ANNEXURE 7

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA*

SUMMARY OF REPORT ON ACTION 7: PREVENT THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS

The permanent establishment concept creates a tax nexus between a country where an entity carries on business and the entity itself. It has been noted that multinationals often structure their business operations such that they avoid creating permanent establishments in the countries in which they operate. This deprives countries of the ability to tax profits arising from such business operations.

In the main, the OECD considers that the main tax risk is occasioned by the following: (i) *commissionnaire* arrangements (ii) artificial avoidance of permanent establishment status through the specific activity exemptions; (iii) fragmentation of activities between closely related parties; and (iv) splitting up of contracts.

The OECD recommends that a principal purposes test (PPT) be added to the OECD Model Tax Convention to address the BEPS concerns related to the abusive splitting-up of contracts. Under the principal purpose rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.[1]

The OECD further recommends that for states that are unable to address the issue through domestic anti-abuse rules, a more automatic rule that prevents transactions that are known to cause treaty shopping concerns should also be included in the Commentary as a provision that should be used in treaties that would not include the PPT or as an alternative provision to be used by countries specifically concerned with the splitting-up of contracts issue.[2]

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[1] OECD/G20 Base Erosion and Profit Shifting Project Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 (2015 Final Report) in para 17..

[2] OECD/G20 Base Erosion and Profit Shifting Project Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 (2015 Final Report) in para 17. See also OECD/G20 Base Erosion and Profit Shifting Project Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 (2015 Final Report) at p.22.

South Africa has the same concerns. As such recommendations are made herein that mirror the above recommendations made by the OECD, *inter alia* that source rules should be revamped, the *commissionnaire* arrangements be considered in South Africa to determine the extent of the problem and that South Africa should adopt the OECD recommendations on changes to the model tax convention.

Recommendations for South Africa

Where the South African Revenue Service (SARS) is not able to pin down the existence of a PE in terms of the current OECD rules, South Africa's source rules should be made strong enough to ensure that the activities of such non-residents in South Africa are taxed on a source basis.

- In this regard, it is recommended that South Africa's source rules in section 9 of the Income Tax Act are refined in line with the OECD 2015 recommendations on Action 7 to ensure they capture all income that is derived by non-residents from goods or services used or consumed in South Africa.

There are concerns in South Africa over the inability for SARS to detect and monitor whether PEs have been established in South Africa. This is especially so where non-residents engage in activities that are allegedly of a temporary nature, such as service activities or, for instance, consultants offering engineering services, or other technical or specialised services. Then there are also challenges where non-residents may escape PE status on allegations of being involved in preparatory or auxiliary activities. This is especially so when non-residents set up representative offices in South Africa. Various solutions to these detection problems could be considered, including the following:

- A system could be put in place to ensure such non-residents are brought into the tax system through filing tax returns. This will ensure that SARS is aware of the business activities of such non-residents in the country. Lack of proper registration means that certain foreign entities are improperly avoiding South African tax altogether.
- Since these representative offices would be renting some offices in South Africa, an obligation could be placed on residents who rent out properties for non-residents to use as representative offices, to ensure they file tax returns.

In South Africa, a PE is defined in section 1 of the Income Tax Act, as defined from time to time in Article 5 of the OECD Model Tax Convention. It should also be noted that South African courts have taken cognizance of the OECD Commentary in interpreting the scope of DTA provisions.

- In this regard, it is recommended that South Africa adopts the new OECD Guidelines on the meaning of the PE concept – even as section 1 of the Income Tax Act clearly provides that PE concept will be defined in South Africa as it is defined from time to time in the OECD Model Tax Convention.

A company that is not tax resident in South Africa but conducts business in South Africa through a PE is taxable in South Africa on the income of that PE that is sourced in South Africa.[3] The reduction of the rate of income tax applicable to non-resident companies from 33% to 28% means that it is more tax efficient for a foreign company to conduct its South African operations through a PE located in South Africa, than to establish a South African subsidiary because the subsidiary would be liable to normal corporate tax at 28% and the dividends paid by a resident subsidiary to a non-resident company are also subject to dividends withholding tax at 15% if there is no tax treaty in place or, where a treaty is in place, the rate of dividends tax may be reduced in terms of an applicable treaty. This uneven playing field in favour of PEs in the form of branches costs the South African fiscus a loss in potential tax revenue.

- It is recommended that above concerns could be corrected by an introduction of a tax on branch profit remittances. It is recommended that South Africa should consider the legal, constitutional and DTA implications of introducing such a tax.

As is discussed in detail in the main report attached hereto, the concept of a "foreign business establishment" in section 9D(1) of the Act which (deals with controlled foreign companies) is key to the base erosion issues. The foreign business establishment exemption is therefore fundamental in determining what amounts are attributed to, and taxed in, South Africa. To address PE concerns relating to foreign business establishments it is noted and recommended that:

- The exemption from tax in respect of income arising in a controlled foreign company with a foreign business establishment is correct as a policy matter.
- Transfer pricing principles together with PE attribution principles should be used to test whether the correct amounts are attributable to the foreign business establishment. In this regard section 9D(9)(b) should be re-considered and consideration should be given to applying the transfer pricing rules and profit attribution principles contained in double tax agreements to the determination of whether amounts qualify for the foreign business establishment exemption.

On a tax policy level, it is important that South Africa does not emphasise legislative amendments to tax laws applicable to outbound MNEs, (for example, CFC rules), over tax laws applicable to inbound MNEs (for example, PE rules and source rules). It is necessary to balance legislation so as to ensure that South African companies are not overtaxed in comparison to non-residents, which would affect their competitiveness. South African outbound MNEs should not be taxed and audited disproportionately higher compared to inbound MNEs. It is therefore recommended that:

[3] See part I section 4(f) of the Taxation Laws Amendment Act 7 of 2010. See also Olivier L 'The "Permanent Establishment" requirement in an International and Domestic Taxation Context: An Overview' (2002) *SALJ* 866.

- The current source rules should be revamped to ensure that they adequately enable SARS to determine when a PE exists so that SARS is able to determine how profits must be attributable to such PEs. Some countries, such as the UK, which is a member of the OECD and signs treaties based on the OECD MTC (as is the case with South Africa) has enacted rules relating to the tax treatment of branches in order to attend to these challenges. South Africa should emulate the UK by enacting provisions which clearly explain the tax treatment of PEs in South Africa. The rules should complement the PE definition in section 1 of the Act and further explain that the OECD rules for attributing profits to PEs would be applied. The rules that require non-residents carrying on business in South Africa to register with SARS aid enforce the source rules in this regard. As a residual matter the normal source rules and/or withholding taxes would apply for those that don't meet the PE threshold.
- Government should consider the prevalence of *commissionnaire* type arrangements to determine the extent of the risk to the South African fiscus.
- South Africa should adopt the OECD recommendations on changes to the MTC and ensure that its double tax treaties are amended as deemed appropriate in line with changes to the OECD MTC.
- It is recommended that South Africa should consider the legal, constitutional and DTA implications of introducing a tax on branch profit remittances.

DTC REPORT ON ACTION 7: PREVENT THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS

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1 INTRODUCTION

For any country to levy tax on any item of income, a connection or nexus should be established between that country and that item of income. The main connecting factors entitling a country to tax income is the connection of that country and the income (source) or the connection of that country to the person who receives the income or to whom the income accrues (residence).[1] Thus a company that is not tax resident in South Africa but conducts business in South Africa through a PE is taxable in South Africa on the income of that PE that is sourced in South Africa.[2] Where double taxation may arise as a result of a resident of one country earning income that is sourced in another country, tax treaties generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a permanent establishment (PE) to which the profits are attributable. The definition of PE included in tax treaties is therefore crucial in determining whether a non-resident enterprise must pay income tax in another State.

The PE issue is perhaps one of the most challenging action items that OECD policymakers face.[3] PE concept is established when a source country has the right to tax the activities of a resident of another country. It is the international standard agreed to for dividing up or sharing profits of a business enterprise where a company is resident elsewhere.[4] Thus the rule is designed to ensure that business activities will not be taxed by a State unless and until the non-resident enterprise has created significant and substantial economic bonds between itself and that State.[5]

The PE concept is defined in Article 5 of the OECD Model Tax Convention (OECD MTC). The general definition of a PE in Article 5(1) is that it is a fixed place of business through which the business of an enterprise is wholly or partly carried out. Article 5 also has a special meaning of PEs with respect to building and constructions sites. Then there is a deemed PE provision, in terms of which a dependent agent is considered a PE if he habitually enters into contracts on behalf of the enterprise in the other contracting state, and that bind the principal. Article 5(4)

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1 Olivier & Honiball *International Tax: A South African Perspective* (2011) 50; Croome et al *Tax Law: An Introduction* (2013) 26-27); Oguttu International Tax Law: Offshore Tax Avoidance in South Africa (2015) 71 – 72).

2 See part I section 4(f) of the Taxation Laws Amendment Act 7 of 2010. See also Olivier L 'The "Permanent Establishment" requirement in an International and Domestic Taxation Context: An Overview' (2002) *SALJ* 866.

3 DL Glenn "Transfer Pricing and Defining PE Most Challenging BEPS Action Items, Practitioners Say" *Tax Analyst* 4 February 2014.

4 AW Oguttu "The Challenges of Taxing Profits Attributed To Permanent Establishments: A South African Perspective" *Bulletin for International Taxation* Vol 64 No.3 (2010) at 165.

5 K Vogel *Double Tax Conventions* (1997) at 280 in para 4.

provides exclusions to the PE concept for activities that are generally considered to be solely of a preparatory and auxiliary nature to activities performed elsewhere.

In South Africa, the Income Tax Act[6] (the Act) applies the PE concept in determining various amounts that are exempt from the withholding taxes on the basis of such amount being taxable in South Africa on the basis of source.[7] Permanent establishment is defined in section 1 of the Act as follows:

> "permanent establishment means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor".

2 CURRENT MEANING OF THE PE CONCEPT

2.1 ARTICLE 5(1)

Article 5(1) contains the general rule regarding the definition of the PE concept. The article defines a PE as "a fixed place of business through which the business of an enterprise is wholly or partly carried on".[8] From this definition, three elements can be identified:

- the existence of a "place of business"
- this place of business must be "fixed"
- the carrying on of the business of the enterprise through this fixed place of business.

