

**Make your own notes
NEVER underline or
write in a book.**

**A comparison between the South African “source rules” in relation
to income tax and the “permanent establishment rules” as contained
in Double Taxation Agreements.**

A thesis submitted in partial fulfilment of the requirements for the degree of

Masters in Commerce (Taxation)

of

Rhodes University

by

Leonie Fourie

November 2007

Abstract

South Africa's right to tax the income of a non-resident is determined in terms of the South African "source rules" established by court decisions in relation to the imposition of tax in terms of the Income Tax Act. Unless a non-resident's income is captured by the South African "source rules" (on the basis that his/its income is derived from a South African source), South Africa would have no right to tax such income, even if such non-resident creates a permanent establishment in South Africa by performing business activities within South Africa which could be considered essential (but not dominant) in nature. In such scenario the activities performed by the non-resident in South Africa may utilise the natural resources and the infrastructure of South Africa, but the South African *fiscus* would be deprived of the right to any tax revenues attributable to the income produced partly by such activities within South Africa. The South African "source rules" refer only to the main or dominant activities giving rise to the income for the purpose of determining the source of such income (and accordingly the right to tax such income). On the other hand, the "permanent establishment rules" as set out under the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital refer to all the taxpayer's essential business activities for the purpose of determining whether or not such activities create a permanent establishment. The result of the narrow nature of the South African "source rules" is that, under certain circumstances, the South African *fiscus* would not necessarily be granted the right to tax all income produced partly within South Africa. The research demonstrated that incorporating the principles underlying the "permanent establishment rules" into South African legislation would be a reasonable and logical solution to the problem of determining the source of income. In so doing, the South African "source rules" would determine the source of income, and consequently South Africa's taxing rights, with reference to the essential business activities giving rise to such income. In such case South Africa would be afforded the right to tax the income of a non-resident in the event that it performs any of its essential business activities within South Africa, albeit not the dominant or main activities giving rise to the income.

Table of contents

	<i>Page</i>
Chapter 1: Introduction.....	5
Chapter 2: Determination of the residence status of a company for South African tax purposes.....	11
2.1 Introduction.....	11
2.2 The definition of a resident.....	12
2.3 Place of effective management of a company.....	12
2.4 Conclusion.....	15
Chapter 3: The South African “source rules”.....	16
3.1 Introduction.....	16
3.2 Establishing the source of income.....	16
3.3 The place where the taxpayer employed his capital.....	20
3.4 The place where the taxpayer performed his business activities.....	26
3.5 The place where the taxpayer concludes the contract, in terms of which the income is derived.....	32
3.6 A combination of the considerations referred to above.....	33
3.7 Apportionment of income between two or more sources, located in different countries.....	47
3.8 A summary of the South African “source rules”.....	52
Chapter 4: The “permanent establishment rules”.....	56
4.1 Introduction.....	56
4.2 The general effect which a DTA could have on the taxability of the non-resident multinational company.....	56
4.3 Article 5 of the OECD Model Tax Convention.....	58
4.4 Article 7 of the OECD Model Tax Convention.....	68

4.5 A logical conclusion on the application of the “permanent establishment rules” contained in Articles 5 and 7 of the OECD Model Tax Convention..... 76

Chapter 5: A comparison between the South African “source rules” and the “permanent establishment rules”..... 80

5.1 Introduction.....80

5.2 Similarities between the “source rules” and the “permanent establishment rules”..... 80

5.3 Contradictions between the “source rules” and the “permanent establishment rules”..... 82

5.4 Conclusion..... 92

Reference List.....95

Chapter 1: Introduction

With effect from 1 January 2001 the source-based taxation system of South Africa was replaced by a world-wide basis of taxation (the so called residence basis of taxation). In accordance with the residence-based system of taxation, the income earned by a non-resident would only give rise to a tax liability in South Africa in the event that the income was “received by or accrued to or in favour of such person from a source within... the Republic” (the definition of “gross income” in section 1 of the Income Tax Act, 58 of 1962).

The term “source” in the context of the “gross income” definition in section 1 of the Income Tax Act No. 58 of 1962 (the Act) is not defined, but the courts have established a number of “rules” for the purpose of determining the “source” of income and the location thereof. These rules are informally referred to as the South African “source rules”. The “source rules” are of particular relevance for the purpose of determining the taxability (from a South African perspective) of the income earned by, *inter alia*, a non-resident multinational enterprise which performs part of its business activities, which collectively give rise to its income, in South Africa.

The South African “source rules” can, in essence, be reduced to the “dominant cause” approach which has been followed by the courts in the past. Income is produced by the performance of activities, work or functions (in other words, such activities, work or functions are the *quid pro quo* or the originating cause of such income) (*CIR v Lever Brothers & Unilever Ltd* (1946 AD 441, 14 SATC 1). The “dominant cause” of income refers to the dominant or main activities, work or functions giving rise to the income in question. In terms of the “dominant cause” approach, where there is more than one originating cause of the income, the source of income is regarded to be located where the so-called “dominant cause” of the accrual of the income is located (*CIR v Black* (1957 (3) SA 536 (A), 21 SATC 226), *Transvaal Associated Hide And Skin Merchants v COT* (1967 (BCA), 29 SATC 97)). In accordance with the “source rules”, South Africa would only be afforded the right to tax the income earned by a non-resident multinational enterprise, in the event that the main or dominant activities, work or functions, giving rise to the income (in other words, the “dominant cause” of

the income), are performed in South Africa. The taxing rights determined in terms of the “source rules”, with specific reference to the “dominant cause” approach followed by the South African courts, would either subject the entire amount of income to tax in South Africa (relating to the income in question, earned by the non-resident multinational enterprise), or no part of it.

The question which should be asked is whether the “source rules” provide for dividing up the tax “cake” and sharing it, in the event that, as is prevalent in the era of multinational enterprises, the business activities of an enterprise are conducted in more than one jurisdiction, one of these being South Africa. Is it the South African courts’ approach to focus only on the main or dominant cause of income for the purpose of determining South Africa’s right to tax such income or is there authority for the apportionment of such income between South Africa and other jurisdictions (for the purpose of sharing the taxing right relating to such income between the various jurisdictions)?

Establishing that the South African domestic tax rules apply to a non-resident (as a result of an application of the “source rules”) only constitutes the first step in determining the taxability of the income earned by such non-resident from a South African perspective. On the basis that a non-resident is by implication resident in another country, the non-resident may be liable to tax on the income in question in his or its own country as well (which is the case in respect of most developed countries, which levy tax on a worldwide basis, in other words, in terms of the residence-based taxation system). Such scenario would give rise to economic double taxation of the same amount of income (in other words, the taxation of the same amount of income by two different jurisdictions).

For the purpose of avoiding economic double taxation, two jurisdictions would enter into an international agreement known as a Double Tax Agreement. In terms of such Double Tax Agreement the two jurisdictions would come to an agreement on how the right to tax the income of the non-resident is to be allocated or “shared” between themselves. A Double Tax Agreement does not create a taxing right but merely allocates an existing right to tax income to a specific jurisdiction (either in whole or in part), or divides such existing tax right between the two jurisdictions. Such allocation

or division of a taxing right is determined in terms of the “permanent establishment rules” contained in Double Tax Agreements. Therefore, if, as a result of an application of the “source rules”, it is found that a non-resident multinational enterprise is liable to tax in South Africa, a Double Tax Agreement would confirm South Africa’s right to tax the profits of such non-resident multinational enterprise, but only to the extent that that enterprise carries on its business through a permanent establishment situated in South Africa (in terms of Article 5 of the OECD Model Tax Convention). Following on this, it is further provided, in terms of a Double Tax Agreement, that only so much of those profits as are attributable to that permanent establishment may be taxed in South Africa (in terms of Article 7 of the OECD Model Tax Convention).

Whilst a Double Tax Agreement determines which country would be afforded an existing taxing right, it also specifically provides for sharing the right to tax, which differs from the South African “source rules”, which seem to suggest an “all or nothing” approach. Whilst the “source rules” determine the source of (and accordingly the right to tax) the income earned by a non-resident multinational enterprise only with reference to the dominant or main activities giving rise to the income (in other words, in terms of the “dominant cause” approach), the rules of a Double Tax Agreement seek to tax proportionately the income of a multinational enterprise in the event that *some* of the essential business activities which give rise to the income are performed in South Africa. In the event that some of the essential business activities are performed within South Africa, a Double Tax Agreement would seek to tax only so much of the income as relates to such activities (such portion is determined in terms of the “permanent establishment rules”). Provided the income earned by a non-resident multinational enterprise is captured by the “source rules”, South Africa would thus be awarded its “fair share” of the tax revenue in view of the above.

However, would South Africa be awarded its “fair share” of the tax revenue in the event that the income earned by a non-resident multinational enterprise is not captured by the “source rules”, whilst *some* of the essential business activities (but not the main or dominant activities), giving rise to the income, are performed in South Africa? Even though a Double Tax Agreement would seek to tax the income attributable to

such activities, it should again be borne in mind that the rules of a Double Tax Agreement do not, in itself, afford South Africa a right to tax income. The terms of the “source rules” could therefore, under such circumstances, deny South Africa that part (or the “fair share”) of the tax revenue, which relates to the non-resident multinational enterprise’s income, as is envisaged by the Double Tax Agreement rules. Is such outcome an unintended consequence of the “source rules” established by the courts?

In a global economy, multinational enterprises perform their business activities throughout the world. Do the terms of the “source rules” deprive South Africa of its “fair share” of tax revenue, under certain circumstances, on the basis that they disregard activities performed in South Africa by a non-resident multinational enterprise, unless they constitute the dominant or main activities which give rise to income?

For the purpose of addressing the questions raised above, further research into the origin of the “source rules” and the envisaged results of the “permanent establishment rules” is required. The goal of the research is to analyse and compare the South African “source rules”, in relation to income earned by a non-resident multinational enterprise, with the South African tax rules pertaining to the identification of a permanent establishment, read together with the rules pertaining to the attribution of business profits to such permanent establishment for tax purposes, accorded by Articles 5 and 7 of the OECD Model Tax Convention (in other words, the “permanent establishment rules”), in order to determine whether the present tax framework provides an appropriate basis for the taxation of multinational enterprises earning income in South Africa.

The research methodology that will be applied in the research will be interpretive. Relevant legislation, the relevant articles in the OECD Model Tax Convention and the findings by the courts in relation to the tax principles underlining the “source rules” will be interpreted for the purpose of defining the “source rules” and the “permanent establishment rules” and for the purpose of understanding their applicability. The research methodology will comprise a critical conceptual analysis of the interpreted

findings in order to reach a conclusion and propose changes to tax legislation, where appropriate.

The results produced by each enquiry will be compared in order to identify any similarities and differences between the rules. It will be determined how such similarities and differences affect the South African *fiscus*' right to receive tax revenues relating to income produced partly by the utilisation of South Africa's natural resources, infrastructure and inhabitants' activities.

The rules will also be evaluated against international benchmarks for the purpose of determining whether or not South Africa is moving towards the tax system followed in other countries. Possible relief available to non-resident multinational enterprises (the income of which is captured by the South African "source rules") in the form of tax credits will also be assessed.

In the event that it is found that the "source rules", as they presently stand, would no longer afford South Africa as much of the tax revenue as is envisaged by the Double Tax Agreement rules, a proposal to include a definition of source in section 1 of the Income Tax Act which is in line with the Double Tax Agreement rules, will be proposed.

The research will be discussed in Chapters 2 to 5 and will, in summary address the following:

In Chapter 2 the determination of the residence status of a company for South African tax purposes will be discussed. In the discussion reference will be made to the definition of a resident as it is contained in section 1 of the Income Tax Act. Such definition will, in turn, be discussed in more detail with specific reference to a company and its place of effective management.

After the determination of the residence status of a company is discussed, the discussion of the research will be continued in Chapter 3 with specific reference to a multinational company which is not tax resident in South Africa. In Chapter 3 South Africa's right to tax the income of such company will be discussed with reference to

the South African “source rules”. For the purpose of defining and understanding the South African “source rules” the relevant court decisions relating to the “source rules” will be analysed to determine the approach followed by the courts in determining the source of income and how, if applicable, the “source rules” have evolved over the years to compensate for the ever-growing globalisation of the economy.

In Chapter 4 the discussion of the research will be continued with specific reference to the non-resident multinational company. In Chapter 4 the rules contained in Double Tax Agreements will be discussed in order to illustrate the impact they have on South Africa’s right to tax the income of a non-resident. The “permanent establishment rules” contained in Double Tax Agreements will be discussed in detail on the hand of the example of the non-resident multinational company, in order to illustrate the circumstances under which South Africa’s right to tax such company’s income would be confirmed and to what extent.

In Chapter 5 the South African “source rules” and the “permanent establishment rules” will be compared in order to identify any similarities and differences. The impact of such similarities and differences on the South African *fiscus* will be illustrated and the adverse effects which the South African “source rules” may produce under certain circumstance will be emphasised. In conclusion, amendments to the South African tax legislation will be proposed to counter the adverse effects that the South African “source rules” may have on South Africa’s right to tax income produced partly within South Africa.

Chapter 2: Determination of the residence status of a company for South African tax purposes

2.1 Introduction

Prior to 1 January 2001 a source-based taxation system existed in South Africa. The system entailed the taxation of all income earned from a source within South Africa, irrespective of whether or not such income was earned by a taxpayer resident in South Africa. Prior to 1 January 2001 South Africa did not have the concept of tax residence status in its Income Tax Act.

With effect from 1 January 2001 the source-based taxation system of South Africa was replaced by a worldwide basis of taxation (the so called residence basis of taxation). The change was effected by the Revenue Laws Amendment Bill 70 of 2000. In accordance with the residence-based taxation system, all income earned by a South African tax resident is taxable in South Africa, irrespective of the location of the source of the income (as a general rule). On the other hand, in terms of the residence-based taxation system, the income earned by a person who/which is not a tax resident of South Africa would only give rise to a tax liability in South Africa in the event that the income was “received by or accrued to or in favour of such person from a source within... the Republic”. This submission is based on the “gross income” definition in section 1 of the Act.

On the basis that South African tax residents are subject to tax on all their income, whilst non-South African tax residents are subject to tax in South Africa only on income earned from a South African source, the first step in evaluating whether or not a person would be liable to tax in South Africa, should thus be determining whether or not such person constitutes a tax resident of South Africa. For the purposes of this thesis only corporate entities will be considered in this regard.

2.2 The definition of a resident

In terms of the definition of resident in section 1 of the Act a person, other than a natural person, is considered to be a resident for South African tax purposes in the event that “it is incorporated, established or formed in the Republic or” in the event that it “has its place of effective management in the Republic...”. A person other than a natural person includes juristic persons such as companies, close corporations, trusts and estates.

