TAXING RECURRENT SERVICES RENDERED BY A FOREIGN COMPANY TO AN ASSOCIATED ENTERPRISE IN SOUTH AFRICA

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ABSTRACT

The objective of the study was to investigate the right of the South African Government to tax the income earned by a foreign company when rendering services in South Africa to a South African associated enterprise on a recurrent basis, together with the right to tax the amounts paid to the employees of the permanent establishment for services rendered in South Africa. At the same time the research investigated whether the services rendered by a foreign company to an associated enterprise in South Africa on a recurrent basis would constitute a permanent establishment, as this is essential before South Africa may tax either the foreign company or the employees of the permanent establishment (where such employees are not resident in South Africa).

The research was conducted by means of a critical analysis of documentary data and data from a limited number of interviews with academics and the authors of textbooks and articles. In order to limit the scope of the research, a number of assumptions were made. Conflicting viewpoints underlying certain of these assumptions were discussed.

Some of the important conclusions reached are that the provisions of the Vienna Convention on the Law of Treaties should be taken into account when interpreting South African legislation (including Double Tax Agreements), and that the Organisation for Economic Cooperation and Development (OECD) Commentary may be relied upon when interpreting OECD based Double Tax Agreements in South Africa. No conclusion was reached on whether to apply an ambulatory or a static basis of interpreting the OECD Commentary, however.

The final conclusion of the research is that the services rendered in South Africa on a recurrent basis would be geographically and commercially coherent and consequently meet the "location test'. It is clear that as the services are rendered regularly and recurrently, they would be regarded as having the necessary permanence and would meet the 'duration test'. The place of business would therefore be regarded as being fixed (having the necessary degree of permanence). As the services would be rendered at the place of business of the South African entity, they would be regarded as being rendered 'through' the place of business and the foreign entity would be regarded as having a permanent establishment in South Africa (as defined in Article 5(1) of the OECD Model Tax Convention). The South African Government would therefore be entitled to tax the income attributable to the permanent establishment and the income earned by the non resident employees, who rendered services in South Africa for the permanent establishment. Once the entitlement to tax exists, South African legislative rules determine how South Africa proceeds to tax the income.

Key words:
Commentary to the OECD Model Tax Convention
International taxation
Organisation for Economic Co-operation and Development, OECD Model Tax Convention
Permanent Establishment
Vienna Convention on the Law of Treaties

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CHAPTER 1- INTRODUCTION

1.1 Context of the research

In the experience of the researcher, as an auditor at the South African Revenue Services, it is quite common that foreign companies render support services to associated South African enterprises on a recurrent basis over a long period of time – and that these services are usually rendered at the premises of the South African enterprises. The present research deals specifically with South Africa's right to tax business profits earned from services which are rendered in South Africa for less than 183 days per annum by a foreign company to a South African associated enterprise, on a recurrent basis, together with the right to tax the amounts paid to the non-resident employees of the permanent establishment for services rendered in South Africa.

As the calculation of a person's liability for income tax in South Africa begins with gross income, it is essential to determine whether or not an amount should be included in the person's gross income.

Section 1 of the Income Tax Act no 58 of 1962, as amended (referred to as "the Income Tax Act"), defines gross income as:

(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic.

The definition of gross income stipulates that South Africa may impose tax on a resident on amounts received or accrued from all sources and on a non-resident person in respect of amounts received or accrued or deemed to be have been received or accrued from a South African source (subject to certain special provisions in the Income Tax Act).

While there is no definition of the term "source" in the Income Tax Act, the following judgments provide guidance on the interpretation of this term:

The word source has several possible meanings ... the one possible meaning is the originating cause of the receipt of the money . . . (CIR v Lever Bros & Unilever Ltd, 1946 AD 441, 14 SATC 1).

The source of income is where the dominant, or main or substantial or real and basic cause of the accrual of income was located (CIR v Black, 1957 (3) SA 536 (A), 21 SATC 226).

The right of the South African tax authorities to tax receipts and accruals therefore differs, depending on the place of residence of the person sought to be taxed. The term resident, when applied to a person other than a natural person (for example a company), is defined in section 1 of the Income Tax Act as a

> person . . . which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic.

The term 'place of effective management' is not defined in the Income Tax Act, but the South African Revenue Services (SARS) has issued Interpretation Note 6, which states that:

> The place of effective management is the place where the company is managed on a regular day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets. (Professional Tax Handbook, 2008: 766)

This interpretation of SARS is not consistent with the Organisation for Economic Co-operation and Development (referred to as the OECD) definition of this term in paragraph 24 of the Commentary on Article 4 of the Model Tax Convention on Income and on Capital, which is prepared by the OECD (referred to as the "Model Tax Convention"), which states that

> The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined . . .
> (OECD, 2008:77)

While the interpretation of the term "place of effective management" is not significant to the thesis, a discussion of the main conflicting interpretations has been included in the thesis in order to provide the context in which the term should be interpreted.

The term resident, when applied to a natural person (for example the employees of the foreign company), is defined in section 1 of the Income Tax Act as a natural person who is

i) ordinarily resident in the Republic: or

ii) not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic-

aa) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessment preceding such year of assessment; and

bb) for a period or periods exceeding 915 days in aggregate during those five preceding years of assessment,

in which case that person will be a resident with effect from the first day of that relevant year of assessment:

Provided that—

A) a day shall include a part of a day, but shall not include any day that a person is in transit through the Republic between two places outside the Republic and that person does not formally enter the Republic through a 'port of entry' as contemplated in section 9(1) of the Immigration Act, 2002 (Act No. 13 of 2002), or at any other place as may be permitted by the Director General of the

Department of Home Affairs or the Minister of Home Affairs in terms of that Act; and

B) where a person who is a resident in terms of this subparagraph is physically outside the Republic for a continuous period of at least 330 full days immediately after the day on which such person ceases to be physically present in the Republic, such person shall be deemed not to have been a resident from the day on which such person so ceased to be physically present in the Republic

Neither Article 3 nor Article 9 of the OECD Model Tax Convention define the term "associated enterprises", but Article 9, in dealing with associated enterprises, describes them as follows in paragraph 1:

a) an enterprise of a Contracting State [which] participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) [where] the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State . . .

It may happen that an amount received by or accrued to a non-resident company is subject to tax in South Africa in terms of the source rules, and also taxed in the country of residence of the company. Section 108 of the Income Tax Act, read in conjunction with section 231(4) of the Constitution of South Africa, Act 108 of 1996, provides for the prevention of or relief from such double taxation by enabling the National Executive to enter into an agreement with the government of any other country. South Africa has entered into such Double Taxation Agreements (referred to as "DTAs") with more than sixty-five countries for purposes of the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.

While the provisions of DTAs are generally regarded as taking precedence over the Income Tax Act, there is some debate regarding the relationship between DTAs and the Income Tax Act (Olivier & Honiball: 2008). This debate is briefly discussed in the

thesis. DTAs do not create taxing rights, but merely allocate taxing rights to the countries in question. It is only the Income Tax Act that is able to impose an income tax liability in South Africa.

South Africa is not a member of the OECD, but was approached in 2007 with a view to possible membership in the future. The OECD website (www.oecd.org) published an article "Members and Partners" on 17 December 2008, which stated that "[i]n May 2007, the OECD countries ... offered enhanced engagement, with a view to possible membership, to ... South Africa".

As South Africa has concluded DTAs with most of its major trading partners, an understanding of DTAs is essential when evaluating the income tax implications of most international transactions, as the said DTAs affect South Africa's right to impose tax on both resident and non-resident persons. The scope of this research has been limited to the circumstances where South Africa may impose tax upon a non-resident.

Each DTA which is concluded generally includes specific provisions and consequently it is necessary to select the most common double taxation agreement model as a basis for the research. Most of the South African DTAs have been based on the Model Tax Convention, which was in existence at the time of signing the DTA. As this thesis seeks to examine South Africa's rights in the future, the latest Model Tax Convention (2008) has been used as a basis for the research. The significance of the OECD Model Tax Convention in South Africa is highlighted by the fact that section 1 of the Income Tax Act refers to the OECD Model Tax Convention when it defines the term "permanent establishment", stating that the term means "a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and Capital of the Organisation for Economic Co-operation and Development". The OECD prepares a Commentary to the Model Tax Convention (hereinafter referred to as the "Commentary"), which is included in the Model Tax Convention (2008). Different views are held regarding the significance of this Commentary when interpreting DTAs (Olivier & Honiball: 2008). The different views regarding the significance of the Commentary have been briefly discussed,

with reference being made to authoritative authors on the topic, foreign case law and the 'Vienna Convention on the Law of Treaties' (1969).

It has been assumed for purposes of this research that a DTA has been concluded between South Africa and the country of residence of the foreign company, and that the DTA has been drawn up in terms of the Model Tax Convention (2008).

Article 7(1) of the Model Tax Convention (2008), which deals with business profits, provides that:

> The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carried on business as aforesaid, the profits of the enterprise may be taxed in the other State, but only so much of them as is attributable to that permanent establishment.

It is clear that when a DTA, which has been drawn up in terms of the Model Tax Convention, has been concluded with another country, South Africa would only be entitled to tax a foreign company, which is resident in the other country, if the foreign company carries on business through a permanent establishment situated in South Africa.

It is therefore essential when assessing South Africa's right to tax transactions, which are conducted in South Africa by a foreign company (in the above circumstances), to ascertain whether the activities constitute a permanent establishment in South Africa – as only then can South Africa tax the transactions.

The term permanent establishment is defined in Article 5(1) of the Model Tax Convention (2008) as

> a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph 6 of the Commentary to Article 5(1) (Model Tax Convention: 2008) elaborates on the definition of a permanent establishment, stating that recurrent activities may also result in a fixed place of business and consequently a permanent establishment.

Once it has been determined that the activities of a foreign company (in the above circumstances) constitute a permanent establishment in South Africa, South Africa would be granted the right to tax the income attributable to the permanent establishment and the provisions of the South African Income Tax Act may then be applied to allocate income to the said permanent establishment. No fixed rules exist, however, on how to attribute profits to a permanent establishment (Olivier: 2009a).

It has been stated that it is quite common that foreign parent companies render support services to associated South African enterprises on a recurrent basis over a long period of time and that these services are usually rendered at the premises of the South African companies. As these services are often only rendered in South Africa for short periods of time each year, the Commentary must be consulted to assist in establishing whether a Permanent Establishment is created by the recurrent services and therefore whether South Africa is entitled to tax the profits of the permanent establishment and the income earned by the employees of the permanent establishment for services rendered in South Africa.

In terms of the Model Tax Convention, the South African government would not only be entitled to tax the income earned by the permanent establishment (in respect of services rendered in South Africa), but also the amounts earned by the employees of the permanent establishment for services rendered in South Africa, which have a South African source (Article 15 of the Model Tax Convention).

As the amounts paid by the South African company to its foreign associated enterprise are often substantial and are generally claimed as a deduction in terms of section 11(a) of the Income Tax Act, it is important to determine whether the foreign company has created a permanent establishment in South Africa, and therefore whether South Africa is entitled to tax the income earned by the foreign company from operating in South Africa, together with the amounts earned by the employees

of the permanent establishment for services rendered in South Africa . South Africa's inability to tax the profits of the South African operations of the foreign company and the amounts earned by the employees of the permanent establishment for services rendered in South Africa, while allowing the deduction of the related amounts for tax purposes in the hands of the South African company, would impact negatively upon the tax collections of the fiscus.

The OECD amended the Commentary, which is included in the Model Tax Convention on Income and on Capital in 2008, to provide an alternative to be used in the negotiation of future DTAs. This alternative includes clauses stating that services rendered in a country may result in the creation of a permanent establishment as a result of presence in a country without the existence of a fixed place of business. These clauses are similar to provisions which have been contained in the 'United Nations Income and Capital Model Convention' (2001) ("UN Model Tax Convention") for many years and are used by South Africa in several of its DTAs. As the 2008 OECD amendment only provides an alternative to be used in the negotiation of future DTAs, it will have limited impact upon the DTAs currently in force, and has only been briefly discussed in the concluding chapter of the thesis.

The broad research question is therefore whether the South African government has the right to tax the income flowing from recurrent services provided by a non-resident company to a South African associated enterprise, as well as the amounts paid to the non-resident employees of the permanent establishment for services rendered in South Africa.

It appears that little has been written on this specific issue and consequently it is submitted that this research will add to the existing body of knowledge.

1.2 Goal of the research

The goal of the research is to investigate the right of the South African Government to tax the income earned by a foreign company when rendering services in South Africa to a South African associated enterprise on a recurrent basis, together with the right to tax the amounts paid to the non-resident employees rendering the

services in South Africa. At the same time it is necessary to investigate whether the services rendered by a foreign company to a local associated enterprise on a recurrent basis constitute a permanent establishment, as this is essential before South Africa may tax either the foreign company or the non-resident employees.

1.3 Methods, procedures and techniques

The research was conducted by means of a critical analysis of documentary data and data from limited e-mail and telephonic interviews with the authors of textbooks and articles and academics, carried out in order to clarify contentious points. The documentary data included: the Income Tax Act, the OECD Model Tax Convention and Commentary, the findings by the local and international courts in relation to double taxation agreements and the OECD Commentary, Reports issued by the OECD and writings by authoritative authors on the topic.

The following positions have been taken in order to establish the context of the research:

1. The country in which the foreign company is resident and South Africa have entered into a DTA, based on the OECD Model Tax Convention.
2. The foreign company, which is rendering services to an associated enterprise in South Africa, is not a resident of South Africa for purposes of the Income Tax Act, and the employees of the permanent establishment, who render services in South Africa, are not residents of South Africa.
3. The employees of the foreign company, who render services in SA, are neither dependant agents nor independent agents of the foreign company and consequently the provisions of Articles 5(5) and 5(6) of the OECD Model Tax Convention, which indicate that the foreign company would be deemed to have a permanent establishment in South Africa as a result of the activities undertaken on behalf of the foreign company, would not be applicable.
4. This thesis has focused solely on the Income Tax implications of the recurrent services rendered by the foreign company, and has not taken the possible value-added tax (VAT) implications into account.

As all the data are in the public domain, no ethical considerations arise.

1.4 Limiting assumptions

In order to structure a cohesive argument the following assumptions have been made for the purposes of research:

While the question of the source of receipts and accruals earned by non-residents is discussed briefly in the thesis, it is assumed that the income earned by the foreign company when rendering services to an associated enterprise in South Africa has its source or deemed source in South Africa, and consequently that the income attributed to the permanent establishment has its source or deemed source in South Africa, and would be subject to tax in South Africa in terms of the South African Income Tax Act. The income earned by the employees of the foreign company, who are rendering services to the associated enterprise in South Africa, is also assumed to have its source or deemed source in South Africa.

The research briefly discussed the opposing views relating to whether or not DTAs take precedence over national tax legislation, as well as the status of the Commentary to the Model Tax Convention. It has been assumed for purposes of this research that the provisions of the DTAs do take precedence over the provisions of the Income Tax Act and that the Commentary should be taken into account when interpreting the DTAs. The Model Tax Convention and the most recent Commentary to the Model Tax Convention (2008), which have been prepared by the OECD, should be taken into account when interpreting DTAs.

It has also been assumed for purposes of this research that the income earned by the foreign company represented Business Profits (dealt with in Article 7 of the OECD Model Tax Convention) and not "Royalty Income" (dealt with in Article 12 of the OECD Model Tax Convention).

A royalty is defined in Article 12(2) of the OECD Model Tax Convention as

> Payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

It is however submitted that as most DTAs entered into by South Africa contain a definition of the term "royalty" (for purposes of the treaty), the definition contained in each treaty should be examined.

The provisions of Article 12 of the OECD Model Tax Convention have not been examined as part of this thesis, and would need to be considered if the amounts paid to the foreign company for services rendered in South Africa were classified as "royalty income". While the provisions of Article 12 of the OECD Model Tax Convention generally allocate the taxing right to the state of residence of the entity earning the income, South Africa has entered a Position in respect of Article 12(1) that it reserves the right to tax income at source. This Position reflects South Africa's view on the Article and would have been taken into account when negotiating DTAs. The implication of the Positions entered by South Africa is discussed in chapter three.

Article 21(1) of the OECD Model Tax Convention, which deals with "other income", states that it relates to types of income not dealt with in the earlier Articles of the Model Tax Convention. Article 21(2) states further that

> The provisions of paragraph 1 shall not apply to income . . . if the recipient of such income, being a resident of a Contracting State, carried on business in the other Contracting State through a permanent establishment situated therein and the right . . . in respect of which income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

It is submitted that Article 21 would not be applicable to a foreign company, which renders services in South Africa on a recurrent basis (resulting in the creation of permanent establishment (as discussed in thesis)) as the amounts paid for the

services rendered would be "effectively connected" to the permanent establishment and consequently Article 21(2) indicates that Article 21(1) would not apply, but rather Article 7.

