Kemmeren, 2012:2). The Commentaries state that the

beneficial owner has the full right to use and enjoy the dividend income without an obligation to pass the income on to another person. This obligation may arise from legal documents or on account of facts or circumstances indicating that, in substance, the recipient does not have the full right of use. Thus the use and enjoyment of the dividend income is not necessarily related to the legal ownership of the share, neither is it related to the use and enjoyment of the share on which the dividend is paid (OECD, 2011:4).

2.3.3.3 Technical meaning

Domestic law, particularly trust law, does not define the concept of beneficial ownership (IBFD, 2011:3).

2.3.3.4 Trustees

As mentioned earlier, the beneficial owner has the full right to use and enjoy income. A footnote to the Discussion Draft states that trustees of a discretionary trust can be the beneficial owners of undistributed dividend income. However, this approach of the OECD has been questioned, since it is trite law that a trustee cannot have full rights over income (IBFD, 2011:3).

2.3.4 Implications for interpretation of the concept *beneficial owner*

The Discussion Draft's proposed clarification signifies a step towards attaining international consensus on the meaning of the term beneficial owner. The term should be interpreted as a global concept and "be given an international meaning not derived from the domestic laws of contracting states". The confusion arising from various interpretations given by some common law jurisdictions where the term

beneficial owner has originally been narrowly interpreted should be greatly reduced. This appears to agree with the decision reached in the U.K. Court of Appeal in the case of *Indofood International Finance Ltd v JP Morgan Chase Bank NA* (Ernst & Young, 2011:3). This case, as well as other relevant cases will be discussed in the following section.

2.4 Judicial interpretation of beneficial ownership

According to the South African Institute of Chartered Accountants ('SAICA'), the issue of what is meant by the beneficial owner of a dividend has not come up for decision by a South African court (SAICA, 2009:1). The author has chosen five international landmark cases in which the concept of beneficial ownership was discussed. These cases represent judgements from countries using both civil and common law systems. Although not all these cases addressed the beneficial ownership of dividend income, important factors that arise from all of them may be useful in the analysis of the concept.

2.4.1 *Prévost Car Inc and Her Majesty the Queen*

The Tax Court of Canada made a decision in 2008 which was of notable interest and importance. This was the case of *Prévost Car Inc and Her Majesty the Queen* 2008 TCC 231 ('Prévost') (SAICA, 2009:1).

In *Prévost*, a Canadian company ('Prévost Canada') paid a dividend to its holding company and sole shareholder, a Dutch company ('Prévost BV') (SAICA, 2009:1). Prévost BV, in turn, was jointly owned by a United Kingdom company and a Swedish

company. The use of Prévost BV was to a certain degree motivated by tax considerations, as it attracted a lower rate of Canadian withholding tax under the Canada-Netherlands Income Tax Treaty. The Dutch company had little other substance and there was a shareholders' agreement that required 80% of dividends received by Prévost BV to be paid to the United Kingdom and Swedish companies (Sharkey, 2011:659).

The court had to decide whether or not Prévost BV was the beneficial owner of the dividend declared by Prévost Canada (SAICA, 2009:3). It was decided that Prévost BV and not the United Kingdom or Swedish companies were the beneficial owners of the dividend (SAICA, 2009:3).

A key factor in reaching this decision was to determine how much discretion Prévost BV was entitled to exercise with regard to its income (Greyling, 2011:88). The court *a quo* could not find evidence that the dividends from Prévost Canada were *ab initio* destined for United Kingdom and Swedish companies, with Prévost BV merely being a funnel (Greyling, 2011:88). The court thereby found that there was no predetermined flow of funds and based its decision on the fact that Prévost BV could only pay dividends that had been declared by its directors and subsequently approved by its shareholders (Greyling, 2011:88).

Firstly, to continue, the use of intermediaries in the form of agents, nominees or conduit companies are discussed, based on findings of this case. In this regard, the Honourable Gerald J. Rip, Associate Chief Justice of the Tax Court of Canada, supported his judgment by stating that:

When an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatory is acting or for whom the nominee has lent his or her name. When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it (*Prévost Car Inc and Her Majesty the Queen 2008 TCC 231:17*).

This judge also referred to the OECD Commentary on Article 10(2) which explains that one should look behind an agent or nominee in order to determine the beneficial owner of a payment and that a conduit company also is not a beneficial owner. He noted that an agent, nominee or conduit company "never has any attribute of ownership of the dividend" received (Penny & Van Loan, 2008:2). It was further explained that, if the owner of shares had a legal obligation to pass on the dividend to a different party, the owner of the shares would not be the beneficial owner of the dividend as well. The reasoning behind the insertion of the term beneficial owner into international double tax agreements appears to be to prevent intermediaries, such as agents and nominees, who were not the beneficial owners of the dividends that they received, from obtaining treaty benefits. The court recognised that, as a matter of law, a holding company is not a mere agent or nominee for its shareholders (SAICA, 2009:2).

A holding company would be the beneficial owner of dividends received by it, unless strong evidence points clearly to the fact that the company is a mere conduit for the transmission of that dividend to its own shareholders (SAICA, 2009:2). The beneficial

owner is not necessarily the person who can ultimately benefit from the dividend either (Kemmeren, 2012:7).

The Prévost case does not address a situation in which an entity receiving passive income has a contractual obligation to pass these income items on to another person. Should there be a “predetermined or automatic flow of funds” through an entity, or a scenario in which income is “*ab initio* destined for” another person with the entity receiving the income acting “as a funnel” or “a conduit” to pass the income through to the other person, it would be a concern. According to the OECD Commentary, where a

...formal owner, as a practical matter, has very narrow powers, such a situation could render such person not to be the *beneficial owner* in relation to the income concerned, as its role is a mere fiduciary or administrator acting on account of the true beneficial owners (Penny & Van Loan, 2008:3).

Prévost BV was not an agent, nominee or conduit based on the reasons that there were no predetermined or automatic flow of funds and Prévost BV was not obligated to pay any dividend based on its deed of incorporation (Kemmeren, 2012:8).

Secondly, Rip GJ continued to describe the meaning of beneficial owner in relation to the dividend by stating the following:

In my view the "beneficial owner" of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is the beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short, the dividend is for the owner's own benefit and this

person is not accountable to anyone for how he or she deals with the dividend income. (*Prévost Car Inc and Her Majesty the Queen 2008 TCC 231:17*)

The focus of the beneficial ownership test was on the payment of the dividend, as distinct from the share. This was done to bridge the gap between civil law and common law. Civil law uses the concepts of bare owner and usufructuary, whilst common law has the principle of holding property as trustee (Du Toit, 2010:507).

It is not stipulated by international tax treaties using the concept of beneficial ownership, whether the beneficial owner of the dividend must also be the owner of the share. The *Prévost* case illustrates this fact: *Prévost Netherlands* was the owner of the shares in respect of which a dividend was declared, but it does not imply that this company was the beneficial owner of those dividends (SAICA, 2009:2).

The judgement in this case can be summarised as a cautious analysis of the concept of beneficial ownership in both common law and civil law, as well as the OECD Commentaries (Sharkey, 2011:659). Du Toit rates this case as pivotal in defining the meaning of beneficial ownership due to the thorough analysis of the meaning of the plain wording in order to reach the international tax meaning of beneficial ownership (Du Toit, 2010:507).

2.4.2 *Indofood International Finance Ltd v JP Morgan Chase Bank*

The meaning of the concept beneficial ownership in relation to interest was the subject of a United Kingdom court judgement in the *Indofood International Finance Ltd v JP Morgan Chase Bank* ('*Indofood*') case in 2006. The interpretation of beneficial owner as given by the OECD MTC in its various publications was upheld by the decision in this case (Interfis, 2009:2).

The case can be summarised as follows: An Indonesian company needed a loan for business purposes and established a Mauritian company to issue the loan in order to benefit from the Indonesian-Mauritian Tax Treaty whereby a lower withholding tax rate of 10% could be obtained (Baker, 2007:18).

The loan amount and the interest rate were identical to that which the Mauritian company borrowed and subsequently lent to the Indonesian parent. Contrary to documentation that stipulated that the interest be paid by the Indonesian company to Mauritius on the first day and on the second day from Mauritius to the directors, the interest was paid directly from Indonesia to the trustees. The Mauritian subsidiary was obligated to on-pay all the interest received and could retain none thereof (Baker, 2007:19).

Subsequently, the Indonesian-Mauritian Tax Treaty was cancelled, which resulted in the 10% reduced rate no longer being available. It was suggested that a Dutch incorporated company be interposed between the Indonesian and Mauritian company to take advantage of the Indonesia-Netherlands Tax Treaty, which also had a 10% reduced withholding tax (Baker, 2007:20).

The crucial question was whether the Dutch company between the Indonesian borrower and the Mauritian company, holding back-to-back loans for the same amounts and receiving and again paying the same amount of interest, could be regarded as the beneficial owner of the interest received (Du Toit, 2010:505). The case also considered whether or not beneficial ownership is excluded where a person is under an obligation to pay dividends, interest or royalties, and also where

these amounts are paid on in the absence of a legal obligation to do so. The specific investigation of back-to-back loan structure is significant in that nothing puts beneficial ownership to a greater test (Du Toit, 2010:505).