A company constituting a resident for South African tax purposes by virtue of its incorporation, establishment or formation in South Africa need not be discussed at length. It is a simple concept, which is sufficiently addressed as follows in paragraph 5.2E of *Silke on South African Income Tax, Memorial Edition, Volume 1*:

...A company that is formed and incorporated in the Republic in terms of s 32 of the Companies Act 61 of 1973 is, it is submitted, clearly a resident because of its formation and incorporation in the Republic, irrespective of where it is managed or where it carries out its business (De Koker, 2006:5-11 – 5-12).

2.3 Place of effective management of a company

A company constituting a resident for South African tax purposes by virtue of its place of effective management being in South Africa warrants further discussion. The term “place of effective management” is not defined in the Act and to date there is no reported decision by a South African court on the meaning of the term. In terms of the South African Revenue Service (SARS) Interpretation note 6 of 26 March 2002 a company’s place of effective management should be determined as follows:

...The place of effective management is the place where the company is managed on a ...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.

Management by these directors or senior managers refer to the execution and implementation of policy and strategy decisions made by the board of directors. It can also be referred to as the place of implementation of the entity’s overall group vision and objectives.

The SARS thus considers the place where the day-to-day management of a company is executed by its directors or senior management to be the place of effective management of such company.

In slight contrast to the above, the following view is expressed in *Income Tax in South Africa* in relation to the meaning of the term “place of effective management”:

The place of ‘effective management’ of an entity... is best described as the place at which the central executive management is located – typically the place from which the managing director exercises his function. This is distinct from the place at which the Board meets and the place or places in which day-to-day operational management is located, although they may well coincide. ...the greater likelihood is that there is only one place of effective management for any one entity, bearing in mind that it is the management of the entity, rather than its operations, which is being considered.

SARS has issued Interpretation Note 6 setting out its view of the meaning of the term. While the note largely follows the analysis above, it also states that SARS will pay heed to the place at which the Board of Directors meets, as well as the place at which operations are conducted. While this may well be relevant in cases where there is no clear separation between the functions of the Board, executive management and operational management..., it is considered that in most cases this would not be an appropriate consideration (Clegg & Stretch, 2007: paragraph 8.3.2.).

According to Clegg and Stretch the place of a company’s effective management is accordingly located where such company’s central executive management exercise their functions. Such location may not necessarily coincide with the location where the company’s day-to-day operational management activities are executed (which appears to constitute the place of effective management in the SARS’ view). It is furthermore submitted that a company can, in all likelihood, only have one place of effective management, whilst its operational management activities may possibly be executed in more than one place at a time.

The view expressed above is in line with the method of determination followed in terms of paragraph 24 of the Commentary on Article 4 of the Organisation for Economic Co-operation and Development Model Tax Convention. In terms of

paragraph 24 the place of a company's effective management is determined as follows:

The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. 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... An entity may have more than one place of management, but it can have only one place of effective management at any one time. (own emphasis)

The above passage and especially the underlined sentences, clearly coincide with the submissions quoted earlier from *Income Tax in South Africa*.

For the purpose of further clarifying the meaning of the term "place of effective management", the following submission of the Special Commissioner in the unreported United Kingdom case, *Wensleydale's Settlement Trustees v CIR*, is of relevance:

I emphasise the adjective "effective". In my opinion it is not sufficient that some sort of management was carried on in Ireland such as operating a bank account in the name of the trustees. "Effective" implies realistic, positive management. The place of effective management is where the shots are called, to adopt a vivid trans-Atlantic colloquialism.

Based on the above paragraph the word "effective" directly preceding the word "management" in the term "place of effective management" implies the term does not refer to normal or ordinary (or day-to-day) management. This is in contrast with the SARS' interpretation of the term "place of effective management". Drawing the conclusion that "'effective' implies realistic, positive management" appears logical and reasonable. Such conclusion is also in support of the views expressed in *Income Tax in South Africa* and the Commentaries on the Organisation for Economic Co-operation and Development Model Tax Convention.

Based on the discussion above, it is inferred that the place of effective management of a company is located where the central executive management of such company is located, and not where the company's day-to-day management activities are

performed. The location of a company's central executive management is typically the place from which the managing director or Chief Executive Officer exercises his function, in other words, "where the shots are called" (*Wensleydale's Settlement Trustees v CIR*).

A company which is not "incorporated, established or formed in the Republic" would thus constitute a resident for South African tax purposes in the event that its central executive management is located in South Africa. Conversely, in the event that it is located outside of South Africa, such company would constitute a non-resident for South African tax purposes. Based on the "gross income" definition in the Act the income of such non-resident company would only give rise to a South African tax liability in the event that the income was "received by or accrued to or in favour of" such company "from a source within... the Republic".

After establishing that a company is a non-resident for South African tax purposes, the second step in determining whether or not such company would be liable to tax in South Africa, should thus be determining whether or not it derived income from a source within South Africa.

2.4 Conclusion

In terms of the South African residence-based taxation system tax residents of South Africa are subject to tax on their worldwide income, irrespective of where it is earned. A company would be considered to be a tax resident of South Africa in the event that it was incorporated or established in South Africa or in the event that the place of its effective management is located within South Africa. In both respects, it would accordingly be subject to tax in South Africa in respect of all its income.

Conversely a company which is not a South African tax resident would only be subject to South African tax in the event that it derives its income from source located within South Africa.

Chapter 3: The South African “source rules”

3.1 Introduction

For the purposes of this thesis focus will be placed on a non-resident company, which carries on the trade of manufacturing and sale. It will be assumed that the manufacturing functions are performed wholly in a jurisdiction outside South Africa whilst the selling functions are performed wholly within South Africa. For ease of reference such company will be referred to as a non-resident multinational company.

The “source rules” are of particular relevance for the purpose of determining the taxability (from a South African perspective) of such non-resident multinational company, in view of the fact that it performs part of its business activities, which collectively give rise to its income, in South Africa (namely the selling functions).

In the event that it is determined that a company is not tax resident in South Africa (for example, the non-resident multinational company), it should be determined whether or not such non-resident company earned income which can be said to have been derived from a source located within South Africa. In such case such income would fall within the “gross income” definition contained in section 1 of the Act. Income constituting “gross income” for South African tax purposes is generally subject to tax in South Africa in terms of the South African domestic tax rules.

3.2 Establishing the source of income

The phrase “source within... the Republic” is not defined in the Act. According to Centlivres CJ in *CIR v Epstein* (1954 (3) SA 689 (A), 19 SATC 221) this may be due to the fact that “the Legislature... was probably aware of the difficulty in defining the phrase”. His comments were based on the view expressed by Watermeyer CJ in *CIR v Lever Brothers & Unilever Ltd* (1946 AD 441, 14 SATC 1), where he indicated “that it was probably an impossible task to formulate a definition which would furnish a universal test for determining when an amount ‘is received from a source within the Union’”. Consequently, in the words of Centlivres CJ in *CIR v Epstein (supra)*, “it is

for the Courts to decide on the particular facts of each case whether ‘gross income’ has or has not been received from a source within the...” the Republic of South Africa.

Accordingly, in the absence of a definition of the phrase “source within...the Republic”, the courts have laid down certain “rules” for the purpose of determining the source of income and the location thereof. These rules are informally referred to as the South African “source rules” (for ease of reference the South African “source rules” will be referred to in this document as the “source rules” only).

The “source rules” have generally been formulated by the courts following the approach suggested by De Villiers JA in his dissenting judgment of *Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes, Southern Rhodesia* (1938 AD 282, 9 SATC 363), namely:

“Source means not a legal concept but something which the practical man would regard as a real source of income. The ascertaining of the actual source is a practical hard matter of fact.” This is a quotation taken from a judgment of ISAACS, J., in an Australian case, *Nathan v F.C. of Taxes* (25, C.L.R. 183).

The above quotation has been referred to with approval in a number of cases dealing with the meaning of the phrase “source within...the Republic” (or “source within the Union”, as it was previously). Generally, the courts thus determine the source of income by taking into consideration the factual matrix of each case, and such facts are approached from the perspective of a “practical man”. In *Transvaal Associated Hide And Skin Merchants v COT* (1967 (BCA), 29 SATC 97) Roper P, in his dissenting judgment, pointed out that since such “practical man” “would need to have business experience and a grasp of income tax law and practice in order to decide” a question on source, “it seems... that in its practical application the phrase means nothing more or less than the judge, considering in a practical way all the factors in the earning of the” income.

To further aid the determination of the source of income the judgment of *CIR v Lever Brothers & Unilever Ltd* (*supra*) produced certain guidelines or “rules” which can be,

and have been, applied in most cases, irrespective of the nature or the income or the business of the taxpayer. These guidelines will be referred to as “universal guidelines” for the purposes of this thesis.

In *CIR v Lever Brothers & Unilever Ltd (supra)* the court had to decide whether or not the source of interest paid on credit was located within the Union of South Africa. In that case the taxpayer company (Lever Brothers) carried on business in England. The taxpayer sold assets to a Dutch company (Mavibel) on credit, on which Mavibel agreed to pay interest. For certain reasons a company (Overseas Holdings) was registered in South Africa. Overseas Holdings entered into an agreement with Mavibel abroad. The result of the agreement was that Overseas Holdings took over from Mavibel, *inter alia*, Mavibel’s obligation to pay to the taxpayer (Lever Brothers) the interest on the credit. The interest was paid out of dividends accruing to Overseas Holdings abroad on shares owned by it and pledged to the taxpayer as security. No services were rendered by Lever Brothers in South Africa and no obligations resting on Lever Brothers or Overseas Holdings were performed in South Africa. In authorising the agreement entered into by Overseas Holdings, the Treasury had imposed a condition that no capital or interest was to be paid from any funds in South Africa and this condition had been fully observed.

In that case, Watermeyer CJ formulated certain guidelines or “rules” which can be followed in determining the source of income. As submitted earlier, some of these guidelines or “rules” can be considered “universal guidelines”. They are summarised as follows:

- The source from which the income has been received must be determined. Such source is determined with reference to the originating cause of the income and not the quarter from which the income comes. The aforementioned originating cause is the work which the taxpayer does to earn the income, the *quid pro quo* which the taxpayer gives in return for which he receives the income. For example, such *quid pro quo* may take the form of a business carried on, an enterprise undertaken, an activity engaged in, or it may take the form of personal exertion (mental or physical), or the employment of capital either by

using it to earn income or by letting its use to someone else, or it can be a combination of these.

- When the source of the income has been determined, it should be located in order to establish whether or not it is within South Africa.

Applying the above guidelines or “rules” to the factual matrix of the case at hand, Watermeyer CJ was of the view that, in that case, the supply of the credit constituted the service which the lender (the taxpayer) performed in return for which he received the interest in question. The provision of the credit was thus the originating cause or source of the interest received by the taxpayer.

Watermeyer CJ accordingly held that:

... the source of the income... was the agreement between the parties that interest should be paid, and the performance by Levers of their obligations under it, which created the right of Levers to receive the money and the corresponding obligation of Overseas Holdings to pay it.

On the basis that the said agreement was concluded and that Lever Brothers performed its obligations under it, outside of the Union of South Africa, the source of the interest was held to be outside the Union of South Africa.

Subsequent to the above case sections 9(6) and 9(7) were, however, introduced into the Act which clarify the determination of the source of interest. Section 9(6) deems the source of interest to be located within South Africa in the event that the interest-producing funds or credit is utilised or applied within South Africa. With reference to corporate entities, in terms of section 9(7) the place of utilisation or application is deemed to be where the borrowing entity is effectively managed (until the contrary is proved).

As will shortly be revealed, whilst applying the “universal guidelines” referred to above with reference to *CIR v Lever Brothers & Unilever Ltd (supra)*, the source of income is generally determined by the courts on different bases, depending on the nature of the income in question or the nature of the taxpayer’s business. For

example, the courts have determined the source of income by taking into account, *inter alia*, one or more of the following considerations, the choice of which depended, to a large extent, on the nature of the income or the business of the taxpayer:

- The place where the taxpayer employed his capital;
- The place where the taxpayer performed his business activities; or
- The place where the taxpayer concluded the contract, in terms of which the income was derived.

The “source rules” will now be discussed in greater detail with reference to the above considerations, after which the concept of the apportionment of income between two or more sources will be addressed.

3.3 The place where the taxpayer employed his capital

In *Overseas Trust Corporation Ltd v CIR* (1926 AD 444, 2 SATC 71) the taxpayer was a company registered in South Africa and it had a branch in Windhoek. It purchased, in South Africa, certain interests in the South-West Africa Protectorate from its majority shareholder. The interests mainly consisted of shares and debentures in liquidated mining companies in the Protectorate. In respect of the shares held in the mining companies there were undistributed dividends due to the taxpayer (by virtue of its shareholding), which were in the hands of the Custodian of Enemy Property. The undistributed dividends were subsequently paid out to the taxpayer. The amount so received exceeded the price that the taxpayer paid for the shares, resulting in a profit. In addition to the aforementioned, the taxpayer also made a profit from the sale of certain shares, effected in Germany. The court had to decide whether the source of the profits was located within South Africa or not.

In determining the source of the profit relating to the dividends paid out by the Custodian of Enemy Property, Innes CJ referred to *Commissioner of Taxes v Dunn & Co.* (1918 AD) for guidance. In the aforementioned case the court looked to the place where the capital, which earned the income, had been employed for the purpose of

determining the source of that income. Innes CJ proceeded to refer to *Income Tax Act Annotated*, p.35 in which Menzies Murray remarked that-

the source of any income may be said generally to be the location of the business, capital, or service which produces the income. If this income-producer is located in the Union, then the particular income has been earned from a source within the Union.

In view of Murray's submission, Innes CJ acknowledged that had the companies in question (the shares of which gave rise to the dividend income in question) been going concerns engaged in their mining operations in the South-West Africa Protectorate, there would have been-

much to be said for the view that the shareholders drew their dividends from the same source as the companies; and that that source was outside the Union, where their business was being carried on and their capital being employed.

The companies were, however, liquidated and were no longer engaged in mining operations at the time when the taxpayer acquired the shares in them. Innes CJ accordingly dismissed the view that any of the business activities, capital, or services which produced the dividend income could have been located in the South-West Africa Protectorate. Innes CJ was accordingly of the view that the "income-producer", relating to the dividend income, could not have been located in the South-West Protectorate.