Each of the factors identified above is analysed in further detail.

2.1.1 Place of business

A PE will only exist if the enterprise has a physical presence in the source state.[9] In terms of the OECD Commentary, the term "place of business" includes any premises, facilities or installations used for carrying on the business of the enterprise. Article 5(2) discussed below provides examples of facilities that can be considered places of business. The "place of business" as a whole must be used and not necessarily each of its individual component parts. Special facilities for carrying on the business are not necessarily required.[10] The enterprise must wholly or partly carry on its business at that place of business. Any activity related to the business of the enterprise would be sufficient to constitute the "carrying on of the

6 Act 58 of 1962.
7 See sections 49D, 50D and 51D.
8 Paragraph 2 of the Commentary to Article 5 of the OECD Model Convention op cit note 3.
9 L Olivier "The 'Permanent Establishment' Requirement in an International and Domestic Taxation Context: An Overview" (2002) 19 *SALJ* at 871.
10 K Vogel *Double Tax Conventions* (1997) in para 4.

business" of the enterprise.[11] The activities carried on at the place of business must be business related and cannot merely consist of, for instance, living quarters of employees.[12]

A place of business may exist where no premises are available or required for carrying on the business of the enterprise and it simply has a "certain amount of space at its disposal" which is used for business activities. Space is considered to be at the disposal of the enterprise:

- Whether or not the premises, facilities or installations are owned, or rented at the disposal of the enterprise.[13]
- No formal legal right to use that place is required.[14]
- A place of business may be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods).[15]
- A PE exists where a foreign enterprise has at its constant disposal certain premises or a part thereof for use by the enterprise.

2.1.2 The place of business must be "fixed"

For a place of business to be fixed, two components have to be met, namely: a specific geographical spot (the location test); and a certain degree of permanence at each geographical spot (the duration test). The location test requires that there must be a link between the place of business and a specific geographical point, but the place of business does not necessarily need to be physically connected to the ground. In a situation where, by the nature of the business, the activities carried on by an enterprise are often moved between neighbouring locations, there may be difficulties in determining whether there is a single "place of business".[16] The test for determining whether a single place of business exists is to consider whether in light of the nature of the business, a particular location within which the activities are conducted constitutes a *coherent whole commercially and geographically* with respect to that business.[17] To be fixed at a specific geographical point does not also mean that the equipment constituting the place of business has to be actually fixed

11 K Holmes International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application (2007) at 151.

12 Richard L Doernberg, Luc Hinnekens, Walter Hellerstein and Jinyan Li *Electronic Commerce and Multijurisdictional Taxation* (2001) at 206.

13 BJ Arnold & M McIntyre *International Tax Primer* 2nd ed (2002) at 119.

14 Holmes "International Tax Policy and Double Tax Treaties" at 151.

15 Para 4.1 of the Commentary on article 5(1).

16 Para 5.1 of the Commentary on article 5(1).

17 Para 5.1 of the Commentary on article 5(1). See AW Oguttu & S Tladi "E-commerce: A Critique on The Determination of a 'Permanent Establishment' for Income Tax Purposes From a South African Perspective (2009) 20 No 1 *Stellenbosch Law Review* 74-96; H Pijl "The Concept of Permanent Establishment and the Proposed Changes to the OECD Commentary With Special Reference to Dutch Case Law (2002) 56 *Bulletin for International Fiscal Documentation* 554 at 555.

to the soil on which it stands. It is enough that the equipment remains on a particular site. [18]

Under the duration test, a certain degree of permanence is required in order for a PE to exist. The business should not be temporary in nature.[19] In South Africa, the courts hold the view that the word "permanent" in "permanent establishment" does not refer to mere temporary use of premises for purposes of trade. In *Transvaal Associated Hide and Skin Merchants v Collector of Taxes, Botswana*[20] it was decided on the facts that the taxpayer's regular occupation of the shed at an annual rental showed that its occupation of the premises was permanent and not temporary. It should also be noted that the word "fixed" does not mean that no interruption of operations may occur, but operations must at least be carried out on a regular basis.[21]

2.1.3 Through which business of the enterprise is carried on

The OECD MTC does not define the term enterprise *per se.* It provides that "the question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States".[22] The OECD MTC does, however, state that the term "enterprise applies to the carrying on of any business"[23] and the term "business includes the performance of professional services and activities of an independent character".[24]

The question which arises in this regard is what constitutes the "carrying on of any business" of an enterprise. The business of the enterprise has to be carried on wholly or partly through the fixed place of business.[25] The phrase "carried on through" infers that the business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose.[26] Mere business relations with

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18 Para 5 of the Commentary on article 5(1).

19 L Olivier & M Honiball *International Tax: A South African Perspective* (2011) at 99; Cristián Gárate "The Fixed Place of Business in the Context of Electronic Commerce" in Hans-Jörgen & Mario Züger *Permanent Establishments in International Tax Law* (2003) at 46; Pijl at 556.

20 29 SATC 97 at 115, 1967 (BCA).

21 Paragraph 6.1 & 11 of the Commentary on Article 5(1) of the OECD Model Convention; Olivier & Honiball at 99. Richard L Doernberg, Luc Hinnekens, Walter Hellerstein and Jinyan Li *Electronic Commerce and Multijurisdictional Taxation* (2001) at 206 notes that this implies that the activities carried on at the establishment must be business related and cannot merely consist of, for instance, living quarters of employees; Pijl at 557.

22 Para 6 of the Commentary on article 3(1)(c) of the OECD MTC.

23 Article 3(1)(c) of the OECD MTC.

24 Article 3(1)(h) of the OECD MTC.

25 Paragraph 7 of the Commentary on Article 5(1) of the OECD Model Convention.

26 AW Oguttu & S Tladi "E-commerce: A Critique on The Determination of a 'Permanent Establishment' for Income Tax Purposes From a South African Perspective" at 76; Doernberg et al at 206 notes that the word "through" suggests that the establishment cannot itself be the business (for instance, by itself being traded, rented or produced). The "carrying on" of the activity need not take place through human intervention alone. See also Kesnia J Levouchkina

the enterprise or other customers in the contracting state are not sufficient.[27] The business does not have to be of a productive character in that it contributes to the profits of the enterprise.[28] The word "through" suggests that the establishment cannot itself be the business (for instance, by itself being traded, rented or produced).[29] The "carrying on" of the activity need not take place through human intervention alone.[30]

Automated equipment: Although the business of the enterprise needs to be carried on through the PE, this does not mean that a PE will exist only if individuals are present. Although the presence of individuals may be required for the setting up of a PE, their ongoing presence is not required.[31] The presence of fully automatic equipment operated and maintained by the enterprise in the host country may constitute a PE. However, if the enterprise merely sets up the machines and then leases them to other enterprises, a PE does not exist.[32]

Employees: Generally, a business is conducted through the employees of the enterprise who are in a paid employment type relationship with such enterprise. Viewed formalistically the employees are generally those of the subsidiary and not the multi-national enterprise. However, the employees of the subsidiary could also create a permanent establishment for the multi-national enterprise if they act as "*de facto*" employees of the multi-national enterprise and not of the subsidiary.

De facto employees: In order to test whether the employees of the subsidiary do not constitute *de facto* employees of the multi-national enterprise (and therefore result in a PE for the multi-national enterprise in South Africa) cognisance should be had to the following guidelines (which are not exhaustive):

- The employees should be under the supervision and control of the subsidiary (as opposed to the multi-national enterprise).
- In particular, the employees of the subsidiary should at all times take instructions from representatives of the subsidiary.
- All employees should report to the directors/managers of the subsidiary and not the multi-national enterprise.

"Relevance of Permanent Establishment for Taxation of Business Profits and Business Property" in Hans-Jörgen & Mario Züger *Permanent Establishments in International Tax Law* (2003) at 20-21.

27 Vogel *Double Tax Conventions (Supra)* at 285 in para 23.

28 P Baker *Double Taxation Conventions* (2005) in para 5B.06.

29 Doernberg et al Electronic Commerce and Multijurisdictional Taxation (Supra) at 206.

30 KJ Levouchkina "Relevance of PE for Taxation of Business Profits and Business Property" in Hans-Jörgen & Mario Züger *PEs in International Tax Law* (2003) at 20-21.

31 OECD "Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention Article 5 (Dec 22 2000) at 36, available at http://www.oecd.org/dataoecd/46/32/1923380.pdf (visited 4 September 2008).

32 Ibid.

Even if the employees do not constitute *de facto* employees of the multi-national enterprise it must still be considered whether the subsidiary, by virtue of its activities could create a permanent establishment for the multi-national enterprise in the source state by virtue of the agency provisions in article 5(5) considered below. Often the multi-national enterprise will enter into various contractual arrangements with a subsidiary in the source state. It must then be analysed whether the activities of the subsidiary could create a PE for the multi-national enterprise in the source state. In particular, it must be considered whether the business of the multi-national enterprise is carried on through a fixed place of business constituted by the subsidiary.

The OECD MTC does not specifically state the duration that the foreign enterprise should spend in another country in order to create a PE, however a minimum of 6 months is seen as a guideline duration.[33]

2.2 ARTICLE 5(2)

Article 5(2) contains an illustrative list of places that often constitute a PE. These include especially: a place of management; a branch; an office; a factory; a workshop; a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. The list is not exhaustive.[34]

Article 5(2) is not self-standing in that, in considering the examples of a PE, the requirements of article 5(1) must also be met.[35] Article 5(2) simply provides an indication that a PE may well exist; it does not provide that one necessarily does exist.[36]

In South Africa, the above is supported by SARS Binding Private Ruling 102 issued on 4 May 2011, which addresses the question whether the registration as an external company for company law purposes results in the creation of a PE in South Africa. In this regard, SARS is of the view that the registration of an external company would not create a PE for the applicant. The ruling was, however, subject to the following conditions and assumptions:

- the applicant's place of effective management would be located in the country in which the applicant was resident;
- the applicant would not have any employees or conduct any business activities in South Africa, other than the maintenance of its external company status for exchange control purposes; and

[33] See Para 6 of OECD Commentary on Article 5(1). The submission by Deloitte to the DTC dated 17 August 2015 is hereby acknowledged.
[34] K Vogel *Double Tax Conventions* (1997) in para 47.
[35] Vogel Double Tax Conventions in para 47.
[36] Para 4 of the Commentary on art 5(2).