As the OECD Model Tax Convention does not include a separate article dealing with fees for technical services, this thesis has not dealt with such an article. Certain of the DTAs entered into by South Africa do contain separate articles dealing with fees for technical services, for example the DTAs, which South Africa concluded with both India and Pakistan include a separate article dealing with "Royalties and Technical Services", while the DTAs with Malaysia and Botswana, include a separate Article dealing with fees for "Technical Services".

Certain DTAs concluded by South Africa include an Article dealing with "Independent Personal Services". This thesis has not dealt with this Article, which only applies to individuals, as the thesis assumes a foreign company rendered the services in South Africa, and the OECD Model Tax Convention (2008) no longer includes such an Article.

This thesis has not taken the Positions, Reservations or Observations of the countries with which SA has concluded DTA's into account. These Positions, Reservations or Observations would indicate the different countries' interpretation of certain provisions of the DTA and would have been taken into account when negotiating the DTAs, and may be taken into account when interpreting the DTAs in the future (in accordance with the provisions of Article 31 and 32 of the Vienna Convention on the Law of Treaties (1969)).

1.5 Overview of chapters to follow

Chapter 2 discusses the legal status of DTAs in relation to the Income Tax Act, the Constitution and national and international rules for the interpretation of statutes.

Chapter 3 discusses the significance of the Commentary on the OECD Model Tax Convention in South Africa, making reference to prominent authors, the Vienna Convention on the Law of Treaties, South African case law and foreign case law.

The chapter also discusses the basis for the assumption that the Commentary should be taken into account when interpreting DTAs, including a discussion of the conflicting views on the reliance which may be placed upon the Commentary. As the Commentary to Article 5(1) provides strong support for the argument that recurrent activities may result in a fixed place of business and consequently a permanent establishment, the assumption that the Commentary may be relied upon is of great importance to this thesis.

Chapter 4 discusses why DTAs require that a permanent establishment be formed in a country before that country has the right to tax the income earned by a foreign company in that country, and discusses the provisions of Article 5(1) of the OECD Model Tax Convention, which provide a definition of permanent establishment (concluding whether recurrent services rendered by a foreign company to an associated enterprise in South Africa would constitute a permanent establishment in South Africa). The chapter also examines the provisions of Articles 5(2) to 5(7) of the Model Tax Convention, which expand further on the concept of a permanent establishment, providing examples and exclusions, and discusses their applicability when establishing whether services rendered by a foreign company on a recurrent basis to a South African associated enterprise would create a permanent establishment in South Africa.

Chapter 5 seeks to determine what income (if any) may be taxed in South Africa when the services rendered in South Africa have resulted in the creation of a permanent establishment, and demonstrates that there are two types of income related to the foreign company's activities in South Africa, which may be subject to tax in South Africa, namely the income attributable to the permanent establishment in terms of Article 7 of the DTA and the income paid to the employees of the permanent establishment, which South Africa may have the right to tax in terms of Article 15 of the OECD DTA. The actual quantification of the amount to be taxed in South Africa has not been dealt with as this is regarded as outside the scope of this thesis.

The final chapter provides a summary of the conclusions arrived at in the research, and concluded that services rendered in South Africa by a foreign company to a

South African associated enterprise on a recurrent basis would constitute a permanent establishment, and consequently the South African Government would be entitled to tax the income attributable to the permanent establishment, as well as the income earned by the non-resident employees of the permanent establishment. The chapter also discusses the "Issues considered, but regarded as outside the scope of the thesis", the "Contentious points raised in the research", the "Limitations of the research" and "Other possible areas for research".

CHAPTER 2 – THE RELATIONSHIP BETWEEN DOUBLE TAXATION AGREEMENTS AND SOUTH AFRICAN LAW

2.1 Introduction

In order to address the first goal of the research, which is to investigate the South African government's rights to tax income earned by a foreign company rendering recurring services to a South African associated enterprise, it was necessary to assume that a DTA had been entered into between the foreign government and the South African government. It is therefore also necessary to establish the legal status of a DTA.

This chapter discusses the relationship between the provisions of DTAs and the provisions of the South African Income Tax Act, making reference to some of the most important principles to be considered when interpreting a DTA in South Africa.

Olivier & Honiball (2008:32) state that:

> Treaties have a dual nature. On the one hand they are classified as international agreements . . . On the other hand, s 108(2) of the South African Income Tax Act provides that once approved by parliament and published in the Government Gazette, a tax treaty becomes part of domestic law.

It is important before referring to the South African legislation, which will influence the interpretation of DTAs in South Africa, to recognise the role that the Constitution of the Republic of South Africa, Act 108 of 1996 (herein after referred to as the "Constitution") plays in law in South Africa.

Section 2 of the Constitution states that:

> This Constitution is the supreme law of the Republic; law or conduct inconsistent with it is invalid, and the obligations imposed by it must be fulfilled.

Section 231(4) of the Constitution, which makes provision for the conclusion of any international agreement, including DTAs, states that:

> Any international agreement becomes law in the Republic when it is enacted into law by national legislation . . . unless it is inconsistent with the Constitution or an Act of Parliament.

Section 108 of the Income Tax Act empowers the National Executive to enter DTAs and states that:

> 1) The National Executive may enter into an agreement with the government of any other country, whereby arrangements are made with such government with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the Republic and of such other country, of tax in respect of the same income, profits or gains, or tax imposed in respect of the same donation, or to the rendering of reciprocal assistance in the administration of and the collection of taxes under the said laws of the Republic and of such other country.
>
> 2) As soon as may be after the approval by Parliament of any such agreement, as contemplated in section 231 of the Constitution, the arrangements thereby made shall be notified by publication in the *Gazette* and the arrangements so notified shall thereupon have effect as if enacted in this Act. (own emphasis)

As section 108(2) of the Income Tax Act refers to section 231 of the Constitution, it is submitted that section 108(1) and 108(2) should be read together with section 231(4) of the Constitution, which is quoted above. Olivier and Honiball (2008) state that a DTA cannot increase the tax burden and may only have the effect of providing relief.

It is further noted from the above quotations that both section 108(2) of the Income Tax Act and section 231(4) of the Constitution state that a DTA shall have the same

effect as if enacted as part of the Income Tax Act. Olivier and Honiball (2008) state further that International agreements do not in themselves enjoy a privileged status in South African law. The view that DTAs are to be regarded as if enacted as part of the Income Tax Act is supported by the judgement in SIR v Downing, 1975 (4) SA 518(A), 37 SATC 249, which stated that a DTA would "have effect as if enacted in Act 58 of 1962 (see s108(2))", and by the judgment in ITC 1544 (1992) 54 SATC 456, which states that

> the terms of a double taxation agreement on which statutory status has been conferred are to be considered as any other statutory provisions to determine the extent to which these conflict with the provisions of another statute and whether such provisions have been modified thereby . . .

As the provisions of DTAs will have the same legal standing and will rank equally with the other provisions of the Income Tax Act, it is submitted that the normal rules of interpretation of statutes in South Africa will apply when interpreting provisions of the DTA, which conflict with the other provisions of the Income Tax Act. Olivier and Honiball (2008) are in agreement with this.

While international debate exists on the issue whether the provisions of domestic law can override the provisions of tax treaties (Olivier & Honiball:2008), it has been assumed for purposes of this thesis that in the event of a conflict between the provisions of DTAs and those of the Income Tax Act, the provisions of the DTA would override those of the domestic legislation.

2.2 South African rules of legislative interpretation

De Koker (2009:25.1A) states as follows:

> In ITC 1384 (46 SATC 95) Steyn, MT applied the 'new approach' to the interpretation of fiscal statutes . . . he emphasized that two principles of construction are of prime importance whenever a statute has to be interpreted, they being that:

- the main task is to ascertain the intention of the legislator, which is primarily to be sought in the language he chose to use; and
- that unless the contrary be clearly evident from the terms of the measure itself, the legislator is presumed not to have intended an unfair, unjust or unreasonable result, and the concomitant of this latter principle is that a statute must be so interpreted as to be as un-oppressive as possible.

The importance of ascertaining the intention of the legislator is supported by the judgment in Dibowitz v CIR, 1952 (1) SA 55 (A), 18 SATC 11, which states that "in the interpretation of fiscal legislation the true intention of the legislature is of paramount importance, and, I should say, decisive."

It is clear that section 108(1) seeks to prevent economic and juridical double taxation and that the section presupposes a liability for tax in terms of the provisions of the Income Tax Act. This conclusion is reached as the section states that "[t]he National Executive may enter into an agreement . . . with a view to the prevention, mitigation . . . of tax in respect of the same income . . . under the . . . laws of the Republic and of such other country". While the objective may be to prevent both juridical and economic double taxation, Olivier and Honiball (2008) make the point that tax treaties generally only eliminate juridical double taxation. Olivier and Honiball (2008:314) explain that economic double taxation refers to the "imposition of comparable taxes by at least two tax jurisdictions on different taxpayers in respect of the same income" and that juridical double taxation refers to "the imposition of comparable taxes by at least two tax jurisdictions on the same taxpayer in respect of the same income".

As the section provides for the conclusion of a treaty to prevent, mitigate or discontinue that liability for tax, it would appear illogical to interpret the section as meaning that it would not apply (eliminate double taxation) when the provisions of the Income Tax Act are in conflict with those of the DTA and impose a liability for tax. Such an interpretation would have the result that the provisions of the DTA would be meaningless and serve no purpose. This view is supported by the Australian judgement in Lamesa Holdings BV 1997 35 ATR 239, 97 ATC 4229 (Olivier &

Honiball: 2008). Foreign case law is, however, not binding upon South African courts and would only have persuasive value.

It is submitted that, as section 108 empowers the National Executive to enter into a DTA to prevent double taxation, it would be reasonable to assume that it was the intention of the legislature when enacting section 108 of the Income Tax Act, that where the provisions of the DTA would prevent double taxation and conflict with provisions of the Income Tax Act, the conflicting provisions should be interpreted in such a manner as to prevent double taxation (in a manner consistent with the objectives of section 108 of the Income Tax Act).

This is supported by the judgment in ITC 1544, which states that:

> the law of South Africa includes s108 of Act 58 of 1962 which itself makes the Income Tax Act subject to the Convention . . .
>
> The effect of s108(2) of the Act is to grant statutory relief in certain circumstances where the South African Act imposes a tax, where the provisions of a double-tax Convention grants an immunity or exemption from such tax to persons governed by the Convention. Tax is not payable to the extent to which an immunity or exemption from tax is granted in terms of a binding double tax Convention which has been proclaimed and thus has statutory effect. Secretary for Inland Revenue v Downing 1975(4) SA 518(A) at 523.

The judgements of the Income Tax Court are, however, not binding upon other South African courts and would therefore only have persuasive value.

It is concluded that the prevention of double taxation is the objective of both DTAs and the provisions of section 108 of the Income Tax Act.

It is further submitted that, as it is the intention of the legislature which should be sought when interpreting legislation, and in this situation the intention of the legislature appears to be consistent with the stated objectives of the section, the

provisions of the Income Tax Act (and the DTAs enacted in terms of section 108 of the Income Tax Act) should be interpreted so as to prevent double taxation.

The view that section 108 should be interpreted in such a way as to eliminate double taxation when there is a conflict between the provisions of the DTA and the other provisions of the Income Tax Act is supported by the principle that a statute must be so interpreted as to be as un-oppressive as possible. This principle finds support in the judgment of Dibowitz v CIR, which states that:

> in the case of an ambiguity a fiscal provision should be construed *contra fiscum* . . . which is but a specific application of the general rule that all legislation imposing a burden upon the subject should, in the case of an ambiguity, be construed in favour of the subject.

De Koker (2009) makes the point that the *contra fiscum* principle must be applied when the provisions of the Income Tax Act reveal an ambiguity. That is, where the provisions of the Act are capable of two constructions, the court will interpret the legislation so as to impose the smaller burden upon the taxpayer. Therefore, when the provisions of the DTA, which is regarded as law in the Republic (in terms of section 231(4) of the Constitution), conflict with the provisions of the Income Tax Act, it is submitted that this results in an ambiguity, which the judgement in Dibowitz v CIR states should be construed in favour of the taxpayer or *contra fiscum*. It is therefore submitted that where the provisions of the DTA conflict with provisions of the Income Tax Act, this ambiguity should be interpreted in favour of the taxpayer, which is consistent with interpreting legislation "contra fiscum" or so as to be as un-oppressive as possible (De Koker:2009).

De Koker (2009:25.3) states that:

> In Isaacs v CIR (1949(4) SA 561 (A)) the court was of the view that . . . the Income Tax Act should not be read as imposing tax upon a taxpayer twice in respect of the same profits unless the language of the statute makes it clear that such a result was intended . . .

It is concluded that the judgment in Isaacs v CIR, which is quoted above, should be considered together with the contra fiscum principle, and as a DTA can never increase the tax burden, but always places a taxpayer in a better position, giving preference to the provisions of a DTA would be consistent with these two cases.

Olivier and Honiball (2008) make the point that when interpreting the provisions of DTAs and the provisions of the Income Tax Act, the provisions should first be interpreted in such a way as to be consistent with each other (taking into account the intention of the legislator). It is submitted that it is only when this method of interpretation fails that one should consider which provision takes precedence and that this would be achieved by taking into account:

a) the intention of the legislator;
b) the principle that legislation should be interpreted so as to be as un-oppressive as possible;
c) the principle that legislation should be interpreted contra fiscum and
d) the principle that the "Income Tax Act should not be read as imposing tax upon a taxpayer twice in respect of the same profits unless the language of the statute makes it clear that such a result was intended" (De Koker 2009:25.3). It is submitted that this merely summarises the principles discussed above.

2.3 Interpretation of Double Taxation Agreements in the context of South African case law

The judgement in ITC 1544 54 SATC 456(T) 1992, which is quoted below, makes it clear that the same principles should be applied when interpreting DTAs as any other South African legislation:

> The terms of a Double Tax Convention on which statutory status has been conferred are to be considered as any other statutory provisions to determine the extent to which these conflict with the provisions of another statute and whether such provisions have been modified thereby.

It is noted, however, that the judgements of the Income Tax Court are not binding upon other South African courts and would only have persuasive value.

Olivier and Honiball (2008) state that the Supreme Court of Appeal's interpretation of a DTA in SIR v Downing raised no specific problems in interpreting the relevant provisions of the DTA in the context of South African domestic legislation. It also appeared from the judgment that the court would most probably embrace an international interpretation when interpreting DTAs.

During 2003 the Supreme Court of appeal decided in AM Moola Group Ltd and Others v C:SARS, 2003 (A), 65 SATC 414 that:

> if there were to be an apparent conflict between general provisions of the Customs and Excise Act and particular provisions of a trade agreement . . . the Act must, of course prevail in such case as the trade agreement, once promulgated, is by definition part of the Act . . .

Prof Olivier stated during interviews (Olivier:2009b) that:

> [t]he Moola judgement is currently the law in SA, but this does not mean that if the Supreme Court of Appeal is confronted with the issue again, it may not reach a different conclusion . . . it may decide to take section 233 into account and the decision will then be different.

Olivier, Brincker and Honiball (2004) provided insight into the international interpretation of DTAs when commenting on the judgement in AM Moola Group Ltd and Others v CSARS, and stated that a decision by the courts to interpret the provisions in the Income Tax Act as prevailing over the provisions of the DTA would be a departure from the international interpretation of DTAs.

It submitted that as the judgment in this case related to trade agreements and not DTAs, it may be argued that the *ratio decidendi* would not be binding upon courts which interpret the relationship between DTA's and the Income Tax Act in future, but would merely be of a persuasive value. It is further submitted that this decision may

be criticised on the basis that it did not take cognisance of section 233 of the Constitution, which requires a court to prefer "any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law."

2.4 The interpretation of Double Taxation Agreements in the context of international law

It is submitted that the following sections of the Constitution are relevant to the interpretation of DTAs as international agreements in South Africa.

Section 232 of the Constitution states that:

> Customary international law is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament.

Section 233 of the Constitution states that:

> When interpreting any legislation every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

Olivier and Honiball (2008:32) state that "international law is defined as a legal system and principles which are binding upon states in their relationship with each other" and that "International law includes the Customary rules of international law, which are often referred to as the 'common law' of public international law . . ."