On the basis that the companies were liquidated, the shares in them were nothing more nor less than instruments entitling the taxpayer to certain monies which had been previously paid to, and were being held by, the Custodian. Such instruments were acquired in South Africa. As a result Innes CJ therefore concluded that the profit "sprang neither from business nor service, but from the employment within the Union of the capital expended in the acquisition of the shares or instruments referred to".

In determining the source of the profit earned on the disposal of the shares in Germany, Innes CJ remarked that the shares had been sold on the instructions of the

taxpayer from Cape Town at prices fixed by it. According to Innes CJ the German brokers were merely employed by the taxpayer to obtain purchasers for the shares, and that the transactions were controlled throughout from the taxpayer's Cape Town office. Innes CJ furthermore noted that there was no proof that the taxpayer carried on any business in Germany or employed any of its capital there. Innes CJ was accordingly of the view that none of the activities, which produced the profit, were performed in Germany. In conclusion Innes CJ therefore held that the source of the profit was located in South Africa where "the profit had been earned by the capital paid for the shares. That capital had been employed in the Union".

In summary the court thus determined the source of the income earned by the taxpayer by looking at the facts at hand and considering all the business activities, services or capital which could have constituted the "income-producer" in order to determine the source of the income. As a result of such enquiry Innes CJ expressed the following views:

- with reference to the dividend income: no business activities or services were performed and no capital was employed in the South-West Africa Protectorate. The "income-producer" could, accordingly, not have been located there. On the basis that the shares merely constituted instruments which entitled the taxpayer to dividends, the acquisition of such shares were accordingly considered to be the "income-producer". The acquisition took place (namely the capital was employed) in South Africa and the source of the income was accordingly held to be located in the Union;
- with reference to the profit on the disposal of the shares: It is inferred from the judgement that Innes CJ considered the activities which were performed in Germany (namely the obtainment of purchasers, under the control of the taxpayer's Cape Town office), to be insignificant or auxiliary in nature, hence the reason why he dismissed it in determining the source of the income. All the business activities, services or capital which could have constituted the "income-producer" were accordingly performed and employed in South Africa. The source was accordingly held to be located within South Africa.

Another case, in which the court regarded the employment of the taxpayer's capital to be the source of the income in question, is *Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes, Southern Rhodesia* (1938 AD 282, 9 SATC 363).

In that case the taxpayer company (Rhodesia Metals Ltd) was incorporated in England. The company purchased, in London (the contracts of sale were made there), certain mining claims located in Southern Rhodesia. The company went into voluntary liquidation and in London, disposed of, *inter alia*, the mining rights at a profit. The court had to decide, *inter alia*, whether or not the profit was earned from a source within Southern Rhodesia.

In his decision Stratford CJ acknowledged that the taxpayer's general business activities were conducted in London. He, however, acknowledged that, in addition to the taxpayer's general business activities, the taxpayer employed its capital in Rhodesia on the basis that the mining claims (which were acquired by the taxpayer) were located in Rhodesia. Stratford CJ based his aforementioned view on the fact that "the risk of depreciation or the hope of appreciation" of the mining claims "was attached to the Rhodesian acquisition". It is submitted further on in his judgment that he considered the fact that the contracts of sale were made in London to have little or no bearing on the matter at hand.

Stratford CJ accordingly drew a distinction between the taxpayer's general business activities which were performed in London and the employment of the taxpayer's capital in Rhodesia, and questioned whether the income was produced by the former or the latter. In addressing the question, Stratford CJ set out to determine whether it was the taxpayer's activities in Rhodesia (namely the employment of the capital in Rhodesia), or the taxpayer's general business activities in London, which constituted "the dominant cause of the profit". In order to determine which activities constituted the "dominant cause" of the income, the court endeavoured to ascertain whether it was the activities performed in London or the activities performed in Rhodesia which proved "instrumental in producing the profit". In this endeavour the court looked to the sequence of events that led up to the earning of the profit and the factual matrix, and found that a Sir Edmund Davis originally acquired the claims and created the

taxpayer. Sir Edmund Davis then gave “the benefit of his valuable acquisition to the Rhodesia Metals” for no consideration. It was the court’s view that it “was this fortunate and cheap purchase of the claims by Rhodesia Metals which enabled that taxpayer to make a profit”. It was furthermore the court’s view that the taxpayer (Rhodesia Metals) made the aforementioned “extremely fortunate purchase in Rhodesia by employing its capital there”. The court accordingly considered Rhodesia to be the location of the source of the profit.

In summary the court thus determined the source of the profit by looking at the factual circumstances and taking into consideration all the activities performed by the taxpayer, namely those in London and those in Rhodesia, which collectively gave rise to the profit. On the basis that the taxpayer performed such activities in two different jurisdictions the court set out to ascertain which of the activities constituted the “dominant cause” of the profit in order to locate the source of the profit. For such purpose the court took into consideration the factual matrix as well as the sequence of the events that led up to the earning of the profit. In considering the aforementioned, the court concluded that the activities performed in Rhodesia (namely the acquisition of the claims by the employment of the taxpayer’s capital) constituted the “dominant cause” of the profit and accordingly held the source of the profit to be located there. After identifying the “dominant cause” of the profit, the court disregarded the activities performed by the taxpayer in London, for the purpose of locating the source of the profit by concluding that the source of the profit was wholly located in Rhodesia. On such basis it is inferred that that court considered the activities in London to be-

- too insignificant in comparison to the activities performed in Rhodesia; or
- too remote from the actual earning of the profit (in other words, auxiliary in character),

so as to justify taking these activities into consideration for the purpose of locating the source of the profit.

Even though no capital in the form of currency was employed by the taxpayer in *Millin v CIR* (1928 AD 207, 3 SATC 170), the court adopted a similar approach, as discussed in relation to the two cases above, in determining the source of the income in question. In that case the taxpayer's wife (Mrs. Millin, whose income was included in the taxpayer's taxable income by the Commissioner) wrote novels in South Africa. A novel was published in England under a contract which was entered into in England. In terms of the contract Mrs. Millin retained the copyright of the novel and the publishers were granted a license to publish the novel. In return for the use of the license the publishers paid Mrs. Millin royalties. The court had to decide whether or not the source of the royalties was located within South Africa.

As a point of departure in determining the source of the royalties the court looked to what produced the royalties. Taking into account the background facts, the court remarked that Mrs. Millin's activities-

- in producing her novels, and
- in granting her publishers in England the right to print and publish the novels (in other words the subsequent dealing in her copyright)

constituted the business activities performed by her, which produced the royalties in question. The court furthermore remarked that her business did not depend on capital in the form of currency, but upon her wits and labour.

Although "Mrs. Millin's business of writing novels was based, not upon capital" in the form of currency, "but upon her wits and labour", the court still considered her business to be based on capital, namely capital in the form of her wits and labour. On the basis that the court considered her business to be based on capital (albeit not in the ordinary sense) the court referred to, *inter alia*, *COT v William Dunn & Co Ltd* (1918 AD 614) for guidance in determining the source of her royalties. In that case the court had regard of the place where the taxpayer employed his capital, which produced the profits in question, in determining the source of the profits.

In applying the test formulated in the aforementioned case, the court concluded that Mrs. Millin performed both her business activities in producing the novels, and her business activities in dealing with her publishers in England, in South Africa. In short it was the court's view that Mrs. Millin exercised her wits and labour, which collectively produced the royalties, in South Africa and the court considered such exercise to constitute the employment of her capital. The court accordingly held that "the source of the whole of her income" was located in South Africa, where she employed her wits and labour. The court considered the fact that the grant to her publishers of the right to publish her book was contained in a contract made in England to be irrelevant.

Similarly to the cases referred to earlier, the court in *Millin v CIR (supra)* thus determined the source of the royalty income on the following bases:

- it took into consideration the factual matrix in order to establish what produced the royalty income (as a result, the court considered the employment by Mrs. Millin of her wits and labour, to be the activities which produced the income);
- it identified those business activities performed by Mrs. Millin which could be considered insignificant, irrelevant or auxiliary in nature and disregarded such activities for the purpose of determining the source of the income (it is inferred that the court considered the making of the contract in England to fall within this category, on the basis that it was considered irrelevant in determining the source of the royalties and on the basis that the source of the whole of the royalties were held to be located in South Africa); and
- it established where Mrs. Millin employed her wits and labour (which, in the court's view, produced the royalties), in order to locate the source of the income, namely South Africa.

3.4 The place where the taxpayer performed his business activities

In *CIR v Epstein* (1954 (3) SA 689 (A), 19 SATC 221) the court considered the location where the taxpayer performed his business activities, which gave rise to the income in question, to be the location of the source of the income. In that case the

taxpayer was resident in Johannesburg where he carried on a business as an agent for foreign firms. In addition he entered into an agreement (signed by both parties in South Africa) with an Argentine firm, to purchase asbestos in South Africa and sell it in Argentina. In terms of the agreement the Argentine firm would find purchasers of asbestos in Argentina and notify the taxpayer of the quantity and quality of asbestos required, the price, and the producer who should be approached to supply it. The taxpayer would then approach the producer to obtain information regarding the availability of the asbestos, which he would convey to the Argentine firm. The Argentine firm would then conclude a sale in its own name with the purchaser, whilst the taxpayer would purchase the asbestos from the producer in his own name. The Argentine firm would then provide the taxpayer with the necessary funds to cover the purchase price of the asbestos, freight and insurance. The taxpayer would then arrange, in his own name, for the shipment of the asbestos to the Argentine purchasers. The taxpayer and the Argentine firm divided any profits so derived equally, and similarly shared any losses. The court had to decide whether or not the profits so derived by the taxpayer were derived from a source within South Africa.

As a point of departure in determining the source of the taxpayer's profits, the court applied the "universal guidelines", formulated by Watermeyer CJ in *CIR v Lever Brothers & Unilever Ltd* (1946 AD 441, 14 SATC 1), to the factual matrix of the case. In applying the "universal guidelines" the court identified the following activities (listed below), performed by the taxpayer in terms of the agreement with the Argentine firm, as the originating cause of the profits in question (on the basis that such activities produced the profits in question). In coming to this conclusion the court pointed out that:

- The taxpayer carried on his business activities, in terms of the agreement, in Johannesburg.
- He rendered no services and spent no money outside South Africa in connection with his association with the Argentine firm.
- He used his own banking account for the purpose of financing the transactions in respect of asbestos.

The court accordingly came to the conclusion that the taxpayer performed all of the activities listed above in South Africa, and that it was as a result of these activities that he earned his portion of the profits from the asbestos business. Based on this fact, the court held that the taxpayer earned his profits (namely the profits in question) from a source within South Africa.

It is noted that the court only looked at the transactions entered into, and the activities performed by the taxpayer, which were directly concerned with the asbestos business, for the purpose of determining the source of the profits in question. In the event that the taxpayer entered into any transactions, or performed any activities, in connection with his agency business, the court disregarded it completely. In addition, the court makes no mention of any income which the taxpayer may have derived from his agency business. It is not clear whether any such activities were performed, any such transactions were entered into or whether the taxpayer earned such income, but the court is completely silent in this regard. If applicable, the source of the income, derived from the agency business, may well have been located outside South Africa and accordingly free from South African tax (bearing in mind that a source-based taxation system existed at the time). In such scenario part of the taxpayer's income would accordingly have been subject to tax in South Africa and part of it would not have been.

Subsequent to *CIR v Epstein (supra)* section 24H(2) was introduced into the Act, which deems a member of a partnership to be carrying on the business or trade of the partnership himself. In terms of section 24H(2) the profits in question would accordingly possibly have been regarded as derived from a source outside South Africa, where the partnership business was, in essence, conducted. With the introduction of the residence-based taxation system in South Africa, section 24H(2) would, however, not have offered Epstein relief, as he would have, by virtue of his residency in South Africa, been subject to tax on his worldwide income, including the profits in question.

In *ITC 81 (1927, 3 SATC 136)* the taxpayer company in question carried on the business of producing and selling goods. Although the taxpayer was registered in South Africa, it conducted its aforementioned business activities wholly outside South

Africa. The taxpayer company produced the goods at a location outside South Africa from where it was conveyed by ship from such location directly to Europe, where the goods were sold by a representative of the taxpayer. The only activities performed by the taxpayer in South Africa consisted of its directors' meetings and the dictation and control of its policy. The taxpayer's representative was subject to general direction from South Africa, but was entrusted with a wide discretion and empowered to complete contracts of sale without confirmation from the taxpayer's directors.

During the tax year in question the taxpayer chartered a ship from Europe (it is inferred that the taxpayer did not own a ship, but commissioned ships for periods at a time when needed) to convey goods, produced by the taxpayer, to Europe for the purpose of selling it there. As the ship was not immediately required by the taxpayer to convey the goods (it is inferred that the ship was chartered before the goods were ready to be shipped off to Europe), the ship was, in the mean time, utilised by the taxpayer to convey a cargo from Europe to America. As a result of this undertaking, the taxpayer earned a profit. The contract pertaining to the aforementioned undertaking was concluded in Europe. The conveyance of the cargo to America did not form part of the taxpayer's usual business activities of producing and selling goods and was accordingly an isolated case.

The court was required to determine whether the source of, *inter alia*, the following income, derived by the taxpayer company, was located within South Africa or not:

- (a) the income derived from the taxpayer's normal business activities, namely the production and sale of goods; and
- (b) the profit earned by the taxpayer as a result of the conveyance of the cargo from Europe to America (on the ship chartered by the taxpayer).

Similarly to *CIR v Epstein (supra)* the court also looked to the activities performed by the taxpayer in order to determine the source of the income in question. In its endeavour to identify the taxpayer's activities, which produced the income referred to in (a) and (b) above, the court set out to identify "the essence" of the taxpayer's business. In this regard G.J. Maritz expressed the view that if contracts formed the "essence of the taxpayer's business", one need not look further than the place where

the contracts were made, for the purpose of determining the locality (or source) from which the income was derived. That was, however, not the position in the case under discussion, according to the court.

In determining the “essence of the taxpayer’s business” the court acknowledged that the business activities, performed by a taxpayer, may be manifold. For the purpose of identifying the “essence of the taxpayer’s business”, the court accordingly considered the taxpayer’s normal business activities (namely the production and sale of goods) separately from the taxpayer’s business activities which stood apart from such normal business activities (for example, the undertaking to convey the cargo from Europe to America). It is inferred that the court was of the view that the income referred to in (a) and (b) above was produced by two separate businesses undertaken by the taxpayer.

The court was of the view that “the essence” of the taxpayer’s normal business activities (of production and sale) was not the making of the contracts of sale, but the taxpayer’s activities in producing the goods, which were performed outside South Africa. The court considered the location where the contracts of sale were concluded to be irrelevant for the purpose of determining the source of the income, derived from the taxpayer’s normal business activities. The court considered the making of the sale contracts to be a mere incident in the taxpayer’s business, which, in essence, consisted of the taxpayer’s producing activities.