On appeal, the court decided in favour of Indofood by finding that the Dutch company could not be the beneficial owner of the interest paid by Indofood (Greyling, 2011:86).

In judgement of the Indofood case, the Court of Appeal unequivocally relied on the published OECD reports and 1986 and 2003 Commentaries on the OECD MTC. The judgement reiterated the commentary on articles 10 to 12 of the OECD. This shows that the court adopted an “international fiscal meaning” for the concept *beneficial owner* in contrast to a “narrow technical” domestic law meaning (Greyling, 2010:49). This is also referred to as the economic substance or practical matter test (Du Toit, 2010:506). The beneficial owner of the interest was the party having the full privilege to benefit from the income and not the formal owner. The Mauritian, and later the Dutch companies, were only administrators of the income and thus were not the beneficial owners of the interest income (Kemmeren, 2012:6).

2.4.3 Swiss Federal Administrative Tribunal

The Swiss Federal Administration Tribunal (‘Swiss administration court’) issued judgement on 7 March 2012 relating to the concept of beneficial ownership from a Swiss withholding tax perspective and related dividend transactions (Waldersyss, 2012:1). Even though *beneficial owner* was defined from a tax treaty perspective, it used a “substance over form” or “economical” perspective (PWC Newsflash, 2012:1).

A brief summary of the facts of this case is as follows: Total return swap transactions relating to Swiss equities were entered into between a Danish bank and parties in the European Union and the United States. In an attempt to minimise hedge exposure, the Danish bank bought Swiss equities from numerous third parties. Once the total return swaps reached maturity, the shares were sold to different parties. All transactions were made by international brokers. Dividends received during the maturity period of the trade were subject to 35 per cent Swiss withholding tax and full refund was claimed under the former Swiss-Danish double tax treaty. The Federal Tax Authority declined the Swiss withholding tax refund on the basis of a lack of beneficial ownership and due to tax avoidance. The Danish bank filed an appeal against this decision. The Swiss administration court ruled in favour of the Danish bank by stating that the beneficial ownership of the dividend was not transferred to the counterparties of the total return swaps, but retained by the Danish bank (PWC Newsflash, 2012:1).

In the court's decision, beneficial ownership was analysed using the underlying economic reality instead of the legal form (Federal Administrative Tribunal Judgement, 2012:14). Under this interpretation, the following factors were decisive in determining beneficial ownership:

- (a) Firstly, to what extent does the recipient of the dividend income have authority and power to decide on the use of that income? Thus a fiduciary or manager who acts on behalf of the *beneficial owner* is excluded from beneficial ownership. Being obligated to pass on income to another shows limited power to decide on the use of the income.

- (b) Secondly, who assumes the risks associated with the income? The more risks assumed, the greater the indication of beneficial ownership. (Federal Administrative Tribunal Judgement, 2012:14).

2.4.4 *Velcro Canada Inc v The Queen*

The Tax Court of Canada issued judgement on 24 February 2012 in the case of *Velcro Canada Inc v The Queen* 2012 TCC 57 ('Velcro') whereby the meaning of the term beneficial ownership was analysed for purposes of a tax treaty between Canada and the Netherlands relating to royalty income.

A brief summary of the facts of this case is as follows: Velcro Canada Inc. ('Velcro Canada') manufactured and sold fastening products. Velcro Canada had licensed these brands and technologies from a connected Dutch company ('VIBV'). Velcro Canada paid royalties to VIBV and withheld and remitted ten percent of these royalties in accordance with the relevant Treaty provision. In 1995, VIBV relocated to the Netherlands Antilles and operated under its laws. In the absence of a tax treaty with the Netherland Antilles, the royalties paid by Velcro Canada to VIBV would have been subject to a 25 percent withholding tax. To mitigate this, VIBV transferred its rights under the license agreement with Velcro Canada, to a wholly-owned Dutch subsidiary ('Dutchco'). Velcro Canada had to pay all royalties to Dutchco, who was then required to pass a certain percentage of these royalties onward to VIBV. VIBV was the third-party beneficiary of the agreements between Velcro Canada and Dutchco who could enforce Dutchco's rights under the agreements. The primary issue to be decided by the Tax Court was whether Dutchco was the beneficial owner of the royalties it received from Velcro Canada for purposes of the Tax Treaty. The

Tax Court held that Dutchco was not the beneficial owner of the royalties and that the beneficial owner was in fact VIBV (Peters, 2012:3).

The court took the following four elements into consideration when determining beneficial ownership: (a) possession; (b) use; (c) risk; and (d) control of the payment of income (*Velcro Canada Inc v The Queen* TCC 572012:9).

2.4.5 Netherlands Supreme Court Case no. 28638

The Netherlands Supreme Court ('HogeRaad') decision also related to treaty interpretation of beneficial ownership. In this case, a stockbroker, residing in the United Kingdom purchased dividend coupons of Royal Dutch Shell from a Luxemburg company. These coupon rights were purchased after Royal Dutch Shell had declared, but not yet paid its dividend. The stockbroker did not purchase the underlying shares of Royal Dutch Shell. The HogeRaad held that the stockbroker was the beneficial owner of the dividend (Krishna & Gervais, 2009:141).

The principle established in this case was that the *beneficial owner* does not have to be owner of the shares.

Having investigated relevant case law on the concept of beneficial ownership, it is necessary to consider certain recent developments regarding the concept.

2.5 Recent developments

The relevance of any recent developments in the interpretation of the term beneficial ownership will now be discussed.

2.5.1 China's Views on Beneficial Ownership

The majority of China's tax treaties provide for a reduced rate of tax on dividends in terms of tax treaties. This reduced rate is only granted to the recipient of the dividend income, provided the recipient is the beneficial owner of the dividend income. The State Administration of Taxation ('SAT') of China issued a Circular 601 ('the Circular') effective from 27 October 2009 (Sharkey, 2011:655). The purpose of this Circular is to inform tax offices how to determine whether an applicant is a beneficial owner or not (Sharkey, 2011:656). Similar to the workings of section 64G(3) of the Act, tax offices around China also make use of the system whereby taxpayers have to apply for the lower rate of tax (Sharkey, 2011:656).

2.5.2 Definition of *beneficial owner*

The Circular stipulates that, in order to be the *beneficial owner*, each of the following four conditions have to be met:

- i. The person has the right to own or dispose of the income and rights or property in the income; and
- ii. The person is usually engaged in substantial business operations; and
- iii. The person is not an agent; and
- iv. The person is not a conduit company

(Sharkey, 2011:656)

The Circular explains that a conduit entity is a company established for purposes of evading or reducing tax. These conduit companies do not perform manufacturing, distribution or management functions and do not have enough substance to meet the minimum legal requirements as set out by the resident countries (Ernst & Young, 2009:2).

2.5.3 The test for beneficial ownership as prescribed by the Circular

Two tests are typically used by the tax authorities to determine whether beneficial ownership is present: the technical test and the substance-over-form test. The technical test examines whether the recipient's ownership of the income has any restrictions or not, that is, whether he is entitled to the income. The substance-over-form test looks beyond the legal form to the economic reality. The Circular stipulates that, in the determination of *beneficial ownership*, both tests should be taken into account (Ernst & Young, 2009:2).

The Circular provides a list of “negative factors” to provide clarity when testing for beneficial ownership of a non-resident recipient. These factors are considered unfavourable in the determination of beneficial ownership status:

- (i) The recipient is obligated to distribute 60 per cent or more of the Chinese-source income to a resident of a third jurisdiction within a certain period of time.
- (ii) The recipient does not conduct substantial business activities that generate income, other than holding the properties or rights that generate the income.

- (iii) If the recipient is a corporation or other type of business entity, the assets, the size of operations, and the human resources of the recipient do not correlate with the income received from China.
- (iv) The recipient has almost no rights to control or dispose of the income or the properties or rights giving rise to the income, and accepts minimal to zero risks.
- (v) With respect to the income received from China, the recipient is exempt from tax or is not subject to tax in the country of residence, or the recipient pays tax in the country of residence, but at a very low effective tax rate.
- (vi) The recipient has a loan or deposit with another party on terms, *inter alia*, amount, interest rate, execution date, that are that are similar in substance to those in the primary loan agreement between the recipient and the Chinese authority.
- (vii) With respect to royalty income from a copyright, patent or other technology, transfer agreement, the recipient has an agreement with another party using the same copyright, patent or other technology. (Ernst & Young, 2009:3)

Thus, the amount of business activities of the recipient is a decisive factor (Ernst & Young, 2009:2).

2.5.4 Comparison with other sources of interpretation

It is submitted that the Circular conflicts with the wording of tax treaties, international jurisprudence and OECD Commentaries. This is as a result of the Circular strongly linking the existence of beneficial ownership to the recipient of the China-source dividend income carrying on substantial business activities in the low-tax jurisdiction.