As stated above DTAs form part of domestic legislation (section 108 of the Income Tax Act read together with section 231 of the Constitution) and section 233 of the Constitution requires the court to interpret any legislation (including DTAs) in a manner consistent with international law. As the customary rules of international law form part of international law (Olivier & Honiball:2008), it is submitted that section 233 of the Constitution would require the court to interpret the DTA in terms of the customary rules of international law (inter alia). It is further submitted that the South

African courts are constitutionally bound to take customary international law into account because section 232 of the Constitution states that customary international law is law in South Africa unless it is inconsistent with the Constitution or an Act of Parliament. Additional motivation for interpreting a DTA in terms of customary international law is that a DTA is an international agreement and consequently should be interpreted in terms of international law.

Rohatgi (2005:27) states that the Vienna Convention on the Law of Treaties applies "to all international treaties, including tax treaties . . ." and "essentially codifies the existing norms of customary international law on treaties". Olivier and Honiball (2008) are in agreement with this statement. It is therefore submitted that the Vienna Convention on the Law of Treaties, which is regarded as a codification of customary international law, should be regarded as law in South Africa in terms of section 232 of the Constitution, and that the South African courts are required by section 232 of the Constitution (read together with section 233 of the Constitution) to take the provisions of the Vienna Convention on the Law of Treaties into account when interpreting legislation (including DTAs and treaties) unless the provisions of the Vienna Convention on the Law of Treaties are inconsistent with the Constitution or an Act of Parliament.

As the rules of the Vienna Convention on the Law of Treaties have been used in case law on the interpretation of DTAs by countries which did not ratify the Vienna Convention on the Law of Treaties, the fact that South Africa did not ratify the Vienna Convention on the Law of Treaties does not affect the applicability of its articles in South Africa (Olivier & Honiball: 2008). The Vienna Convention on the Law of Treaties includes the following articles, which it is submitted, are relevant when interpreting DTAs in relation to the other South African legislation.

Article 26: Pacta sunt servanda

> Every treaty in force is binding upon the parties to it and must be performed by them in good faith.

The effect of article 26 of the Vienna Convention on the Law of Treaties is that the DTAs concluded by a country are binding upon it, and that a country should honour the terms of the DTA and not utilise domestic legislation to override the provisions of the treaty. Passing domestic legislation, which overrides the provisions of a DTA, is a breach of international law and does not in any way affect the continued existence of the country's international obligation (Vogel:2004).

It is further submitted that the doctrine of legitimate expectation is also relevant when considering the requirement upon South Africa to respect and abide by the terms of DTAs, which it has concluded. The doctrine of legitimate expectation has been defined in Administrator, Transvaal and Others v Traub and Others (1989) 4All SA 924 (AD) as "the duty to act fairly".

Article 31: General rule of interpretation

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

Olivier and Honiball (2008) confirm that the principles of the Vienna Convention on the Law of Treaties should be taken into account when interpreting a DTA and that the agreement should be interpreted in good faith and in the light of its objects, which are to "avoid the same income being taxed twice".

It is concluded that interpreting an agreement in good faith includes honouring the agreement, which was concluded with another country, and not using domestic legislation to override the provisions of the DTA. It is also clear that if the provisions of the DTA conflict with domestic legislation, the courts should prefer the interpretation of the DTA, which would be consistent with its object and purpose, which is to eliminate double taxation.

Rohatgi (2005: 39) states that:

The primary purpose of double tax treaties is to avoid and relieve double taxation through equitable (and acceptable) distribution of tax claims between countries . . .

2.5 Conclusion

This chapter has discussed the legal status of a DTA, in relation to the Income Tax Act, the Constitution and national and international rules for the interpretation of statutes. From the discussion presented in this chapter, the following conclusions can be made:

a) As DTAs have a dual nature – forming part of domestic legislation and being classified as international agreements - the DTA will have the same legal effect as any other section in the Income Tax Act, and should therefore be interpreted in accordance with the South African rules regarding the interpretation of statutes.

b) When there is a conflict between the provisions of the DTA and the provisions of the Income Tax Act, it is concluded that the provisions of the DTA should be taken as overriding the conflicting legislation in the Income Tax Act. This conclusion is supported by the following:
   i) The intention of the legislator must be taken into account when interpreting legislation. As the DTA was entered into in order to prevent taxation being levied twice in respect of the same income and it is the objective of both section 108 and the DTA that double taxation be prevented, it is concluded that the legislation would be meaningless if the provisions of the Income Tax Act override the provisions of the DTA.
   ii) In the event of ambiguity a fiscal provision should be construed *contra fiscum* (that is in favour of the subject). It is therefore submitted that if the provisions of the Income Tax Act and the provisions of the DTA are in conflict, the court would interpret the conflicting legislation in such a manner as to impose the least burden upon the taxpayer. This is consistent with the objective of the DTA, which is to prevent, mitigate or discontinue double taxation.

iii) "The Income Tax Act should not be read as imposing tax upon a taxpayer twice in respect of the same profits unless the language of statute makes it clear that such a result was intended." (De Koker 2009:25.3). It is submitted that this too is consistent with the intention of entering into the DTA, which is to prevent, mitigate or discontinue double taxation.

c) As section 232 of the Constitution provides that customary international law forms part of the law in South Africa (unless it is inconsistent with the Constitution or an Act of Parliament), it is concluded that the Vienna Convention on the Law of Treaties , which is a codification of customary international law, would form part of South African law and the principles detailed in the Vienna Convention on the Law of Treaties should be taken into account when interpreting South African legislation (including DTAs).

d) The South African courts would again be required to take the provisions of the Vienna Convention on the Law of Treaties into account when interpreting South African legislation, as section 233 of the Constitution requires the courts to interpret legislation (including DTAs) in a manner consistent with international law (of which customary international law forms a part).

e) The following provisions of the Vienna Convention on the Law of Treaties should be taken into account when interpreting treaties (including DTAs):
    i) The treaty is binding upon the parties to the treaties.
    ii) The treaty should be interpreted in the light of its objects and purpose, which it is submitted is similar to the South African requirement that the intention of the legislature should be looked to.
    iii) The treaty should be interpreted in good faith.
    iv) A country should not invoke domestic legislation as a justification for failing to perform a treaty.

As the courts of South Africa are required by the Constitution to take the provisions of the Vienna Convention on the Law of Treaties into account when interpreting DTAs, it is submitted that when the provisions of a DTA conflict with provisions in the

Income Tax Act, the DTA should be interpreted so as to give effect to its objects and purposes, which is the elimination of double taxation.

Attention was drawn to the judgment in the case AM Moolla Group Ltd and Others v C:SARS, which concluded that "domestic law must prevail in any apparent conflict between the general provisions of the statute and the particular provisions of the trade agreement."

It is noted that this judgment is in conflict with the submission made by the writer of the present thesis and with the earlier judgment in SIR v Downing. While the judgment of the Supreme Court of Appeal is binding upon lower courts, it submitted that as the judgment in this case related to trade agreements and not DTAs, it may be argued that the *ratio decidendi* would not be binding upon courts which interpret the relationship between DTA's and the Income Tax Act in future, but would merely be of a persuasive value. It is further submitted that the judgment may not be correct as it may be argued that it is in conflict with the provisions of section 233 of the Constitution. As stated by Prof Olivier (2009b), the Supreme Court of Appeal may reach a different conclusion if confronted with the same issue again.

CHAPTER 3 – THE SIGNIFICANCE OF THE COMMENTARY ON THE OECD MODEL TAX CONVENTION IN SOUTH AFRICA

3.1 Introduction

It was concluded in chapter 2 that when there is a conflict between the provisions of the DTA and the provisions of the Income Tax Act, the provisions of the DTA should be taken as overriding the conflicting legislation in the Income Tax Act. It was further concluded in chapter 2 that the Vienna Convention on the Law of Treaties, which is a codification of customary international law, would form part of South African law, and should be taken into account when interpreting South African legislation, including DTAs.

While it was assumed for the purposes of this research that the Commentary should be taken into account when interpreting DTAs, this chapter seeks to discuss the basis for this assumption both in the light of international and South African law. This assumption is of great importance to the thesis as the Commentary to Article 5(1) provides strong support for the argument that recurrent activities may result in a fixed place of business and consequently a permanent establishment The contention that this, in turn, may grant South Africa the right to tax the income earned by the foreign company for services rendered in South Africa on a recurrent basis is therefore largely based upon the Commentary to Article 5.

3.2 Commentary to the OECD Model Tax Convention

As stated, there are conflicting views on the significance of the OECD Commentary

Vogel (1997: 43) states that:

> The OECD MTC [Model Tax Convention] and its Commentary are very important for the interpretation of tax treaties in that they provide a source from which the courts of different States seek a common interpretation . . .

Olivier and Honiball (2008:42) state that:

> the main reason for the importance of the OECD MTC [Model Tax Convention] is that it forms the basis of most modern treaties. The OECD Commentary on the application and interpretation of the MTC has become widely accepted and is generally followed by countries which use the MTC as basis for their treaties and as an interpretive aid in applying their treaties . . .

Where a country has entered into a DTA, which is based upon the OECD Model Tax Convention, and has neither expressed its disagreement with the interpretation set out in the Commentary during the negotiations, nor entered an observation or a reservation concerning that Article, there is a presumption that it accepts the Commentary for purposes of the treaty. Englen (2006), Skaar (1991) and Vogel (1997) are in agreement with this view.

Reservations and Observations are entered by countries, which are members of the OECD, and which wish to record their disagreement with the Commentary. Non-member countries, by contrast, have been entitled to enter Positions from 1997 onwards, with the agreement of the OECD. Neither the Reservations, Observations nor Positions have any legal status.

Englen (2006) states that if the parties to the DTA have failed to note their disagreement with OECD Commentary, and have entered into a DTA, which is identical to the OECD Model Tax Convention, they have tacitly agreed to interpret the treaty in accordance with the Commentary. Englen (2006: 109) states that:

> either party ... had every reason to believe that it was the parties' intention to interpret and apply the provisions of the treaty in accordance with Commentaries on the corresponding provisions of the OECD Model.

Certain of the authors, who disagree that reliance should be placed on the OECD Commentary (in the case of countries, which are either members of the OECD or non-members), have been referred to below.

Rohatgi (2005:43) believes that the Commentary may be of limited value and states that "[f]or non-OECD States, the Commentaries are a persuasive factor in treaty interpretation."

Ellis (2000) is not in agreement that the OECD Commentary should be relied upon and points out that as the Commentary is changed so frequently it has become less authoritative and less valuable. Ellis (2000) goes on to state that the Commentary does not provide a clear interpretation, but a background.

While Ward (2006:99) states that the OECD Commentaries are "not binding as customary law, nor have they become binding on the basis of good faith, estoppel and the protection of legitimate expectations", he does agree that the OECD Commentaries that existed at the time that the DTA was entered into would form part of the legal context of the treaty (as explained in the Supreme Court of Canada decision The Queen v Crown Forest Industries Ltd, 95 DTC 5389, at 5396 and 5398).

3.3 Vienna Convention on the Law of Treaties

Section 232 of the South African Constitution states that:

> Customary international law is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament.

As stated in chapter 2, the Vienna Convention on the Law of Treaties is regarded as a codification of customary international law and as such it would form part of South African legislation (unless it is inconsistent with the Constitution or an Act of Parliament). As concluded in the previous chapter the provisions of the Vienna Convention on the Law of Treaties should be taken into account together with the other rules of legislative interpretation when interpreting South African legislation, including DTAs.

Rohatgi (2005: 39 & 40) states that "Article 31 provides the general rule of interpretation" and as "the VCLT [Vienna Convention on the Law of Treaties], and

not the domestic law of the Contracting States, governs the interpretation of treaties", it is submitted that an analysis of the provisions governing the interpretation of DTAs should begin with an analysis of the provisions of Article 31 of the Vienna Convention on the Law of Treaties.

Article 31(1) of the Vienna Convention on the Law of Treaties, which is quoted in the previous chapter, requires that treaties be interpreted "in accordance with the ordinary meaning given to the terms of the treaty". This requirement provides strong support for the argument that the Commentary, which provides clarity on the meaning of the terms used in the DTA, should be referred to in order to interpret the provisions of a DTA.

Vogel (2000:615) states that:

> it is recognised that the "ordinary meaning" includes an established technical meaning, in particular the "international tax language" developed in tax treaty matters . . .

Vogel (1997) states that the ordinary meaning of a term is not necessarily that given to the term in everyday usage, and in the case of an OECD based DTA it is assumed that the parties intended to convey the meaning contained in the Commentary and consequently that meaning would constitute the "ordinary meaning" of the term for purposes of interpretation.

Wattel and Marres (2003:226) make the point that the ordinary meaning referred to in Article 31(1) of the Vienna Convention on the Law of Treaties does not necessarily refer to "normal language", but rather to the "usual meaning of the term in a given context".

Further to this, the judgement in SIR v Downing, 1975 (4) SA 518(A), 37 SATC 249 refers to the "international tax language" used by the Model Tax Convention, and states that these terms are defined in the Model Tax Convention. It is submitted that this supports the argument that the OECD Commentary defines or conveys the ordinary meaning of the terms used in the Model tax Convention.

In as much as the OECD Commentary provides the "ordinary meaning" of the terms used in the DTA, article 31(1) of the Vienna Convention on the Law of Treaties therefore requires that the DTA be interpreted in accordance with the said ordinary meaning.

Article 31(4) of the Vienna Convention on the Law of Treaties states that:

> [a] special meaning shall be given to a term if it is established that the parties so intended.

Jones (2002) argues that if the Commentary is not regarded as providing the "ordinary meaning" of the terms of the DTA, it should be regarded as containing a special meaning of treaty terms (in terms of article 31(4) of the Vienna Convention on the Law of Treaties), and that in the case of OECD based DTAs the parties intended that such special meanings should apply, particularly when the parties to the treaty have not entered any observations to the OECD Commentary. This viewpoint is supported by Vogel (1997 & 2000).

Article 32 of the Vienna Convention on the Law of Treaties states that:

> Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:
>
> a) leaves the meaning ambiguous or obscure; or
> b) leads to a result which is manifestly absurd or unreasonable.

Jones (2002) argues further that at the very least the Commentary provides a supplementary means of interpretation (in terms of article 32), which may be used to confirm the meaning resulting from the application of article 31.

Rohatgi (2005: 42 & 58) states that "[e]xtra-textual materials . . . do not constitute context and may only be used to confirm, but not to contradict, or as an independent support for Article 31 interpretation . . . it can only be used as a secondary source to confirm the meaning under Article 31 if it is unclear . . . The OECD MTC and Commentaries are generally considered as a supplementary means of interpretation under the VCLT Article 32 . . . it is difficult to justify including them as part of context under VCLT Article 31."

Olivier and Honiball (2008) also argue that the authority for taking the Commentary into account is found in article 32 (that is as supplementary means of interpretation), but make the point that certain authors (for example Van Brunschot (2005)) merely regard the Commentary as an expert opinion of great weight and not binding in nature.

The Vienna Convention on the Law of Treaties, which is regarded as law in South Africa, provides support for the argument that the Commentary should be taken into account when interpreting DTAs in South Africa as the Commentary provides clarity or support for the terms used in the DTA. It has been shown that the OECD Commentary provides either the "ordinary meaning" of the terms used in the DTA (as required by Article 31(1)), or a "special meaning" of the treaty terms (as required by Article 31(4)), or lastly it may provide a supplementary means of interpretation (as required by Article 32).

3.4 The South African perspective on the significance of the Commentary

Olivier and Honiball (2008:82) state that:

> In SIR v Downing 37 SATC 249 (A), the court upheld the dicta of the lower court that in a treaty context South Africa was bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts utilised in the OECD Model Double Taxation Convention, as South Africa has adopted that Model for its own treaties. Furthermore, under s 232 of the Constitution South African courts are bound to apply customary international law rules and practice. Therefore, to the extent that there are

> OECD guidelines on the interpretation of the concept or other international commentaries, which express the meaning of the phrase as utilised in tax treaties worldwide, South African courts would take cognisance of such guidelines and commentaries to interpret the meaning in the context of the tax treaty.

Olivier and Honiball (2008) further emphasised that despite the fact that South Africa is not an OECD member state, the South African courts have accepted that the OECD Model Tax Convention and Commentary have been accepted in South African case law and used to interpret treaties, and consequently the OECD Model Tax Convention and Commentary probably form part of South Africa's customary international law.