It is inferred that the court considered-

- the taxpayer’s selling activities in Europe;
- the taxpayer’s directors’ meetings in South Africa; and
- the dictation and control of the taxpayer’s policy (which took place in South Africa)

to be insignificant or auxiliary in nature when compared to the taxpayer’s producing activities, and on such grounds disregarded it for the purpose of determining the source of the income. On the basis that the court regarded “the essence” of the

taxpayer's normal business to be the taxpayer's producing activities, which took place outside South Africa, the court held that the income, referred to in (a) above, was not received from a source within South Africa.

In summary the court thus determined the source of the income, derived from the taxpayer's normal business activities, as follows:

- taking into consideration the facts of the case, the court set out to identify which of the taxpayer's business activities constituted "the essence" of the taxpayer's normal business, in order to identify the activities which produced the income;
- the court identified the business activities performed by the taxpayer which could be considered insignificant, irrelevant, incidental or auxiliary in nature (viewed in the context of the taxpayer's normal business as a whole) and disregarded such activities for the purpose of determining the source of the income; and
- the court located the taxpayer's normal business activities, which it considered "essential" in nature, for the purpose of locating the source of the income.

The court then proceeded to consider the taxpayer's isolated business activities (which did not form part of the taxpayer's normal business), consisting of the undertaking to convey the cargo from Europe to America, on its own footing for the purpose of determining the source of the profit derived from such undertaking (namely the profit referred to in (b) above). The court considered it "necessary only to look to the locality of each of the activities which produced income. If the locality was in" South Africa "the income was derived from a source within" South Africa. On the basis that, in view of the factual matrix, the taxpayer performed all the activities relating to the undertaking to convey the cargo from Europe to America, outside South Africa (for example, the ship was chartered by the taxpayer's representative in Europe from Europe, the contract in question was made in Europe and the voyage did not include a stop at a South African port), the court held that the source of the profit referred to in (b) above was located outside South Africa.

Unlike the taxpayer's normal business activities, none of the activities concerned with the profit referred to in (b) were performed in South Africa. Logically the source

could only have been located outside South Africa, bearing in mind that the court considered it “necessary only to look to the locality of the activities which produced the income”.

3.5 The place where the taxpayer concludes the contract, in terms of which the income is derived

In addition to the background information submitted above in connection with *ITC 81* (1927, 3 SATC 136), the court was also presented with the following background information:

At another time during the tax year in question a ship was chartered by the taxpayer for the purpose of conveying goods produced by the taxpayer at a location outside South Africa, to Europe for the purpose of selling it there. During this voyage the cargo of produce was lost at sea. The cargo had been insured under an insurance contract concluded by the taxpayer in South Africa. As a result of the loss of goods, the taxpayer received an insurance pay-out in terms of the insurance contract, equal to the value of the lost goods. The court had to determine whether or not the source of the insurance pay-out was derived from a source within South Africa.

The court proceeded to consider the taxpayer’s business activities relating to the insurance contract on its own footing (in other words, separately from the taxpayer’s normal business activities of production and sale), for the purpose of determining the source of the insurance pay-out. Again the court considered it “necessary only to look to the locality of each of the activities which produced income. If the locality was in” South Africa “the income was derived from a source within” South Africa. It was the court’s view that the making of the insurance contract constituted the business activity which produced the income in question. On the basis that the taxpayer concluded the insurance contract in Cape Town, South Africa, the court held that the insurance pay-out was derived from a source within South Africa.

It is inferred that the court considered the making of the insurance contract to constitute the essential activity, performed by the taxpayer, which produced the

insurance pay-out. Again, the court considered the taxpayer's business activities relating to the insurance contract separately from the taxpayer's normal business activities, as well as the taxpayer's other isolated business activities (for example, the taxpayer's undertaking to convey a cargo from Europe to America). The court thus considered it necessary to determine separately the source of each stream of income, and only with reference to the activities which directly gave rise to each such stream of income, whilst ignoring any other activities performed by the taxpayer. In addition, in considering each stream of income, the court dismissed any activities, performed by the taxpayer, which could be considered insignificant, incidental or auxiliary in nature, for the purpose of determining the source of the income stream.

3.6 A combination of the considerations referred to above

In *ITC 432* (1939, 10 SATC 437) the taxpayer company was incorporated in England and carried on in South Africa the business of erecting and maintaining lifts in buildings. The taxpayer did not manufacture lifts in South Africa and the only stock maintained by the taxpayer in South Africa consisted of a supply of spare parts for the purpose of fulfilling contracts for the maintenance of lifts. All lifts were manufactured in England. The taxpayer's business was managed by a South African representative. Such representative was appointed under a general power of attorney granted in London, to represent the company in South Africa and Rhodesia (now known as Zimbabwe). The financial centre of the company was located in South Africa, but at times, profits were remitted to the taxpayer company's parent company in London.

During the relevant tax year the taxpayer won a tender for a contract for the supply and erection of a lift in Rhodesia. The tender was accepted in Rhodesia. The lift was manufactured in England and sent directly from the factory to Rhodesia. The taxpayer sent a number of its technical expert employees from South Africa to supervise the erection of the lift by workmen engaged in Rhodesia. On completion of the contract, payment of the contract price was made by the client to Rhodesian agents of the taxpayer, by whom it was remitted, after deducting their commission, to South Africa. As a result of the contract, the taxpayer made a profit. The court had to

decide whether or not the profit, derived from the contract, was derived from a source within South Africa.

In determining the source of the profit the court looked at the factual circumstances and took into consideration all the taxpayer's activities which could have given rise to the profit, namely-

- the location where the taxpayer's capital was employed;
- the location/s where the taxpayer's business activities were performed; as well as
- the location where the contract in question was concluded by the taxpayer.

The court acknowledged that the contract in question did not merely entail the selling of the lift and the delivery thereof at a stipulated place. The court was of the view that a great deal of the work concerned with the contract, consisted of the actual activities of erecting the lift, which took place in Rhodesia. For the purpose of performing the aforementioned work in Rhodesia, the taxpayer had to employ technicians skilled in the erection of lifts and engage workmen. The taxpayer remunerated the aforementioned employees and workmen. The activities performed by the taxpayer in South Africa were in essence limited to the tendering process. The court consequently considered Rhodesia to be the place where the taxpayer employed its capital. .

The court then proceeded to take into consideration the location where the contract was concluded. On the basis that the contract was accepted in Rhodesia, the court considered the location where the contract was concluded to be in Rhodesia.

The court then took a final step in determining the location of the source of the income by taking into consideration the location where the taxpayer performed its business activities. It was the court's view that a part of the tendering activities, the taxpayer performed all the work, concerned with the contract, in Rhodesia. The court held that it was in Rhodesia that the taxpayer company's activities were employed "through the company's representatives" and that it was there "that the labour was

performed which resulted in the earning of the profit". In conclusion the court held that "[f]or these reasons we come to the conclusion that the source of this particular income was Rhodesia".

It is inferred that the court considered the taxpayer's tendering activities in South Africa to be insignificant or auxiliary in nature, and this was the reason why it was disregarded in the court's endeavour to locate the source of the taxpayer's profit. In locating the source of the profit, the court only took into consideration the taxpayer's activities which were performed in Rhodesia, namely the making of the contract, the employment of the taxpayer's capital and the performance of the lift erection activities. It is accordingly inferred that the court considered the taxpayer's activities in Rhodesia to have been sufficiently significant, essential or dominant in nature so as to consider it the activities which produced the profit, hence the reason why only these activities were focussed on in locating the source of the profit. Again, the court identified the aforementioned activities by taking into consideration all the facts of the case and more specifically all the activities which could have produced the profit in question.

In the case above the court was not faced with the problem of weighing up one originating cause (namely the activities which produced the income in question) of the income against another on the basis they were located in different jurisdictions. This may have been required of the court in *ITC 432 (supra)* had one of the considerations (namely the place where the contract was concluded, the place where the capital was employed, or the place where the business activities were performed) indicated the source to be located within South Africa. For example, in considering the location where the contract was concluded, it could have been found that the contract was concluded in South Africa. In such scenario, attention is drawn again to the submission of De Villiers J.A. in his dissenting judgment of *Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes, Southern Rhodesia* (1938 AD 282, 9 SATC 363), namely that the facts of each case must be looked to from a practical man's perspective in order to determine the source of the income. In *Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes, Southern Rhodesia (supra)* the court was faced with more than one possible originating cause of the income, located in two different

countries, and proceeded to look to the dominant cause of the income in question. Perhaps such approach would have been appropriate in *ITC 432 (supra)* as well, had the court been required to make such a choice. Such approach was, in fact, considered appropriate in *CIR v Black* (1957 (3) SA 536 (A), 21 SATC 226) and *Transvaal Associated Hide And Skin Merchants v COT* (1967 (BCA), 29 SATC 97) which will now be discussed.

In *CIR v Black (supra)* the taxpayer lived in Johannesburg and carried on the business of a stockbroker in partnership with two other persons. The taxpayer's firm conducted arbitrage business in association with a firm of London stockbrokers who were members of the London Stock Exchange. Apart from the taxpayer's Johannesburg transactions, he sent £7,000 to the London firm to enable them to deal speculatively on his behalf in shares quoted on the London Stock Exchange. The taxpayer had discussions in South Africa with a partner in the London firm during which the taxpayer authorised the London firm to deal in shares on his behalf without reference to him. In effect, in the majority of cases, transactions in London were, however, only effected after the London firm had discussed the sale or purchase (as the case might be) with the taxpayer.

The purchases and sales of the London shares were effected by the London firm in London, where the shares were paid for, held and delivered and where the proceeds were received. From these London share-dealings the taxpayer made a net profit. The court had to decide whether or not the said profit was derived from a source within South Africa.

In determining the source of the profit in question, the court looked at the facts of the case and took into account a combination of the considerations referred to earlier, namely-

- the location where the taxpayer's capital was employed;
- the location where the activities, which gave rise to the profit, were performed; as well as
- the location where the contract was concluded.

In its endeavour to identify the activities which gave rise to the profit in question, the court pointed out that the “present case was one in which a profit was gained, on balance, by a series of transactions of purchase and sale”. The court also proceeded to also take into account the location where the taxpayer employed his capital and held that together with the transactions of purchase and sale of the London shares, “they constituted a business in which all parts of the productive transactions were carried out and all the” taxpayer’s “capital, cash and credit, was used in London”. The court furthermore pointed out that the making and executing of the contracts of purchase and sale also took place in London.

The only activities relating to the purchase and sale of the London assets, which were performed by the taxpayer in South Africa, were the final authorisation or confirmation of the transactions. The court was of the view that, in the light of the distinct business of buying and selling shares in London, such factor could not reasonably and in truth be seen as the originating cause of the accrual of the income. It was the court’s view that the taxpayer merely had the right to terminate the authority given to the London firm to buy and sell shares for him, but until he did so they could effectively deal on his behalf without reference to him.

Schreiner ACJ submitted that in the event that the Commissioner could “show that the only true and reasonable conclusion on the facts found was that the dominant, or main or substantial or real and basic cause of the accrual of income was to be found in Johannesburg...”, the court would have considered the source of the profit to be located in South Africa. The Commissioner could not, however, discharge this onus and Schreiner ACJ accordingly dismissed the appeal and held the following:

A reasonable person could certainly reach the conclusion... that there was a distinct business of buying and selling shares in London, and that the fact that the respondent was a stockbroker carrying on a similar business in Johannesburg was at most a factor which facilitated the carrying on of his London business. ...another reasonable conclusion which could not be said to be untrue was that the main, the real, the dominant, the substantial source of the income was the use of the respondent’s capital in London and the making and executing of the contracts in London.

In summary the court thus determined the source of the taxpayer's profit by taking into consideration all the relevant facts in order to identify the activities which produced the profit in question. In identifying the activities which produced the profit, it is inferred that the court considered that the taxpayer's activities in authorising or confirming the purchases and sale of the London shares (as well as the taxpayer's other stockbroker business activities in Johannesburg) to be insignificant or auxiliary in nature when compared to the activities performed in London on the taxpayer's behalf. Such inference is based on the fact that the former activities were ignored by the court in its endeavour to locate the source of the profit. For such purpose, the court only took into consideration the activities performed in London on the taxpayer's behalf. In the court's view the activities performed in London constituted "the main, the real, the dominant, the substantial source of the income", hence the reason why the court considered the source of the profit to be wholly located in London (in other words, outside South Africa).

In *Transvaal Associated Hide And Skin Merchants v COT (supra)* the taxpayer company was registered in South Africa and had its head office in Johannesburg. The taxpayer carried on the business of a dealer in hides and skins. It purchased green (uncured) hides from abattoirs where the animals were slaughtered. Before transporting the hides to South Africa to be sold in South Africa, the hides had to be cured to prevent putrefaction. This was done by washing and salting the hides, then stacking them for a number of days. The process of curing did not change the essential character of the hides. A purchaser who was a leather manufacturer would immediately soak the hides to restore them, as far as possible, to the condition of green hides.

One of the abattoirs from which the taxpayer purchased green hides was located in Lobatsi, Botswana. For the purpose of curing and packing the hides, the taxpayer maintained at Lobatsi a staff of twenty to thirty residents of Botswana. The staff carried out the curing and packing activities in a shed which was an extension of the abattoir buildings, for which the taxpayer paid a rental fee. The taxpayer earned income in respect of the hides acquired from the Lobatsi abattoir, which were sold in South Africa. The court had to decide whether or not the above income was derived from a source within Botswana.

As a point of departure the court considered the factual matrix and identified the activities which collectively produced the income in question, and acknowledged that both the activities in South Africa (namely the selling of the hides) and the activities performed in Botswana (namely the curing and packaging of the hides) produced the income in question. On the basis that the aforementioned activities were performed in two different jurisdictions, the court (in terms of the judgment given by Schreiner JA) considered it necessary to choose between the country where the hides were cured, namely Botswana, and the country where they were sold, namely South Africa, for the purpose of locating the source of the income. For various reasons, the court considered apportioning the income between sources located in both countries inappropriate. For the purpose of making the choice between South Africa and Botswana in order to locate the source of the income, the court held “that the dominant (or main or substantial or real and basic) cause of the accrual of the income” had to “be sought”.