It is asserted that a conduit company cannot have beneficial ownership and that a conduit company can be identified by its lack of substantial business activities, but this is an oversimplification of the concept of a conduit as described in the OECD Commentary (Sharkey, 2011:659-660).

It is quite possible that a company with substantial business activities lacks beneficial ownership and is being used as a mere conduit for a particular amount of income. A company with no substantial business activities can have beneficial ownership and not be a conduit of the type envisioned in the Commentary. Even though the Circular does refer to other factors in relation to ownership, the requisite for substantial business activity is likely to be the main point of focus of a decision maker's attention (Sharkey, 2011:660).

2.6 Conclusion

The purpose of this chapter was to provide an analysis of factors that should be taken into account to define and determine beneficial ownership; the term currently used in section 64D of the Act. This analysis commenced with an investigation into the common law and civil law definitions. The OECD MTC and its Commentaries provided possible factors to assist in identifying the beneficial owner. In the absence of a decision by a South African court, the judgements in the five international court cases emphasised the important factors needed for this analysis.

In a review of the international use of the term beneficial ownership over 45 years, Du Toit (2010:500) highlights that it was first used by common law states in their tax

treaties and reached the conclusion that the meaning of the concept has “not really” evolved away from that in the domestic law of the common law states. The notable international cases discussed previously that have dealt with beneficial ownership, namely the *Indofood* and *Prévost* cases, both confirm the original concept at common law. This is confirmed by Du Toit (2010:500) when stating that, regardless of the tests performed in both these court cases, “applying the meaning of beneficial ownership in the common law states would have resulted in the same finding”.

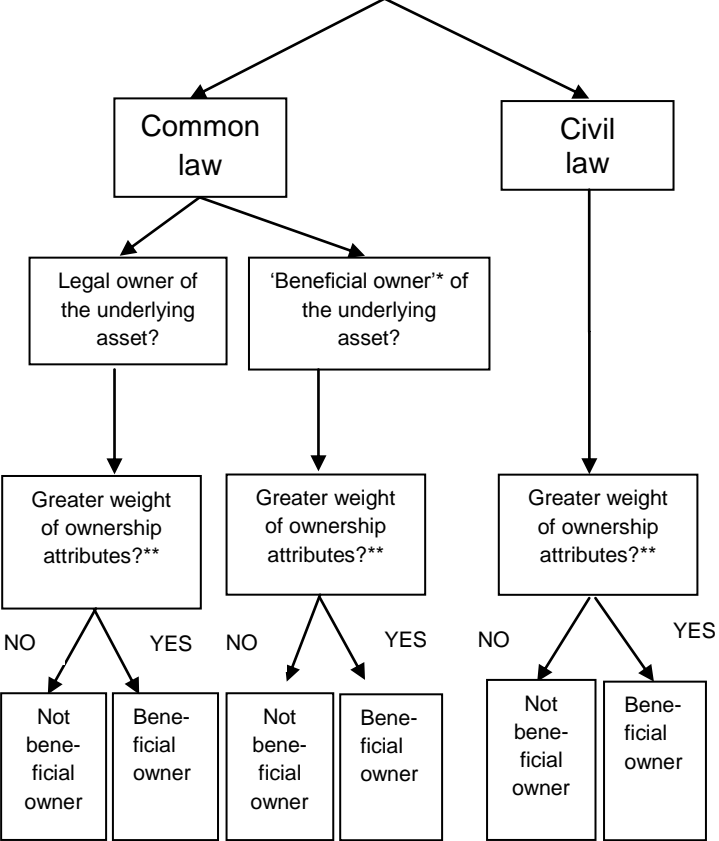
Based on Du Toit’s opinion that the meaning of beneficial ownership in essence is that of the common law, this was the starting point for the interpretation of the meaning of the concept. Beneficial ownership can be determined by the nature and extent of the rights and obligations of the parties, and this is determined by the specific circumstances of each case. Formal legal title cannot constitute beneficial ownership unless the person has a right, at least to certain degree, to deal with the property as his own. The beneficial owner will be the person whose ownership attributes outweigh that of any other person (Ryynänen, 2003:361).

The OECD’s Discussion Draft further defines this explanation by the explicit exclusion of agents, nominees and conduit entities. A practical test is provided to assist in identifying a conduit entity by investigating the degree of management responsibility. Ownership of underlying assets generating the income is not the deciding factor; instead who has the use and enjoyment of the income from that asset has to be determined.

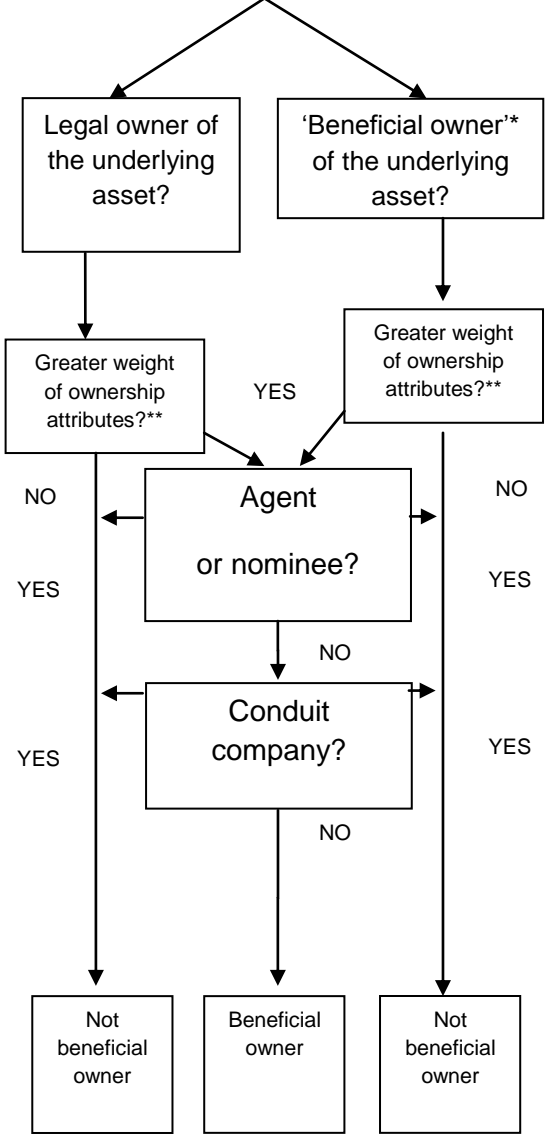
The five international cases confirm the importance of the ownership attributes as a factor to determine the beneficial owner. In each case, it was evaluated according to who has discretion, authority and power to make decisions regarding the income generated by the underlying asset. The factors extracted from the analysis above to determine the beneficial owner, are depicted in Figure 2.1 and Figure 2.2 below.