- the applicant would not have a dependent agent operating on its behalf in South Africa.

This provides some indication that, in terms of South African domestic tax law, the registration of an external company in its self will not result in the creation of a PE for a non-resident in South Africa.

2.2.1 Furnishing of services

Some South African DTAs contain an additional inclusion applicable to the furnishing of services in Article 5(2) which provides that the definition of PE specifically includes:

> "the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned."

The OECD MTC does not contain a provision similar to this provision. However, the United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model) contains a similar provision in Artice 5(3)(b) which states that:

> "the term 'permanent establishment' also encompasses… The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned."

The South African Tax Court has pronounced on the interpretation of this services clause in relation to Article 5(1) in the case of *AB LLC and BD Holdings LLC v Commissioner of the South African Revenue Services*.[37]

Facts

The appellant was an advisory group with global reach that was incorporated in the United States of America concentrating on the airline industry. The appellant came to South Africa in 2007 to provide certain strategic and financial advisory services to an airline company, and once done left the country in 2008. The services were delivered from February 2007 and ended in May 2008. During this period, the appellant's employees came to South Africa as and when required. During the 2007 calendar year, the appellant's employees were in South Africa for a period exceeding 183 days.

[37] (13276) [2015] ZATC 2.

The nature of the work provided required the appellant’s employees to be based at the premises of the service recipient for which the service recipient provided the appellant with space in the boardroom inside the service recipient’s premises. The employees of the appellant only had access to the premises on weekdays during working hours. At times the employees were based at different geographical areas within the premises of the service recipient, and would, for short periods, have to go to other departments of the service recipient. The South African Revenue Service (“SARS”) assessed the appellant for the 2007, 2008 and 2009 tax years.

The applicable provisions

As is the case in article 5(2) of the OECD MTC of the DTA between South Africa and the USA (the DTA) contains a list of specific items as examples of PEs. However, the salient inclusion is contained in para (k) of Article 5(2) of the DTA which is not contained in the OECD MTC. Article 5(2)(k) provides that the definition of PE specifically includes:

> "the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned.”

It is worth noting that the Article 5(1) of the DTA is identical to Article 5(1) of the OECD MTC, and the interpretation of this provision of the DTA will be of wide application and relevance as South African treaties generally follow the OECD Model Convention. The identical nature of the general provisions of the DTA and the OECD MTC were the basis upon which the court ruled that it would rely on the commentary to the OECD Model Convention to the interpretation of the definition of PE

Judgment

(i) The relationship between Article 5(1) and Article 5(2)(g)

The court analyzed the import of the word "includes". The court began by looking at the definition of the word in the Collins English Dictionary (Complete and Unabridged), which states that “include” means, *inter alia*, “to add as part of something else; put in as part of a set group, or category" (par 25). The court then proceeded to explore various judicial pronouncements (to wit *Jones & Co v Commissioner for Inland Revenue* 1926 CPD 1*; Rosen v Rand Townships Registrar* 1939 WLD 5 and *R v Debele* 1956 (4) SA 570 (A)) on the word which have a common factor that include has an attribute of enlarging a meaning of a word or phrase, by adding things that would ordinarily not be covered by the word or phrase that is enhanced by the word "include".[38]

[38] Par 28 – 29.

The court then deduced from the use of the words “specifically includes” that the drafters of the treaty intended that the factors referred to in the specific inclusion be made part of the definition referred to in the general provision and be given special attention when determining whether an enterprise is operating through a PE.[39] It therefore has to be interpreted that the contents of the specific inclusion must be read to mean that they are an integral part of the general provision.[40] On this analysis, as soon as an enterprise’s activities fall within the ambit of the specific inclusion it becomes liable for taxation in the non-resident country. The court held that there is no need for a further or separate enquiry as to whether the requirements of the general provision have been met and that the two articles cannot be read disjunctively.

The court acknowledged that this interpretation of the word "include" might be contrary to the position the OECD takes in this regard in para 12 of the OECD Commentary on Article 5, which is as follows:[41]

> “This paragraph (i.e. 5(2)(a)-5(2)(f)) contains a list, by no means exhaustive, of examples, each of which can be regarded prima facie, as constituting a permanent establishment. As these examples are to be seen against a background of the general definition given in paragraph 1, it is assumed that the Contracting States interpret the terms listed, ‘a place of management’, ‘a branch’ ‘an office’ etc., in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1".

The court held that what is recommended by the OECD for these articles has no bearing on the issue of the relationship between the general provision and specific inclusion. The court stated that Article 5(2)(k) is specific in nature and different from articles 5(2)(a) – 5(2)(f) of the OECD MTC. Unlike the said articles 5(2)(a) – 5(2)(f), Article 5(2)(k) does not refer to a place of work, but rather to a form of work. It is a different species. Therefore, the interpretive approach adopted with regard to articles 5(2)(a) – 5(2)(f) cannot be replicated without thought or input with regards to Article 5(2)(k). The court further held that as far as Article 5(2)(k) is directly concerned, the OECD Commentary is of no assistance. Given that there is no such article in the OECD MTC, its silence on the matter is understandable. However, its silence does not mean that an inference to the effect that what it says or recommends with regard to the relationship between Article 5(1) and Articles 5(2)(a) – 5(2)(f) is applicable to the relationship between the general provision and the specific inclusion. The court therefore concluded that there is no room for such an inference given the material differences between the specific inclusion and articles 5(2)(a) – 5(2)(f) of the OECD Commentary.[42]

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[39] Par 30.
[40] Par 30.
[41] Par 30.
[42] Par 31.

(II) "fixed place of business…wholly or partly carried on"

The appellant referred to the Canadian case of *The Queen v Dudney* (WA (2000) D.T.C. 6169) whose facts were particularly similar to the current case. However, the main difference is that in *Dudney*, the taxpayer would, from time to time, provide training to the employees of the local service recipient and the training would take place in different parts of the local service recipient's premises where these employees were based. The taxpayer could not do any of his own business while located on any of the local service recipient's premises. He could not use the telephone for any business other than that which was related to the services he was providing to the local service recipient.[43] The court distinguished *Dudney* from the current case, stating that in the current case the appellant was, at all times, present in the boardroom during the tenure of the contract. Further that the appellant had exclusive use of this space for the entire duration of the contract. The court stated that the appellant "had at its disposal constant access to the boardroom during working hours. Access during non-working hours was neither necessary nor requested. This flows directly from the fact that compliance with its obligations in terms of the contract required regular intensive interaction with employees of the service recipient, which, it goes without saying, was most suitable during normal working hours".[44] The court then concluded that there can be no doubt that the appellant had established a fixed place of business in South Africa, while carrying out its obligations in terms of its contract with the service recipient.[45]

The appellant contended that, as it did not have access to the boardroom after normal working hours, and the fact that it was restricted to solely conduct the business relating to the contract with the service recipient, it was not able to conduct any of its business not relating to the service recipient. The appellant argued that this limitation demonstrates that the appellant was not able to conduct all its business from the service recipient premises, and that therefore the appellant could not have established a PE at the service recipient's premises. The court found that the difficulty faced by this contention is that it flies in the face of the definition of PE in the DTA. The defining characteristic in terms of the general provision is that it must be "a fixed place of business through which the business of an enterprise is wholly *or partly* carried on". Thus, the appellant is not required to carry out all its business from the "fixed place of business". Even if the appellant performed some of its obligations to the service recipient from another premises, the appellant would, nevertheless, have established a PE if it performed only some of its obligations to the service recipient.[46]

[43] Par 34.
[44] Par 42.
[45] Par 42.
[46] Par 43.

The court then concluded that to the extent that it is necessary for there to be compliance with the general provision before a finding that the existence of a PE has been proved, such has been proven in this case.[47]

(III) 183 day requirement

The court had to consider whether the appellant rendered services for periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned. It was common cause that the appellant satisfied the 183 day requirement for the 2007 and 2008 years. With regards to the 2009 tax years the appellant contended that if an entity spends less than 183 days in any twelve month period commencing or ending in a taxable year in a non-resident state, then that entity cannot be said to have set up a PE in that state.[48] Holding that the appellant was liable to tax in South Africa for the 2009 year in which the appellant spent less than 183 days in the tax year, the court stated:[49]

> "The fact that the duration spanned over two fiscal years does not mean that the 183 day period has to be separately calculated for each fiscal year for, as stated in the Commentary on the OECD Model, if the presence in each fiscal year was only 5½ months, then the entity would avoid paying tax to the country in which the income was earned (or profits made) despite the fact that its presence in that country was for longer than 183 days. This interpretation, which is the one we are enjoined by the appellant to adopt, defeats the object of the DTA, is contrary to the intention of the parties and stands in stark contrast to the interpretation proffered in the OECD Commentary."

2.3 ARTICLE 5(3)

This Article provides that a building site or construction or installation project constitutes a PE only if it lasts more than twelve months. The twelve month time limit is intended to encourage businesses to undertake preparatory or ancillary operations in another State so as enable permanent commitment without becoming immediately subject to tax in that State. There are, however, concerns that the twelve month time limit could be subject to abuse:

- The building site or construction or installation project could, as a result of modern technology, be of very short duration and still result in a substantial profit for the enterprise.
- The time limits could be used by foreign enterprises to set up artificial arrangements to avoid taxation in their territory.[50]

2.4 ARTICLE 5(4)

Article 5(4)(a)-(f) sets out certain exclusions to the PE definition, namely:

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47 Par 44.
48 Par 46.
49 Par 48.
50 Para 10 of the Commentary on art 5(3) of the UN Model Tax Convention.