In order to make such choice the court proceeded to consider the importance of the activities that took place in each of the two countries. The court acknowledged that the selling of the cured hides was necessary to bring the income to hand, and that, as much as the curing, they were “a *causa sine qua non* of the accrual of the income”. On the basis that the curing and the selling took place in two different countries, Schreiner JA then expressed the view that-

the place where a *causa sine qua non* exists cannot be decisive of the place of the origin of the income, for there may be a number of *causae sine qua non*. One must look for something more – something like the dominance or basicity used in the abovementioned list of expressions; or like what I venture to call the highest, or higher, degree of essentiality.

Schreiner JA remarked that it would be unreasonable and artificial to attribute the source of the income wholly to the sales, which only in the end produced the money. He compared the facts to the present case to a process of mining or manufacture and made the analogy that before the sale of any parcel of mined and treated ore or of manufactured goods can take place “there is an unrealised profit in the ore or the goods which the sale only turns into cash”.

The court regarded the green hides in the abattoir to be like un-mined or untreated ore or the raw material of the manufacturer, and regarded the cured hides to be like mined and treated ore or manufactured goods. The court was accordingly of the view that the curing process constituted “the really vital element in the hide and skin dealer’s business”. The fact that the curing process was relatively simple and that the tanner generally restores the hides, as far as possible, to their former green condition made no difference in the court’s view.

Turning to the selling function in South Africa Schreiner JA remarked that in the hide and skin business “there is no need to have elaborate selling offices - a room, and a telephone would suffice”. Comparing the selling function to the curing function he pointed out that the selling offices need not be situated in any particular place whereas sufficient curing facilities must be situated at the site of the abattoirs, which were, in this case, situated in Botswana.

The court was of the view that a dealer in hides and skins need not be an expert marketer. The court considered the cured hides to be “a merchantable article” which can produce an income (perhaps a smaller income if the seller is an inexperienced marketer) by the sale thereof. On the other hand Schreiner remarked that a dealer in hides and skins could not gain a cent of profit “unless he possessed and used the means for curing the green hides that he bought”. His submission was based on the fact that green hides would be damaged and destroyed by putrefaction if not cured.

In conclusion the court dismissed the appeal and, in summarising its views, held:

The characteristic feature of a hide and skin merchant’s business is not that he buys and sells goods but that he cures hides and skins which he is thus enabled to sell. ...the curing of the green hides is more truly essential to the gaining of profit than the sale of the wet salted hides... the curing is dominant over the selling. It is more basic, or more truly the main or substantial or real and basic cause of the accrual of the income.

Similarly to the other cases discussed thus far, the court set out to determine the source of the income in question by considering the factual circumstances and in so

doing identifying the activities which collectively produced the income. The court found that the activities which produced the income were performed both within Botswana and within South Africa. Unlike the cases discussed earlier, it appears as though it was not obvious to the court which of the activities was sufficiently dominant, essential or significant in nature, in the light of the production of the income, so as to justify only focusing on such activities for the purpose of determining the source of the income, whilst ignoring those which were insignificant or auxiliary in comparison. In order to choose the country in which the source of the income was located, the court examined each step in the taxpayer's business activities, as well as the nature of the taxpayer's business in order to ascertain which of the activities constituted the real, the dominant, the most essential or main activities which produced the income. After identifying such activities, the court considered the source of the income to be wholly located where such activities were performed (namely Botswana). It is accordingly inferred that the court considered the taxpayer's other business activities (namely those performed in South Africa) sufficiently insignificant or auxiliary in nature so as to justify disregarding it for the purpose of locating the source of the income.

In *Essential Sterolin Products (Pty) Ltd v CIR* (1993 (4) SA 859 (A), 55 SATC 357) the taxpayer discovered, in South Africa, a substance (the active substance) effective in the treatment of prostata hypertrophy. In order to market the medicine it had to be registered by a medicines control authority. The taxpayer obtained registration in West Germany through a West German corporation, Hoyer, which acted as its distributor in West Germany. In addition certain West German patents were registered to protect the use of the active substance for the treatment of prostata hypertrophy.

Initially the taxpayer's *modus operandi* was to manufacture the active substance, dissolve it in a solvent and precipitate it onto what is termed 'a carrier' in order that it should assume monomolecular form, and this was all done in South Africa. The active substance, in this form, was then exported to Hoyer in West Germany. Hoyer, in turn, would add fillers, put the compound into capsules and package and market the product under the registered trade mark "Harzol".

During 1976 the taxpayer established a so-called “front company”, the Intermuti, registered in Switzerland, through which to market its product. Thereafter the taxpayer supplied its product, the active substance, to Intermuti which in turn sold it at a profit to Hoyer. In due course another company was registered in West Germany and used as the medium for the introduction into the German market of a “generic” or patent medicine which contained the same active substance but was sold “over the counter” (unlike Harzol which was supplied on medical prescription only) under different packaging and a different trade mark.

In 1977 the taxpayer incorporated yet another company in the Netherlands Antilles in order that it should hold the patents registered in the taxpayer’s name. That company, in turn, subsequently established a number of wholly-owned subsidiaries in certain countries, including Switzerland in order to develop markets outside West Germany. During 1982 an agreement was entered into in Europe in terms whereof Hoyer acquired, *inter alia*, all the issued shares in Intermuti for a consideration of DM16 750 000. This amount also included DM4 000 000 (referred to as the inability consideration) due in terms of an agreement (the inability agreement) whereby Hoyer was licensed to manufacture the active substance for exclusive supply to another group company, Interbio, in the event of the inability of the taxpayer to do so. The court had to decide, *inter alia*, whether or not the amount of DM4 000 000 was derived from a source within South Africa.

Considering the relevant facts, the court identified a number of activities and/or factors which collectively produced the income in question. Following the views expressed in *CIR v Black (supra)*, the court considered it “appropriate to weigh these factors in order to determine the dominant or main or substantial or real and basic cause of the receipt” in order to determine and locate the source of the income. The court proceeded to look at the activities (which gave rise to the income in question), performed by the taxpayer both within and outside South Africa, as well as the location where the inability agreement was concluded, in order to determine the “dominant or main or substantial or real and basic cause of the” income. In doing so Corbett CJ noted the following:

- The whole foundation of the taxpayer's "business rested upon the rights flowing from registration, the patent and trade mark rights and the contractual rights *vis-à-vis* Hoyer, all of which were acquired and exercised in West Germany".
- The only activity that the taxpayer performed in South Africa was the manufacture of the active substance, which was then exported, in an unmarketable form to West Germany.
- On receipt of the product from South Africa Hoyer, in West Germany, had to add fillers, put the compound into capsules and package the product before it could place the product on the West German market.
- "The income in question (the inability consideration) was an ingredient of the reorganisation of the business and the grant to Hoyer of a substantial interest therein". The business so reorganised was predominantly conducted in Europe by European subsidiaries of the taxpayer.
- The income in question "was linked not merely to an inability to supply the active substance from South Africa, but to an inability to supply it from anywhere in the world".

In view of the above circumstances, and in view of the fact that the inability agreement was concluded in Germany, the court came to the conclusion that "the dominant or main or substantial or real and basic cause of the receipt" (*CIR v Black (supra)*) was not located in South Africa and accordingly held that "the originating cause of the receipt of the inability consideration, and therefore the source thereof, was not within South Africa".

In this case the court followed an approach similar to those followed in *CIR v Black (supra)* and *Transvaal Associated Hide And Skin Merchants v COT (supra)* for the purpose of determining the source of the income. After identifying the activities which produced the income, it set out to identify those activities which could be considered the main or dominant activities which produced the income. On the basis that the taxpayer performed the bulk and the most essential of its business activities outside South Africa, the court concluded that the source of the income was located wholly outside South Africa. Again, the court, in locating the source of the income, completely disregarded the taxpayer's activities performed in South Africa. Again it

is inferred that the court considered the aforementioned activities sufficiently insignificant or auxiliary in nature so as to justify disregarding it for the purpose of locating the source of the income.

The most recent reported case which dealt with the source of income, more particularly interest income, is *First National Bank of Southern Africa Ltd v Commissioner for South African Revenue Service* (64 SATC 245). In that case the taxpayer carried on business as a South African commercial bank with an essentially South African client base. The taxpayer undertook certain international financing transactions with its clients in South Africa and earned interest income as a result of it. In any international financing transaction the starting point was a request from a client of the taxpayer, usually a corporate client, for a foreign credit facility to fund its exports, its imports or its working capital requirements in South Africa and the bulk of the funding was for the latter purpose. The taxpayer, at all material times, had access to foreign currency borrowed by it, as and when required, from foreign banks interested in lending money to a South African bank.

The sequence of activities which formed part of the international financing transactions undertaken by the taxpayer is set out as follows:

- The foreign currency was made available to the taxpayer's client in New York and had to be repaid there.
- The foreign currency was sourced by way of loans from a foreign bank by a foreign exchange dealer employed by the taxpayer in, and operating from, South Africa.
- The taxpayer did not have a branch in New York nor did the client concerned have a separate account with the taxpayer there. The client was debited in South Africa with the rand equivalent of the available foreign currency. In the majority of cases the foreign currency was brought to South Africa, converted into rand, through the agency of the taxpayer and its various divisions, none of

which operated in isolation, all forming an integral part of the taxpayer's overall structure.

- The rand equivalent of the foreign currency was made available to the client, and utilised by it, in South Africa.
- The add-on margin of interest, which constituted the taxpayer's income from the overall loan transaction, was debited in rand against the client's branch account in South Africa.
- While notionally the client was required to repay the foreign currency loan in New York in the currency concerned, in practice the loan was repaid to the taxpayer (certainly in the majority of cases) in rand in South Africa before it was converted back to the required currency, using the taxpayer's structures in South Africa, and eventually paid into its Chase Manhattan Bank account.

The court had to decide whether or not the interest earned by the taxpayer from such international financing transactions was derived from a source within South Africa.

Smalberger ADP rejected the taxpayer's contention that the source of interest is necessarily located where the funds, which attract the interest, are made available. In this regard the taxpayer attempted to rely on the decision of *CIR v Lever Brothers & Unilever Ltd* (1946 AD 441, 14 SATC 1). Smalberger ADP pointed out that the facts of the present case differed materially from those the court was faced with in *CIR v Lever Brothers & Unilever Ltd (supra)*. The court in the present case proceeded to point out that in that case Watermeyer CJ did consider the provision (or the making available) of the credit (or the funds) to be "the originating cause or source of the interest received by the lender..." and that the location of the source was where such provision took place.

However, Smalberger ADP added that Watermeyer CJ only came to such conclusion after he considered the relevant factual matrix and in so doing identified the activities which produced the interest. According to Smalberger ADP the consideration of the

relevant factual matrix in order to identify the activities which produced the interest income in order to locate the source of the interest, would have been “a totally needless exercise if he intended to convey, or for it to be understood, that the sole criterion for determining the location of the source of interest was where the credit... was made available”.

It is inferred that the court in *CIR v Lever Brothers & Unilever Ltd (supra)* did, accordingly, not formulate a universal “rule” which implied that the source of interest is necessarily located where the funds are made available, but rather that all the facts should be taken into consideration in order to determine the source of interest income and the location thereof.

In view of the sequence of the activities, forming part of the international transactions undertaken by the taxpayer, Smalberger ADP held the following:

Apart from the fact that contractually the foreign currency was made available to the borrowing client in New York and had to be repaid there, all the other important factors which caused the interest income to arise (and which constituted the dominant cause of the receipt of the interest) had their origin in South Africa and flowed from the appellant’s business activities and operations here. ... On an overall conspectus of the relevant factual matrix, and applying the principles enunciated in the *Essential Sterolin* case, the source of the interest, which is the subject of the present appeal, was in my view located in South Africa... (own emphasis)

The court, accordingly, did not consider the location where the credit or the loan was made available (namely New York) to be “the originating cause or source of the interest received by the taxpayer” (*CIR v Lever Brothers & Unilever Ltd (supra)*). Instead the court considered the factual matrix in order to identify the activities which produced (or caused the arising of) the interest income and applied the principle of identifying the “the main, the real, the dominant, the substantial” activities which gave rise to the interest income (*CIR v Black (supra)*, *Transvaal Associated Hide And Skin Merchants v COT (supra)* and *Essential Sterolin Products (Pty) Ltd v CIR (supra)*) in order to determine and locate the source of the interest income. On the basis that the taxpayer performed its main business activities and operations in South Africa, the court considered the activities performed in New York, to be insignificant or auxiliary

in nature when compared to the activities performed in South Africa. On this basis that court disregarded the taxpayer's activities in New York for the purpose of determining the source of the interest income and the location thereof. The court accordingly focussed only on the taxpayer's activities which it considered to be main or dominant in nature, for the purpose of locating the source of the interest income.

3.7 Apportionment of income between two or more sources, located in different countries

The principle of apportionment has been addressed with approval in a number of authoritative texts, which will now be referred to.

In regard to the principle of the apportionment of income between two or more sources, the following is submitted in *Meyerowitz on Income Tax* (Meyerowitz, 2005: paragraph 7-17):

If of a number of sources none is merely incidental so that it may be ignored for the purpose of ascertaining the source of income or if none lends itself to being regarded as the basic, dominant, substantial, main or real one, then it would *ex hypothesi* follow that the profits from each source must be treated independently.

In support of his view, Meyerowitz referred to the following remarks, *obiter*, of Watermeyer CJ in *CIR v Lever Brothers & Unilever Ltd* (1946 AD 441, 14 SATC 1), in which the possibility of apportioning an amount between sources, located in different countries, was addressed:

...it is obvious that a taxpayer's activities, which are the originating cause of a particular receipt...may...occur in different countries, and, consequently, after the activities which are the source of the particular 'gross income' have been identified, the problem of locating them may present considerable difficulties, and 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... but I am not aware of any decision which has laid down clearly what would be the governing consideration in such a case.

It is noted in *Income Tax Cases & Materials* (Emslie, Davis, Hutton, Olivier, 2001: 110) that the above remarks of Watermeyer CJ, *obiter*, are authority for the apportionment of income where such income is attributable to more than one source, which are located both within and outside South Africa.

Reference is also made in *Income Tax Cases & Materials* to *CIR v Tuck* (1987 (2) SA 219 (T), 49 SATC 28) where the principle of apportionment was accepted by the court in relation to income which bore the characteristics of both a revenue and a capital nature. It was held by the court that it is sometimes possible to apportion a receipt between the two categories “where a receipt, having regard to its *quid pro quo*, contained both an income element and an element of a capital nature”. Corbett JA remarked in that case “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”. With reference to this case the following is submitted in *Income Tax Cases & Materials*:

An interesting question which emerges from the *Tuck* judgement is whether acceptance of the principle of apportionment will be extended to the area of source, where the applicability of the principle of apportionment has been confined to *obiter dicta*. The approach followed by the Court in *Tuck's* case should in our view be extended to source particularly as Corbett JA used the *Lever Bros's* originating cause test in establishing the existence of two legal *causae* (Emslie et al, 2001: 288).