Figure 2.1 The factors in determining *beneficial owner*

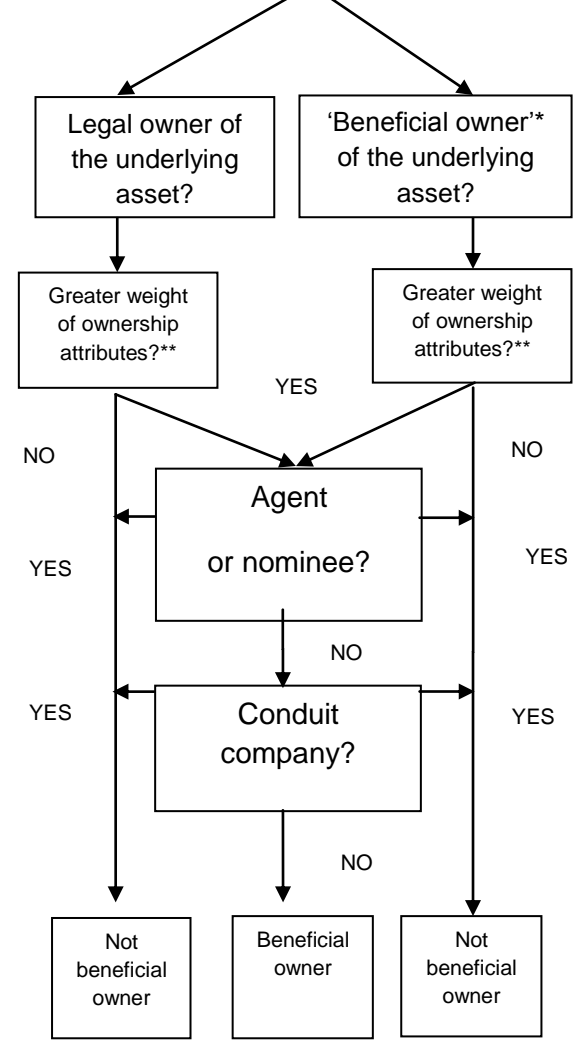
A. Domestic law



B. OECD



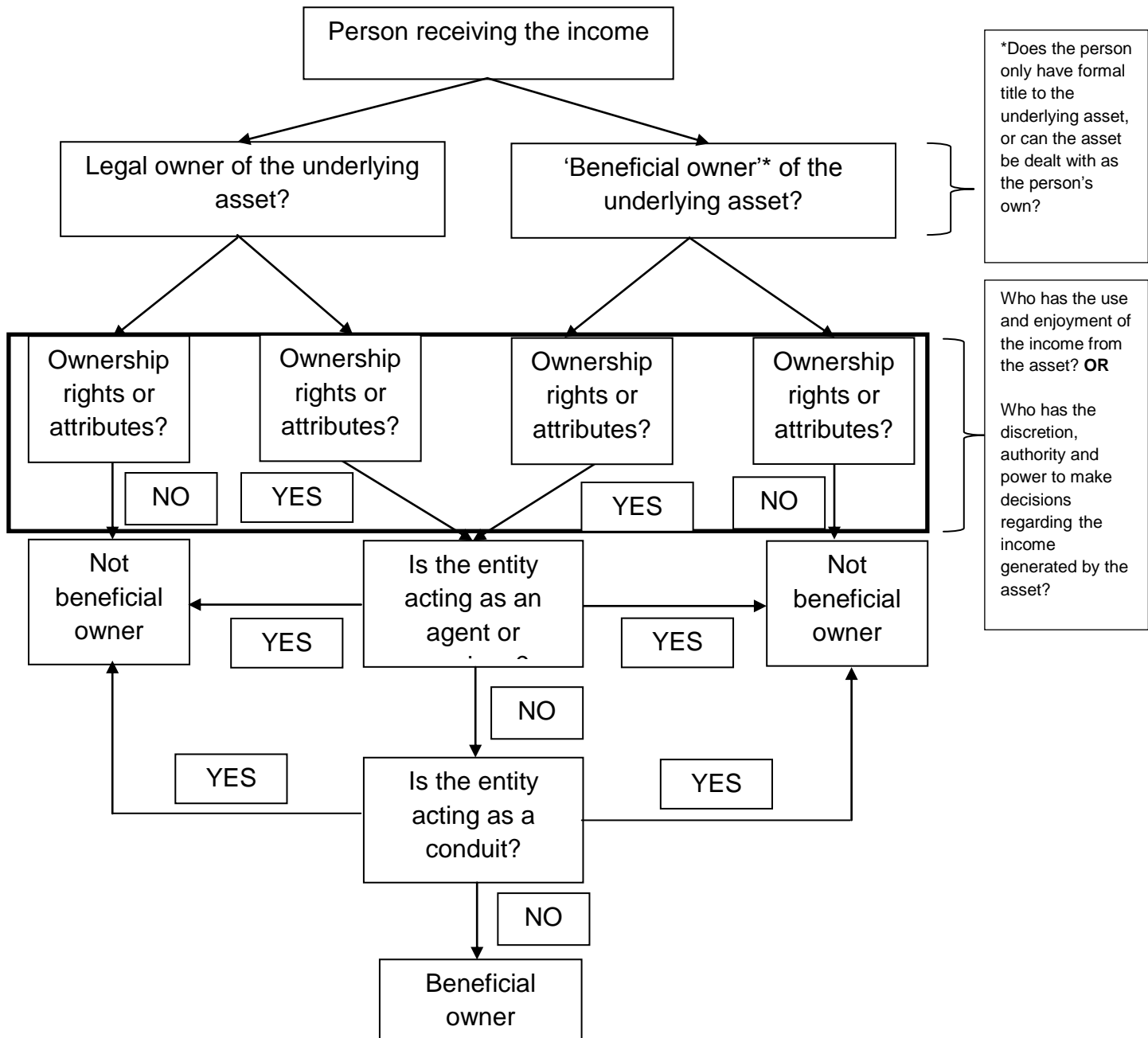
C. Judicial interpretation



*Does the person only have formal title to the underlying asset, or can the asset be dealt with as the person's own?

Who has the use and enjoyment of the income from the asset? **OR
Who has the discretion, authority and power to make decisions regarding the income generated by the asset?

Figure 2.2 The factors in determining *beneficial owner* (combined from Figure 2.1)



Before these factors can be applied to determine who is liable for Dividends Tax in a discretionary trust, it is necessary to have an understanding of the nature of a trust, as well as of the rights and obligations of trustee and trust beneficiary in terms of the trust property. This is discussed in Chapter 3.

CHAPTER 3
THE NATURE OF TRUSTS IN SOUTH AFRICA

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3.1 Introduction

The concept of beneficial ownership is particularly important for trusts (Louw 2012:1). In South Africa, two types of trust are recognised, namely the *bewind* trust and the ownership trust. The discretionary trust is one of the two types of ownership trust commonly utilised in South Africa (Louw, 2012:1).

In terms of the new legislation, Dividends Tax may be the liability of the *beneficial owner* of the dividend in certain instances (section 64EA(a)). It is therefore important to correctly identify the beneficial owner to determine who is liable for paying the Dividends Tax.

Chapter 2 has provided an analysis of factors that should be taken into account to define and determine beneficial ownership. In order to apply these factors in the case of a discretionary trust, it is important, firstly, to understand the nature of a trust and, secondly, to understand the rights and obligations of the trustee and beneficiary in terms of the trust property (capital and/or income).

3.2 General definition of a trust

According to Honoré and Cameron (1992:2) reference can be made to trusts in a “wide and narrow” sense. The “wide” definition of a trust describes the scenario where a person holds or administers property on behalf of another, or for an impersonal object, and not for his personal benefit.

In the “narrow” sense, the founder of a trust has handed over control of property to a trustee. The trustee must administer or dispose of this property for the benefit of a trust beneficiary or beneficiaries. Thus, a fiduciary obligation is created whereby the trustee acts in an official capacity (Honoré & Cameron, 1992:3). It is also necessary to consider the legal definitions of a trust, as provided in relevant Acts, both internationally and in South Africa.

In terms of Article 2 of the Hague Convention on the Law applicable to Trusts and their Recognition, a trust is defined as follows:

For the purposes of this Convention, the term "trust" refers to the legal relationships created – *inter vivos* or on death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.

A trust has the following characteristics –

- a) the assets constitute a separate fund and are not a part of the trustee's own estate;
- b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
- c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

Notwithstanding the fact that South Africa is not a party to the convention above, South Africa's trust law does conform to this definition (Honoré & Cameron 1992:3).

The Trust Property Control Act No. 57 of 1988 ('Trust Property Control Act') was promulgated in South Africa and section 1 defines a trust as:

The arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed –

- (a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or
- (b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument.

As South Africa's legal system is founded on legal precedent to a large extent, one also has to consider case law in this regard (Du Bois, 2007:76).

Cameron JA in *Land and Agricultural Bank of SA v Parker and others* (2005(2) SA 77 (SCA):83) defined a trust as follows:

It is an accumulation of assets and liabilities. These constitute the trust estate, which is a separate entity. But though separate, the accumulation of rights and obligations comprising the trust estate does not have legal personality. It vests in the trustees, and must be administered by them – and it is only through the trustees, specified as in the trust instrument, that the trust can act.

The statement drawn from this case, that a trust is not a legal person, however, is subject to any statutory definition (De Koker & Williams, 2012). The Act defines a 'person' as including 'any trust'. This implies that the trust is a separate taxpayer and the trustees are representative taxpayers in respect of the trust (De Koker & Williams, 2012:1). The Act defines a trust in section 1 as:

Any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person.

It follows, then, that a trust can be subject to tax in its capacity as a person (Haupt, 2013:796). The nature and characteristics of a trust is discussed in the following section.

3.3 The nature of a trust

The following characteristics of a trust are applicable to South African law:

- (i) It is a relationship,
- (ii) The relationship is one of a fiduciary character,
- (iii) The relationship is one in respect of property,
- (iv) Equitable duties are imposed upon the holder of the title to the property to administer it for the benefit of another, and
- (v) The intention to create this relationship has been manifested.

(Scott & Fratcher, 1967:195)

The different parties to this relationship are discussed next, followed by a discussion of the ownership of the trust property (capital and/or income).

3.4 The trustees

The nature of the office of the trustee, as well as his or her rights and powers will now be discussed.

3.4.1 Nature of the office of trustee

Section 1 of the Act defines a trustee as

... any person having the administration or control of any property subject to a trust, usufruct,⁴ fideicommissum,⁵ or other limited interest or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability.

In the case of *Doyle v Board of Executors* (1999(2) SA 805 (C):815), it was held that a trustee has an obligation to account to a beneficiary. This is strongly linked to the fiduciary duty of the trustee (Geach & Yeats, 2007:93). The fiduciary duty is a responsibility to conduct trust administration prudently and in utmost good faith (Du Toit, 2002:67). Given the fact that trustees act in a fiduciary capacity, it becomes necessary to consider the legal position and powers of the trustees.

⁴Usufruct means the right to use the thing of another in such a way as to preserve its substantial character (Claasen, 2012:1).

⁵Fideicommissum means "a grant of property to a person subject to a condition that he will hand over the same either wholly or in part, and that either immediately or after a certain time, and either simply or conditionally, to a third party" (Claasen, 2012:1).