An example of the South African courts placing reliance upon the principles laid down in the Commentary to the OECD Model Tax Convention is to be found in the judgment of ITC 1503 (1990), 53 SATC 342, which was required to determine whether the interest earned fell within or outside the scope of the provisions of the DTA. The said judgment states that "the meaning of the Double Taxation Agreement must be determined according to the principles governing the interpretation of contracts in the Republic of South Africa" and relied upon "the principles laid down in the Commentary to the OECD convention ..." when analysing the nature of the interest earned.

It is, however, noted that Olivier and Honiball (2008) do not reach a firm conclusion on whether or not the OECD Commentary forms part of South Africa's customary international law, but present several divergent views. It is therefore concluded that there is a lack of consensus on whether the OECD Commentary should be regarded as customary international law in South Africa. While Engelen (2006) and Ward (2006) are of the view that the OECD Commentary should not be regarded as customary international law, it is submitted that they do not take the South African perspective described above into account.

If the OECD Commentary is regarded as Customary International law in South Africa, section 232 of the Constitution would regard the OECD Commentary as law

in the Republic (unless it is inconsistent with the Constitution or an Act of Parliament) and thereby provide additional authority for the reliance upon the Commentary when interpreting OECD based DTAs in South Africa (in addition to the authority provided by the Vienna Convention on the Law of Treaties).

Honiball (2001) argues that if the OECD Commentary were to be regarded as customary international law (and consequently binding upon our courts), it should only be so regarded to the extent that it is generally accepted by the member states, and that to the extent that it merely sets out divergent views it will be of persuasive value only.

3.5 A Static or ambulatory interpretation

It is still debatable whether a so-called static or ambulatory interpretation should be followed when interpreting DTAs – that is, whether the Commentaries, which existed at the time the treaty was concluded should be taken into account or whether later Commentaries should also be taken into account (Olivier & Honball:2008)

Rohatgi (2005: 45) states that: "[t]he Introduction to the OECD MTC suggests that the existing treaties concluded under the previous or current Model treaties should be interpreted and applied along the lines of the latest Commentaries . . . except where the OECD MTC has been changed in substance." Rohatgi (2005: 46) states further that "[a]lthough there is no agreed view on the legal status of subsequent Commentaries issued after a treaty has been concluded, they are widely used by taxpayers, tax authorities and, in particular, the Courts for guidance in interpreting older treaties."

Olivier and Honiball (2008:46) state that:

> The main arguments in favour of a static approach are legal certainty and *pacta sunt servanda* as a treaty is an agreement entered into by the two Contracting States, and should therefore be interpreted based on the intentions of the parties at the time it was entered into. Subsequent developments are irrelevant as the parties did not consider them at the time the treaty was entered into and

neither did parliament consider such developments. On the other hand, the main argument in favour of the ambulatory approach is that as tax laws are applied to an ever-changing environment, not to adapt tax laws to these changes may result in a situation which was never intended by the Contracting States.

If the Commentary is regarded as conveying either the "ordinary meaning" of the terms of a treaty (in terms of article 31(1) of the Vienna Convention on the Law of Treaties) and is thus binding, or a "special meaning" which the parties attributed to a term (in terms of article 31(4) of the Vienna Convention on the Law of Treaties), it follows that only the Commentary which existed at the time of the treaty's conclusion would be capable of determining the meaning of the words of the treaty, and that an amendment at a later time cannot retroactively establish the "ordinary meaning" (Vogel 1997 and 2000).

Watel & Marres (2003) differ and argue that the Vienna Convention on the Law of Treaties does not stipulate that the "ordinary meaning" of the term (per article 31(1)) is restricted to the "ordinary meaning" at the time that the treaty was concluded, and consequently later Commentaries can also shed light on the "ordinary meaning" of terms used in earlier treaties.

A conclusion will not be drawn in respect of the arguments concerning the ambulatory or static interpretation of the OECD Commentary as this thesis is based upon the latest OECD Model Tax Convention (2008), which includes the 2008 Commentary. As the implications of a Commentary issued after a DTA is concluded are not relevant for purposes of this thesis, the impact of the 2008 Commentary upon double taxation agreements concluded in terms of earlier versions of the Model Tax Convention has not been considered. While it is not essential that a conclusion be drawn in respect of these issues, the arguments have been provided as insight into some of the relevant associated issues.

3.6 Foreign case law dealing with the significance of the Commentary

Rohatgi (2005: 44) states that "despite their legal limitations, the OECD Commentaries and Reports are widely used by the Courts for treaty interpretations."

In the case Thiel v Federal Commissioner of Taxation (1990) 21 ATR 531 (537), the Australian High Court held that there was no reason why the OECD Model Tax Convention and Commentary should not be taken into account when interpreting a DTA (Olivier & Honiball: 2008). Vogel (1997) argues that the case supported the view that the OECD Commentary provided a "special meaning" in terms of article 31(4) of the Vienna convention on the Law of Treaties when it stated in the judgment that the OECD Model Tax Convention and Commentary were "a guide to the current usage of terms by the parties".

Rohatgi (2005: 45) states that the judgment held that "the OECD Model Convention and Commentaries should be regarded as part of the context under VCLT Article 31, applied as customary international law. In any event they should be part of the supplementary means of interpretation."

In the British case Sun Life Assurance of Canada v Pearson (1984) STC 461(UK) the judgment states that "it is common ground . . . that the Commentaries must be referred to as a guide to the interpretation of the treaty."

In the Canadian case Crown Forest Industries Ltd v The Queen (1995) 95 DTC 5389 the judgment stated that: ". . . a Court may refer to extrinsic materials which form part of the legal context (these include accepted Model Conventions and official commentaries thereon) . . ."

The judgement in Cudd Pressure Control Inc v the Queen (1999) CTC 1,12 (Canada) states that "the OECD Commentaries, therefore, can provide some assistance in discerning the legal context surrounding double taxation conventions in international law."

While the judgments of foreign courts would not be binding upon a South African court, they would be regarded as of persuasive value and would strengthen the argument for relying upon the OECD Commentary when interpreting OECD based DTAs.

3.7 Reservations, Observations and Positions

South Africa is not a member of the OECD and entered a Position on Article 5(3) in the 2005 OECD Model Tax Convention and Commentary, which Position has remained in the 2008 OECD Model Tax Convention and Commentary. The Position, which South Africa has entered together with Albania, Serbia and Montenegro, Slovenia , Thailand and Vietnam is contained in paragraph 14 and states that the countries

> [r]eserve the right to treat an enterprise as having a permanent establishment if the enterprise furnishes services, including consultancy services, through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period.

It is clear that the above Position is in contrast with the requirements of a fixed place of business as set out in Article 5 of the OECD Model Tax Convention. The Position is published in the 2008 Model Tax Convention and would reflect South Africa's stance when negotiating new treaties, which are based upon the OECD Model Tax Convention.

It is submitted that the Position, which South Africa entered, is consistent with Article 5(3)(b) of the South African Model Tax Convention, which is available on the internet at www.pmg.org.za/docs/ 2005/050817oecdmalaysia.pdf and is "used to compare the OECD Model and whatever DTA is being shown to the Parliamentary Finance Committee in the context of a South African Model" (West: 2009). While a detailed discussion of the South African Model Tax Convention is regarded as outside the

scope of this thesis, it is noted that the Article 5(3)(b) of the South African Model Tax Convention is almost identical to Article 5(3)(b) of the UN Model Tax Convention.

3.8 Conclusion

While there appears to be a lack of certainty over the reliance which may be placed upon the OECD Commentary when interpreting DTAs, it will be assumed for purposes of this thesis that the OECD Commentary may be relied upon when interpreting an OECD based DTA in South Africa.

This assumption has been made after taking the following into account:

a) The Vienna Convention on the Law of Treaties, which is a codification of customary international law, and as such forms part of South African law provides support for the argument that the Commentary should be taken into account when interpreting treaties in South Africa.
b) The judgment in SIR v Downing upheld the principle that the South African courts were bound to take cognisance of the guidelines for interpretation issued by the OECD in its Commentary as South Africa had adopted the Model Tax Convention as a basis for its own treaties. The judgment in ITC1503 also relied upon "the principles laid down in the Commentary to the OECD convention ..." when analysing the nature of the interest earned.
c) Foreign case law, which would be of persuasive value in South Africa, also provides support for placing reliance upon the OECD Commentary when interpreting DTAs, which are drawn up based upon the OECD Model Tax Convention.

The Position entered by South Africa in respect of Article 5 of the OECD Model Tax Convention is in contrast with the requirements of a fixed place of business in relation to a Permanent Establishment as set out in Article 5 and reflects South Africa's stance when negotiating new treaties. This position is discussed in more detail later in the thesis.

CHAPTER 4 – THE CONCEPT OF A PERMANENT ESTABLISHMENT

4.1 Introduction

The conclusion reached in chapters 2 and 3 is that the provisions of DTAs override the provisions of the Income Tax Act (when there is a conflict) and that the OECD Commentary should be taken into account when interpreting DTAs.

This chapter will explore the reason why DTAs require that a permanent establishment be formed in a country before that country has the right to tax the income earned in that country by a foreign company, and will discuss the provisions of Article 5(1) of the OECD Model Tax Convention, which provides a definition of a permanent establishment. The provisions of Article 5(1) (and the Commentary to Article 5) will also be discussed in so far as they are relevant in determining whether the recurrent services rendered in South Africa would result in the creation of a permanent establishment.

It is assumed for purposes of this thesis that the recurrent services, which were rendered in South Africa by a foreign company to an associated enterprise, were rendered at all times at the same premises of the South African entity, and that the South African entity made space available or placed space at the foreign company's disposal for this purpose. It is further assumed that the foreign company rendered the services in terms of a contract, which the parties intend to honour indefinitely.

Article 7(1) of the OECD Model Tax Convention sets out the circumstances in which a country may tax the profits of an enterprise and provides that:

> [t]he profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.

It is therefore essential when assessing South Africa's right to tax transactions, which are conducted in South Africa by a foreign company, to ascertain whether the

activities constitute a permanent establishment in South Africa, as only then can South Africa tax the transactions.

It will be concluded in this chapter that the rendering of services on a recurrent basis at the same place of business would result in the foreign company having a permanent establishment in South Africa.

4.2 Why is the existence of a permanent establishment essential?

Paragraph 1 of the Commentary to Article 5 of the OECD Model Tax Convention states that:

> [t]he main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State.

Vogel (1997) argues that a State may only tax the profits earned by a resident of another Contracting State to the extent that the resident of the other Contracting state carries on business through a permanent establishment situated in the first State, and that the first State should only have the right to tax when significant economic bonds have been created between the enterprise and that State. He argues further that where the economic ties between the enterprise and the foreign country are loose, the right to tax should be limited to the country of residence.

Olivier (2002:870) states that:

> until the enterprise sets up a permanent establishment, the infrastructure of the host country is not relied upon to earn income.

Steyn (2003:48) states that:

> once a foreign entity enjoys the benefits of actively participating in economic activities in the host country, it should also contribute towards taxes on the income earned in the host country in such a manner.

Paragraph 9 of the Commentary on Article 7 states that

> it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights.

It is concluded from the arguments presented above that the rationale behind requiring that the activities of the enterprise constitute a permanent establishment before the host State will be entitled to tax the profit flowing from the activities, is that the enterprise should only be required to pay tax in the host State once it has relied upon the host country's infrastructure or enjoyed the benefits of actively participating in the country's economic activities. This appears to be consistent with the argument that recurrent services rendered in a State over a period of time would constitute a permanent establishment (discussed in more detail below). An enterprise, which renders services in a State on a recurrent basis over a period of time, can be assumed to have relied upon the host country's infrastructure or enjoyed the benefits of actively participating in the country's economic activities.

4.3 Article 5(1) of the OECD Model Tax Convention

The term permanent establishment is defined in Article 5(1) of the OECD Model Tax Convention (2008) as:

> a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Olivier and Honiball (2008) explain that the activities of the non-resident must have three attributes for them to qualify as a permanent establishment in terms of Article 5(1):

- a place of business;

- which is fixed (in other words the place of business has a degree of permanence); and
- the business of the enterprise is carried on through the fixed place of business.

This is also mentioned in paragraph 2 of the Commentary to Article 5.

These three attributes of permanent establishments will be dealt with in more detail below.

a) A place of business

Olivier and Honiball (2008) state that the enterprise must have a physical presence in the source State before it can be said to have a place of business. An office or factory has been provided as an example.

Paragraphs 4 and 4.1 of the Commentary on Article 5 state that the term "place of business" includes any "premises, facilities or installations", which are used for the carrying on of business. The paragraphs in the Commentary make the following additional points about the place of business:

- it is not necessary that an entire premises be available for the enterprise's use before a "place of business" can be said to exist; a "place of business" would, however, exist even if only a space were made available for the use of the enterprise;

- the enterprise is not required to have exclusive use of the space, and is only required to have a space at its disposal;

  Paragraph 4.3 of the Commentary on Article 5 provides an example of space being placed at the disposal of an individual, and indicates that this requirement would be met if the employee of company A has an office at his

disposal while performing his duties on behalf of company A in company B (assuming that it is for a period of time).

- it is irrelevant whether the "place of business" is owned, rented or otherwise made available for the use of the enterprise, and it may even be located in the business premises of another enterprise;

  Paragraph 4 of the Commentary on Article 5 illustrates this by indicating that a pitch in a market place would constitute a place of business – even though the enterprise in question would not own the pitch, and may or may not pay rent for the use of the pitch.

- it is further not required that there be a formal legal right to use the place.

It is submitted that these four points, which are contained in the Commentary on Article 5, would be applicable when determining whether the recurrent activities of the foreign company at the premises of the associated enterprise in South Africa constituted a "place of business". In the experience of the writer of the present thesis, the foreign company, which renders services in South Africa on a recurrent basis to an associated enterprise, often neither rents the space it uses nor has exclusive use to the space, but makes use of space made available to it (or placed at its disposal at the premises of the associated enterprise).

It is concluded from the above that the services rendered by a foreign company at a space made available at the premises of the South African associated enterprise on a recurrent basis may create a "place of business".

Olivier (2002) makes the point that the term "business" neither requires that the permanent establishment contribute towards the profits of the enterprise, nor requires that it be productive on its own. Vogel (1997) agrees with this view. This point is regarded as relevant when determining whether the services rendered constitute a "place of business" as it implies that the nature of the services rendered is irrelevant, provided the services are for the benefit of the enterprise.

b) The place of business must be fixed (having a degree of permanence)

Skaar (1991) states that the most important feature of a permanent establishment is the requirement of a fixed place of business as this emphasises the establishment of the enterprise in the country and differentiates it from source-state taxation.

Olivier and Honiball (2008:97) state that:

> For a place of business to be fixed, two components have to be met, namely: (1) a specific geographical spot has to exist, referred to as the "location test"; and (2) there must be a certain degree of permanence at each geographical spot, referred to as the "duration test" . . .

These two tests are dealt with in more detail below.

i) The location test

Paragraph 5 of the Commentary on Article 5 states that the place of business has to be a "fixed one"' that is to say "there has to be a link between the place of business and a specific geographical point".

Paragraph 5.1 of the Commentary on Article 5 states that a single place of business will generally be considered to exist where, in light of the nature of the business, activities are carried out in different places within a particular location – but only if the particular location constitutes a coherent whole, commercially and geographically, with respect to that business.

Olivier and Honiball (2008) argue that when applying the location test the activities of the enterprise must be evaluated in the context of the business conducted. It is essential for purposes of this test that there be commercial and geographic coherence.

Paragraphs 5.2 to 5.4 of the Commentary on Article 5 provide the following illustration of the principle discussed in paragraph 5.1:

1. A mine, an office block (in which a consulting firm regularly rents different offices), an outdoor market or a fair may constitute a single place of business even though business activities may move from one location to another, as the sites have a commercial and geographic coherence.
2. The requirement of commercial coherence is illustrated by a painter, who performs work in a large office block, which is regarded as being within a limited geographic area. In the event that that the painter works for unrelated clients in the building, the building should not be regarded as a single place of business for purpose of that work. If the painter, however, undertook painting work throughout the office block for a single client, this would be regarded as a single project and consequently the building would be regarded as a single place of business – constituting a coherent whole commercially and geographically.
3. Conversely, activities may be conducted as part of a single project (and with the necessary commercial coherence), but may lack geographic coherence and consequently not be regarded as a single place of business. An example of this would be a consultant, who renders services at different branches of the same company (in separate locations) in terms of a single contract. While the activities of the consultant would have the necessary commercial coherence, each branch would be regarded as a separate location or place of business. However, if the consultant moved from office to office within the same building, the activities would be regarded as being performed at a single location or place of business.