Further support of the principle of apportionment in this regard can be found *Income Tax in South Africa, Cases & Materials* where it is submitted that the decision in *Millin v CIR* (1928 AD 207, 3 SATC 170)-

has been criticised on the basis that there were two distinct sources, namely the writing of the books and the contract granting the right to publish, and that the income ought to have been apportionment between the two; see Meyerowitz and Spiro para 212 (Williams, 2005: 78).

In view of the above it is evident that, on paper, there is clearly approval of the principle of apportionment where income is derived from two or more sources, located both within and outside South Africa.

In addition to the above there appears to be a “well-established principle that *prima facie* the locality of the source of income derived from services rendered is the place where they are performed” (*ITC 1104* (1967, 29 SATC 46) at 50, a Rhodesian case). In that case the court allowed for the apportionment of the taxpayer’s income between two jurisdictions where the services, which produced the income, were rendered.

In *ITC 1104* (*supra*) the taxpayer carried on the business of a commercial diver in Salisbury. He kept his equipment in Salisbury where he also kept an office. He was usually approached by his customers in Salisbury. When carrying out a contract, it was the taxpayer’s practice to proceed to the site where the work was to be performed and he took with him his equipment. At the site the taxpayer required a small temporary office in which to keep the required records of the work as well as for correspondence purposes.

During the year of assessment under review the taxpayer entered into a contract in Salisbury for carrying out diving operations in the bed of the Zambezi River below the wall of the Kariba Dam. The contract involved working in the riverbed on both sides of the boundary line between Rhodesia and Zambia. It was accepted that fifty-two per cent of the work was done on the Zambian side of that line and that forty-eight per cent on the Rhodesian side.

The court had to decide whether or not the income earned by the taxpayer on the contract was derived from a source within Rhodesia. The Commissioner contended that the full amount was derived from a source within Rhodesia and the taxpayer contended that only forty-eight per cent (based on time spent) of the income was derived from a source within Rhodesia.

The court (JB Macaulay QC) submitted that there was no doubt that the circumstances urged were insufficient to override “the well-established principle that *prima facie* the locality of the source of income derived from services rendered is the place where they are performed”. The court proceeded to point out the following:

- The work contracted for “was performed wholly *in situ*, whether on the Rhodesian side of the border or the Zambian side”.
- The work carried out on each side of the border “was an independent service”, each day’s work, on whichever side of the border it was performed, attracted a fee of £25 per diver per day.
- “The taxpayer’s obligation was to hold his team available at the site at Kariba to work either in Zambia or in Rhodesia according to the company’s daily requirements”.

In view of the above the court came to the conclusion that the fees paid for the work performed by the taxpayer and his team were earned in the places where the work was done. The court accordingly held that the “sources of the receipt... were located in both countries”. In view of the fact that the basis of the apportionment was not contested, the court held that the taxpayer’s gross income was “no more than forty-eight per cent of £8,568”, that “being the amount of the receipts accruing from a source in Rhodesia”.

It should however be noted that the principle of apportionment (more specifically the principle of apportionment which concerns income which was not produced by the rendering of services) has not yet been formulated as part of the “source rules” by the South African courts. This submission is based on the fact that, although it is likely that the modern-day court would most probably consider the concept of apportionment in a favourable light when the circumstances call for it, the concept has been restricted thus far to *obiter dicta*. This view finds support in the discussion to follow.

When faced with a suggestion of apportionment in *CIR v Epstein* (1954 (3) SA 689 (A), 19 SATC 221), Schreiner JA submitted, *obiter*, in his dissenting judgment that-

...this, in the absence of any statutory guide to its operation, would be practically unworkable in a case of this kind. Where work has been done in producing or improving raw material which is sold elsewhere by the same person, it might be possible to apportion...

He then proceeded to refer to *Millin v CIR (supra)* where the matter of apportionment was also addressed. In *Millin v CIR (supra)* reference was made to the judgment of the Privy Council in the case of *Commissioners of Taxation v Kirk* (1900, A.C. 588). In that case the taxpayer company carried on the business of mining in New South Wales. No contracts of sale concerning the extracted ore were made in New South Wales, but rather in London and Melbourne. The taxpayer made profits as a result of the sales. The question put to the court was whether the taxpayer had *any* income in New South Wales within the meaning of the Income Assessment Tax of that Colony. The court answered the question in the affirmative. The court did not, however, lay down that only a portion and not the whole of the income was earned in New South Wales. According to Solomon CJ (in *Millin v CIR (supra)*) the reason for this was that that was not the question the court had to answer. The court confined itself strictly to answering the question put to it.

In *Lovell and Christmas Ltd. v Commissioner of Taxes* (1907, A.C. 46) the court confirmed the view expressed in *Commissioners of Taxation v Kirk (supra)*, namely that “the Privy Council did not decide that, wherever any process in the earning of profits was carried on, some portion of the income was taxable in the country in which the process was carried on” (*Millin v CIR (supra)* at 180).

In view of the above Schreiner JA, in his dissenting judgment, concluded in *CIR v Epstein (supra)* that “[i]n the present case there would, it seems, be no justification for attempting to apportion the profits between Argentina and South Africa”. An apportionment of the income was not allowed in the majority judgment of *CIR v Epstein (supra)* either (in this regard, refer to the discussions under heading 3.4).

Although *Transvaal Associated Hide And Skin Merchants v COT* (1967 (BCA), 29 SATC 97) is not a South African case, reference was made by the court to South African cases in the relevant passages which will now be discussed. In that case the court was faced with income which was produced by activities which were performed in two different countries, so that the source was located partly in one country and partly in another. In considering the principle of apportioning the income between the two countries, Roper P (in his dissenting judgment) referred to the following, often

quoted, remarks, *obiter*, of Watermeyer CJ in *CIR v Lever Brothers & Unilever Ltd (supra)*:

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 according to the particular circumstances of the case, but I am not aware of any decision which has laid down clearly what would be the governing consideration in such a case.

Roper P pointed out that Watermeyer CJ “left open the question whether in such cases the income should or should not be apportioned”. Roper P then briefly referred to Schreiner JA’s suggestion in *CIR v Epstein (supra)* “that apportionment should take place in such cases”, but dismissed it on the grounds that “the idea suggested in these passages has however, so far as I am aware, not been developed in any South African cases” (own emphasis).

Instead of applying apportionment, the South African courts (as did the courts in *Transvaal Associated Hide And Skin Merchants v COT (supra)* and *Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes, Southern Rhodesia* (1938 AD 282, 9 SATC 363)) address the problem of determining the location of the source of income, where the income is produced by activities, performed both within and outside South Africa, by locating the main, the real, the dominant or the substantial activities giving rise to the income (in other words, the “dominant cause” of the income) (*CIR v Black (supra)*, *ITC 1491* (53 SATC 115), *Essential Sterolin Products (Pty) Ltd v CIR* (1993 (4) SA 859 (A), 55 SATC 357), *First National Bank of Southern Africa Ltd v Commissioner for South African Revenue Service* (64 SATC 245)). In other words, in such case, in terms of the “source rules” the location of the main, the real, the dominant or the substantial source (or cause) of the income is considered to be the location of the source of the income.

3.8 A summary of the South African “source rules”

In view of the discussions above the “source rules” can be summarised as follows:

- In terms of the “source rules” the source of income is determined with reference to the originating cause of the income and not the quarter from which the income comes. This originating cause is the work, functions or activities which the taxpayer performs to earn the income, the *quid pro quo* which the taxpayer provides in return for which he receives the income. The aforementioned work, functions or activities are identified by the courts by taking into consideration the relevant factual matrix.
- Where it is determined that the income is derived from more than one originating cause, located both within and outside South Africa (in other words, the activities which produce the income are performed both within and outside South Africa), the “source rules” can in essence be reduced to the “dominant cause” approach. Such approach has been followed by the courts in the past, as discussed. In terms of this approach, the source of income is considered to be the so-called “dominant cause” of the accrual of the income. The activities which produce the income, which can be considered the main or dominant activities producing the income, constitute the “dominant cause” of the income. The activities which cannot be considered to be the main or dominant activities producing the income (in other words, activities which, it is inferred, are insignificant or auxiliary in nature) are disregarded for the purpose of locating the source of the income. The courts are, however, vague as to the exact method how the main or dominant activities are to be distinguished from the insignificant or auxiliary activities and as a result, the “source rules” offer no clear methodology in this regard.
- In terms of the “source rules” the location of such “dominant cause” is considered to be the location of the source of the income. In the event that such location falls to be inside South Africa, the relevant income would form part of the taxpayer’s “gross income” for South African tax purposes (in view of the “gross income” definition). Such income would accordingly be subject to tax in terms of the South African tax rules.

From the above discussion it is inferred that, in accordance with the “source rules”, South Africa would only be afforded the right to tax the income earned by the non-resident multinational company referred to in paragraph 3.1., in the event that the “dominant” or “main” activities, giving rise to the income, are performed in South Africa. The taxing rights determined in terms of the “source rules”, with specific reference to the “dominant cause” approach followed by the South African courts, would either subject the entire amount of the income in question to tax in South Africa, or no part of it at all. This submission is based on the fact that the South African courts have not, as yet, incorporated the principle of apportionment into the “source rules”, as discussed earlier.

In the discussions above it is, however, apparent that the courts have in the past isolated the transactions concerned with the income in question, when determining the source of the income, whilst disregarding any other transactions or activities which are not directly concerned with the income in question (*CIR v Epstein* (1993 (4) SA 859 (A), 55 SATC 357), *ITC 81* (1927, 3 SATC 136)). Such “form of apportionment” would not, however, impact on a non-resident multinational company which performs all its manufacturing activities in a jurisdiction outside South Africa and all its selling functions inside South Africa (assuming such activities to be all its trade consists of and assuming all its income is derived from such trade). This submission is based on the fact that such taxpayer would not enter into isolated income-producing transactions which do not form part of its “normal business operations”, nor would it be engaged in more than one trade. The taxpayer would accordingly produce its income from a single trade, executed from two different jurisdictions. A court would thus be faced with one income-stream, produced by one trade, albeit from two different locations. There would, accordingly, be no transactions to isolate from the “normal business operations”.

In the event that an application of the “source rules” establishes the source of the income of the non-resident multinational company to be located in South Africa, such income would be subject to tax in South Africa in terms of the South African domestic tax rules. However, establishing that the South African domestic tax rules apply in respect of such non-resident’s income, only constitutes one in a number of steps in determining the taxability of the income earned by such non-resident

multinational company from a South African perspective. The enquiry should accordingly not be laid to rest at this point. It is necessary to take the next step to fully understand the impact the provisions of the Act would have on such non-resident multinational company, taking into account the effect of a Double Tax Agreement between South Africa and the residence jurisdiction of the non-resident multinational company.

Chapter 4: The “permanent establishment rules”

4.1 Introduction

In the event that an application of the “source rules” determines the source of the income derived by the non-resident multinational company (referred to earlier), to be located within South Africa, South Africa would be afforded the right to tax such income, as explained in the previous chapter. However, the same amount of income may be subject to tax in the non-resident’s country of residence as well. Similarly to South Africa, a residence-based taxation system may exist in such country (such taxation system exists in most developed countries). A residence-based taxation system entails the taxation of a resident’s world-wide income, which would therefore include the income in question from the non-resident multinational company’s perspective. This would result in the same amount of income being taxed in two jurisdictions. Such form of double taxation is commonly referred to as economic double taxation.

For the purpose of avoiding the economic double taxation referred to above, and for the purpose of fostering international trade, two jurisdictions would normally enter into an international agreement, known as a Double Tax Agreement (DTA). The terms of such DTA would stipulate how the said jurisdictions are to “share” or allocate the right to tax the income earned by a taxpayer (who/which is resident in one of the jurisdictions) between themselves. Such “sharing” or allocation of the right to tax the taxpayer’s income is aimed at eliminating economic double taxation.

4.2 The general effect which a DTA could have on the taxability of the non-resident multinational company

Assuming a DTA exists between South Africa and the residence jurisdiction of the non-resident multinational company, the terms of such DTA would accordingly stipulate the manner in which South Africa and such jurisdiction are to allocate the right to tax the income derived by the non-resident multinational company between themselves. In analysing the manner in which such DTA would allocate the taxing

right between the two jurisdictions, it will be endeavoured in the discussion to follow to highlight the fact that-

- in situations where the activities performed in South Africa could be considered to be an extension of the non-resident multinational company's business (wholly or partly), South Africa's right to tax the income in question would be confirmed (but only to the extent that the income is attributable to such activities);
- in situations where the activities performed in South African could be considered auxiliary in nature (in other words, not essential in nature) when viewed in the context of the non-resident multinational company's business as a whole, South Africa's right to tax the relevant income would not be confirmed.

It will furthermore be demonstrated that, in order to determine the manner in which the right to tax the income of the non-resident multinational company is to be allocated between the two jurisdictions, the factual matrix will be taken into account in terms of the rules of a DTA. Very specific rules which are contained in a DTA, informally known as the "permanent establishment rules", will then be applied to the factual matrix in order to determine the allocation of the taxing right. It will be endeavoured in the discussion to follow to clearly illustrate the manner in which such allocation of a taxing right will be determined in terms of the "permanent establishment rules".

In the discussion to follow it should be borne in mind that, in terms of the South African law, the rules of a DTA cannot create or increase a taxing right (such inference was drawn by E Brincker, M Honiball and L Olivier in *International Tax: A South African Perspective*, page 341, with reference to the judgment of *SIR v Downing*, 37 SATC 249). The aim of the provisions of a DTA is merely to allocate or share an existing right to tax income between two jurisdictions. From South Africa's perspective and with reference to the non-resident multinational company, a DTA could therefore not, in itself, afford South Africa the right to tax the non-resident multinational company's income. A DTA may, however, alter a taxing right afforded to South Africa as a result of an application of the "source rules". Such alteration

would be given effect, as part of the South African domestic tax rules, in terms of the provisions of section 108 of the Act, which states *inter alia* that-

[t]he 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...of the levying, under the laws of the Republic and of such other country, of tax in respect of the same income...

In accordance with section 108(2) of the Act the arrangements contained in such an international agreement have effect as if enacted in the Act itself. In *International Tax: A South African Perspective*, page 337, the view is expressed that a DTA constitutes an international agreement for the purposes of section 108(2). Following on this, it is submitted that the rules of a DTA are “enacted into South Africa’s national legislation in terms of the empowerment provisions of s 108(2) of the Income Tax Act” (Brincker, Honiball & Olivier, 2004: 337).