- the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose processing by another enterprise;
- the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collection of information, for the enterprise;
- the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character, for example, solely for the purpose of advertising or the supply of information or for scientific research; and
- the maintenance of a fixed place of business solely for any combination of activities mentioned above provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.[51]

The common feature of these activities is that they are, in general, preparatory or auxiliary activities.[52] The provisions of Article 5(4) limit the otherwise wide scope of the definition of a PE in Article 5(1). Article 5(4) is thus designed to prevent an enterprise of one State from being taxed in the other State if it carries on, in that other State, activities of a purely preparatory or auxiliary character.[53] It should be noted that Article 5(4) requires that the place of business is used solely for the purpose mentioned in the sub-paragraphs. If the activity goes beyond the purpose specified in the paragraph, the exclusion offered by Article 5(4) does not apply.[54] The OECD is of the view that the decisive criterion in distinguishing between activities that are of a preparatory or auxiliary nature and those that are not, is whether or not the activity of a fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.[55]

A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise cannot be regarded as doing preparatory or auxiliary activity, for such a managerial activity exceeds this level.[56]

2.5 ARTICLE 5(5)

This article provides that:

51 Article 5(4) of the OECD Model Convention.
52 Oguttu & Tladi "E-commerce: A Critique on The Determination of a 'Permanent Establishment' for Income Tax Purposes From a South African Perspective" 78.
53 Holmes International Tax Policy and Double Tax Treaties at 156.
54 Holmes International Tax Policy and Double Tax Treaties at 156.
55 Paragraph 24 of the Commentary on article 5 of the OECD MTC.
56 Paragraph 24 of the Commentary on article 5 of the OECD Model Convention.

> "Notwithstanding the provisions of paragraphs 1 and 2 of this Article, where a person - other than an agent of an independent status to whom paragraph 6 of this Article applies – *is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts on behalf of the enterprise,* that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 of this Article which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph" (emphasis added).

Although an enterprise may not have a fixed place of business in a host state, a PE is deemed to exist where a dependent agent has authority to conclude contracts on behalf of the enterprise and habitually exercises this authority in the source country.[57]

Accordingly, there is a two-stage enquiry as to whether an agent constitutes a PE of its principal. The first enquiry is whether the agent is dependent or independent. If the agent is independent, no PE would exist. If the agent is a dependent agent, the next enquiry is whether he has, and habitually exercises, authority to conclude contracts on behalf of the principal. The person making use of the authority must do so repeatedly and not merely in isolated cases.[58] Persons (whether individuals or juristic persons) whose activities may create a PE should not be independent agents. According to the OECD, the factors which play an important role in deciding whether a person is a dependent or independent agent are:

- the amount of freedom the person has to enter into contracts on behalf of the enterprise. Where the person operates under detailed instructions and control, this indicates a dependent status; and
- If the risk is borne by the agent, then the agent acts independently.[59]

2.5.1 Authority to conclude contracts

Paragraph 31 of the Commentary on Article 5(5), states that it is a generally accepted principle that an enterprise should be treated as having a PE in a State if there is, under certain conditions, a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2 of the OECD Model Convention.

Paragraph 32 of the Commentary on Article 5(5) then provides that persons whose activities may create a PE for the enterprise are so-called dependent agents, i.e. persons, whether or not they are employees of the enterprise, who are not independent agents under Article 5(6). Such persons may be either individuals or

[57] Article 5(5) of the OECD Model Convention. See also L Dazinger *International Tax Law* (1991) at 334; and R Rohatgi *Basic International Taxation* (2002) at 77; see also Pijl at 560.

[58] Olivier & Honiball at 105; Oguttu & Tladi "E-commerce: A Critique on The Determination of a 'Permanent Establishment' for Income Tax Purposes From a South African Perspective" at 78.

[59] Paragraph 37-38 of the Commentary on article 5 of the OECD Model Convention.

companies and need not be residents, nor have a place of business in the state in which they act for the enterprise.

In circumstances where a subsidiary has been set up in order to avoid the creation of a PE in South Africa it is unlikely that the subsidiary will constitute an "independent agent" as contemplated in Article 5(6) - discussed below. In this regard, it is relevant to note that the OECD Commentary acknowledges that it would not have been in the interest of international economic relations to provide that the maintenance of any dependent person in itself would lead to a PE for the enterprise. Such treatment is therefore limited to persons who, in view of the scope of their authority, or the nature of the activity, involve the enterprise to a particular extent in business activities in the State concerned. Therefore, Article 5(5) proceeds on the basis that only persons who have the authority to conclude contracts can lead to a PE for the enterprise maintaining them. In such a case, the person has sufficient authority to bind the enterprise's participation in the business activity in the state concerned.

The use of the PE concept in this context pre-supposes that the person makes use of this authority repeatedly and not merely in isolated cases. It is further acknowledged that the lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent; for example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives but does not formally finalise orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves transactions.

Paragraph 33 of the Commentary on Article 5(5) states:

> "The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise... A *person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated* or if the first person has not formally been given power of representation. The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise". The fact that the person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise" (emphasis added).

Whilst the South African courts have not considered the meaning of the dependent agency provisions in any treaty concluded by South Africa and, in particular, what is meant by the phrase "*is acting on behalf of an enterprise and has, an habitually exercises, in a contracting state, an authority to conclude contracts on behalf of the enterprise*", this aspect has been considered in a number of international cases, which may be considered to provide guidance in this regard. Whilst such cases will not be binding on South African courts, they may provide persuasive authority.

DDIT v B4U International Holdings Limited

In the Indian case of *DDIT v B4U International Holdings Limited* [(ITA 880/MUM/2005) (AY2001/02)], the Indian court had to decide, in the context of the treaty between India and Mauritius on:

- whether the Mauritian principal ("MCo") was subject to tax in India as a result of the Indian agent establishing a dependent agency PE for MCo in India and;
- if such a PE indeed existed, and on the assumption that the Agent was remunerated on an arm's length basis, whether there were there any additional profits of MCo that could be taxed in India.

The facts of the case were, broadly as follows: MCo's business comprised the telecasting of TV channels such as B4U Music, MCM, etc. During the year of assessment under consideration, MCo's revenues from India consisted of collections from time slots given to advertisers in India. It is relevant to note that the channels broadcast by MCo in India, were all "free to air" channels, which meant that they could be shown on cable networks without any subscription fee. In other words, the sole purpose of the business of MCo in India was to generate revenue by offering advertisement slots or time slots to Indian advertisers. The activities and duties of the Agents were therefore essentially the "lifeblood" of the business of MCo in India.

The Indian Tax Commissioner argued that on a plain reading of the agreement entered into between MCo and its Agents, it was evident that the Agents were working exclusively and wholly for MCo. He further stated that the Agent was authorised to conclude contracts, by relying on the following clause in the agreement entered into between MCo and its Agents:

> "in the event of the termination of this agreement by B4 International, B4 Multi shall supply to B4 International such information as B4 International may request, to invoice and collect any outstanding amounts from advertisers and/ or agencies which were earned, but not invoiced or collected, prior to determination of the agreement".

The Commissioner submitted that if the power to conclude contracts was not with the Agents, this clause would not have been required.

In delivering judgment in this case, the court referred to the following important clauses of the agreement between MCo and its Agents and made the following observations as to the functions of the Agents:

> "It will create a rate card for the sale of advertising time on the B4U channels, which will be used only after it is approved by B4 International. Any sales, which deviate from the approved rate card, must be approved by B4 International which will be provided from time to time to RBI..."

With regard to the above clause, it was held that the above showed that the decision on any pricing was controlled by MCo exclusively.

> “B4 International shall invoice advertisers ... B4 Multi will collect and keep all sales revenue until such as the approval of the Reserve Bank of India is obtained to remit such sales revenue to B4 Multi...”.

The court held that the aforementioned clause shows that invoices were raised by MCo only. The Agent only obtained approval, collected money and remitted same to the owner of the revenue, namely MCo. The court further referred to the contractual clause which stated as follows:

> “[B4 Multi acknowledges that B4 International shall retain the absolute right to reject any advertisement submitted to be exhibited on the B4 channels at its sole discretion. B4 Multi acknowledges that it cannot bind B4 International to accept any requisition made by a potential advertiser to exhibit its advertisement on the B4 channels and that it shall merely forward the requisitions of such advertisers to B4 International. In this regard B4 International will make best efforts to provide B4 Multi with general guidelines regarding unacceptable advertisement ... “

The court held that the above clause clarified that the Agent only forwarded the advertisements to MCo, who had a right to reject same. No control vested in the Agent. The contract further provided that [e]xcept with the prior written consent of B4 International, B4 Multi shall not bind, whether directly or indirectly, B4 International or seek to act on behalf of B4 International”.

It was held that the above clause was very clear on the roles of each partner, being that both are independent of each other.

The court ruled that, on a plain reading of the aforementioned clauses, it was demonstrated that the Agent was not the decision maker, nor did it have the authority to conclude contracts. In particular, the Agent had no authority to fix the rate or to accept an advertisement. It could merely forward the advertisement to MCo, who had the right to reject it. No deviation could be made from the rate card by the advertiser until MCo approved it. The Agent was an independent contractor and was therefore not a servant or employee of the MCo. It was further held that the job of the Indian Agent was well defined namely:

- to generate the maximum amount of advertising sales;
- not to deviate from the approved rate card without permission from the principal;
- to ensure all advertisers had the valid Indian documentation required;
- the Agents were not permitted to represent other television networks which contain non-fictional programming broadcast in the same languages as the B4 channels;
- to undertake market analysis;
- to forward advertisements to the principal. The principal had the absolute right to reject any advertisement;
- the principal retained the right to sell advertisement time and such right was not given to the Agent;

- all activities were subject to control of the principal, and the Agent could not bind the principal without prior consent. It could only forward requests of advertisers, collect payment and obtain approvals.

In light of the above, the court held that it was clear that the Agent did not have any power to conclude contracts and furthermore that, on the facts, it could not be said that the Agent had habitually exercised its authority to conclude contracts binding the principal. It was held that the term “has” has reference to legal existence of such authority (i.e. to conclude contracts) in terms of a contract between a principal and agent. The court held that on reading the agreement, it was evident that such powers were not conferred on the Agent. It was further stated that the words “habitually exercises”, have reference to a systematic course of conduct on the part of the Agent. In the case on hand, there was neither legal existence of such authority, nor was there any evidence to prove that the Agent had habitually exercised such authority. In fact, the principal had raised all the invoices to advertisers.