Olivier and Honiball (2008) argue that when evaluating recurrent activities the enterprise should return regularly to a specific location to satisfy the "location test". As it has been assumed for purposes of this thesis that the foreign company would return to the same premises each time it rendered services in South Africa, it is concluded that the premises would be regarded as a single place of business (even though the services may be rendered at different sites within the premises of the South African associated enterprise). The services would be rendered for one entity (within a particular location), and consequently have both commercial and geographic coherence. The rendering of services at different offices or sites within a business premises would appear to be materially similar to the example of a painter

undertaking work for a single client at an office block (provided in the Commentary and mentioned above).

In the circumstances described above, it would appear that it is of no consequence whether the recurrent services were rendered in terms of a "master contract" or in terms of separate contracts with the South African associated enterprise, and that this would not impact upon the commercial coherence. Olivier (2009c) stated in an interview that she is in agreement with this.

It is further submitted that, if the foreign company were to render services at different business premises (or branches) of the South African entity, the necessary geographic coherence would not exist and each business premises (or branch) would constitute a separate location and be evaluated separately to conclude if it meets the requirements of a fixed place of business.

ii) The duration test

Olivier and Honibali (2008) state that when applying the duration test, a certain degree of permanence is required – that is business of a purely temporary nature would be excluded. This view is supported by paragraph 6 of Commentary on Article 5.

Skaar (1991) states that it is essential to the existence of a permanent establishment that there must be an intention to use the place of business permanently or for an indefinite duration, and that it is this intention to use the place for an indefinite period, which characterises the permanence of the place of business.

It is therefore concluded that the activities of the enterprise should have a certain degree of permanence and be conducted with the intention of being permanent before the "duration test" would be met.

Paragraph 6 of the Commentary on Article 5 explains that experience has shown the following with regard to the degree of permanence:

- Where the business is conducted for less than 6 months, a permanent establishment normally would not exist, and that
- There are many cases where business, which is conducted for a period longer than 6 months, constitutes a permanent establishment.

It is therefore concluded that where services are rendered in a State on a recurrent basis for more than 183 days at a time, the activities would normally be regarded as having the necessary degree of permanence in terms of the "duration test". It is consequently only when the recurrent services are rendered in a country for less than 183 days per annum that an exception to the general rule, referred to inter alia in paragraphs 6 and 6.1 of the Commentary on Article 5 , needs to be considered.

Paragraphs 6 and 6.1 of the Commentary provide two exceptions to the above guideline:

1. Where the activities of the business are of a recurrent nature, each period of time during which the place is used should be considered in combination with the other times the place is used.

   Temporary interruptions of activities do not cause a permanent establishment to cease to exist, and usage which takes place regularly (all be it for short periods of use) over a long period of time, should not be regarded as being purely temporary in nature.

2. Where the activities of the enterprise were carried on exclusively by the permanent establishment in that country: in such a case, as a result of the strong connection to the country, an exception may be made even though the business may have a short duration.

The first exception is consistent with the argument that recurrent services rendered on a regular basis at the same location in South Africa constitute a permanent establishment, and is in line with the discussion below. A discussion of the second exception is however regarded as being outside the scope of this thesis.

Vogel (1997) expresses the view in respect of recurrent activities or services that where the activities or services are carried out on a regular basis and in the same place of business, a permanent establishment will be taken to exist. The permanence test is not affected by interruptions in operations, which occurred in the normal course of business, provided the business activities are resumed at the same place.

Olivier and Honiball (2008) reinforce this point by stating that when evaluating if business activities will meet the duration test, the words 'fixed' or 'permanent' should not be taken to mean that the operations should be conducted without interruption, but that the operations should at least be carried out on a regular basis.

It is repeated in paragraph 7 of the Commentary on Article 5 that it is not a requirement that there be no interruption of operations for the activity to be permanent in nature, but that the operations must at least be carried out on a regular basis.

It was pointed out in the German lower court's decision in the Market Vendor, Finanzgericht Munster in EFG 19966, 501, case that "where a vendor conducts business at different stalls at the same market on a regular basis, a fixed place of business (that is the market) exists notwithstanding that a different stall may be used at different times". This again appears to confirm both that temporary interruptions do not deprive a place of business of its permanence, and also that the court would regard a market place (or a limited geographic area) as a single location for purposes of the location test.

It is the experience of the writer of this thesis that in situations where a foreign company renders recurrent services to a South African associated enterprise, these services are rendered over a long period of time, in terms of a single contract and with the intention of continuing indefinitely (as assumed for purposes of this thesis).

It is therefore clear that where it is the intention of the foreign company, which renders services in South Africa, to render such services on a regular basis at the same premises for an indefinite period, the place should be regarded as having the

necessary permanence. This would be consistent with the argument that recurrent services rendered over a long period of time at the same premises should be regarded as having the necessary permanence to meet the "duration test". It is also clear that the place of business would not be deprived of its permanence if it is in the normal course of business for the foreign associated enterprise to interrupt its activities in South Africa and return to the same place at a later date.

c) The business of the enterprise must be carried on through the fixed place of business

Paragraph 4.6 of the Commentary to Article 5 states that the words "through which" must be given a wide meaning and would apply to any situation where the business activities of the enterprise are carried on at a particular location, which is at the disposal of the enterprise.

Paragraph 7 of the Commentary to Article 5 emphasises that it is essential that the enterprise, which is using the place of business, must carry on its business wholly or partly through the said place of business for the fixed place of business to constitute a permanent establishment.

It is assumed for purposes of the thesis that the services of the foreign company would be rendered at the place of business of the South African entity and would therefore qualify as being rendered 'through' the place of business.

4.4 Conclusion: Article 5(1)

The rationale behind requiring that the activities of the enterprise should constitute a permanent establishment before the host State will be entitled to tax the profit of the activities, is that the enterprise should only be required to pay tax in the host State once it has relied upon the host country's infrastructure or enjoyed the benefits of actively participating in the country's economic activities.

The services rendered by a foreign company on a recurrent basis to an associated enterprise would create a "place of business" - in spite of the fact that the foreign

company may have no formal legal right to the space, provided that the space is made available to it.

Services, which are rendered regularly on a recurrent basis at the same premises and to the same South African entity, would be geographically and commercially coherent and consequently meet the "location test'. It is clear that as the services are rendered regularly and recurrently, and with the intention to do so indefinitely, they would be regarded as having the necessary permanence and meet the 'duration test'. The place of business would therefore be regarded as being fixed (having the necessary degree of permanence).

As the services would be rendered at the place of business of the South African entity, they would be regarded as being rendered "through" the place of business and the foreign company would be regarded as having a permanent establishment in South Africa (as defined in Article 5(1) of the OECD Model Tax Convention).

Article 5 of the OECD Model Tax Convention contains seven paragraphs, all of which need to be taken into account before one is able to conclude whether the activities of the foreign company constitute a permanent establishment in South Africa, and consequently what the tax implications of these activities are. For example, Articles 5(3) and 5(4), which are discussed below, override Article 5(1) and may reveal that no permanent establishment exists.

4.5 Articles 5(2) – 5(7) of the OECD Model Tax Convention

Articles 5(2) to 5(7) of the OECD Model Tax Convention expand further on the concept of a permanent establishment, providing examples and exclusions. This section of the thesis seeks to examine these Articles and discuss their applicability when establishing whether services rendered by a foreign company on a recurrent basis to a South African associated enterprise would create a permanent establishment in South Africa.

Vogel (1997) states that when evaluating whether or not a permanent establishment exists, one should begin by comparing the activities of the enterprise to the

provisions of Articles 5(1) to 5(4) of the OECD Model Tax Convention. If Articles 5(1) to 5(4) reveal that a permanent establishment exists, there is no need to revert to Articles 5(5) and 5(6). As Articles 5(3) and 5(4) are regarded as overriding the provisions of Articles 5(1) and 5(2), the fact that Articles 5(1) or 5(2) reveal that a permanent establishment exists would not be conclusive. It is only if Articles 5(1) or 5(2) reveal the non-existence of a permanent establishment on account of the absence of a fixed place of business that Articles 5(5) and 5(6) should be referred to.

It will be shown in this discussion that none of the provisions in Articles 5(2) to 5(7) would be applicable to the situation discussed in this thesis or would add to the conclusions arrived at.

Article 5(2)

Article 5(2) of the OECD Model Tax Convention states that:

> The term "permanent establishment" includes especially:
> a) a place of management;
> b) a branch;
> c) an office;
> d) a factory;
> e) a workshop, and
> f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Olivier and Honiball (2008) state that inclusion in the list of activities provided in Article 5(2) does not in itself provide conclusive evidence of the existence of a permanent establishment. The OECD Commentary makes it clear that the list has to be viewed in the context of the general definition in Article 5(1).

Paragraph 12 of the OECD Commentary on Article 5 supports the view that Article 5(2) merely provides examples of a permanent establishment, stating that:

> [a]s these examples are to be seen against the background of the general definition given in paragraph 1, it is assumed that the Contracting State interprets the terms listed . . . in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1.

Vogel (1997) is in agreement with this.

It is therefore concluded that the fact that an establishment as listed in Article 5(2) exists in the source country, does not necessarily imply that a permanent establishment will exist, and that the activities of the fixed place of business would first need to meet the requirements set out in Article 5(1) of the OECD Model Tax Convention before they would be classified as a permanent establishment. Olivier and Honiball (2008) are in agreement with this.

Vogel (1997) (and paragraph 12 of the OECD Commentary on Article 5) makes the point that the opening sentence of Article 5(2) indicates that the list provided should not be regarded as exhaustive, but as examples.

It would therefore appear from the above that the mere fact that the services rendered in South Africa by the foreign company correspond with one of the activities listed in Article 5(2), does not of itself indicate that the activity should be regarded as a permanent establishment, and that the activity would first have to meet the criteria detailed in Article 5(1).

Article 5(3)

Article 5(3) of the OECD Model Tax Convention states that:

> A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

Olivier and Honiball (2008) state that Article 5(3) of the OECD Model Tax Convention overrides Article 5(1) and consequently the provisions of Article 5(3) replace the 'permanence test' with a 'duration test'. Vogel (1997) is in agreement with this.

Honiball (2009a) explained in an interview that each fixed place of business should first be evaluated in terms of Article 5(1). Then, if the activities qualify as a permanent establishment in terms of Article 5(1), the provisions of Article 5(3) should be examined to determine if they provide an exemption and override Article 5(1). Article 5(3) does not deem a permanent establishment to exist, but merely provides a possible exclusion or "window period". It is submitted that this interpretation is arrived at as the Article states that a permanent establishment will exist "only if it lasts for more than . . ."

Honiball (2009b) stated during an interview that:

> When you apply a literal as well as a purposive approach to interpreting Article 5(3), it is clear that it is a relaxation or concession, commonly referred to as a window period. Consequently, you still need to have a "fixed base" to get into Article 5(1), but if the fixed base is within the window period, even though there is what would normally be a PE [permanent establishment], it is an exempt PE.

Honiball (2009c) stated further during an interview it was not the intention that Article 5(3) take the activities carried out in different years into account. The "window period is there for once off projects only" and is an "absolute test". Article 5(3) would not provide an exemption for recurrent services, which are rendered in South Africa for less than 183 days per annum on a recurrent basis, and consequently services, which are rendered on a recurrent basis at the same place of business, may still create a permanent establishment in terms of Article 5. The general rules provided in paragraph 6 of the Commentary to Article 5(1), which deal with the exception in respect of recurrent activities (discussed above), would therefore still apply when evaluating the tax implications of recurrent services rendered in South Africa.

If the services rendered were closely related to a "building site or construction or installation project" and formed "part of the single commercial project (single client)"

(Honiball:2009), the activities may fall under those listed in Article 5(3). It is concluded, however, that the exclusion provided in Article 5(3) would not apply as the services were rendered on a recurrent basis and Article 5(3) is not intended to cover recurrent activities (Honiball:2009c).

While it is outside the scope of this thesis, which is confined to the provisions of the OECD Model Tax Convention, it is noted that many of the bilateral DTAs, which are concluded between countries, include other activities in Article 5(3) (inter alia the rendering of services). While the window period provided for in Article 5(3) may apply to these activities (including the rendering of services) if they are in respect of "once-off projects" and have a different tax consequence to the OECD Model Tax Convention, it is submitted that the Article 5(3) "window period" or exclusion would not apply to recurrent services rendered in the manner contemplated in this thesis (as stated above).

While most of the DTAs concluded by South Africa incorporate Article 5(3) as reflected in the OECD Model Tax Convention, South Africa has concluded some DTAs, which include the alternative as set out in Article 5(3) of the United Nations Income and Capital Model Convention (2001) (the "UN Model Tax Convention").

Article 5(3) of the UN Model Tax Convention (2001), which tends to increase the taxing rights of the source country, states that

> The term "permanent establishment" also encompasses:
>
> a) a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;
> b) the furnishing of services, including consulting 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 six months within any twelve-month period.

Unlike Article 5(3) of the OECD Model Tax Convention, which provides a "window period" or exclusion for activities, which would otherwise be regarded as a permanent establishment in terms of Article 5(1), Article 5(3) of the UN Model Tax Convention deems certain activities to be a permanent establishment. Honiball (2009b) is in agreement with this. This has the effect that Article 5(3) increases the scope of activities which are regarded as a permanent establishment, which in turn increases the taxing rights of the source country (consistent with the United's Nations' overall bias towards the developing source countries). Article 5(3) of the UN Model Tax Convention also increases the activities listed in sub-paragraph (a) (when compared to Article 5(3) of the OECD Model Tax Convention) to include assembly and supervisory activities, and includes a sub-paragraph (b), which regards the "furnishing of services" as a permanent establishment in certain circumstances.

Article 5(4)

Olivier and Honiball (2008) state that Article 5(4) excludes certain activities, which are of an incidental, preparatory or ancillary nature, from the definition of permanent establishment – even if they are carried on through a fixed place of business in terms of Article 5(1).

Vogel (1997) states that Article 5(4) should also be regarded as a "lex specialis", that takes precedence over Articles 5(1) and 5(3). If the facilities or activities fall under the list of exceptions in Article 5(4) there will be no permanent establishment – even if the requirements of Article 5(1) have been met. Olivier and Honiball (2008) agree with this view.

Vogel (1997) states further that Article 5(4) provides a list of facilities and activities, which are of a preparatory or auxiliary nature and exceptions to the permanent establishment concept in Article 5(1). The list should be regarded as non-exhaustive and is designed to include a whole range of auxiliary activities.

Paragraph 23 of the Commentary to Article 5 states the following as concerns a fixed place of business, which may be regarded as being of a preparatory or auxiliary character:

> It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question.

It was stated during 'The joint South African Revenue Service and OECD Workshop (2005)' that when determining if the activities of the enterprise should be regarded as preparatory or auxiliary one must look at the nature of the business of the particular enterprise, and ask whether the activities of the fixed place of business form an essential or significant part of the activity of the enterprise as a whole. Olivier and Honiball (2008) are in agreement with this.

Paragraph 24 of the Commentary to Article 5 states that:

> [t]he decisive criteria is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole . . . a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity.. .
>
> A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity.

Subparagraphs (a) to (c) provide examples of preparatory or auxiliary activities, which would qualify for the Article 5(4) exclusion, but it is submitted that these sub-paragraphs would not apply to the rendering of services as they relate to the "use of facilities solely for the purpose of storage, display or delivery of goods" and the "maintenance of a stock of goods . . . "

As subparagraph (d), however, relates to the purchasing of goods or merchandise and the collecting of information, and subparagraph (e) relates to "any other activity of a preparatory or auxiliary character", these subparagraphs may apply to the rendering of services.

Paragraph 26 of the Commentary on Article 5 states that

> Moreover, subparagraph e) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of subparagraph e).

It is submitted that the above comments are included because Article 5(4)(e) specifies that the activity must be "for the enterprise". As Article 5(4)(d) also includes the specification that the activity must be "for the enterprise", the above comments would appear to apply to Article 5(4)(d) as well.

Vogel (1997) states further that the object of the activity covered by sub-paragraphs (d) and (e) must be "solely in favour of the enterprise to which the business belongs", and that it should not be aimed at benefiting a third party directly. It is only when the activities are carried out for the enterprise itself that such preparatory or auxiliary activities do not constitute a permanent establishment. Olivier and Honiball (2008) are in agreement with this. If the activities constitute services, which are rendered to a third party, they will constitute the enterprise's main object and consequently fall outside of the ambit of Article 5(4).