3.4.2 Legal position and powers of the trustees

The provisions of the trust deed and the Trust Property Control Act determine the legal position of the trustees. Provisions of the trust deed will, however, not change the fact that trustees are the owners of the trust property, but do not necessarily have a beneficial interest therein (Olivier & Honiball, 2009:15).

The fiduciary responsibilities of a trustee are set out in section 9(1) of the Trust Property Control Act. This section instructs the trustee to act with the “necessary care, diligence and skill” when performing his duties and exercising his powers, as is “reasonably expected of someone who manages the affairs of another “.

The trustee’s powers are determined by the trust deed (Olivier, 1990:75). The trust deed stipulates how trust property should be managed and the trustee’s powers are limited to those granted in the trust deed. There can be no implied powers of administration (Olivier, 1990:76). Thus, trustees may not act over and above the powers that are granted to them in the trust deed.

Section 19 of the Trust Property Control Act governs failure by the trustee to account or perform duties whereby a court order can be obtained directing the trustee to comply with a request or to perform a certain duty. Thus a trustee has a duty to perform all the duties as stipulated in the trust deed and to ensure that all terms and conditions of the trust deed are abided by (Geach & Yeats, 2007:88).

The powers of a trustee can be categorised as compulsory or discretionary. A compulsory power is an unambiguous directive. An example of such a directive is a

provision in the trust deed that all fixed properties shall be sold within 12 months and the proceeds invested on fixed deposit for the duration of the trust (Olivier 1990:75-76). The trustee then has the power and duty to sell and invest as directed. There, to some extent, is discretion in the manner that a power has to be exercised. In the case of various possibilities, it is the trustee's fiduciary responsibility to weigh up the various possibilities and decide on the best course of action (Olivier, 1990:75-76).

Wide powers are customarily bestowed on trustees to ensure proper administration of the trust property at all times, particularly where the trust remains in operation for an extended period of time (Du Toit, 2002:74). In the case of a discretionary trust, a trustee has discretionary powers in respect of the allocation and distribution of income and/or capital of the trust to the beneficiaries (Olivier, 1990:75-76).

3.5 The beneficiaries

Administrators, Estate Richards v Nichol (1996 (4) SA 253 (C): 258), confirmed the importance of the five essential elements needed to be present for a valid trust to be created, namely:

- (i) The intention of the founder to create a trust;
 - (ii) The communication by the founder of that intention in a manner appropriate to create an obligation;
 - (iii) The property subject to the trust must be defined with reasonable degree of certainty;
 - (iv) The definition of the trust object using a reasonable degree of certainty;
- and

- (v) The lawfulness of the trust object (Honoré & Cameron, 1992:96).

Should any of these elements be absent, no valid trust exists (Du Toit, 2002:27). Of relevance is the fourth element, which stipulates that a definition be given “with reasonable certainty of the object of the trust” (*Administrators, Estate Richards v Nichol* (1996(4) SA 253 (C):258). Trusts are predominantly set up to benefit trust beneficiaries (Du Toit, 2002:31). Thus it is the nature of a trust that the trustees hold assets on behalf of beneficiaries (Geach & Yeats, 2007:61).

Section 1 of the Act defines a beneficiary in relation to a trust as “a person who has a vested or contingent interest in all or a portion of the receipts, the accruals, or the assets of a trust. The reference to a contingent interest includes the beneficiary of a discretionary trust”.

The interests or rights of the beneficiary are determined by the terms and conditions of the trust deed, or by the manner in which the trustees have exercised their discretion in favour of the beneficiaries, in accordance with the trust deed. Two types of rights could exist, namely discretionary rights and vested rights (Geach & Yeats, 2007:20).

A discretionary right means that the beneficiary can only benefit to income and/or capital to the extent that the trustees have exercised their discretion. A beneficiary may only demand the delivery of income and/or capital once the trustees have exercised this discretion regarding the income and/or capital (Geach & Yeats, 2007:20).

It is sometimes incorrectly argued that the beneficiary of a discretionary trust has no rights at all (Geach & Yeats, 2007:20). The beneficiaries might not have any vested rights as the income and/or capital received by them is at the discretion of the trustees. However, the beneficiaries do have a right against the trustees to administer the trust in accordance with terms and conditions of the trust deed (Geach & Yeats, 2007:20). This is a personal right against the trustees for the proper administration of the trust (Olivier, 1990:88).

A discretionary right becomes a vested right to income and/or capital once the trustee has exercised his/her discretion and made the decision to distribute income and/or capital to the beneficiaries (Geach & Yeats, 2007:21). This vested right can now be regarded as a personal right against the trustees and income and/or capital or the transfer of an asset can be claimed (Geach & Yeats, 2007:21).

Despite the discretionary or vested rights that beneficiaries might have to the income and/or capital of the trust, in accordance with the trust deed and the discretion of the trustees, it is important to consider the ownership of trust assets.

3.6 Ownership of trust property

The concept of ownership, which can be divided into legal and beneficial ownership, originated from the English common law (Honiball & Olivier, 2009:2).

In terms of this study, the trustee can thus be the legal owner of the assets, for example the shares, and the beneficiary can be the beneficial owner of the dividend income earned on these shares (Honiball & Olivier, 2009:2).

Despite the fact that South Africa's legal system is primarily derived from Roman Dutch law, it has incorporated the English trust principles as an institution into its legal system. In addition, the South African courts have created a unique trust law over the years (Honiball & Olivier, 2009:2), yet have retained the characteristic of dual ownership, thereby distinguishing between formal ownership (legal ownership) and enjoyment of the benefits (beneficial ownership) flowing from the trust property (Olivier, 1990:13).

The case of *Braun v Blann & Botha* (1984(2) SA 850 (A):859) emphasised that the English legal terminology of legal and equitable (beneficial) ownership is foreign to South African law. However, Joubert JA in the judgement of this case maintained that the trustee was the owner of the trust property, although not for his personal benefit (legal ownership), and that the benefits of the trust property belong to the income and/or capital beneficiaries of the trust (beneficial ownership) (Olivier, 1990:20).

Therefore, in considering the narrow definition of a trust, it is an arrangement whereby control and ownership is bequeathed to the trustees (legal ownership), as determined by the terms and conditions of the trust deed, for the benefit of beneficiaries (beneficial ownership) (Geach & Yeats, 2007:1).

Thus, the trustee is regarded as the owner of the property, but it is not for his personal benefit. Legal ownership is also referred to as bare or non-beneficial ownership. This implies that the trustees will not hold the property for their own use or enjoyment (Geach & Yeats, 2007:2). All benefits of ownership belong to the beneficiaries (Olivier, 1990:3).

The distinction between legal and beneficial ownership emphasises the fiduciary obligation whereby the trustee acts in an official capacity on behalf of the beneficiaries and not in his private capacity on his own behalf (Honoré & Cameron, 1992:3).

3.6.1 The trustee as legal owner of the trust property

In the case of a donation of property to a discretionary trust, it involves the transfer of property by the donor to the trustees of the trust on certain terms and subject to certain conditions (Clegg, 2012:4). Legal ownership of the donated assets vests in the trustees in their capacity as trustees, and not in the beneficiaries (Clegg, 2012:4). It is important to note that a trustee is bound to keep his personal property separate from property held by him in the trust (Clegg, 2012:4).

In terms of the trust deed, the trustees are appointed by the donor and are responsible to conserve and administer the trust property in accordance with their powers and duties as specified in the trust deed (Clegg, 2012:4). It follows that the trustees are also obliged to distribute the income and/or capital of the trust in accordance with the provisions of and in accordance with their discretion as provided for in the trust deed (Clegg, 2012:4).

These principles of legal ownership were confirmed in the case of *Joubert and Others v Van Rensburg and Others* (2001(1) SA 753(w):756) where it was held that a trustee's role is not that of an agent, but of a principal when entering into any contract and performing thereunder. This ownership is not beneficial ownership since trust property is administered in accordance with the trust deed for the benefit of the trust beneficiaries (Geach & Yeats, 2007:71). The property, liabilities, rights and duties of the trust vest in the trustee in his official capacity only (Geach & Yeats, 2007:19).

In another case, Steyn CJ came to the decision in *Commissioner for Inland Revenue v Macneillies's Estate* (1961(3) SA 833 (A):840) that the assets and liabilities of a trust vest in the trustee. In his capacity as a trustee, it can be said that the trustee is the owner of the trust property but that he is merely holding an office and ownership of the assets results from this office. As a result of his fiduciary position, the trust is always administered for the sole and exclusive benefit of the trust beneficiaries (Olivier, 1990:61).

3.6.2 The beneficiary's rights to the trust property of a discretionary trust

Since legal ownership of the trust assets vests in the trustees, any income derived from such property is received by or accrued to the trustees (Olivier, 1990:89). The content of the trust deed determines the extent of the beneficiaries' rights and whether they have a claim to the property (income and/or capital). However, in addition to legal ownership, beneficial ownership also needs to be considered (Olivier, 1990:89).