In light of this decision, it is evident that the point of departure in determining whether an agent may constitute a PE for its principal on the basis of the agency provisions of the treaty, regard must first be had to the agreement entered into between principal and agent. Where the agreement clearly stipulates the functions of the agent and it is evident that the agent has no authority to negotiate, conclude, vary any term or represent the principal in dealings with the principal’s customers, *prima facie*, the agent will not create a PE for its principal. However, regard should also be had to whether such agent, outside the scope of any legal existence of such authority, habitually exercises the authority to conclude contracts on behalf of its principal. Therefore, it must be ensured that the parties’ conduct corresponds with the wording of the agreement and that all agreements are implemented in accordance with its form.

2.5.2 Remarks from the South African perspective

A typical attempt to avoid a PE in South Africa is for a foreign multinational entity to establish a South African subsidiary and pay an arm’s length fee to the subsidiary. The subsidiary will then employ the various entities required by the multi-national enterprise.

- In this regard it is important to note that a PE will not necessarily be avoided if a multi-national enterprise sets up a subsidiary and pays it an arm’s length fee. The subsidiary will be taxed in South Africa on its fee. However, there is a separate enquiry which must be undertaken as to whether the multi-national enterprise itself is carrying on business through a permanent establishment in South Africa by virtue of the control and influence that the multinational entity exercises over the subsidiary. If so then the multi-national enterprise, as a separate entity, will be taxable in South Africa in respect of the profits attributable to the subsidiary's activities in South Africa.

- In conducting this enquiry it is necessary to focus on the facts of the arrangement using the OECD Guidelines and South African domestic law concepts of, for example, *de facto* employment relationships. If, *inter alia*, the employees look to the multi-national enterprise as their true employer they may create a *de facto* employment relationship with it, thereby creating a PE for that multi-national enterprise in South Africa.
- In terms of the dependent agency provisions it is principally a factual enquiry as to whether the subsidiary in South Africa is both legally and economically independent of the multi-national enterprise and acts in the ordinary course of its business. If it is a dependent agent then it is also a factual enquiry as to whether it has and habitually exercises the right to conclude contracts on behalf of its principal. Since this is not a formalistic test of where the contract is signed, but rather where, in substance, it is concluded, the facts will determine whether a PE exists.
- The substance of the agent's powers should be rigorously tested, i.e., the fact that the contracts are formally signed outside South Africa does not mean that they are not concluded in South Africa by the dependent agent.
- The tests provided by the OECD and applicable foreign case law are sufficient in order to avoid the concern expressed in relation to this Action, i.e., the artificial avoidance of a PE in the source state (South Africa).
- There is a concern relating to the setting up of *commissionnaire* arrangements in the context of multi-national enterprises investing in South Africa.

2.6 ARTICLE 5(6)

This Article states that:

> "An enterprise of a Contracting State shall not be deemed to have a PE in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

In accordance with paragraph 37 of the OECD Commentary on Article 5(5) of the OECD MTC, a person will be independent and will therefore not constitute a PE of the enterprise on whose behalf he acts, if:

- he is independent of the enterprise both legally and economically; and
- he acts in the ordinary course of his business when representing his principal.

In terms of paragraph 38 of the OECD Commentary, where the person's commercial activities for the enterprise are subject to detailed instructions or comprehensive control by it, the person is legally dependent on the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the agent or the enterprise it represents.

2.6.1 Legal independence

South Africa has no case law on the concept of legal independence. International case law has commented on this concept as follows:

- In *Taisei Fire and Marine Insurance Co. Ltd* 104 TC No. 27 (May 2, 1992), the tax court in the United States of America referred to the commentaries by the OECD on the 1963 draft Model Convention. With regard to legal independence, the court noted that the principal had no shareholder interest in the agent and no representative of the principal was a director, officer or employee of the agent. The court also considered other factors, including whether the agent had complete discretion in conducting the business on behalf of the principal.
- In *Donroy Ltd v United States*, 301 F.2d 200, 206 (9th Circuit.1982), an independent agent was compared with an employee. The court found that, in contrast to a dependent agent/employee, an independent agent contracts to do a piece of work according to his own methods and without being subject to the control of his employer except as a result of the work.

In summary, an agent is legally independent if he can conduct the business of the principal according to his own view, expertise and methods without intervention from the principal.

2.6.2 Economic independence

Vogel[60] states the following:

> "The main criteria for assessing an agent's economic independence of the enterprise he represents are the details of how his business relations with the enterprise are shaped, particularly in economic respects. The personal independence… of an agent may thus well be questioned if the latter, while retaining his independent status in legal respects, were to work for only one principal and were, therefore, to be economically dependent on the principal. It will in those cases by no means be rare for such agent to be bound – though not legally, but at any rate factually – to obey his principal's instructions to the same degree as an employee and consequently to be regarded as being a dependent agent…"

In light of the above, in order for an agent to be economically independent from his principal, the agent's business must be able to stand on its own and not look to the principal for its very economic viability. A further consideration when determining economic independence is whether the agent shares business risk with the principal or carries his own business risk. These factors indicate whether or not the agent's business is integrated with that of his principal.

It is also relevant to consider how many principals the agent represents. If the agent represents a single principal for a long period of time, it may be more difficult to

[60] K Vogel Double Taxation Conventions (1997) at 345.

demonstrate that the agent is economically independent of the principal. The key consideration therefore, is whether on balance of all the relevant facts and considerations, the agent's activities constitute an autonomous business conducted by him in which he bears the risk and receives the reward through the use of his entrepreneurial skills and knowledge.

2.6.3 Ordinary course of business

Paragraph 38.7 of the Commentary on Article 5(6) states that a company is not acting in the ordinary course of its business when it performs activities that belong to its principal and which do not form part of its own business.

2.7 ARTICLE 5(7)

The Article states that:

> "The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a PE or otherwise), shall not of it itself constitute either company a PE of the other".

Article 5(7) implies that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a PE of its parent company. This Article makes it clear that a controlling interest by a parent company in its subsidiary does not automatically result in the controlled subsidiary being a PE of its controlling parent company.[61] In other words, tax treaty law recognises the independence which a company has under private law.[62]

The inclusion of the words "…shall not of itself…" implies that a subsidiary may still constitute a PE of its parent company based on other factors. For example a subsidiary may be deemed a~~n~~ dependent agent on the basis of a special parent/subsidiary relationship (other than that of control under company law) and thus become a PE of its parent company.[63] Thus if the activities of the subsidiary on behalf of the parent fall within the other provisions of article 5, this may constitute a PE.[64] A parent company may, under Article 5(1), be found to have a PE in a State where a subsidiary has a place of business if space or premises belonging to the subsidiary are at the disposal of the parent company and constitute a fixed place of business through which the parent carries on its own business (unless those activities are of a preparatory or auxiliary nature).[65]

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61 B Arnold & M Mclntyre *International Tax Primer* at 121.
62 Vogel *Double Tax Conventions* in para 189.
63 Vogel *Double Tax Conventions* in para 192.
64 Baker Double Taxation Conventions in para 5B.33.
65 Holmes International Tax Policy and Double Tax Treaties at 163.

3 THE 2013 OECD BEPS REPORT

The *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) called for a review of that definition to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition.

The 2013 OECD report on *Addressing Base Erosion and Profit Shifting,* the OECD notes the following about the current treaty definition of permanent establishment:

> "It had already been recognised way in the past that the concept of permanent establishment referred not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carried on business in the country concerned via a dependent agent (hence the rules contained in paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention). Nowadays it is possible to be heavily involved in the economic life of another country, *e.g.* by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent). In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits, especially where the profits from such transactions go untaxed anywhere".

The 2013 OECD BEPS Report noted that the PE concept is a crucial element of the model treaty, which is designed to limit a source country's tax jurisdiction over foreign businesses.[66] It has been under attack for years, from both sides - from multinationals that abuse it by compartmentalising, and from developing countries that want to reclaim their jurisdiction.

Following up on the BEPS Report, the OECD published its BEPS Action Plan in July 2013. The BEPS Action 7 which deals with preventing the Artificial Avoidance of PE Status recommended that countries ***"****Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionnaire arrangements and the specific activity exemptions. Work on these issues would also address related profit attribution issues".*

- The BEPS Report recognises that the current definition of PE must be changed in order to address BEPS strategies.
- The BEPS Action Plan also recognises that in the changing international tax environment, a number of countries have expressed a concern about how international standards, on which bilateral tax treaties are based, allocate taxing rights between source and residence States. However, the BEPS Action Plan indicates that whilst actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income. [67]

66 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 19.
67 OECD/G20 2015 Final Report on Action 7 in para 3.

Action 7 of the 2013 OECD BEPS Report called on countries to develop measures to prevent the artificial avoidance of PE status. On the international front, the OECD embarked on developing changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of *commissionnaire* arrangements (see below for definition) and the specific activity exemptions. The 2013 Report also envisaged that the work on these issues will also address related profit attribution issues. [68]

In the 2013 OECD BEPS Report, the OECD notes that "in many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor".[69]

4 THE 2015 OECD REPORT

4.1 ARTIFICIAL AVOIDANCE OF PE STATUS THROUGH *COMMISSIONNAIRE* ARRANGEMENTS AND SIMILAR STRATEGIES

The OECD states that a *commissionnaire* arrangement may be loosely defined as an arrangement through which a person sells products in a State in its own name, but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a PE to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). A foreign enterprise that uses a *commissionnaire* arrangement does not have a PE because it is able to avoid the application of Article 5(5) of the OECD Model Tax Convention, to the extent that the contracts concluded by the person acting as a *commissionnaire* are not binding on the foreign enterprise.

- Since Article 5(5) relies on the formal conclusion of contracts in the name of the foreign enterprise, it is possible to avoid the application of that rule by changing the terms of contracts without material changes in the functions performed in a State.
- *Commissionnaire* arrangements have been a major preoccupation of tax administrations in many countries with a civil law code. A c*ommissionnaire* agent does not conclude contracts in the principal's name which results in the shifting of profits out of the country where the sales take place without a

68 Ibid.
69 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 9.

substantive change in the functions performed in that country. Accordingly, a number of court cases, principally *Zimmer Ltd*[70] in France, *Dell AS*[71] in Norway, and *Boston Scientific International BV*[72] in Italy, have held that a *commissionnaire* agent does not fall within article 5(5) and so is not a taxable PE. On the other hand, a recent decision concerning *Dell Spain*[73] held that the *commissionnaire* agent constituted a Spanish PE, mainly because it performed other services for its Irish principal, such as logistics and marketing. In most of those cases the tax administration's arguments were rejected.