It can therefore be concluded that the provisions of Article 5(4)(d) and (e) could not apply to the services rendered in South Africa by a foreign company to a South African associated enterprise, as the services would not be rendered to the foreign enterprise itself, but to a third party (the South African associated enterprise), and consequently constitute the enterprise's main object and fall outside the ambit of Article 5(4).

Paragraph 21 of the OECD Commentary to Article 5 states that

> subparagraph f) provides that combinations of activities mentioned in subparagraphs a) to e) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed

place of business resulting from this combination is of a preparatory or auxiliary character.

It is clear that subparagraph (f) would not apply to the rendering of services to an associated enterprise in South Africa as it specifically refers to activities which qualify under subparagraphs (a) to (e) and, as stated above, the rendering of services to an associated enterprise would not qualify for exclusion under any of these subparagraphs (for the reasons mentioned above). The provisions of Article 5(4) will therefore not be discussed in any further detail as they would not be applicable to the rendering of services to an associated enterprise in South Africa.

Articles 5(5) and 5(6)

These Articles deal with dependent and independent agents, which operate in a country (for example South Africa) on behalf of a foreign company. As stated in chapter 1, a position has been taken that the employees of the foreign company, who render services in SA, are not dependant agents of the foreign company and consequently the provisions of Articles 5(5) of the OECD Model Tax Convention, which indicate that the foreign company would be deemed to have a permanent establishment in South Africa as a result of the activities undertaken on behalf of the foreign company, would not be applicable.

As the recurrent services are assumed to be rendered by employees of the foreign company, it is clear that they would not be rendered by independent agents of the foreign company, and consequently Article 5(6) would not be applicable to this thesis. As it is concluded that these two paragraphs are not applicable to this thesis they will not be discussed in any further detail.

Article 5(7)

Article 5(7) of the OECD Model Tax Convention 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 permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

It is concluded from this article that the mere fact that a foreign company may own the South African associated enterprise, or is owned by the South African associated enterprise, would not of itself mean that the South African associated enterprise is a permanent establishment of the foreign company.

This is supported by paragraph 40 of the Commentary to Article 5, which states that:

> It is generally accepted that the existence of a subsidiary company does not of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

While the above quoted paragraph from the Commentary to Article 5 (together with Article 5(7)) specifically relates to a parent company and subsidiary company, it is submitted that the same principles may be applied to associated enterprises, which are companies – that the mere fact that two companies are associated to each would not cause the one company to be a permanent establishment of the other.

Olivier and Honiball (2008) confirm that a permanent establishment does not arise as a result of ownership, control or association between enterprises.

It is further concluded from this article that the fact that a foreign company carries on business in South Africa (whether through a permanent establishment or otherwise), shall not of itself mean that the South African party is a permanent establishment of the foreign company.

This is not of direct relevance to this thesis, which examines the activities carried out by a foreign company to an associated enterprise in South Africa.

It is submitted that as this thesis deals with South Africa's right to tax the recurrent services rendered in South Africa by a foreign company, it is the activities carried on in South Africa, which must be examined to determine if they constitute a permanent establishment and thereby entitle South Africa to tax them, not the foreign company itself. It is outside the scope of this thesis to consider whether the foreign company itself should be regarded as a permanent establishment of the South African associated enterprise.

Paragraph 41 of the Commentary to Article 5 states further that:

> A parent company may, however, be found, under the rules of paragraph 1 or 5 of the Article, to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company . . . and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraphs 3 and 4 of the Article . . .

While paragraph 41 (and Article 5(7)) specifically refers to a parent company and a subsidiary company, it is submitted that the same principles may be applied to associated enterprises, which render services to each other. It is clear that paragraph 41, which is quoted above, supports the argument put forward in this thesis that services rendered by a foreign company at the premises of an associated enterprise in South Africa, which constitute a fixed place of business, will constitute a permanent establishment of the foreign company.

4.6 Conclusion: Articles 5(2) – 5(7)

This section of the chapter has discussed the applicability of Article 5(2) to 5(7) of the OECD Model Tax Convention when establishing whether services rendered by a foreign company on a recurrent basis to a South African associated enterprise would

create a permanent establishment in South Africa. From the discussion presented in this chapter, it is concluded that Article 5(2) merely provides examples of activities which would constitute a permanent establishment, and one would first need to establish whether the activities meet the definition of a permanent establishment in terms of Article 5(1) before concluding that the services rendered result in the creation of a permanent establishment. It is therefore clear that these sub-paragraphs do not add to this thesis.

Article 5(3) of the OECD DTA would have limited applicability in this thesis as it does not include services rendered in the list of activities for which it provides an exclusion or "window period". It is further submitted that even if the services rendered formed part of a "building site or construction and installation project", the exclusion or "window period" provided in Article 5(3) would not apply as the services were rendered on a recurrent basis.

Article 5(4) would not be applicable to this thesis as the only subparagraphs, which could relate to the rendering of services (namely subparagraphs (d) to (f)) require that the activity be carried out "for the enterprise", which would not be the case as the services are rendered to an associated enterprise of the enterprise in South Africa and not the enterprise itself.

It has been assumed for purposes of this thesis that the recurrent services, which are rendered in South Africa on behalf of the foreign company, are not rendered as either a dependent or independent agent of the foreign company, and consequently the provisions of Articles 5(5) and 5(6) would not be applicable to this thesis.

While paragraph 41 of the Commentary on Article 5, which deals with subparagraph 7, supports the conclusion that services rendered by a foreign company at the premises of an associated enterprise in South Africa, which constitute a fixed place of business, will constitute a permanent establishment of the foreign company, it is submitted that Article 5(7) does not add to the analysis of whether or not such recurrent services constitute a permanent establishment.

It is concluded from an analysis of the various sub-paragraphs of Article 5 that the recurrent services rendered by the foreign company at the premises of the South African associated enterprise would satisfy the criteria for a permanent establishment, which are set out in Article 5(1), and consequently a permanent establishment would exist at the place where the services are rendered in terms of Article 5(1) of the OECD Model Tax Convention.

CHAPTER 5 – DETERMINING THE INCOME WHICH MAY BE TAXED IN SOUTH AFRICA

5.1 Introduction

While chapter 4 concluded that the recurrent services rendered by the foreign company may result in the creation of a permanent establishment in South Africa and concluded that Articles 5(2) to 5(7) do not apply to the circumstances contemplated in the present research, it must still be determined what income (if any) may be taxed in South Africa, as a DTA only allocates the right to tax income and does not determine how much of the income will be taxed in a contracting state.

This chapter seeks to determine what income (if any) may be taxed in South Africa when the services rendered in South Africa have resulted in the creation of a permanent establishment. It will be demonstrated that there are two types of income related to the foreign company's activities in South Africa, which may be subject to tax in South Africa, namely the income attributable to the permanent establishment in terms of Article 7 of the DTA and the income paid to the employees of the permanent establishment, which South Africa may have the right to tax in terms of Article 15 of the OECD Model Tax Convention.

It is submitted that as the permanent establishment in South Africa may be regarded as an extension of the foreign company and as the foreign company and the South African company are "associated enterprises" (as discussed in Article 9 of the OECD Model Tax Convention), transfer pricing considerations may arise in relation to the quantification of the amount attributable to the permanent establishment. While a discussion of the possible transfer pricing considerations detailed in the OECD "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (2001) is regarded as being outside the scope of this thesis, the provisions of Article 9(1), which deal with the accrual of profits to Associated Enterprises, will be discussed below.

As there is a lack of clarity, and several divergent views concerning the attribution of profits to a permanent establishment (Olivier:2009a), the attribution of profits to a

permanent establishment will only be briefly discussed in this thesis. The actual quantification of the amount to be taxed in South Africa will not be dealt with as this is regarded as outside the scope of this thesis.

5.2 Taxing income earned from services rendered in South Africa

While the definition of "gross income" in section 1 of the Income Tax Act provides that South Africa may tax non-residents on South African source or deemed South African source income (and it was assumed in chapter 1 that the foreign company and the employees of the foreign company were not residents of South Africa), if a DTA exists between the two countries the DTA will indicate which country has the right to tax, and these provisions will override any conflicting provisions in the Income Tax Act (as discussed in chapter 2). South Africa would therefore only be entitled to tax the income earned by the foreign company and the employees of the permanent establishment, if it is from a South African or deemed South African source and the DTA allocates the right to tax to South Africa (assuming that the country of residence of the foreign company has an OECD based DTA with South Africa).

Article 7 of the OECD Model Tax Convention deals with business profits and states in paragraphs 1 and 2 that:

1) The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2) Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it 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 enterprise of which it is a permanent establishment.

It is concluded from Article 7(1) of the OECD Model Tax Convention (quoted above), that the income earned by the non-resident foreign company would be taxable only in the country of its residence, unless the foreign company has a permanent establishment in South Africa, in which case South Africa would be entitled to tax the foreign company, but only in respect of the income attributable to the South African permanent establishment. If the activities of the foreign company, however, do not constitute a permanent establishment in South Africa, South Africa would have no right in terms of the DTA to tax the income earned by the foreign company - even if the income was from a South African or deemed South African source (assuming that an OECD based DTS exists between the country of residence of the foreign company and South Africa). It is therefore clear that one would begin by establishing if the activities of the foreign company have resulted in the creation of a permanent establishment in South Africa, as this will determine whether the DTA allocates the right to tax the income attributable to the permanent establishment to South Africa. The existence of a permanent establishment therefore plays a significant role in determining the tax implications of recurrent services rendered in South Africa as South Africa would not be entitled to impose tax on the income earned in South Africa in terms of the Income Tax Act if the DTA has not allocated the right to tax to South Africa.

If, however, the activities of the foreign company constitute a permanent establishment in South Africa, the question remains how much of the income earned by the foreign company may be attributed to the permanent establishment and taxed in South Africa. There has been a great deal of debate concerning how profits should be attributed to a permanent establishment, and this has resulted in the OECD first issuing a Report on the Attribution of Profits to Permanent Establishments in December 2006, and then adopting the final report on the "Attribution of Profits to Permanent Establishments" in July 2008, which deals with the attribution of profits to permanent establishments in general (Part I), to the financial sector in Part II, which deals with banks, in Part III, which deals with global trading and in Part IV, which

deals with insurance. A discussion of OECD Report on the Attribution of Profits to Permanent Establishments issued in June 2008 is, however, regarded as being outside the scope of this thesis.

A discussion draft on a new Article 7 (together with Commentary) was released for comment in July 2008. The OECD invited interested parties to submit comments on or before the 31st of December 2008, and it is anticipated that the new version of Article 7 will be included in the next update to the OECD Model Tax Convention, which is tentatively scheduled for release in 2010. The discussion draft on the new Article 7 has not been discussed in this thesis as it is regarded as being outside the scope of this thesis.

Article 7(1), which is quoted above, indicates that if the activities of the foreign company have resulted in the creation of a permanent establishment in a state, the state would only be entitled to tax the income, which is attributable to the permanent establishment in that state, and Article 7(2), which is also quoted above, states that this income should be calculated as if the permanent establishment were an independent entity with the profits determined in terms of the "arm's length" rule. Olivier & Honiball (2008:109) state that "there is debate whether in a South African permanent establishment context, a tax treaty can create a tax liability" and that "it remains the prerogative of the domestic legislature to legislate the particular deducting provision or the particular taxing provision."

Olivier and Honiball (2008: 93) state further that

> the 'permanent establishment' concept is . . . nothing more than the provision of a legal framework for the circumstances in which the source country will have the right to tax a non-resident enterprise on source income . . .

Rohatgi (2005: 32) states that "[t]he primary purpose of a tax treaty is to allocate taxing rights and to provide relief if double taxation arises . . . only the domestic tax law in each country has the taxing power under its legislative enactment . . . a treaty can restrict the taxing power or the amount of tax due under domestic law, but not increase them."

Pijl (2008: 473) states that

> Art 7 [Article 7] of the OECD Model, however, says nothing regarding the computation of the taxable basis under the domestic law of the PE [Permanent Establishment] State. Under Art 7 of the OECD Model, the modalities of taxation . . . are left to the sovereignty of the PE State . . .

Mary Bennett, Head of Tax Treaty, Transfer Pricing at the OECD states that "[t]here is . . . a difference between attributing profits under Art 7 of the OECD Model, which is an exercise to determine the maximum amount of profits that the PE state may tax . . . and the determination of the taxable income of the PE under the domestic law of each state" (Bennett, 2008: page 470).

Paragraph 30 of the Commentary on Article 7 clarifies that Article 7(3) of the OECD Model Tax Convention only deals with the attribution of expenses for purposes of determining the profits attributable to a permanent establishment, but does not deal with the issue of whether those expenses (once attributed to the permanent establishment) are in fact deductible as this is a matter left to domestic law.

Article 9(1) states that where associate enterprises transact and

> conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

As this thesis deals with a foreign company rendering services to a South African associated enterprise through a permanent establishment, it is submitted that the provisions of Article 9 may be applicable to this thesis and support Article 7(2), which is quoted above and which states that the profits, which should be attributable to a

permanent establishment, are those which "it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities".

It is submitted that the above quotations, which indicate that the provisions of Article 7 should not be used to determine the profit subject to tax in a country, would also be applicable to the provisions of Article 9. It is therefore concluded that although the provisions of a DTA may result in the creation of a permanent establishment, the DTA only allocates the right to tax between the two countries – it does not stipulate how much income should be taxed.

It is submitted that if the South African company and the foreign company are regarded as "connected persons" as defined in section 1 of the Income Tax Act (for example where both companies form part of the same group of companies, or where at least 20 per cent of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company, the provisions of section 31, which state that the "consideration in respect of the transaction" may be adjusted "to reflect an arm's length price for the goods or services", may be applicable when determining the income earned by the permanent establishment in South Africa. This matter will however not be discussed in any further detail as it is regarded as being outside the scope of this thesis.

5.3 South African source rules

Receipts and accruals of any person are included in taxable income and subject to taxation in South Africa through the definition of "gross income" (section 1 of the Income Tax Act) which includes, in the case of a non-resident person, receipts and accruals from a South African or deemed South African source.

Olivier and Honiball (2008:50) state that:

> One of the fundamental questions to ask in deciding whether income is taxable in a particular country is whether a connection, or nexus, exists between the income and the country . . .

The term "source" is not defined in the Income Tax Act, and De Koker (2009: 5.3) states that the reason for this is "that it is not possible to define satisfactorily the qualities that will determine the source of income in all circumstances". The judgement in First National Bank of Southern Africa Ltd v Commissioner for South African Revenue Services, 2002 (A) 64 SATC 245 stated that the "legislature had not attempted to define the phrase 'source . . . within the Republic' and had left it to the courts to decide on the particular facts of each case whether an amount was or was not received from such a source" and that "each case has to be decided on its own facts". Certain of the judgments, which deal with the term "source", are discussed below.

The judgment in CIR v Lever Bros & Unilever Ltd, 1946 AD 441, 14 SATC 1 is regarded as the *locus classicus* in South Africa with regard to the test to be applied to determine the actual source of income and states that "the source of receipts, received as income, is not the quarter whence they came, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them." It is clear from this judgment that the originating cause of the income earned would represent the source of the income and must be determined in order to ascertain if the income is from a South African source.

De Koker (2009) states that the source or originating cause of income from employment and other services rendered is located where the services are rendered. Williams (2005) is in agreement with this.

In the South Rhodesian case of COT (SR) v Shein, 1958 (3) SA 14(FC), 22 SATC 21 the court was required to determine where the source of income earned for managing a store in Bechuanaland was situated. In the judgment it was stated that "it now seems settled law that generally the source of such income is the place where the services for which the salary is paid are rendered." While it is clear that foreign case law is not binding upon South African courts, it is submitted that this judgement would be of persuasive value in South Africa.

The judgment in Millin v CIR, 1928 AD 207,3 SATC 170, an Appellate Division decision and therefore binding, provides support for the conclusion that the source of income earned for services rendered is situated where the services were actually rendered, and held that the "exercise of her wit and labour, which constituted the capital employed in her business, was employed wholly in the Union . . . and, therefore . . . the source of the whole of her income would be in the Union".

The judgement in CIR v Epstein, 1954(3) SA 689(A), 19 SATC 221 also provides further support for the conclusion that the source of income earned for services rendered is situated where the services were actually rendered, and held that "[a]ll of the activities of the respondent were carried on in the Union and it was as a result of these activities that he earned the profits . . . It therefore follows that those profits were received from a source within the Union."