On the basis that DTA’s pertaining to a large number of countries, including South Africa, are based on the OECD Model Tax Convention, the OECD Model Tax Convention is referred to for the purpose of applying the rules of a DTA between South Africa and another country (with which South Africa has a DTA, for example the residence jurisdiction of the non-resident multinational company). In addition, the OECD has issued Commentaries on the Articles of the OECD Model Tax Convention for the purpose of interpreting the rules contained in the OECD Model Tax Convention in more detail. The OECD Model Tax Convention and the Commentaries thereon will accordingly now be referred to for the purpose of explaining the DTA rules in more detail, with specific reference to the non-resident multinational company.

4.3 Article 5 of the OECD Model Tax Convention

In terms of a DTA South Africa (in its capacity as one of two “Contracting States” which are parties to the DTA) would be afforded “the right... to tax the profits of an enterprise of the other Contracting State” in the event that that enterprise “carries on its business through a permanent establishment situated” within South Africa

(paragraph 1 of the Commentary on Article 5 of the OECD Model Tax Convention). With reference to the non-resident multinational company referred to earlier, South Africa's right to tax the income of such company would accordingly be confirmed by the rules of the DTA between South Africa and the company's residence jurisdiction, in the event that that company creates a permanent establishment in South Africa by virtue of its selling functions (which are performed within South Africa).

Emphasising the significance of establishing whether or not a non-resident has a permanent establishment in existence in South Africa, it is submitted in *Klaus Vogel on Double Taxation Conventions, Third Edition* that "the existence of a permanent establishment is the decisive condition for the taxation of income from business activities... pertaining to such activities" (Vogel, 1997: 280). Following on the aforementioned submission, Vogel explains the essential meaning of a permanent establishment as follows:

...a contracting State may tax the profits derived by an enterprise of the other contracting State only to the extent that the enterprise carries on business through a permanent establishment situated in the territory of the first-mentioned State. This rule is designed to ensure that business activities will not be taxed by a State unless and until they have created significant economic bonds between the enterprise and that State... (own emphasis)

Domestic tax law governing international transactions often tends to develop rather broad conditions for taxing income from business activities in order to make for maximum extension of national taxation. In contrast, the permanent establishment concept employed in international tax law is narrower. (Vogel, 1997: 208)

From South Africa's perspective, the general aim of the rules of a DTA is accordingly to seek to tax the income of a non-resident entity only in the event that, and to the extent that, it conducts its business activities within the jurisdiction of South Africa on such level that it creates "significant economic bonds" with South Africa. In such case, the non-resident would be considered to be conducting its business activities through a permanent establishment in South Africa. On the other hand, it is not the aim of the rules of a DTA to seek to tax the income of a non-resident entity in the event that its business activities, performed within South Africa, are too insignificant to create "economic bonds" with South Africa. In such case, the non-resident would

not be considered to be conducting its business activities through a permanent establishment in South Africa. The former scenario is commonly referred to as “trading in a jurisdiction” (namely South Africa, in this case), whilst the latter scenario is commonly referred to as “trading with a jurisdiction”.

In the context of the rules pertaining to DTA’s, the term “permanent establishment” is defined in paragraph 1 of Article 5 of the OECD Model Tax Convention. Paragraph 1 of Article 5 and the Commentaries on the Articles of the OECD Model Tax Convention pertaining thereto will accordingly be referred to for guidance in determining whether or not the non-resident multinational company’s selling functions, performed wholly within South Africa, creates a permanent establishment which is situated within South Africa (it has already been noted that the company’s manufacturing functions are performed wholly outside South Africa).

Paragraph 1 of Article 5 of the OECD Model Tax Convention

Paragraph 1 of Article 5 of the OECD Model Tax Convention defines “the term ‘permanent establishment’ to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on”.

In accordance with the Commentary on Article 5 of the OECD Model Tax Convention the essential characteristics of a permanent establishment are that it constitutes “a distinct ‘*situs*’ or a ‘fixed place of business’... through which the business of an enterprise” (for example the non-resident multinational company) “is wholly or partly carried on” (OECD on Fiscal Affairs, 2005: paragraph 2, page 85). In elaboration of the aforementioned it is submitted in the Commentary that the business activities of a non-resident enterprise, which are performed within South Africa, would create a permanent establishment in South Africa in the event that it exhibits the following characteristics:

- The activities are performed at a place of business, in other words, at a facility, for example a premises or, under certain circumstances, at a place where machinery or equipment are present. (own emphasis)

- The place of business referred to above is fixed, in other words it is a distinct place with a certain degree of permanence. (own emphasis)

- The business of the non-resident enterprise (for example the non-resident multinational company) is wholly or partly carried on through the aforementioned fixed place of business. This typically entails the employees or an agent of the non-resident enterprise conducting the business of the enterprise wholly or partly in the State in which the fixed place is situated, namely, in this case, South Africa. (own emphasis)

In order to supply a more detailed understanding to the definition of a permanent establishment, the definition will now be discussed in more detail with reference to the relevant distinctive words or phrases included in the definition (which were emphasised above), namely:

- (a) place of business;
- (b) fixed;
- (c) through;
- (d) the business of an enterprise is wholly or partly carried on.

(a) Place of business

In terms of the Commentary on Article 5 of the OECD Model Tax Convention the term “place of business”, as it is used in the context of the permanent establishment definition, includes “any premises, facilities or installations used for carrying on the business of” an “enterprise whether or not they are used exclusively for that purpose” (OECD on Fiscal Affairs, 2005: paragraph 4, page 86). A certain amount of space at the disposal of an enterprise, it is submitted, is sufficient for rendering such space a place of business, provided the enterprise carries on in that place its business activities (or part thereof). It is further observed in the Commentaries that it is not material whether “the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise”.

The Commentary offers the following examples of what may constitute a place of business for the purposes of the permanent establishment definition:

- a pitch in a market place;
- a certain permanently used area in a customs depot;
- the business facilities of another enterprise, if utilised by the enterprise in question (for example, the non-resident multinational company). Such circumstance may, for example, arise where the non-resident multinational company has at its permanent disposal certain premises (or a part thereof), which is owned by another enterprise, in return for which it pays the owner a rental amount;
- no formal legal right to use a premises, facility or installation is required, with the result that a location, which is illegally occupied by an enterprise for the purpose of carrying on the whole or part of its business activities, could also constitute a place of business.

In terms of the Commentary, the mere presence of an enterprise at a particular location does not, however, necessarily mean that that location is at the disposal of that enterprise so as to render such location a place of business for the purpose of the permanent establishment definition. For example a salesman who regularly visits a customer to take orders and to meet the purchasing director in his office to do so, would not render such office a place of business in relation to his employer. This submission is based on the fact that such office would not be at the disposal of the salesman's employer.

The Commentary offers the following example where the presence of a representative of an enterprise at the premises of another enterprise could render such premises a place of business in relation to the former enterprise, for the purposes of the permanent establishment definition:

An enterprise's employee who, for an extended period of time, is allowed to use an office of another enterprise in order to ensure that the latter enterprise complies with its obligations under contracts concluded with the employee's employer. In such

case, the employee would be carrying on activities related to the business of the enterprise of which he/she is an employee. The office which is at the employee's disposal at the other enterprise would, in such case, constitute a permanent establishment of his/her employer. Such submission is however subject to the provision that the office is at the employee's disposal for a sufficiently long period of time so as to constitute a fixed place of business, and that the activities that are performed there are not preparatory or auxiliary in nature.

From the above it is inferred that the non-resident multinational company would create a permanent establishment in South Africa in the event that its employees render activities in South Africa which are sufficiently essential in relation to the business of the company, as a whole, for a sufficiently long period of time. (own emphasis)

(b) Fixed

In the permanent establishment definition reference is made to the word "fixed" in relation to the place of business. In terms of the Commentary on Article 5 of the OECD Model Tax Convention the fact that the place of business has to be a fixed one implies that "there has to be a link between the place of business and a specific geographical point" and that the place of business should be "a distinct place" (OECD on Fiscal Affairs, 2005: paragraph 5, page 87).

It is further noted in the Commentary that a place of business in the context of the permanent establishment definition does not refer to a place which is of a purely temporary nature, but rather one which has a certain degree of permanence. In explanation of what "a certain degree of permanency" entails, the following is noted in the Commentary:

...experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (OECD on Fiscal Affairs, 2005: paragraph 6, page 88).

In accordance with the Commentary “temporary interruptions of activities do not”, however, “cause a permanent establishment to cease to exist” (OECD on Fiscal Affairs, 2005: paragraph 6.1, page 89).

(c) Through which

In terms of paragraph 4.6 of the Commentary on Article 5 of the OECD Model Tax Convention, the words “through which” as they are used in the permanent establishment definition should be afforded “a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose”.

(d) The business of an enterprise is wholly or partly carried on

In the Commentary on Article 5 of the OECD Model Tax Convention the inference is made that a place of business could only constitute a permanent establishment in the event that the enterprise in question (for example, the non-resident multinational company) utilises it to carry on its business wholly or partly through it. It is noted in paragraph 7 of the Commentary on Article 5 that the activities performed at such place of business need not be “of a productive character”. In this regard it is submitted in paragraph 3 of the Commentary of Article 5 that “[w]ithin the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole” (OECD on Fiscal Affairs, 2005: paragraph 3, page 86). This view seems to accord with the approach followed by the court in *First National Bank of Southern Africa Ltd v Commissioner for South African Revenue Service (surpa)*, where the factual matrix pertaining to the taxpayer’s business as a whole was taken account of by the court for the purpose of determining South Africa’s right to tax the taxpayer’s income in question. The court was accordingly of the view that all the activities comprising the taxpayer’s business, contributed to the income in question.

It is furthermore submitted in paragraph 7 of the Commentary on Article 5 that, in addition, such activities “need not be permanent in the sense that there is no

interruption of operation”, but that the activities should be carried out “on a regular basis”.

Paragraphs 2 and 4 of Article 5 of the OECD Model Tax Convention

Paragraphs 2 of Article 5 of the OECD Model Tax Convention extends the permanent establishment definition to include certain specific activities which would otherwise have been excluded therefrom, whereas paragraph 4 of Article 5 offers examples of activities which should be deemed to be excluded from constituting a permanent establishment, on the basis that they are considered auxiliary in nature (in other words, not essential in nature).

In terms of paragraph 2 of Article 5 the following would typically constitute a permanent establishment (provided the business of the non-resident is partly or wholly conducted through the following):

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop, and
- a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

In accordance with paragraph 4 of Article 5 the following is deemed to be excluded from constituting a permanent establishment (in other words, they are exceptions to the general permanent establishment definition, even if the enterprise’s activities are carried out through a fixed place of business):

- the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

- the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- the maintenance of a fixed place of business solely for any combination of activities mentioned in the list above, provided the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

In terms of paragraph 21 of the Commentary on the Article 5 of the OECD Model Tax Convention the common feature of the activities listed above is that they are, in general, “preparatory or auxiliary activities”. In terms of paragraph 24 of the Commentaries on Article 5 of the OECD Model Tax Convention the “decisive criterion” to follow in determining whether or not an activity is preparatory or auxiliary in nature, is to establish “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”.

For example, in the event that the general purpose of a fixed place of business is “one which is identical to the general purpose of the whole enterprise”, the activities rendered at the fixed place of business would not be considered preparatory or auxiliary in nature, but rather essential and significant in view of the activities of the enterprise as a whole (OECD on Fiscal Affairs, 2005: paragraph 24, page 95). It is furthermore noted in the Commentaries that a “fixed place of business which has the function of managing an enterprise or even only a part of an enterprise cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds” the level at which preparatory or auxiliary activities are performed.

Summary of Article 5 of the OECD Model Tax Convention

From the discussion above it is inferred that the selling functions performed by the non-resident multinational company in South Africa would create a permanent

establishment in South Africa, in the event that it adheres to, for example, the following requirements:

- The selling functions are performed at a place of business located within South Africa, for example, a premises or a location where the non-resident multinational company has a certain amount of space at its permanent disposal. For example, the selling functions are performed in an office owned or rented by the company which is located within South Africa.
- The place of business referred to above is a distinct place which is linked to a specific geographical point located within South Africa, for example, an office which is located in Johannesburg. Such office is maintained as the non-resident multinational company's fixed place of business in South Africa, for a period of no less than six months.
- The selling functions of the non-resident multinational company are wholly and regularly carried on through the fixed place of business referred to above (for example, at the office located in Johannesburg), by the personnel of the non-resident multinational company who are concerned with the selling functions of the company.
- The selling functions performed within South Africa include the management activities pertaining to the selling operations of the non-resident multinational company. Accordingly, the selling functions can be regarded as an essential part of the activities of the company as a whole, as opposed to preparatory or auxiliary in nature. (own emphasis)

Assuming the above requirements (or similar requirements which meet the criteria contained in Article 5 of the OECD Model Tax Convention) are adhered to with reference to the non-resident multinational company, the selling functions, performed by the said company, will thus create a permanent establishment of the company in South Africa. In such case South Africa's right to tax the income of the non-resident multinational company will be confirmed by the relevant DTA.

As explained earlier, South Africa's right to tax the income of the non-resident multinational company will, however, be restricted to the income determined in terms of Article 7 of the OECD Model Tax Convention. Article 7 will now be discussed to ascertain the impact it may have on the taxability of the non-resident multinational company's income from a South African perspective.

4.4 Article 7 of the OECD Model Tax Convention

In terms of paragraph 1 of Article 7 of the OECD Model Tax Convention the income of the non-resident multinational company, referred to above, may be taxed in South Africa, "but only so much" of such income "as is attributable to" its "permanent establishment" situated in South Africa.

The attribution referred to above is governed by Article 7 of the OECD Model Tax Convention, but due to its complex nature reference to other sources of guidance in this regard is vital. Guidance in relation to the attribution process can, for example, be found in the *OECD Report on the attribution of profits to permanent establishments*, the latest issue of which was released in December 2006.

In terms of the *OECD Report on the attribution of profits to permanent establishments* there is a broad consensus among OECD member countries that the conclusions reflected in the said report constitute the preferred approach to attributing profits to permanent establishments in terms of Article 7, given modern-day multinational business models and practices. It is, however, further noted in the report that the additional guidance, reflected in the report, is intended (for the time being) to supplement the existing Commentary on Article 7 of the OECD Model Convention, "but only to the extent that such guidance does not conflict with the existing Commentary" (OECD, 2006: 4). The inference is thus made that such report should be referred to (in addition to the Commentary on the OECD Model Tax Convention) for guidance pertaining to the attribution of the income of the non-resident multinational company to its permanent establishment situated within South Africa.