In terms of income beneficiaries, the trust deed must be consulted to determine whether the beneficiary's right to the income of the trust is a vested or a contingent right. Once vested, thus stipulated as a vested right by the trust deed or by means of the trustees exercising their discretion to distribute the income, the income will be an asset in the beneficiary's estate (Olivier, 1990:89).

As the trust deed determines the right of the beneficiaries to the income of the trust (Olivier, 1990:76), one has to consider the implications when the trust deed stipulates that the trustees have discretion over the trust income and there is a contingency attached to that discretion. An example is where the trust deed stipulates that trust income can only be distributed in accordance with the trustees' discretion at the end of a specified period if a beneficiary conducts himself/herself in an orderly and acceptable manner for the duration of that period. The trust deed could therefore grant the trust founder, under certain circumstances, the right to recall a beneficiary's right to income from the trust (Stiglingh, *et al.*, 2013:862). Another example is where the trust income can only be distributed to a beneficiary according to the trustees' discretion if and once the beneficiary reaches the age of 25 years (for example). In both these instances there is a probability that the income will never be distributed to the beneficiary.

In the case of a discretionary trust where the trustees have discretion to distribute any income, the beneficiary's vested right only arises when the trustee has exercised his discretion. The fact that income is taxed in the hands of the beneficiary in terms of the Act confirms this vested right (Olivier, 1990:90).

3.7 Conclusion

The purpose of this chapter was to understand the nature of a trust. The type of trust being dealt with will affect, *inter alia*, the rights of the beneficiaries; the ownership of the trust property; and the power of the trustees (Geach & Yeats, 2007:2). The discretionary trust is a form of ownership trust whereby the founder transfers ownership of property to a trustee to be held for the benefit of beneficiaries (Honiball & Olivier, 2009:3). Within the context of the discretionary trust, the nature of the office of the trustee was discussed, accompanied by an explanation of the trustee's legal position and powers. A clarification of the rights and obligations of trust beneficiaries followed and led to an explanation of the ownership of trust property (capital and/or income).

It was established that the trustee is the legal owner of the trust property. However, the function of a trustee is to hold the trust property for the benefit of the beneficiary. Because one is dealing with a discretionary trust, the trust property (income and/or capital) only vests in the beneficiary once the trustee has exercised his discretion to that effect. Until such time, the beneficiary is not entitled to the trust property and has only a contingent right, or hope, to it (Louw, 2012:1-2). This causes one to consider at what instance, if ever, the beneficiary becomes the beneficial owner of dividend income, and who is liable for paying the Dividends Tax once dividends are distributed to a trust. This forms the basis of Chapter 4 where the factors of beneficial ownership in Chapter 2 will be combined with the discussion in Chapter 3 to reach a possible conclusion.

CHAPTER 4
DETERMINATION OF THE BENEFICIAL OWNER OF DIVIDEND INCOME IN A
DISCRETIONARY TRUST

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4.1 Introduction

The purpose of this chapter is to determine who the *beneficial owner* is of dividend income received by a discretionary trust. The factors of beneficial ownership, as identified in Chapter 2, are used as guidelines, together with the discussion of the nature of a trust in Chapter 3. Based on Figure 2.2 in Chapter 2, the following steps were been formulated to reach a conclusion:

Step 1: Identification of the legal owner of the underlying asset (the share)

Step 2: Identification of the *beneficial owner* of the underlying asset

Step 3: Determining whether the legal owner and beneficial owner have ownership rights or attributes in terms of the income (the dividend income)

Step 4: Determining whether the entity possessing ownership rights is acting as an agent or nominee or conduit

Each of the above-mentioned steps is discussed in the sections that follow.

4.2 Identification of the legal owner of the underlying asset

In terms of this study, the underlying asset is the share giving rise to dividend income. Chapter 3 gave the narrow definition of trust whereby control and ownership of the shares were granted or transferred to the trustees. In terms of this definition, the trustees became the legal owners of the shares (Geach & Yeats, 2007:1). It is in the trustees' fiduciary capacity that they are the owners of the trust property. The shares are always administered for the sole and exclusive benefit of the trust

beneficiaries (Olivier, 1990:61). It follows that the trustees' legal ownership is a form of non-beneficial ownership (Geach & Yeats, 2007:2).

4.3 Identification of the *beneficial owner* of the underlying asset

In order to be the *beneficial owner* of the underlying shares, the person has to be able to deal with the shares as his/her own (Olivier *et al.*, 2009:140). Even though the beneficiary does not hold the legal title to the shares in accordance with trust law, they do have a right to enforce the terms of the trust deed, which may stipulate that they acquire final ownership of the shares (Krishna & Gervais, 2009:140). In terms of a discretionary trust, the beneficiary only has a vested right once the trustees have exercised their discretion in respect of the distribution of the shares (Olivier, 1990:89). This gives the beneficiaries a personal right to claim the shares (Geach & Yeats, 2007:21) and the beneficiaries can be considered the *beneficial owners* of the shares. The findings in *Braun v Blann & Botha* (1984(2) SA 850 (A):859) support this view of equitable (beneficial) ownership belonging to the trust beneficiaries.

However, according to the OECD's Discussion Draft, ownership of the underlying asset that is generating the income is not the deciding factor, rather the party who has the use and enjoyment of the income from that asset (OECD, 2011:4). The next step is to determine whether the trustees (legal owners) or the beneficiaries (beneficial owners) possess ownership rights or attributes in terms of the dividend income.

4.4 Determining whether the legal owner and beneficial owner have ownership rights or attributes.

In Chapter 2 it was established that the allocation of ownership rights or attributes is a legal question and that the nature of the rights held by the trustees and beneficiaries have to be considered (Greyling, 2011:72). In conclusion to that chapter, two parameters were set to determine whether a person possesses ownership rights or attributes, either of which has to be met. In terms of the first parameter, ownership rights or attributes belong to the person who has the use and enjoyment of the dividend income (Ryynänen, 2003:361). The second parameter allocated ownership rights or attributes to the person with the discretion, authority and power to make decisions regarding the dividend income. Considering the nature of the rights of the trustees and beneficiaries as explained in Chapter 3, a discussion of these two parameters will follow.

As discussed in 3.6.2 there may be instances where the beneficiaries may never become entitled to the trust income. These instances will now be discussed in the form of two examples, and applying the two parameters referred to above.

As the trust deed determines the right of the beneficiaries to the income of the trust (Olivier, 1990:76), one has to consider the implications when the trust deed stipulates (for example) either of the following:

Example 1

The trust deed specifies that the trustees have discretion over the trust income, the discretion is exercised and income is distributed to the beneficiaries.

Example 2

The trust deed specifies that the trustees have discretion over the trust income and there is a contingency attached to that discretion. An example is where the trust deed stipulates that trust income can only be distributed in accordance with the trustees' discretion at the end of a specified period if a beneficiary conducts himself/herself in an orderly and acceptable manner for the duration of that period. A similar case is where the trust income can only be distributed to a beneficiary according to the trustees' discretion if and once the beneficiary reaches the age of 25 years. In both these instances there is a probability that the income will never be distributed to the beneficiary.

With the above trust deed specifications in mind, one can now consider the parameters using two examples.

4.4.1 Parameter one: Use and enjoyment of the dividend income

In the Example 1 it is assumed that trustees have exercised their discretion and distributed dividend income to the beneficiaries of the trust. Even though dividend income derived from the shares is received by or accrued to the trustees (Olivier, 1990:89), it is a characteristic of a South African trust that the trustees only act in a fiduciary capacity and administer the dividend income on behalf of the beneficiaries (Honoré & Cameron, 1992:2). Further OECD commentary stipulates that, where a

“formal owner” of an asset has very narrow powers, such as the trustee, such person would not be the *beneficial owner* of the income concerned, as its role is a “mere fiduciary or administrator” acting on account of the true beneficial owners (OECD, 2011:4). Once the trustees have exercised their discretion, the beneficiaries of the discretionary trust may demand the delivery of the dividend income since their right to the dividend income is vested (Geach & Yeats, 2007:20). It can therefore be concluded that the beneficiaries, and not the trustees, have the use and enjoyment of the dividend income and possess ownership rights or attributes.

In Example 2 it is assumed that the trustees have not exercised their discretion to distribute dividend income to the beneficiaries and there is a possibility that the income might never be distributed to the beneficiaries (due to a contingency). Until the trustees have exercised their discretion and the fulfilment of the contingency, the beneficiaries only have a right against the trustee for proper administration of the trust. The beneficiaries are not entitled to the trust assets and have only a contingent right, or hope, to them (Louw, 2012:2). It might be questionable whether the trustees can be the *beneficial owners* since they do not have full rights over the income in accordance with trust law (IBFD, 2011:3).

It has been suggested that the trust, with the trustees, acting in their official capacity on behalf of the trust, could be seen as the *beneficial owner* of the dividend income (OECD, 2011:3). Bearing in mind that ownership attributes have to be weighed up (Olivier *et al.*, 2000:319), it is plausible for the trust to be the beneficial owner (Louw, 2012:2). This will be the case in Example 2.