It is concluded that South Africa would regard the source of the income earned by the foreign company from rendering services to its associated enterprise in South Africa (together with the source of the income earned by the employees of the foreign company, who were paid to render the services in South Africa) as being where the services were actually rendered, which is in South Africa. As it has been assumed that the foreign company (together with its employees) are not residents of South Africa and the Income Tax Act provides that persons other than residents may only be taxed in South Africa on income, which has a South African or deemed South African source, it would appear that the Income Tax Act provides the necessary authority to tax the income earned by the foreign company (and its employees) for services rendered within South Africa as this income would have a South African source. It is submitted, however, that South Africa would only be entitled to tax the service income, which has a South African source, if the DTA between South Africa and the country of residence of the foreign company gives South Africa the right to tax such income.

The situation may arise, however, where the amount paid to the foreign company (and/or its employees) may be in respect of services, which were rendered partly within South Africa and partly outside South Africa. As South Africa's right to tax the foreign company (and its employees) as non-residents is limited to the income,

which is of a South African or deemed South African source, and the source of this income would be partly within South Africa and partly outside South Africa, a problem may arise in determining how much income is taxable in South Africa (being of a South African source).

The Fifth Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1997) stated in chapter 5, paragraphs 5.51 and 5.5.2 that

> [a] tax regime where taxability arises by virtue of an activity carried on through a presence in a taxing jurisdiction carries with it the inevitable notion of allocation of income to that presence . . . The concept of apportionment has been recognised by our Courts . . . The principle of apportionment as raised in the Lever Brothers case may be regarded as authority for the apportionment in determining source issues . . .

De Koker (2009: 5.4) states that, although the Income Tax Act makes no provision for the apportionment of the source of income, the Tax Court has "authorised the apportionment of the source of income derived from services" in ITC 77 (1927) 3 SATC 72.

Williams (2005:25) states that

> The weight of judicial opinion seems to favour the view that apportionment is, in principle, permissible, but that the practical difficulties in assigning income to different sources may compel the assessment to be based only on the "dominant or main or substantial or real and basic source of the accrual" . . .

The following excerpt from the judgement in CIR v Lever Bros & Unilever Ltd provides support for the view that the apportionment of income based upon the source of the income should be allowed in principle:

> Turning now to the problem of locating a source of income, it is obvious that a taxpayer's activities, which are the originating cause of a particular receipt, need not all occur in the same place and may even occur in different countries,

> and consequently, after the activities which are the source of the particular "gross income" have been identified . . . it may be necessary to come to the conclusion that the "source" of a particular receipt is located partly in one country and partly in another . . . Such a state of affairs may lead to the conclusion that the whole of a receipt or part of it, or none of it is taxable as income from a source within the Union . . .

The judgement in Essential Sterolin Products (Pty) Ltd v CIR, 1993 (4) SA 859 (A), 55 SATC 357 confirms that it is often difficult to determine in which country the source of the income is located, and states with reference to the judgement in CIR v Black, 1956(3) SA 536(A), 21 SATC 226 that "[t]here may be a number of causal factors relevant to the ascertainment of source and, here it would seem, it is appropriate to weigh these factors in order to determine the dominant or main or substantial or real and basic cause of the receipt."

The judgement in First National Bank of Southern Africa Ltd v Commissioner for South African Revenue Services confirmed that the legal principles, which should be taken into account when determining the source of income earned, were correctly articulated in the judgment of Essential Sterolin Products (Pty) Ltd v CIR, and that the "principles and approach laid down in the Essential Sterolin case were not in any way at variance with the judgment of Watermeyer CJ in the Lever Bros case."

Although the case of Tuck v CIR, 1988(3) SA 819(A), 50 SATC 98 relates to the distinction between the revenue or capital nature of amounts received, it is submitted that the following excerpts from the judgement provide support for the principle that income may need to be apportioned in certain circumstances:

> There is, so far as I am aware, no authority for this proposition in our case law. Nevertheless . . . it seems to me that in a proper case apportionment provides a sensible and practical solution to the problem which arises when a taxpayer receives a single receipt and the quid pro quo contains two or more separate elements, one or more of which would characterize it as capital. It could hardly have been the intention of the legislature that in such circumstances the receipt

be regarded wholly as an income receipt . . . or wholly as a capital receipt . . . The problem in this case is to establish an acceptable basis of apportionment.

As neither the judgement in Essential Sterolin Products (Pty) Ltd v CIR nor the judgment in First National Bank of Southern Africa Ltd v Commissioner for South African Revenue Services sought to apportion the source of the income earned, but chose to determine the dominant source after weighing the facts of the case, it is concluded that the arguments put forward by The Fifth Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1997), De Koker (2009) and Williams (2005) would not necessarily be followed by the courts in a situation where the services are rendered partly in South Africa and partly outside South Africa. The income earned from rendering services has been regarded as having a South African or deemed South African source for purposes of this thesis, and consequently the principles governing the possible apportionment of income will not be discussed in any further detail.

5.4 Attribution of profits to a Permanent Establishment

Paragraph 18 of the Commentary to Article 7 states that there are two steps in determining the profit to be attributed to a permanent establishment. The first step of the two-step process is a functional and factual analysis of the activities using guidance provided by the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2001) in order to hypothesize the Permanent Establishment as a distinct and separate enterprise. The second step is to calculate the income to be attributed to the permanent establishment using the principles developed for application of the arm's length principle between associated enterprises.

In an interview, Olivier (2009d) stated that "[a]s the OECD guidelines are currently not very clear, I do not see a problem if a state uses domestic laws to allocate the profits.". Olivier (2009d) further confirmed that while the OECD recently issued a guide on the attribution of profits to a permanent establishment, no fixed rules exist concerning the attribution of income to a permanent establishment. It is therefore submitted that once it has been determined that there is a permanent establishment

in South Africa, the South African source rules would be used to attribute profits to the permanent establishment.

Rohatgi (2005) confirms that it is left up to the domestic legislation of the source state to determine the taxable income, and states further that there are two main methods of attributing profits, namely the "direct method", which refers to attribution of profits on an arm's length basis (technically more correct) and the "indirect method", which is formula based and although easier may not reflect the profits calculated using the "arm's length" basis.

Paragraph 11 of the Commentary to Article 7 provides that profits may be attributed to a permanent establishment based upon the functions performed even though the entity as a whole does not make a profit, and by contrast no profit may be attributed to the permanent establishment – even though the entity as a whole did make a profit. This confirms that the quantum of taxable income should be determined assuming an "arm's length" basis.

It is concluded that income should be attributed to the permanent establishment in terms of South African statutory and case law, and that only South Africa legislation contains the necessary taxing provisions. As the Income Tax Act states that a non-resident will be taxed only on income from a South African or deemed South African source, South Africa would only be entitled to tax the income of a foreign company, which is attributable to a permanent establishment in South Africa and which has a South African or deemed South African source.

DTAs based upon the United Nations Model Tax Convention often attribute income to permanent establishments using the "force of attraction principle". Olivier and Honiball (2008:106) explain that the term "force of attraction" indicates that a country may tax all profits derived in that country if the foreign company has a permanent establishment in the country, "irrespective of whether that income is derived through or otherwise economically connected with the permanent establishment".

As paragraph 10 of the OECD Commentary on Article 7 states that the profit which may be taxed in a country is limited to the profit attributable to the permanent

establishment in the country, and the application of the general force of attraction principle seeks to tax income, which is clearly not attributable to the permanent establishment, it is concluded that this principle is not consistent with the OECD Model Tax Convention. Bennett (2008) is in agreement that this principle should be rejected.

It is concluded from paragraphs 10, 11 and 25 of the Commentary on Article 7 (when read together) that the profit to be attributed to a permanent establishment will be limited to that arising as a result of the activities carried on by the foreign enterprise through the permanent establishment, and that this is of particular relevance when the activities of different parts of an enterprise may result in income being generated in the same country. This may be relevant to the thesis as the income attributable to the permanent establishment in South Africa should be limited to the activities carried on by the permanent establishment and not include the results of any other activities of the foreign company in South Africa.

Olivier and Honiball (2008) highlight the following problems, which may arise if the OECD recommendations are used to attribute profits to a permanent establishment in South Africa:

1) Notional amounts, which the permanent establishment would be deemed to have incurred in terms of the arm's length principle, but which were not actually incurred as the permanent establishment and the foreign head office form part of the same company, and a taxpayer cannot transact with itself, would not be deductible.
2) The question whether South Africa has a right to tax income, which is neither from a South African nor a deemed South African source, yet which is attributed to the permanent establishment.

It is concluded that as the "gross income" definition in section 1 of the Income Tax Act only includes the income of a non-resident, which is from a South African source or a deemed South African source (and not amounts from outside of South Africa), South Africa would not have a right to tax the income mentioned in point 2 above.

It is concluded from the above that one would begin by establishing if the activities of the foreign company have resulted in the creation of a permanent establishment in South Africa, and that if a permanent establishment has been created the South African source rules would be used to attribute profits to the permanent establishment. It is further concluded that while the DTA may grant South Africa the right to tax the income attributable to the permanent establishment, it is only the South African legislation which contains the necessary taxing provisions.

5.5 Taxing amounts paid to employees of a Permanent Establishment

South Africa's right to tax the income earned by the employees of the permanent establishment is discussed by examining the provisions of Article 15 of the OECD Model Tax Convention (and the applicable OECD Commentary). Article 15 presupposes a contractual relationship between an employer and an employee, and would therefore not deal with the income accruing to an independent contractor (Olivier & Honiball: 2008).

Article 15(1) provides a general rule for the taxation of income from employment, including salaries and wages and other similar remuneration. The income will be taxed in the State of Residence of the employee, unless the services are rendered in another State, in which case the income earned in respect of services rendered in the other State will be taxed in that other State. This general rule does not apply, however, in respect of pensions, government services and the non-employment remuneration of directors, as these types of income are covered by Articles 18 and 19 of the OECD Model Tax Convention.

The general rule provided in Article 15(1) would have the effect (if taken in isolation) that the income earned by an employee of a foreign company, who is a resident of the foreign country, would be taxable in South Africa if the income was earned for services rendered while in South Africa. It is submitted that this general rule equates to taxing the amount paid for services rendered by an employee on a source basis. Taxing employment income earned in South Africa based upon where the employment is actually exercised, is consistent with the judgments of several South

African court cases (for example CIR v Lever Bros & Unilever Ltd and CIR v Epstein).

Article 15(2) contains an exception to paragraph 1. This exception has the effect that the income earned as a result of services rendered to an employer will be taxed in the State of residence of the employee if all three of the conditions of paragraph 2, which are listed below, are met:

a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
c) The remuneration is not borne by a permanent establishment which the employer has in the other State.

The first two conditions mentioned above will not be discussed for purposes of this thesis as they are regarded as being outside the scope of this thesis. As it was concluded in chapter 4 that the services rendered by the foreign company would be regarded as a permanent establishment in South Africa, the third condition will be discussed in more detail below.

Paragraph 7 of the OECD Commentary on Article 15 states that the

> phrase 'borne by' must be interpreted in the light of the underlying purpose of subparagraph c) of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that could give rise to a deduction . . . in computing the profits of a permanent establishment situated in the State where the employment is exercised.

Paragraph 7 of the OECD Commentary goes on to explain that it is not necessary that the permanent establishment claim the remuneration as a deduction, but that the correct test is whether any deduction was available to the permanent establishment in respect of the remuneration paid (taking the principles of Article 7

into account). It is submitted that the principle of Article 7, which is referred to, is that profits similar to those which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities in the same or similar circumstances, should be attributed to the permanent establishment. The expenditure referred to would therefore include not only the expenditure actually claimed by the permanent establishment, but would include all expenditure, which the permanent establishment is entitled to claim.

If the remuneration paid to an employee for services rendered in South Africa is borne by a permanent establishment of the foreign company, which is located in South Africa and it claims (or is entitled to claim) the amount as a deduction when computing the profits of the permanent establishment, the third condition of Article 15(2) would not be met and consequently the exception provided by Article 15(2) would not apply. An employee of the foreign company would therefore not be able to rely upon the exception provided in Article 15(2) with regard to amounts earned for services rendered to a South African permanent establishment of the foreign company, irrespective of where the amounts were paid or whether the permanent establishment claimed the expenditure as a deduction.

Article 15 of the OECD DTA would therefore grant South Africa the right to tax the income earned by the employees of the permanent establishment for services rendered in South Africa, and it would be left to the South African Income Tax Act to tax the said income. As stated above, South African case law is consistent with source principle in Article 15(1) and the income earned by these employees would be subject to income tax in South Africa.

As stated in chapter 1, it has been assumed for purposes of this thesis that the employees of the permanent establishment are not resident in South Africa. Section 1 of the Income Tax Act states that a natural person will be regarded as resident in the Republic if he or she is either ordinarily resident or physically present in the Republic for a minimum period of time during the current year (as well as during each of the preceding five years). It is submitted that if the employees of the permanent establishment are physically present in the Republic for sufficient time they will be regarded as residents of the Republic for Income Tax purposes, and

consequently, "the total amount, in cash or otherwise, received by or accrued to or in favour of such resident" (section 1) will be included in the person's gross income and subject to tax in South Africa. If this leads to the employees being resident in South Africa and another country, there are Articles in the OECD DTA, which deal with the allocation of taxing rights, but a discussion of such Articles is regarded as being outside the scope of this thesis.

5.6 Conclusion

It has been demonstrated that South Africa would only be entitled to tax a foreign company if it has a permanent establishment in South Africa, and that South Africa would only be entitled to tax the income attributable to the permanent establishment. While the OECD has issued guidelines concerning the attribution of income to permanent establishments, it will be assumed for purposes of this thesis that South Africa would be entitled to use domestic statutory and case law to attribute profits to the South African permanent establishment.

It has also been shown that it is only the South African Income Tax Act which has the right to impose tax in South Africa, and that the definition of "gross income" in section 1 of the Income Tax Act states that a non-resident would be subject to tax in South Africa only on income from a South African or deemed South African source. It is submitted that as the income earned by the South African permanent establishment as a result of services rendered in South Africa would have a South African source, the income would be taxable in South Africa.

It is also concluded that South Africa would have the right to tax the income earned by employees of the permanent establishment for services rendered in South Africa, and that it would be left to the South African Income Tax Act to impose tax on the said income, in terms of the provisions of the Income Tax Act.

CHAPTER 6 – CONCLUSION

6.1 The argument presented

The goal of the research was to investigate the right of the South African government to tax the income earned by a foreign company rendering services in South Africa on a recurrent basis to a South African associated enterprise, and the right to tax the amounts paid to the non-resident employees of the permanent establishment rendering the services in South Africa.

Chapter 2 discusses the legal status of DTAs in relation to the Income Tax Act, the Constitution and national and international rules for the interpretation of statutes, and concludes that a DTA will have the same legal effect as any other section in the Income Tax Act, and when there is a conflict between the provisions of the DTA and the provisions of the Income Tax Act, the DTA should be taken as overriding the conflicting legislation in the Income Tax Act. It is further concluded that the provisions of the Vienna Convention on the Law of Treaties should be taken into account when interpreting South African legislation (including DTA).

Chapter 3 discusses the significance of the Commentary on the OECD Model Tax Convention, and the conflicting views on the reliance which may be placed upon the Commentary. It is concluded that the OECD Commentary may be relied upon when interpreting OECD based DTAs in South Africa after taking the following into account:

- the significance of the Vienna Convention on the Law of Treaties, which is regarded as a codification of customary international law, and as such forms part of South Africa law;
- the judgment in SIR v Downing 37 SATC 249(A) 1975, which upheld the principle that the South African courts were bound to take cognisance of the guidelines for interpretation issued by the OECD in its Commentary as South Africa had adopted the Model Tax Convention as a basis for its own treaties;
- the views of Olivier and Honiball (2008), who suggested that the OECD Commentary may be regarded as Customary International law in South Africa

as a result of its acceptance by the South African courts, and therefore forms part of South African law; and

- foreign case law, which would be of persuasive value in South Africa, and which provides support for placing reliance upon the OECD Commentary when interpreting DTAs, which are drawn up based upon the OECD Model Tax Convention.

It is concluded in chapter 4 that the services rendered by a foreign company on a recurrent basis to an associated enterprise would create a "place of business" - in spite of the fact that the foreign company may have no formal legal right to the space, provided that the space is made available to it.

Services, which are rendered regularly on a recurrent basis at the same premises and to the same South African entity, would be geographically and commercially coherent and consequently meet the "location test'. It is clear that as the services are rendered regularly and recurrently, they would be regarded as having the necessary permanence and meet the 'duration test'. The place of business would therefore be regarded as being fixed (having the necessary degree of permanence).