- Similar strategies that seek to avoid the application of Article 5(5) involve situations where contracts which are substantially negotiated in a State are not formally concluded in that State because they are finalised or authorised abroad, or where the person that habitually exercises an authority to conclude contracts constitutes an "independent agent" to which the exception of Article 5(6) applies even though it is closely related to the foreign enterprise on behalf of which it is acting.
- The OECD notes that clearly, in many cases, *commissionnaire* arrangements and similar strategies were put in place primarily in order to erode the taxable base of the State where sales took place. Changes to the wording of Article 5(5) and 5(6) are therefore needed in order to address such strategies. In this regard, the OECD recommends that:
    - As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business.
    - Changes are therefore to be made to Article 5(5) and 5(6) and the Commentary thereon to address *commissionnaire* arrangements and similar strategies by ensuring that the wording of these provisions better reflect this underlying policy. [74]
    - Such changes, however, are not intended to address BEPS concerns related to the transfer of risks between related parties through low-risk distributor arrangements. In these arrangements, sales generated by a local sales workforce are attributed to a resident taxpayer, which is not the case in the situations that the changes to Article 5(5) and 5(6) are intended to address. Given this difference, BEPS concerns related to low-risk distributor arrangements are best addressed through the work on Action 9 (Risks and Capital) of the BEPS Action Plan.[75]

70 French Supreme Court, No. 3047 15, Mar. 31, 2010.
71 Norwegian Supreme Court, HR-2011-02245A, Dec. 2, 2011.
72 Italian Supreme Court, No. 3769, Mar. 9, 2012.
73 Spanish Central Economic Administrative Court, RG 2107-07, Mar. 15, 2012.
74 OECD/G20 2015 Final Report on Action 7 in the Executive Summary.
75 OECD/G20 2015 Final Report on Action 7 in para 9.

4.2 ARTIFICIAL AVOIDANCE OF PE STATUS THROUGH THE SPECIFIC ACTIVITY EXEMPTIONS

Article 5(4) of the OECD Model Tax Convention includes a list of exceptions (the “specific activity exemptions”) according to which a permanent establishment is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph.

4.2.1 List of activities included in Article 5(4)

Action 1 of the OECD Report on *Addressing the Tax Challenges of the Digital Economy*, OECD, 2015b) notes that when the exceptions to the definition of permanent establishment that are found in Article 5(4) of the OECD Model Tax Convention were first introduced, the activities covered by these exceptions were generally considered to be of a preparatory or auxiliary nature. Since the introduction of these exceptions, however, there have been dramatic changes in the way that business is conducted.

The OECD 2014 Discussion Draft on Action 7, [76] states that it is difficult to justify the application of exception (a) and (b):

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; and
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery

to the PE concept where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online.[77]

Regarding Article 5(4)(b) MNEs often carry out significant business in the source state where they have a dependent agent who maintains a stock of goods from which delivery is made to customers in that state. Article 5(5) of the OECD MTC deems a PE to exist if a dependent agent habitually concludes contracts on behalf of the enterprise in the other contracting state, even if there is no physical place of business

Article 5(4)(c) excludes from the PE concept the “maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose processing by another enterprise”. An important BEPS issue is whether an enterprise’s stock of goods maintained with a toll-manufacturer will cause the location where the goods are maintained to be at the disposal of the enterprise. In terms of the current PE rules, if the stock of goods is at the disposal of the enterprise, and the other

76 OECD Public Discussion Draft on Action 7 (31 October 2014 – 9 January 2015) in paras 18-19.

77 OECD Public Discussion Draft on Action 7 (31 October 2014 – 9 January 2015) in para 19.

conditions for PE status under article 5(1) are satisfied, then a PE would be created. If however, the maintenance of that stock of goods by a toll manufacturer is for purposes of storage display or delivery a PE would not be constituted. However, in modern business models a toll manufacturer could be part of the MNE group of companies. As a connected enterprise, it is necessary to determine whether maintaining of the goods will meet or fail the preparatory and auxiliary test.

Article 5(4)(d) excludes from the PE concept "the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise". However with modern business models, an MNE can collect information for the enterprise and disguise it by repackaging it into reports prepared for these enterprises, thereby avoiding PE status.[78] This is particularly so for companies dealing in electronic products, which can collect user data in one country and use that data to sell targeted advertisements to advertisers in another country. Revenues collected from advertisements targeted to users in one country are then be funnelled through subsidiaries in low tax jurisdictions, thus avoiding PE status in those countries in which the advertisements are collected.[79] With modern businesses where an MNE has a connected affiliate in a source state that collects information that is related to the business as a whole, such an affiliate should be considered a PE of the MNE.

Article 5(e) and 5(f) exclude from the PE concept other activities of "preparatory or auxiliary" nature. The purpose of these exclusions is to prevent an enterprise from being taxed in the other State, if it only carries on activities of a purely preparatory or auxiliary character.[80] There is however uncertainty about the meaning of the phrase "preparatory or auxiliary" and so the need for guidance on its meaning. An example of preparatory of auxiliary activities given in article 5(4)(e) is the maintenance of a fixed place of business solely for the purpose of advertising or the supply of information or for scientific research. However, not all scientific research activities can qualify as "preparatory or auxiliary" activities. In the modern world, real value can be created through scientific research as well as the development and testing of products and services, in continuous processes of innovation and improvement. Spending on innovation is key to the success of many businesses today. However under the current rules, a MNE could continue to claim that an affiliate in a country carrying out research and development is a contract researcher, and that its activities are "preparatory or auxiliary" to the sales of final products.

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78 OECD Public Discussion Draft on Action 7 (31 October 2014 – 9 January 2015) in para 28.

79 SS Jonstone "News Analysis: Chasing Google -- The Global Struggle to Tax Ecommerce" 10 February 2014.

80 Para 18 of the Commentary on art 5(4); see also K. Holmes *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application* (IBFD, 2007), p. 156.

In its 2015 final Report on Action 7, the OECD notes that depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities.[81]

- OECD recommendation: In order to ensure that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) is to undergo modification to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character.
- BEPS concerns related to Article 5(4) also arise from what is typically referred to as the "fragmentation of activities". Given the ease with which multinational enterprises (MNEs) may alter their structures to obtain tax advantages, it is important to clarify that it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Article 5(4).
- Thus the OECD has come up with an anti-fragmentation rule to address these BEPS concerns.[82]

4.2.2 Fragmentation of activities between closely related parties

Concerns have been raised about MNEs avoiding PE status by "fragmenting activities" and taking advantage of article 5(4)(f) which excludes from the PE concept "the maintenance of a fixed place of business solely for any combination of activities in article 5(4)(a)-(e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character".

Currently paragraph 27.1 of the Commentary on article 5(4)(f) which deals with the application of Article 5(4)*f*) in the case of what has been referred to as the "fragmentation of activities" provides that:

> "Subparagraph f) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs a) to e) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not "separated organisationally" where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity".

However, the wide application of the article 5(4)(f), since it covers a combination of activities, often creates nexus in the source country that is not preparatory or auxiliary.

[81] OECD/G20 2015 Final Report on Action 7 in the Executive Summary.
[82] Ibid.

MNEs can avoid PE status by artificially fragmenting their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities. This is especially so in relation to delivery warehouses used as part of the digital trading model. Concerns about the fragmentation of group operations among multiple group entities in order to avoid PE status, can be exemplified by the decisions in *Dell Spain* and in the Italian case of *Philip Morris GmbH*,[83] both of which adopted a substantive approach in determining that multiple PEs of foreign group companies existed as a result of fragmented group operations.

The OECD explains that, given the ease with which subsidiaries may be established, the logic of the last sentence in paragraph 27.1 "an enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity" should not be restricted to cases where the same enterprise maintains different places of business in a country but should be extended to cases where these places of business belong to closely related enterprises.

- The OECD recommends that some BEPS concerns related to Article 5(4) will therefore be addressed by the anti-fragmentation rule which will take account not only of the activities carried on by the same enterprise at different places but also of the activities carried on by closely related enterprises at different places or at the same place. This new rule is the logical consequence of the decision to restrict the scope of Article 5(4) to activities that have a "preparatory and auxiliary" character because, in the absence of that rule, it would be relatively easy to use closely related enterprises in order to segregate activities which, when taken together, go beyond that threshold.[84]
- The new *anti-fragmentation rule will read as follows:*
  "Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and
  a) *that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or*
  b) *the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation".*

4.3 OTHER STRATEGIES FOR THE ARTIFICIAL AVOIDANCE OF PE STATUS

4.3.1 Splitting-up of contracts

83 Italian Supreme Court, Nos. 3667, 3368, 7682, and 1095, Mar. 7, 2002.
84 OECD/G20 2015 Final Report on Action 7 in para 15.

Article 5(3) of the OECD MTC provides for a special PE rule for building sites, construction, and installation projects that last for more than 12 months. However, contractors and sub-contractors especially those engaged in exploration and exploitation on the continental shelf often split contracts to abuse the 12 months PE time in article 5(3) so that they each cover a period less than the prescribed time limit, thereby avoiding PE status through such artificial arrangements.

Currently, the splitting-up of contracts in order to abuse the exception in Article 5(3) is dealt with in paragraph 18 of the Commentary on Article 5 so as to address the abuse to the exception.[85]

The paragraph states as follows:

> "The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations".

The splitting-up of contracts in order to avoid the existence of a PE is a concern with regard to MNE service activities such as those of consultants or engineers who often allege that their services are of a temporary nature. To address these concerns paragraph 42.23 of the Commentary on article 5 suggests an alternative service-PE provision that countries may be include in treaties. Paragraph 42.45 of the OECD Commentary on article 5(4) also recommends that legislative or judicial anti-avoidance rules may apply to prevent such abuses.