Also, in terms of the Act, the trust is recognised as a person for income Tax purposes (section 1) and the trust could be subject to tax in its capacity as a person (Haupt, 2012: 796).

4.4.2 Parameter two: Discretion, authority and power to make decisions regarding the dividend income

In terms of the second parameter, the discussion concerns whether it is the trustees or the beneficiaries who have the discretion, authority and power to make decisions regarding the dividend income. This discussion commences on the basis of the assumption that the trustees have exercised their discretion and distributed dividend income to the beneficiaries of the trust (as in Example 1, above).

In the *Velcro* case, the following elements were taken into consideration when determining beneficial ownership: (a) possession; (b) use; (c) risk; and (d) control of the payment of income (*Velcro Canada Inc v The Queen* TCC 57, 2012:9).

Chapter 3 of this study established the principle that the trustee is the legal owner of the shares that give rise to the dividend income. However, the Trust Property Control Act stipulated in its definition of a trust that, even though ownership of the trust property was bequeathed to the trustee, it was always for the benefit of the beneficiaries in accordance with the trust deed. Further, the trustees' powers are always limited to those granted in the trust deed (Olivier, 1990:76). Thus possession, use and control of the payment of the dividend income are determined by the conditions of the trust deed. Combine this with the fact that the trustees are acting in an official capacity, and not a personal capacity (Honoré & Cameron, 1992:3), the

elements identified in the Velcro case point to the beneficiaries of the trust as possessing ownership attributes and being the *beneficial owners* of dividend income.

The above view is substantiated by the Swiss administration court's decision. It was held that a person acting in a fiduciary capacity could not be the beneficial owner since the obligation to pass on income to another displayed limited authority and power in respect of the income (Federal Administrative Tribunal Judgement, 2012:14). In terms of this interpretation, the ownership attributes of the beneficiary still outweigh those of the trustees. Thus, similar to the conclusion reached in respect of parameter one, it be concluded that the beneficiaries, and not the trustees, have the use and enjoyment of the dividend income and possess ownership rights or attributes in Example 1.

Assuming that the trustees have not exercised their discretion to distribute dividend income to the beneficiaries (as in scenario two, above), the ownership attributes of the trustees and the beneficiaries have to be weighed up. In terms of Example 2, the beneficiaries are still not entitled to the trust assets and only have a contingent right to them (Louw, 2012:2) until the trustees have exercised their discretion and the contingency has been fulfilled. Although the trustees do not have full rights over the income (IBFD, 2011:3), the discretion, authority and power to make decisions regarding the dividend income lies with the trustees for the greater part. Thus it can be argued that the trust is still the *beneficial owner* of dividend income in the case of Example 2, reaching the same conclusion as that in terms of parameter one.

In the preceding steps, it was identified that the trust, with the trustees acting as representative taxpayers, was the possible *beneficial owner* of the dividend income in the case where dividend income remained undistributed and the trustees did not exercise their discretion (due to a contingency contained in the trust deed). It now becomes necessary to consider whether the trust can be seen as an agent, nominee or conduit in respect of the dividend income not distributed by the trustees.

4.5 Determining whether the *beneficial owner* is acting as an agent, nominee or conduit

The discussion in Chapter 2 established that intermediate recipients of the dividend income, namely agents, nominees or conduit companies acting as a fiduciary or administrator, cannot be the *beneficial owner* (OECD, 2011:4). The Conduit Companies Report supported this statement by explaining that, even though the conduit company was the “formal owner” of an asset with “narrow powers” in relation to the income, the company could not be the *beneficial owner* (OECD, 2003:145). The Prévost and Indofood cases relied on the views of the OECD to reach the same decision with regard to agents, nominees and conduit companies. The judge in the Prévost case stated that, if property is in the name of a nominee and the nominee is acting in accordance with another person’s instructions, one has to see on whose behalf the nominee is acting. The Indofood case excluded administrators of income as *beneficial owners* (Kemmeren, 2012:6).

Based on the OECD’s reasoning for excluding intermediate recipients, it is necessary to firstly determine whether the trustees have the full right to use and enjoy the

dividend that is received and, secondly, to ascertain whether the trustees have limited powers over the dividend because of their fiduciary duty or other duty which obligates the trustee to pass the payment received on to the beneficiary (OECD, 2011:4). A further practical test looked at the degree of legal responsibility in managing the conduit. The greater the degree of management responsibility, the more likely it is that the conduit will be the *beneficial owner* of the income (Krishna & Gervais, 2009:141).

In Chapter 3, the nature of the office of trustee is described. Section 1 of the Act clearly stipulates that the trustee is acting in fiduciary capacity. The Trust Property Control Act further gives instruction that this fiduciary responsibility should be carried out “as is reasonably expected of someone who manages the affairs of another”. This clearly points towards limited powers over the dividend income. Furthermore, the extent of the trustees’ powers is determined by the trust deed (Olivier, 1990:75), which is legally enforceable by court order in terms of section 19 of the Trust Property Control Act. The trustees are thus acting in accordance with instructions in the trust deed and may not deviate from it without legal consequences as set out in the Trust Property Control Act (section 19).

In terms of parameters one and two, it can thus be concluded that the trustees do not have the full right to use and enjoy the dividend. As a result of this fiduciary responsibility, it renders the trust as similar to an agent or nominee or conduit company. The trust beneficiaries, therefore, will again be the *beneficial owners* of the dividend income as retained by the trust.

However, in the case where a trust beneficiary has contingent rights, also referred to as a contingent beneficiary, the position of the trust as possible agent, nominee or conduit also has to be considered.

As discussed previously, a contingent beneficiary arises when the trust deed provides that the beneficiary's ability to claim payment of income is conditional or contingent upon the occurrence of an uncertain future event (Du Toit, 2002:109). Before the contingency has taken place or the condition has been fulfilled, the beneficiary only has a contingent right to the income. This equates to a mere expectation or "spes" which will not be an asset in the beneficiary's estate (Du Toit, 2002:109). In terms of the practical test for identifying a conduit, there could be a greater degree of management responsibility, making the trust the *beneficial owner* of the dividend income.

4.6 Withholding of Dividends Tax at a reduced rate

The secondary focus of the study is the analysis of the rate at which a resident company must withhold Dividends Tax in terms of section 64G(3) of the Act.

In accordance with this section of the Act, dividend payments to foreign residents may be subject to a reduced rate where the applicable DTA between South Africa and their country of residence provides for such (SARS, 2013:3).

Now that the beneficial owner has been identified, either the foreign trust or the foreign trust beneficiary, dependent on the facts in each case, needs to make a

declaration to the company that declares the dividend that the dividend is subject to that reduced rate as a result of the application of the DTA (section 64G(3)(b)(i)). If no declaration is made, the company is required to withhold tax at the full rate (SARS, 2013:3).

4.7 Conclusion

The purpose of this chapter was to determine who the *beneficial owner* is of dividend income received by a discretionary trust by using the factors of beneficial ownership identified in Chapter 2 as guidelines, together with the discussion of the nature of a trust in Chapter 3. This has addressed the primary focus of this study.

Based on Figure 2.2 in Chapter 2, the following steps were followed:

Step 1: Identification of the legal owner of the underlying asset (the share)