As the services would be rendered at the place of business of the South African entity, they would be regarded as being rendered 'through' the place of business and the foreign company would be regarded as having a permanent establishment in South Africa (as defined in Article 5(1) of the OECD Model Tax Convention).

Chapter 4 also discusses Articles 5(2) to 5(7) of the OECD Model Tax Convention and concludes that the articles are either not applicable or do not add anything to resolving the research question.

Chapter 5 demonstrates that South Africa would only be entitled to tax a foreign company if it has a permanent establishment in South Africa, and that South Africa would only be entitled to tax the income attributable to the permanent establishment. While the OECD has issued guidelines concerning the attribution of income to permanent establishments, it was assumed, based on the arguments presented, that for the purposes of this thesis, South Africa would be entitled to use domestic

statutory and case law to attribute profits to the South African permanent establishment.

It has also been shown that it is only the South African Income Tax Act, which has the right to impose tax in South Africa and that, as the definition of "gross income" in section 1 of the Income Tax Act provides that a non-resident would be subject to tax in South Africa only on income of a South African or deemed South African source, the income earned by the South African permanent establishment as a result of services rendered in South Africa would have a South African source, and consequently the income would be taxable in South Africa.

It was also concluded that South Africa would have the right to tax the income earned by an employee of the permanent establishment for services rendered in South Africa, and that it would be left to the South African Income Tax Act to impose tax on the said income, in terms of the provisions of the Income Tax Act.

6.2 Issues considered, but regarded as outside the scope of the thesis

The following issues relating to the field of the research were considered in the thesis, but a comprehensive discussion was judged to be outside of the scope of the research:

2008 Changes to the Commentary on the OECD Model Tax Convention

The OECD made changes to its Commentary on Article 5 in the 2008 OECD Model Tax Convention, which was released in June 2008. The changes, which provide an alternative to the provisions contained in Article 5 for services provided by a foreign enterprise to third parties in a State, are contained in paragraphs 42.11 to 42.48 of the Commentary and are proposed for use in future treaty negotiations,. The Commentary states in paragraphs 42.24 and 42.25 that the "alternative provision constitutes an extension of the permanent establishment definition . . ." and that "the provision has the effect of deeming a permanent establishment to exist where one would not otherwise exist under the definition provided in paragraph 1 and the

examples of paragraph 2." Paragraph 42.23 states that the alternate provision applies, notwithstanding the provisions of Articles 5(1) and 5(2).

Paragraph 42.25 states that "[i]f it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to apply the provision in order to find a permanent establishment. Since the provision simply creates a permanent establishment when none would otherwise exist, it does not provide an alternative definition of the concept of permanent establishment and obviously cannot limit the scope of the definition in paragraph 1 . . . "

It is therefore submitted that if the recurrent services of the foreign company result in the formation of a permanent establishment in South Africa (in terms of the provisions of Article 5(1)), the OECD proposed provision would not affect or limit this (if the DTA between the country of residence of the foreign company and South Africa contained the proposed provision).

The OECD Commentary to Article 5 provides insight into the reason for the 2008 changes to the Commentary in paragraph 42.14 to 42.16, and states that:

> Some States . . . are reluctant to adopt the principle of exclusive residence taxation of services that are not attributable to a permanent establishment situated in their territory but that are performed in that territory . . . They consider that, from the exclusive angle of the pure policy question of where the profits originate, the State where services are performed should have a right to tax even when these services are not attributable to a permanent establishment as defined in Article 5 . . . These States are concerned that some service businesses do not require a fixed place of business in their territory in order to carry on a substantial level of business activities therein and consider that these additional rights are therefore appropriate.

The term "services" is not defined in the OECD Model Tax Convention and it is submitted that it is intended that the term be interpreted broadly, and within the ordinary meaning given to the term. Many large industrialised countries have

included provisions similar to the OECD proposed provision in their DTA with developing countries so as to give the developing countries greater right to tax on the basis of source.

Russo (2008) provides a brief outline of paragraphs 42.11 to 42.48 of the Commentary on Article 5 and states that the alternative provision introduces three basic principles:

1. that services performed outside of the source state are not taxable therein, and that services are performed in the state where persons are physically present for the purpose of providing such services;
2. that tax should be levied on a net rather than gross basis, and that the expenses incurred to produce the income from services should be taken into account in determining the taxable income; and
3. that source state taxation is allowed only when a certain threshold is reached .

Paragraph 42.22 of the Commentary confirms the third bullet point above and states that "there should be a minimum level of presence in a State before such taxation is allowed."

Paragraph 42.23 provides the following example of a provision, which may be included in DTAs:

> Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State
>
> a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 percent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
> b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for

connected projects through one or more individuals who are present and performing such services in that other State

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purpose of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.

As paragraph 42.34 states that sub-paragraph 42.23 (a) refers to an enterprise carried on by a single individual, it is submitted that this sub-paragraph would not be applicable to this thesis as the thesis assumes that a foreign company rendered the services in South Africa (not a single individual).

Paragraph 42.39 states that subparagraph 42.23(b) "addresses the situation of an enterprise that performs services in a Contracting State in relation to a particular project (or for connected projects)", and it appears that this sub-paragraph may be relevant to recurrent services rendered in South Africa by a foreign company. Paragraph 42.41 explains further that the term "connected projects" was intended to "cover cases where the services are provided in the context of separate projects . . . but these projects have commercial coherence". Various factors are provided in paragraph 42.41, which may be relevant when determining if projects should be regarded as "connected projects". These factors include (inter alia):

- "whether the projects are covered by a single master contract"; and
- "whether the nature of the work involved under the different projects is the same".

It is submitted that while each case would need to be evaluated based upon its merits, in the writer's experience as an auditor at the South African Revenue Services, the services which are rendered on a recurrent basis by a foreign company to an associated enterprise in South Africa, are often rendered in terms of a "master contract" and the nature of the work performed is often the same. It is therefore submitted that if the recurrent services rendered in South Africa by a foreign company are not rendered "for the same project" they may qualify as a "connected project".

Paragraph 42.23(b) also requires that the services be performed through one or more individuals, who are present and performing the services in the State for a minimum period of 183 days in any twelve month period.

It is therefore concluded that if the recurrent services are rendered for the "same project" or a "connected project" (either in terms of a "master contract" or because the nature of the work is the same), and the individuals performing the services were present in South Africa for more than 183 days in any twelve month period, the provisions of paragraph 42.23 (quoted above) may well apply. It must be stressed, however, that these provisos would only be relevant in the future if the DTA between South Africa and country of residence of the foreign company includes such a provision.

Paragraph 42.46 states further that the proposed provision would have the effect that the activities carried on would be "deemed to be carried on through a permanent establishment in that other State for the purposes of all the provisions of the Convention . . . and the profits derived from the activities carried on in the other State in providing these services are attributable to the permanent establishment and are therefore taxable in that State pursuant to Article 7." Paragraph 42.47 goes on to emphasise that by "deeming the activities carried on in the performing of the relevant services to be carried on through a permanent establishment . . . the provision allows the application of Article 7 . . ." and therefore the State is entitled to tax the profits attributable to the activities.

It is concluded that the paragraph 42.23, which is provided as an alternative for inclusion in future DTA, would only be applicable to the recurrent services rendered by a foreign company in South Africa if the services were rendered in terms of the same contract (or as part of a "connected project"), and if the recurrent services had not qualified as a permanent establishment in terms of Article 5(1) of the OECD Model Tax Convention. If the proposed provision were to be included in the DTA between South Africa and country of residence of the foreign company, it would therefore extend the definition of a permanent establishment to include situations where a "fixed place of business" does not exist in South Africa, and not limit the definition of a permanent establishment.

Paragraph 5(3)(b) of the UN Model Tax Convention, which is almost identical to the Article 5(3)(b) in the South African Model Tax Convention states that:

> The term "permanent establishment" also encompasses:
>
> (b) 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 six months within any twelve-month period.

The provisions of Article 5(3)(b) of the UN Model Tax Convention deems a permanent establishment to exist based upon physical presence and does not require a fixed place of business to exist. While the Article 5(3)(b) of the UN Model Tax Convention was not compared in detail to the OECD proposed provision as this is regarded as being outside the scope of this thesis, it is submitted that Article 5(3)(b) of the UN Model Tax Convention is materially similar to the 2008 OECD proposed provision (contained in paragraph 42.23 of the 2008 OECD Commentary to Article 5). While a detailed discussion of the South African Model Tax Convention (referred to in chapter 3) is regarded as outside the scope of this thesis, it is noted that the Article 5(3)(b) of the South African Model Tax Convention is almost identical to Article 5(3)(b) of the UN Model Tax Convention.

The DTAs concluded by South Africa have been examined and out of eighteen DTA's concluded with African countries, twelve include an Article 5(3)(b) service provision which is similar to the clause included in the South African Model Tax Convention. Of fifty DTA's concluded with other non-African countries in the world (many of which are large industrialized countries which may render services in South Africa), only twenty DTA include provisions similar to the Article 5(3)(b) service provision in the South African Model Tax Convention. It is noted, however, that many of the more recent treaties tend to include a provision similar to Article 5(3)(b) of the South African Model Tax Convention, which would extend South Africa's right to tax services rendered in South Africa.

Value-Added Tax

This thesis has focused solely on the Income Tax implications of the recurrent services rendered by the foreign company, and has not taken the possible value-added tax (VAT) implications into account. While a detailed analysis of the possible VAT implications of the recurrent services rendered in South Africa is regarded as being outside the scope of this thesis, a brief discussion of the possible VAT implications of recurrent services rendered in South Africa follows.

Section 23 of the Value-Added Tax Act no 89 of 1991, as amended (the "VAT Act"), states that:

> Every person who, on or after the commencement date, carries on any enterprise and is not registered, becomes liable to be registered -
>
> a) at the end of any month where the total value of taxable supplies made by that person in the period of 12 months ending at the end of that month in the course of carrying on all enterprises has exceeded R1 million;
>
> b) at the commencement of any month where there are reasonable grounds for believing that the total value of the taxable supplies to be made by that person in the period of 12 months reckoned from the commencement of the said month will exceed the above-mentioned amount . . . (own emphasis)

Section 1 of the VAT Act defines a "vendor" as "any person who is or is required to be registered under this Act . . . "

Section 1 of the VAT Act also defines the term "taxable supply" as

> any supply of goods or services which is chargeable with tax under the provisions of section 7(1)(a), including tax chargeable at the rate of zero per cent under section 11; (own emphasis)

Section 7(1)(a) of the VAT Act states that :

> Subject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value-added tax-
>
> a) on the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him . . . (own emphasis)

It is clear from the definitions quoted above that if a person carries on an "enterprise" in South Africa, and has taxable supplies or reasonably expects to have "taxable supplies" in excess of R1 million in a twelve month period, the person is required to be registered. It is also clear from the definition of a "vendor" that both a person who is registered and one who ought to be registered, is classified as a "vendor". As the definition of "taxable supply" includes "services", it is submitted that the services rendered by the foreign company in South Africa would qualify as a "taxable supply" (subject to the provisions of section 7(1)(a)).

Section 1 of the VAT Act defines the term "enterprise" as meaning

> a) in the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the

Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration . . . (own emphasis)

While the facts surrounding the rendering of the services must be considered, it is submitted that rendering of services on a recurrent basis in South Africa may be regarded as the continuous or regular carrying on of an enterprise or activity in the Republic, and, if that is so, it is concluded that the foreign company would be required to register for VAT (in terms of section 23 of the VAT Act) and levy VAT on the services rendered to the South African associated enterprise (if the supply of the services is regarded as a taxable supply and the value of the taxable supply exceeds or is reasonably expected to exceed R1 million in a twelve month period).

6.3 Contentious points raised in the research

The following arguments have been raised by other authors, which are in conflict with certain of the conclusions of this thesis:

1. The activities conducted at the fixed place of business by the foreign company would be regarded as of a subsidiary nature in relation to the overall purpose of the company, and consequently a permanent establishment would not be deemed to exist in terms of Article 5(1) of the OECD Model Tax Convention.

   It is submitted that Article 5(1) does not require that the activities of the permanent establishment be that of the core business of the company, and that it is Article 5(4) which may exclude the fixed place of business from the definition of permanent establishment as a result of the activities being of an auxiliary or preparatory nature. However as stated in chapter 4, Article 5(4) would not be applicable to the activities of the foreign company in South Africa as the services are rendered to a third party and not to the entity itself.

2. Rendering services at different places on the premises of the South African company does not represent the same geographical location and consequently a fixed place of business would not exist.

It is submitted that while paragraphs 5.2 to 5.4 of the OECD Commentary to Article 5 provide support for the argument that the services rendered within a premises would constitute one location and therefore a fixed place of business (as discussed in chapter 4), if the services were rendered at separate places of business, it is clear that the fixed place of business test would have to be satisfied at each place.

3. The fact that the space is not at the foreign company's continuous disposal, or for their exclusive use, has also been raised as an indication that the activities do not constitute a fixed place of business.

   As stated in chapter 4 it is neither required that the space be at the foreign company's continuous disposal, nor that the foreign company have exclusive use of the place of business.

4. There is no link between the different types of services rendered at the different places in the factory at different times. It is therefore questionable whether the services rendered are recurrent in nature as each visit is requested individually and the services rendered at each visit may not be identical.

   It is submitted that if the services are rendered in terms of a "master contract", which states that a certain type of service will be rendered to the South African entity as and when required, the necessary continuity and recurrence of activity would be present, and the activities may be regarded as recurrent in nature. While each case must be decided based upon its own facts, it appears that where the foreign company renders different, unrelated services to the South African entity, this may lack the "commercial coherence" required for a "fixed place of business".

5. It may be argued that the time spent rendering services during each recurrent visit is insufficient for the necessary permanence and consequently would not constitute a permanent establishment.

It is impossible to provide a set guideline and each case would have to be judged on its own set of facts in order to establish if the recurrent services rendered in South Africa have resulted in the necessary degree of permanence.

6. It may prove difficult to attribute profits to the work done in South Africa.

   While it is impossible to provide a set guideline and each case would have to be judged on its own set of facts, it is submitted that the South African source rules would be used to attribute the profits to the permanent establishment.

6.4. Limitations of the research

Due to the fact that this is a thesis of limited scope, several assumptions were made in the thesis. Certain of these assumptions arise because the writer of this thesis has taken a view on a contested issue, which view is supported by eminent authors on the subject.

The following assumptions were adopted for the purpose of the thesis:

1. That the income earned by the foreign company when rendering services to an associated enterprise in South Africa has its source or deemed source in South Africa, and that the income earned by the employees of the foreign company, who are rendering services to the associated enterprise in South Africa, has its source or deemed source in South Africa.

2. Consequently it has been assumed for purposes of this research that the income attributed to the permanent establishment has its source or deemed source in South Africa, and would be subject to tax in South Africa in terms of the South African Income Tax Act.

3. That the provisions of the DTAs do take precedence over the provisions of the Income Tax Act and that the Commentary should be taken into account when interpreting the DTAs.

4. That the income earned by the foreign company represented Business Profits (dealt with in Article 7 of the OECD Model Tax Convention) and not "Royalty income" (dealt with in Article 12 of the OECD Model Tax Convention).

6.5 Other possible areas for research

In addition to a detailed analysis of issues pertaining to the limiting assumptions, the following additional areas for research or research questions have come to light during the completion of this thesis:

1. Should a fee for technical services be taxed as "Royalties" in terms of Article 12 of the OECD Model Tax Convention, as "Business Profits" in terms of Article 7 of the OECD Model Tax Convention (as assumed for purposes of this thesis) or in terms of a separate article ? This would include an analysis of how this new article would fit into the existing OECD Model Tax Convention and the principles contained therein.

2. A critical analysis of the OECD Report on the Attribution of Profits to permanent establishments, which was issued in July 2008, from a South African perspective. This would include a comparison of the principles contained in the OECD Report on the Attribution of Profits to permanent establishments (2008), the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2001) and South African legislation and case law.

6.6 Conclusion

The present research was prompted by a practical question relating to South African taxing rights under a DTA in a frequently occurring situation where the inability of the tax authorities to levy income tax on the income generated would represent a substantial loss of revenue. In an argument using deductive reasoning and based on the theoretical principles established in tax legislation, the OECD Model Tax

Convention and the related Commentary, case law and the opinions of eminent authorities on the topic, within the limiting assumptions made, the thesis has shown that services rendered in South Africa by a foreign company to a South African associated enterprise on a recurrent basis would constitute a permanent establishment, and consequently the South African Government would be entitled to tax the income attributable to the permanent establishment, as well as the income earned by the non-resident employees of the permanent establishment.

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