<u>OECD recommendation:</u>

- The Principal Purposes Test (PPT) rule that will be added to the OECD Model Tax Convention as a result of the adoption of the Report on Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*) will address the BEPS concerns related to the abusive splitting-up of contracts. Under the principal purpose rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.[86]
- For States that are unable to address the issue through domestic anti-abuse rules, a more automatic rule that prevents transactions that are known to cause treaty shopping concerns will also be included in the Commentary as a provision that should be used in treaties that would not include the PPT or as

[85] OECD/G20 2015 Final Report on Action 7 in para 16.
[86] OECD/G20 2015 Final Report on Action 6 in the Executive Summary.

an alternative provision to be used by countries specifically concerned with the splitting-up of contracts issue. [87]

4.3.2 Strategies for selling insurance in a State without having a PE therein

Insurance companies may do large scale business in a State without having a permanent establishment in that State. The OECD acknowledges that insurance (including re-insurance) raises difficult issues as regards the question of where profits that represent the remuneration of risk should be taxed.[88] Currently paragraph 39 of the Commentary on Article 5 suggests that:

According to the definition of the term "permanent establishment" an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business.

In order to obviate this possibility, various conventions concluded by OECD Member countries include a provision which stipulates that insurance companies of a State are deemed to have a PE in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a PE by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

In its 2015 Final Report on Action 7, the OECD notes that:

- As part of the work on Action 7, BEPS concerns related to situations where a large network of exclusive agents is used to sell insurance for a foreign insurer were also examined.
- It was ultimately concluded, however, that it would be inappropriate to try to address these concerns through a PE rule that would treat insurance differently from other types of businesses and that BEPS concerns that may arise in cases where a large network of exclusive agents is used to sell insurance for a foreign insurer should be addressed through the more general changes to Article 5(5) and 5(6). [89]

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[87] OECD/G20 2015 Final Report on Action 7 in para 17. See also OECD/G20 2015 Final Report on Action 6 at 22.
[88] OECD Public Discussion Draft on Action 7 (31 October 2014 – 9 January 2015) in para 40.
[89] OECD/G20 2015 Final Report on Action 7 in para 18.

4.4 PROFIT ATTRIBUTION TO PES AND INTERACTION WITH ACTION POINTS ON TRANSFER PRICING

The OECD work on Action 7 also addresses attribution of profit issues. This work focusses on whether the existing rules of Article 7 of the OECD Model Tax Convention would be appropriate for determining the profits that would be allocated to PEs resulting from the changes included in this report.

- The conclusion of that work is that these changes do not require substantive modifications to the existing rules and guidance concerning the attribution of profits to a PE under Article 7 but that there is a need for additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in this report, in particular for PEs outside the financial sector.
- There is also a need to take account of the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital.[90]

However work on attribution of profit issues related to Action 7 could not be undertaken before the work on Action 7 and Actions 8-10 had been completed. Follow-up work on attribution of profits issues related to Action 7 and the necessary guidance will be provided before the end of 2016, which is the deadline for the negotiation of the multilateral instrument that will implement the results of the work on treaty issues mandated by the BEPS Action Plan. [91]

5 ADDRESSING PE ISSUES IN SOUTH AFRICA

5.1 REVAMPING THE SOURCE RULES

The concept of *commissionnaire* is not provided for in South African legislation *per se*. The OECD defines commissionnaire as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products.The PE issues pertaining to *commissionnaire* agency are of concern in South Africa regardless of the fact that South Africa in not a civil law country and the *commissionnaire* agency concept is not applied as is especially where proxies are employed to escape the PE rules, which could pose a risk for South Africa.

The OECD's concerns articulated above refer to circumstances where a multi-national enterprise avoids creating a PE in the source state in order to avoid source based taxation in that jurisdiction. With respect to South Africa the issues that arise relate *inter-alia* to:

- Concerns about the issue of tax compliance;

[90] OECD/G20 2015 Final Report on Action 7 in para 19.
[91] OECD/G20 2015 Final Report on Action 7 in para 20.

- Concerns about calculating the profit attributable to the PE and ensuring compliance with the transfer pricing rules in the source state (South Africa); and
- Concerns by MNEs that having a PE in a source state means claiming foreign tax credits in the resident state of the multi-national enterprise, which credits are sometimes in excess of the resident state's tax (so the excess constitutes an additional permanent tax cost) or, in the case of, *inter alia*, the USA, the resident state places restrictions on the use of foreign tax credits.

Where the South African Revenue Service (SARS) is not able to pin down the existence of a PE in terms of the current OECD rules, South Africa's source rules should be made strong enough to ensure that the activities of such non-residents in South Africa are taxed on a source basis.

- In this regard, it is recommended that South Africa's source rules in section 9 of the Act[92] are refined in line with the OECD 2015 recommendations on Action 7 to ensure they capture all income that is derived by non-residents from goods or services used or consumed in South Africa.

5.2 DETECTING NON-RESIDENT'S REPRESENTATIVE OFFICES - ALLEGEDLY PREPARATORY OR AUXILIARY ACTIVITIES

There are concerns in South Africa over the inability for SARS to detect and monitor whether PEs have been established in South Africa.

- This is especially so where non-residents engage in activities that are allegedly of a temporary nature, such as service activities or, for instance, consultants offering engineering services, or other technical or specialised services.
- Then there are also challenges where non-residents may escape PE status on allegations of being involved in preparatory or auxiliary activities. This is especially so when non-residents set up representative offices in South Africa.

Various solutions to these detection problems could be considered, including the following:

- A system could be put in place to ensure such non-residents are brought into the tax system through filing tax returns. This will ensure that SARS is aware of the business activities of such non-residents in the country. Lack of proper registration means that certain foreign entities are improperly avoiding South African tax altogether.
- Since these representative offices would be renting some offices in South Africa, an obligation could be placed on residents who rent out properties for non-residents to use as representative offices, to ensure they file tax returns.

5.3 DEFINITION OF PE

92 Ibid

As stated earlier, in South Africa, a PE is defined in section 1 of the Income Tax Act, as defined from time to time in Article 5 of the OECD Model Tax Convention. Even though South Africa is not a member of the OECD, it has got OECD Observer Status. As member of the G20, which has worked together with the OECD on the BEPS project, South Africa, is expected to follow the minimum standards and the reinforced international standards such as those relating to the PE concept in tax treaties so as to prevent double taxation and double non-taxation. It should also be noted that South African courts have taken cognizance of the OECD Commentary in interpreting the scope of DTA provisions.[93]

- In this regard, it is recommended that South Africa adopts the new OECD Guidelines on the meaning of the PE concept – even as section 1 of the Income Tax Act clearly provides that PE concept will be defined in South Africa as it is defined from time to time in the OECD Model Tax Convention.

5.4 TAXATION OF SOUTH AFRICAN BRANCHES

As stated in the introduction, a company that is not tax resident in South Africa but conducts business in South Africa through a PE is taxable in South Africa on the income of that PE that is sourced in South Africa.[94] Under the secondary tax on companies (STC) regime (now repealed) a resident company was, in addition to tax on its income at a rate of 28%, also liable for secondary tax on companies at the rate of 10% of dividends declared by the company to its shareholders. With income tax and STC combined, a resident company was thus subject to an effective tax rate of 34,5%. As non-resident companies with South African sourced income were not subject to STC, the income tax rate of non-resident companies on South African income was increased to 33% following the introduction of STC, so as to place non-resident companies on par with resident companies.

With the introduction of dividends tax on 1 April 2012 (and the repeal of STC) resident companies paid tax at a lower rate than non-resident companies. The reason is that insofar as cash dividends are concerned, the person liable for dividends tax is the beneficial owner of the dividend and not the company declaring the dividend. As the resident company is not liable for dividends tax its effective rate of tax is 28%. The result is that following the introduction of dividends tax, non-resident companies were subject to tax at an additional 5%, being the difference between the rate at which it is taxed (33%) and the rate applicable to resident companies (28%). The income tax rate for PEs was therefore reduced to 28% to create parity and avoid discriminating against non-resident companies.

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93 *SIR v Downing* 1975 (4) SA 518 (A).

94 See part I section 4(f) of the Taxation Laws Amendment Act 7 of 2010. See also Olivier L 'The "Permanent Establishment" requirement in an International and Domestic Taxation Context: An Overview' (2002) *SALJ* 866.

The reduction of the rate of income tax applicable to non-resident companies from 33% to 28% means that it is more tax efficient for a foreign company to conduct its South African operations through a PE located in South Africa, than to establish a South African subsidiary because the subsidiary would be liable to normal corporate tax at 28% and the dividends paid by a resident subsidiary to a non-resident company are also subject to dividends withholding tax at 15% if there is no tax treaty in place or, where a treaty is in place, the rate of dividends tax may be reduced in terms of an applicable treaty. This uneven playing field in favour of PEs in the form of branches costs the South African fiscus a loss in potential tax revenue.

- ➢ It is recommended that above concerns could be corrected by an introduction of a tax on branch profit remittances. It is recommended that South Africa should consider the legal, constitutional and DTA implications of introducing such a tax.

It is noted that South African resident companies are exempt from the withholding tax on dividends and that is of no concern in this regard as there is no loss to the South African fiscus.

5.5 PE CONCERNS RELATING TO CREATING A FOREIGN BUSINESS ESTABLISHMENT IN A JURISDICTION

The concept of a “foreign business establishment” in section 9D(1) of the Act which (deals with controlled foreign companies)[95] is key to the base erosion issues. In particular, controlled foreign companies which qualify for the “foreign business establishment exemption” contained in section 9D(9)(b) read with section 9D(9A) of the Act do not have any amounts equal to their taxable income attributed to their South African resident shareholders in terms of section 9D(2) of the Act. The foreign business establishment exemption is therefore fundamental in determining what amounts are attributed to, and taxed in, South Africa.
This is particularly important in respect of controlled foreign companies set up in low tax jurisdictions, since those with operations in high tax jurisdictions may:

- qualify for the “high tax exemption” contained in the proviso to section 9D(2A) of the Act;
- even if they do not qualify for this exemption, the income allocated to the South African resident shareholders brings with it foreign tax credits in terms of section 6*quat* of the Act which reduce the amount of South African tax payable in respect of such amounts.