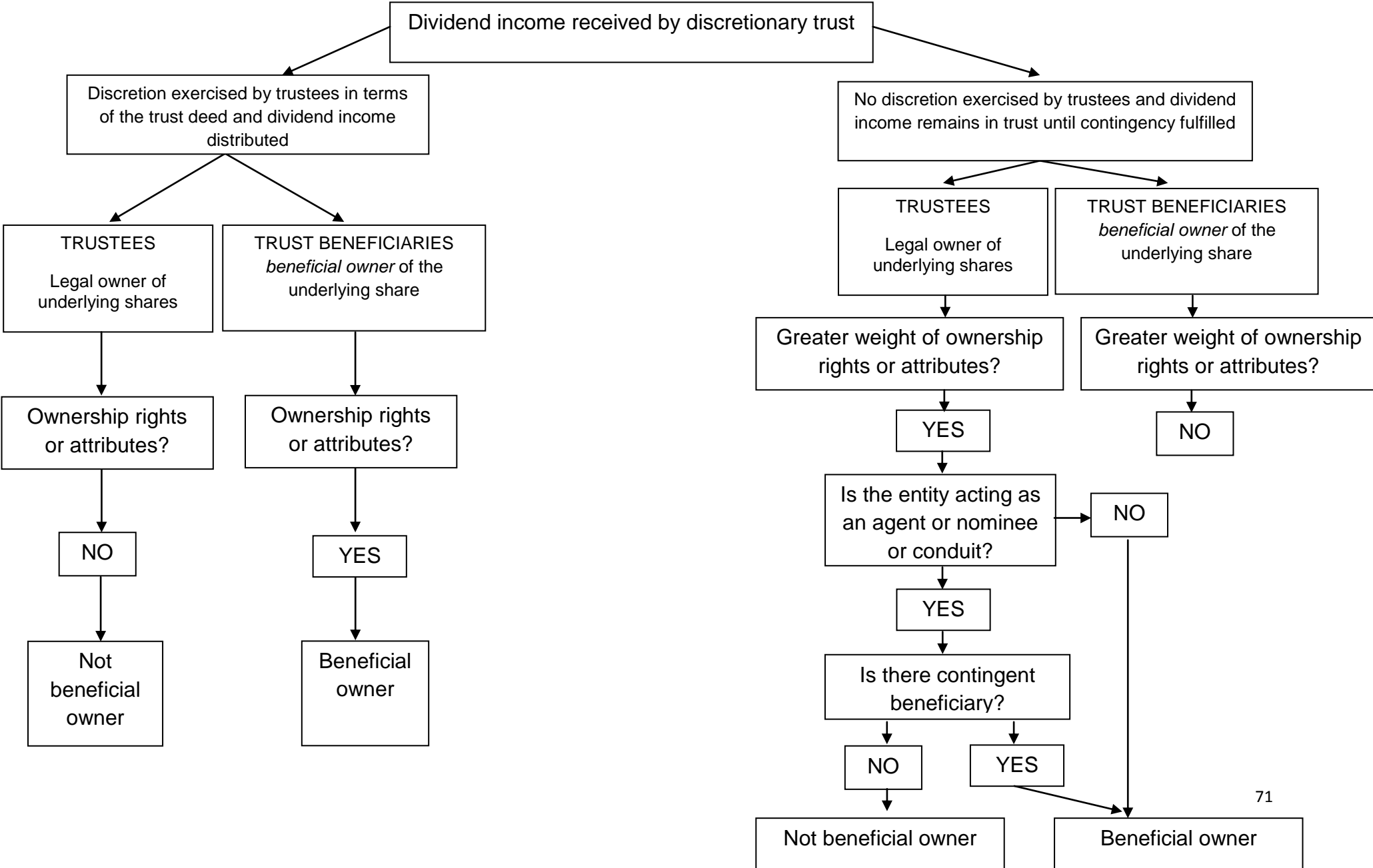
Step 2: Identification of the *beneficial owner* of the underlying asset

Step 3: Determining whether the legal owner and beneficial owner have ownership rights or attributes in terms of the income (the dividend income)

Step 4: Determining whether the entity possessing ownership rights is acting as an agent or nominee or conduit

These steps were applied to a discretionary trust and are depicted in Figure 4.1 below.

Figure 4.1 The *beneficial owner* of dividend income received by a discretionary trust



In terms of the steps depicted in Figure 4.1, the trust beneficiary remains the *beneficial owner* of dividend income received by a trust in the case of the income having been distributed by the trustees in having exercised their discretion in terms of the trust deed.

In the event of the trust having contingent beneficiaries, the beneficiaries might not have full rights to, or enjoyment of the income. In addition, the greater weight of ownership might lie with the trustees and, consequently, with the trust. In the case of contingent beneficiaries, it is suggested that the trust, with the trustees acting in their official capacity on behalf of the trust, could be seen as the *beneficial owner* of the dividend income.

The secondary problem of determining at which rate Dividends Tax must be withheld in terms of section 64G(3) could now be addressed by virtue of the steps above. In the event of a foreign trust or a foreign trust beneficiary, as the *beneficial owner* of a dividend, the rate at which Dividends Tax is withheld could be reduced as a result of the application of a DTA.

CHAPTER 5

SUMMARY AND CONCLUSION

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5.1 Summary

This study aimed to set parameters for determining who the beneficial owner of dividend income within the context of a discretionary trust is; where the dividend is paid in respect of shares held in a resident company; and to the extent that the dividend does not consist of a distribution of an asset *in specie*. The instances when the reduced rate at which a resident company must withhold Dividends Tax in terms of section 64G(3) of the Act were also clarified.

In order to achieve these objectives, consideration was given to the following in an attempt to clarify and substantiate the aim of this study:

- To analyse the factors that should be taken into account to define and determine *beneficial ownership*
- To analyse the proposed meaning of the term *beneficial owner* for Dividends Tax purposes
- To identify who the *beneficial owner* entitled to the benefit of the dividend attaching to shares held by a discretionary trust is
- To identify who the *beneficial owner* is for purposes of obtaining a reduced rate of Dividends Tax in terms of section 64G of the Act

In order to conclude, a brief summary of each chapter will be given.

5.1.1 Chapter 1

In terms of the new Dividends Tax which came into effect on 1 April 2012 (National Treasury 2012:14), Dividends Tax may be the liability of the *beneficial owner* of the dividend in certain instances (section 64EA (a)). This makes it important to correctly identify the *beneficial owner* and also who would be liable for paying the Dividends Tax. The first problem that arose was the question of how the term *beneficial owner* is interpreted in South Africa. Even though the term *beneficial owner* is specifically defined in section 64D of the Act as “the person entitled to the benefit of the dividend attaching to the share”, there remains a distinct difference between the legal ownership and economic ownership of the share (PWC Synopsis, 2012:6). Applying the definition to discretionary trusts might be problematic as the trustees, as the legal owners of the shares, hold the shares in trust for the benefit of the beneficiaries (PWC Synopsis, 2012:6). The beneficiaries are the economic owners of the shares (PWC Synopsis, 2012:6). Depending on how *beneficial owner* is interpreted, the person entitled to the benefit of the dividend attached to the share can either be the beneficiary or the trust itself (Louw, 2012:1).

Accordingly, this study focused on an analysis of the concept of *beneficial ownership* providing factors which should be taken into account to define and determine *beneficial ownership*.

The secondary focus of the study analysed the instances when a reduced rate at which a resident company must withhold Dividends Tax, in terms of section 64G(3) of the Act, will apply.

5.1.2 Chapter 2

Due to this study's focus on the identification of the *beneficial owner* of dividend income for Dividend Tax purposes, the concept of *beneficial ownership* was analysed. The purpose of the analysis was to identify components of the concept of *beneficial ownership*. This could assist in determining who is liable for Dividends Tax in terms of section 64EA(a) of the Act, or who would qualify for a reduced rate of the withholding tax in terms of section 64G(3).

This analysis was done by scrutinising domestic law meanings of beneficial ownership, followed by an investigation into the OECD MTC and its Commentaries. A study of relevant case law concluded the analysis. The analysis revealed that formal legal title cannot constitute beneficial ownership unless the person has a right, at least to certain degree, to deal with the property as his own. The beneficial owner will be the person whose ownership attributes outweighs that of any other person (Ryynänen, 2003:361). Two parameters were set to determine whether a person possesses ownership rights or attributes, either of which has to be met. In terms of the first parameter, ownership rights or attributes belong to the person who has the use and enjoyment of the dividend income (Ryynänen, 2003:361). The second parameter allocated ownership rights or attributes to the person with the discretion, authority and power to make decisions regarding the dividend income. The factors in determining the beneficial owner are depicted in Figure 2.1 and Figure 2.2. It is submitted that these factors can assist to clarify the meaning of the term for Dividends Tax purposes.

5.1.3 Chapter 3

In order to identify who the *beneficial owner* entitled to the benefit of the dividend attaching to shares held by a discretionary trust is, a broad discussion on the nature of a trust was necessary. It included an explanation of the rights and obligations of the trustee and beneficiary in terms of the trust property (capital and/or income). When dealing with a discretionary trust, the trust property (income and/or capital) only vests in the beneficiary once the trustee has exercised his/her discretion to that effect. Before such time, the beneficiary is not entitled to the trust property and has only a contingent right to it (Louw, 2012:1).

5.1.4 Chapter 4

The purpose of this chapter was to determine who the beneficial owner is of dividend income received by a discretionary trust. Based on Figure 2.2 in Chapter 2 and the discussion of the nature of a trust in Chapter 3, steps were formulated to reach a conclusion. In terms of these steps, it was possible to identify who the *beneficial owners* entitled to the benefit of the dividend attaching to shares held by a discretionary trust is. The trust beneficiary remains the *beneficial owner* of dividend income received by a trust in the case of the income having been distributed by the trustees in having exercised their discretion in terms of the trust deed. In the case of contingent beneficiaries, it is suggested that that trust, with the trustees acting in their official capacity on behalf of the trust, could be seen as the *beneficial owner* of the dividend income.

5.2 Conclusion

Thus, in terms of section 64EA(a) of the Act, which determines the liability for Dividends Tax to the extent that it does not consist of a distribution of an asset *in specie*, the trust beneficiary is liable for the Dividends Tax in the event of dividend income being distributed by the trust. In the case of a contingent beneficiary, the trust would be liable for Dividends Tax.

The secondary focus of the study concerned identifying instances when the reduced rate at which a resident company has to withhold Dividends Tax in terms of section 64G(3) of the Act would apply. Once the foreign beneficial owner has been identified, either the trust or the trust beneficiary, dependent on the facts in each case, has to submit, to the company declaring the dividend, a declaration that the dividend is subject to a reduced rate as a result of the application of an agreement for the avoidance of double taxation. In such cases the company must withhold tax at a reduced rate.

As is evident from the conclusions above, the study has accomplished all the objectives set out in section 1.4.

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