A “foreign business establishment” is in many ways similar to a PE and therefore it is appropriate that this aspect be considered in this discussion on Action 7. A “foreign business establishment” is *inter alia* defined in section 9D(9)*(b)* of the Act as “a fixed place of business located in a country other than the Republic that is used or will

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95 Ibid

continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year…”. This issue is the opposite of that articulated in Action 7, in that it relates to the setting up of a foreign business establishment in, typically, a low tax jurisdiction in order to shelter income from allocation to South Africa under the controlled foreign company rules. It should therefore be analysed whether the current foreign business establishment exemption achieves its objective or whether amendments should be made to this concept in section 9D of the Act.

The exclusions from the foreign business establishment exemption principally relate to the so-called “diversionary rules”, which deal with tax deductible amounts payable by South African residents to the controlled foreign company. Therefore, amounts which reduce the South African tax base, as a matter of principle, do not qualify for the foreign business establishment exemption. However, it should be considered whether these exclusions are wide enough and still appropriate. Many of the exclusions were first legislated when section 9D was enacted in 2000/2001.

The second issue for consideration is whether there should be further exclusions from the foreign business establishment exemption in respect of amounts which do not directly reduce the South African tax base. This is so in relation to interest payments from a controlled foreign company in a high tax jurisdiction to a controlled foreign company in a low tax jurisdiction. Often this results in double non-taxation of such interest payments. The same issue arises in respect of other amounts falling within the ambit of the foreign business establishment exemption.

To address PE concerns relating to foreign business establishments it is noted and recommended that:

- The exemption from tax in respect of income arising in a controlled foreign company with a foreign business establishment is correct as a policy matter.
- Transfer pricing principles together with PE attribution principles should be used to test whether the correct amounts are attributable to the foreign business establishment. In this regard section 9D(9)(b) currently states as follows:

  “subject to subsection (9A), in determining the net income of a controlled foreign company in terms of subsection (2A), there must not be taken into account any amount which…is attributable to any foreign business establishment of that controlled foreign company (whether or not as a result of the disposal or deemed disposal of any assets forming part of that foreign business establishment) and, in determining that amount and whether that amount is attributable to a foreign business establishment

  (i) that foreign business establishment must be treated as if that foreign business establishment were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and

dealing wholly independently with the controlled foreign company of which the foreign business establishment is a foreign business establishment; and

(ii) that determination must be made as if the amount arose in the context of a transaction, operation, scheme, arrangement or understanding that was entered into on the terms and conditions that would have existed had the parties to that transaction, operation, scheme, agreement or understanding been independent persons dealing at arm's length.."

Instead of this wording, consideration should be given to applying the transfer pricing rules and profit attribution principles contained in double tax agreements to the determination of whether amounts qualify for the foreign business establishment exemption.

5.6 WITHHOLDING TAXES IN SOUTH AFRICA

The challenges of identifying non-residents' activities of a temporary nature (such as engineering and consultancy services) and the need to pin down such activities have been ameliorated by South Africa's withholding tax regime. In 2012, the National Treasury considered that withholding taxes relating to dividends, interest and royalties differed as to rates, timing, refunds and other procedures. While some of these differences can be justified, the National Treasury considered that many of these differences have arisen simply due to the dates on which these provisions were enacted, and that the result is a lack of coordination among these withholding taxes, which thereby complicates administration of, and compliance with, these taxes. Concluding that greater uniformity was needed to greatly reduce these burdens, the National Treasury sought to unify these withholding taxes to remedy the lack of coordination. In terms of the Explanatory Memorandum to the Taxation Laws Amendment Act 2013, an effort was made to unify South Africa's withholding tax regime as a measure to prevent base erosion. South Africa imposes the following withholding taxes in the Act:

- <u>Withholding Tax on Royalties</u>:[96] South Africa has a long history of imposing withholding tax in the case of cross-border royalties (previously levied at 12%). To ensure uniformity of withholding taxes, in 2013 a 15% final withholding tax on royalties was enacted, which is levied on the amount of any royalty paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received by or accrued to that foreign person from a source within the Republic in terms of section 9(2)*(c)*, *(d)*, *(e)* or *(f)* of the Act.
- <u>Withholding Tax on Dividends</u>:[97] Dividends tax at a rate of 15% is levied on shareholders in respect of dividends paid by any company other than a headquarter company. The dividends tax is levied on dividends paid by South

96 Sections 49C-49G

97 Sections 64D-64N.

African resident companies or by non-resident companies listed on a South African stock exchange.

- Withholding Tax on Interest:[98] A withholding tax on interest is levied, at a rate of 15% on the amount of any interest paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within the Republic in terms of section 9(2)*(b)* (effective from 1 March 2015).
- Withholding Tax on Service Fees:[99] A withholding tax on service fees was legislated and was to be levied, at a rate of 15% on the amount of any service fee paid by any person to or for the benefit of any foreign person, to the extent that the amount is regarded as having been received by or accrued to that foreign person from a source within the Republic. This has been repealed prior to coming into effect.[100]
- Withholding Tax on Entertainers and Sportspersons:[101] A final withholding tax at a flat rate of 15% is levied on the amount received by or accrued to a non-resident entertainer or sportsperson.
- Withholding Tax on Proceeds of Immovable Property disposed of by a Non-resident:[102] Any person who purchases immovable property situated in the Republic which is disposed of by a non-resident must withhold from the amount payable to the non-resident a withholding tax equal to: 5% if the non-resident is an individual; 7.5% if the non-resident is a company; and 10% if the non-resident is a trust. If the actual tax on the transaction is less than the withholding tax, the non-resident may apply to SARS for a directive as to the lesser amount to be withheld.

South Africa requires that non-residents with South African sourced income register for tax in South Africa. Where there non-residents comply with this requirement, the SARS is able to collect taxes on South African sourced income. However, there are enforcement challenges where the non-resident merely chooses not to comply.

To prevent double taxation, there are exemptions to each of these withholding taxes in the relevant provisions. For instance, the rules relating to the withholding taxes on interest and royalties provide that a foreign person will be exempt from the withholding tax if the foreign person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which such payment is made. The relevant rules also provide for an exemption from the relevant withholding tax if the interest or

98 Sections 50A-50H.
99 Sections 51A-51H.
100 On the details of the withholding tax on service fees, see AW Oguttu "An Overview of South Africa's Withholding Tax Regime" *TaxTalk* (March/April 2014).
101 Sections 47A-47K.
102 Section 35A.

royalty is effectively connected with a permanent establishment of that foreign person in the Republic.[103]

The effectiveness of these withholding taxes is greater in cases where the non-resident's country of residence does not have a double tax treaty with South Africa. Treaties based on the OECD MTC often set limits on the rates of withholding taxes that may be levied by source countries while the UN MTC is more in favour of withholding taxes.

The optimal effectiveness of South Africa's withholding tax regime will have to be backed up through double tax treaty reforms, through the re-negotiation of older treaties or signing protocols to take into consideration the withholding taxes now in place. Most of South Africa's treaties do not provide favourable withholding tax rates for South Africa. Now that the domestic withholding tax rate is generally uniform at 15%, it is imperative that, if withholding taxes are to be relied on, then the South Africa's treaty negotiators re-negotiate and negotiate better treaty rates for South Africa.[104]

It should however be noted that high withholding taxes can be a deterrent to foreign investment. Foreign investors prefer to base investments in jurisdictions with low withholding tax rates. Thus, in treaty negotiations, efforts should be made to ensure a balanced approach that does not stifle foreign investment and at the same time preserves South Africa's tax base.[105]

Even though the OECD principles suggest that the taxation of income of non-residents in a source state should be limited to those attributable to a PE, the mere existence of a PE should not shield all locally sourced income from withholding taxes. South African sourced interest, royalties or service fees earned by foreign entities outside of the PE rule should still be subject to a 15% withholding tax.

6 CONCLUDING REMARKS AND MORE RECOMMENDATIONS

On a tax policy level, it is important that South Africa does not emphasise legislative amendments to tax laws applicable to outbound MNEs, (for example, CFC rules), over tax laws applicable to inbound MNEs (for example, PE rules and source rules). It is necessary to balance legislation so as to ensure that South African companies are not overtaxed in comparison to non-residents, which would affect their competitiveness. South African outbound MNEs should not be taxed and audited disproportionately higher compared to inbound MNEs. Based on the above, the following recommendations are made:

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103 See sections 49D, 50D and 51D.

104 AW Oguttu "An Overview of South Africa's Withholding Tax Regime" *TaxTalk* (March/April 2014).

105 Ibid.

- The current source rules should be revamped to ensure that they adequately enable SARS to determine when a PE exists so that SARS is able to determine how profits must be attributable to such PEs. Some countries, such as the UK, which is a member of the OECD and signs treaties based on the OECD MTC (as is the case with South Africa) has enacted rules relating to the tax treatment of branches in order to attend to these challenges. South Africa should emulate the UK by enacting provisions which clearly explain the tax treatment of PEs in South Africa. The rules should complement the PE definition in section 1 of the Act[106] and further explain that the OECD rules for attributing profits to PEs would be applied. The rules that require non-residents carrying on business in South Africa to register with SARS aid enforce the source rules in this regard. As a residual matter the normal source rules and/or withholding taxes would apply for those that don't meet the PE threshold.
- Government should consider the prevalence of *commissionnaire* type arrangements to determine the extent of the risk to the South African fiscus.
- South Africa should adopt the OECD recommendations on changes to the MTC and ensure that its double tax treaties are amended as deemed appropriate in line with changes to the OECDMTC.[107]
- It is recommended that South Africa should consider the legal, constitutional and DTA implications of introducing a tax on branch profit remittances.
- In view of the status of a DTA under South African law and since the South African courts have taken cognizance of the OECD Commentary in interpreting the scope of DTA provisions, it is submitted that our courts would be entitled to apply the substance versus form doctrine of our common law or the general anti-tax avoidance rules (GAAR) contained in Part IIA of Chapter III of the ITA to counter abuse of the PE provisions of a DTA to avoid, postpone or reduce South African tax. In respect of the specific examples of potential abuse of the PE concept outlined in the BEPS Action 7 Report, it is submitted that either the substance versus form doctrine or the GAAR could potentially be applied to counter such abusive practices.[108]

106 Ibid
107 This recommendation is supported by Deloitte in its submission to the DTC dated 17 August 2015.
108 This recommendation was submitted by Wally Horak in his report to the DTC in October 2015.