Due to the complex nature of the attribution process, the discussion to follow will focus only on the considerations which are taken into account, on a general basis, for the purpose of attributing income to a permanent establishment.

Paragraph 2 of Article 7 of the OECD Model Tax Convention

In terms of paragraph 2 of Article 7 of the OECD Model Tax Convention, so much of an enterprise's profits will be attributed to its permanent establishment as those

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.

The above passage is considered in paragraph 10 of section B of the *OECD Report on the attribution of profits to permanent establishments* to mean the following:

The profits to be attributed to an enterprise's permanent establishment are the profits that the permanent establishment

would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2).

The term "arm's length" refers, for example, to the scenario which is created when two enterprises, which are independent with reference to each other (in other words they are not connected persons), enter into dealings with each other. Such enterprises will be regarded as dealing at arm's length. An independent enterprise will generally seek to gain the best advantage for itself when entering into a contract with an independent third party, usually with the ultimate goal to maximise its profits.

The attribution of the profits of the non-resident multinational company to its permanent establishment, located within South Africa, should accordingly be performed on the hypothetical basis that the permanent establishment constitutes an independent enterprise in relation to the non-resident multinational company. In the light of such hypothesis the profits attributable to the permanent establishment should

be equal to the profits that would have been contended for by an independent enterprise in the event that such enterprise executed the selling functions (which are in reality executed by the non-resident multinational company through the permanent establishment in South Africa). Such independent enterprise would, in layman's terms, contend for its "fair share of the profits". The following simplistic example of such hypothesis can be offered:

- (i) A company (company X) is engaged in the manufacture of products in a jurisdiction located outside South Africa.
- (ii) Rather than engaging in the selling of the manufactured products in South Africa itself, company X disposes of the manufactured products to an independent enterprise, resident and located in South Africa. For economic reasons company X would attempt to achieve the highest possible price for its products and the independent enterprise, resident in South Africa, would attempt to acquire such products at the lowest possible price. The price that the two parties would agree upon would constitute an arm's length price. Any profit made on the disposal of the products by company X to the independent enterprise will be recognised in the accounts of company X.
- (iii) The independent enterprise, resident in South Africa, then sells the manufactured products to the public in South Africa. Any profit made on the disposal of the products in South Africa would be recognised in the accounts of the independent enterprise.

In view of the principles underlying the above simplistic example, the profits attributable to the non-resident multinational company's permanent establishment in South Africa (performing functions and assuming risks similar to those of the independent enterprise described in the example above) should, in general terms, be equal to the profit referred to in (iii) above.

For the purpose of determining the monetary value of the profits attributable to a permanent establishment on the basis envisaged in Article 7, the above arm's length

principle is generally applied with reference to the so-called “authorised OECD approach”.

The authorised OECD approach

In terms of the *OECD Report on the attribution of profits to permanent establishments* the authorised OECD approach is based on the so-called “functionally separate entity” approach and requires a “two-step analysis”. It is noted in the said report that the purpose of the first step is to hypothesise appropriately the permanent establishment and the remainder of the enterprise to which the permanent establishment relates-

as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises.

In other words, in relation to the non-resident multinational company, the purpose of the first step is to appropriately split the functions, assets and risks comprising the business of the non-resident multinational company between the said company and its permanent establishment as if they were two distinct and separate enterprises. It is explained in the *OECD Report on the attribution of profits to permanent establishments* that the assets and risks, forming part of the business of the enterprise, are to be allocated between the permanent establishment and the remainder of the enterprise in relation to the business functions or activities to which it relate. As explained earlier, a permanent establishment will not be created in a jurisdiction unless the business activities performed in such jurisdiction are sufficiently essential in relation to the enterprise as a whole. The assets and risks associated with those activities should therefore be attributed to the permanent establishment.

For example, in the event that (very simplistically expressed) forty per cent of the business functions or activities (to which certain assets and risks are attributable) of the non-resident multinational company are performed by the permanent establishment in South Africa, forty per cent of the non-resident multinational

company's assets and risks are to be attributed to the permanent establishment in South Africa.

The second step in the two-step analysis entails the determination of the profits to be attributed to the functions performed, asset utilised and risks assumed by the permanent establishment. The profits so attributable are determined with reference to arm's length principles.

An effective way in which to explain the second step of the authorised OECD approach is to explain it with reference to the so-called "value chain" approach. A value chain represents an entity's business cycle from beginning to end. As submitted earlier, the non-resident multinational company is engaged in the business of manufacture and sale. In the event that it is engaged in the manufacture and sale of plastic toys, the value chain approach could, on a very simplistic basis, be analysed as follows with reference to the functions to be performed, assets to be utilised and risks to be assumed (which are based on examples):

<u>Activities:</u>	<u>Functions to be performed:</u>	<u>Assets to be utilised:</u>	<u>Risks to be assumed:</u>
(i) The acquisition of the raw materials (for example, plastic) to be used in the manufacturing process (which is to be executed in a jurisdiction outside South Africa).	Procurement (of raw materials).	Financial resources (to finance the acquisition).	The risk of loss of financial resources (due to, for example, theft).
	Transportation (of the raw materials to the manufacturing plant).	Human capital (for example, employees, to perform the functions). Vehicles (to be used for the transportation function).	The risks associated with employment, for example, labour disputes. The risk of vehicle theft or damages.

			The risk of inventory loss or damage.
(ii) The manufacturing and packaging of the plastic toys (outside South Africa).	Manufacturing (of the toys). Packaging (of the toys).	Equipment and machinery (used in the manufacturing process). The plant. Financial resources. Human capital (to perform the functions).	The risk of damages to and loss of equipment and machinery. The risk of damages to the plant. The risks associated with employment.
(iii) The storage of the toys.	Storage (of the manufactured toys).	Storage facility (in which the toys will be stored, for example a shed).	The risk of damages to the storage facility. The risk of inventory loss or damage.
(iv) The transportation of the toys to South Africa.	Transportation (of the toys to South Africa).	Vehicles (to be used for the transportation function). Human capital (to perform the functions).	The risk of vehicle theft or damages. The risks associated with employment.

(v) The storage of the toys in South Africa.	Storage (of the toys in South Africa).	Storage facility (in which the toys will be stored, for example a shed).	The risk of damages to the storage facility. The risk of inventory loss or damage.
(vi) The sale and delivery of the toys in South Africa.	Marketing (of the toys). Selling (of the toys to the South African market). Transportation (of the toys to the selling points).	Human capital (to perform the functions). Equipment and furniture (used for the selling function). Vehicles (to be used for transportation). Financial resources.	The risks associated with employment. The risk of loss of or damage to equipment and furniture. The risk of loss or damage to vehicles. The risk of loss of financial resources.

Assuming the non-resident multinational company seeks to make a profit through its business undertakings, each step listed above would generally add value to the final or end product. The toys referred to in (vi) above would generally be sold at a profit margin in excess of the costs incurred in respect of the various activities or stages described in (i) to (vi) above. Such increase in value would be attributable to, *inter alia*-

- the changes which the raw materials underwent as a result of the manufacturing process, ultimately resulting in the plastic toys;
- the materials used in the packaging of the toys;

- the transportation of the toys to the end-customer's market;
- the marketing of the toys; and
- the selling functions engaged in the selling of the toys.

Assuming each toy unit is sold for an amount of R200 (and an overall profit of R100), throughout a particular business cycle, the purpose of the second step, referred to earlier, is to determine how much of the R200 is attributable to each of the functions performed, assets utilised and risks assumed in respect of the activities listed under (i) to (vi) above. Such attribution is to be done on the basis of the arm's length principles referred to earlier. In other words, the share of the R200 attributable to each function performed, asset utilised and risk assumed should be equal to that which an independent enterprise would have contended for had it performed, utilised or assumed the relevant function, asset or risk (in view of the circumstances unique to the business in question).

The sum of the profit-shares to be attributed (in terms of the arms' length principles) to each of the functions, assets and risks performed, utilised and assumed by the permanent establishment in South Africa (in terms of an earlier example it was assumed that forty per cent of the non-resident multinational company's functions, assets and risks are performed, utilised and assumed by the permanent establishment) in respect of the particular business cycle, represent the profits attributable to that permanent establishment for such business cycle in terms of step two of the authorised OECD approach. Assuming the total profit-share attributable to the permanent establishment amounts to R40 (of the overall R100 profit) per toy unit, the result would be that forty per cent of the profits earned by the non-resident multinational company in respect of the said business cycle are attributable to the permanent establishment in South Africa.

Summary of the attribution process

Assuming, throughout a particular year of assessment-

- forty per cent of the functions, assets and risks comprising the business, as a whole, of the non-resident multinational company are performed, utilised and assumed by its permanent establishment in South Africa;
- the example of the R200 selling price (and R100 overall profit) per toy unit applies and remains unchanged;
- the basis of attributing R40 of the above R100 profit per toy to the permanent establishment, per the said example, applies and remains unchanged;

forty per cent of all profits earned by the non-resident multinational company would be attributable to the permanent establishment in terms of Article 7 of the OECD Model Tax Convention.

4.5 A logical conclusion on the application of the “permanent establishment rules” contained in Articles 5 and 7 of the OECD Model Tax Convention

In the event that it is determined-

- that the selling functions performed by the non-resident multinational company in South Africa create a permanent establishment in South Africa (in terms of Article 5 of the OECD Model Tax Convention); and
- that forty per cent of the non-resident multinational company’s profits are to be attributed to its permanent establishment in South Africa (in terms of Article 7 of the OECD Model Tax Convention),

the DTA between South Africa and the residence jurisdiction of the non-resident multinational company would accordingly confirm South Africa’s right to tax the income of the non-resident multinational company. As a result of such confirmation of South Africa’s taxing right, forty per cent of the non-resident multinational company’s profits would be subject to tax in South Africa. Such tax would be

determined in terms of the Act, which stipulates a tax rate of thirty-four per cent under the circumstances at hand. A rate of thirty-four per cent would apply, on the basis that, for South African tax purposes, the permanent establishment of the non-resident multinational company would constitute a “branch” of such company, which is located within South Africa. A “branch” is not defined in the Act, but the equation between the meaning of a “branch” and the meaning of a permanent establishment is drawn in paragraph 13.6 of *Silke on South African Income Tax, Memorial Edition, Volume 2*. In that paragraph a “branch” is described as, “in essence a legally dependent segment of an enterprise” which, “from an economic and commercial point of view” has “a certain degree of independence in carrying on the business of the enterprise and its activities are not confined to work of a preparatory or auxiliary nature” (De Koker, 2006:13-9). In view of the discussion above it is clear that the aforementioned description is in line with the permanent establishment definition.

The non-resident multinational company would possibly be subject to tax on the said forty per cent of its profits in its jurisdiction of residence as well (which would most likely be the case in the event that a residence-based taxation system exists in its jurisdiction). In the absence of relief in this regard, the said profits would in such case be taxed twice, namely once in South Africa and once in the residence jurisdiction of the non-resident multinational company. For the purpose of avoiding the same amount of income being tax twice in the hands of the non-resident multinational company, such company would, in terms of the relevant DTA, be allowed to claim any taxes imposed in South Africa as a credit against the tax payable in its own jurisdiction with reference to the relevant income.

In the event that the non-resident multinational company is, for example, resident in the United Kingdom, the relief referred to above would be provided for in terms of sections 792 to 806M of the United Kingdom’s Income Tax and Corporation Tax Act of 1988 (the United Kingdom Tax Act). With reference to the non-resident multinational company, such relief would typically entail the reduction or crediting of its taxes payable in the United Kingdom, with the taxes imposed in South Africa on its profits attributable to its permanent establishment in South Africa.

As is the case with the South African Income Tax Act (more specifically section 6quat of the Act), there are a number of requirements which have to be met before the double taxation relief would be given under the provisions of the United Kingdom Tax Act. With reference to the non-resident multinational company the requirements generally include the following:

- the taxes imposed in South Africa (in respect of the profits attributable to the permanent establishment of the non-resident multinational company) should be payable by the non-resident multinational company in terms of the South African tax Act and in accordance with the DTA between South Africa and the United Kingdom;
- the taxes referred to above must have been levied on income which was derived from an actual or deemed source located within South Africa (in other words, a source located outside the United Kingdom); and
- the United Kingdom tax, against which the tax credit is to be given, should be computed with reference to the same income with reference to which the South African tax was computed, namely the profits attributable to the permanent establishment of the non-resident multinational company.

Assuming that the above requirements are adhered to, the non-resident multinational company would accordingly be granted relief in respect of any taxes imposed in South Africa in respect of the profits attributable to its permanent establishment in South Africa. The non-resident multinational company would consequently be taxed on the total of its income once, and such tax revenue would be shared between South Africa and the United Kingdom as a result of the DTA between the two countries.

In a global economy the universal application of the DTA rules becomes extremely important, not only to avoid economic double taxation, but also to ensure the validity of the foreign taxes imposed, in respect of which a credit is sought by the taxpayer in his/its country of residence for the purpose of reducing his/its domestic tax liability (namely, in the above example, the taxes imposed in South Africa, in respect of which a credit would be sought by the non-resident multinational company in the United Kingdom in order to reduce its tax liability in the United Kingdom). If, for example,

South Africa seeks to tax 100 per cent of the non-resident multinational company's profits, the United Kingdom would, having regard to the DTA between itself and South Africa, only allow a tax credit equal to a South African tax liability which is attributable to forty per cent of the non-resident multinational company's profits (in other words, thirty-four per cent multiplied by forty per cent of the company's profits). Such limitation of the tax credit would be based on the fact that South Africa is legally, in terms of the DTA, only entitled to tax forty per cent of the non-resident multinational company's profits (the forty per cent of the company's profits being based on the examples used above).

Chapter 5

A comparison between the South African “source rules” and the “permanent establishment rules”

5.1 Introduction

From the discussions up to now it is clear that there are both similarities and contradictions between the “source rules” and the “permanent establishment rules”. Such similarities and contradictions will now be enquired into, with specific reference to the non-resident multinational company referred to earlier, in order to determine the impact it has on the South African *fiscus*.

5.2 Similarities between the “source rules” and the “permanent establishment rules”

As a point of departure, the source of income is determined in terms of the South African “source rules” by taking into consideration the relevant factual matrix in order to identify the activities which collectively produce the income. In the event that the activities identified are performed in more than one jurisdiction (which is prevalent in an era of multinational enterprises), the source of the income is determined only with reference to the main or dominant activities (in other words, the “dominant cause”) which produce the income in question, in terms of the “source rules”. Any other activities performed by the taxpayer are disregarded for the purpose of determining the source of the income (it is inferred that such activities are considered sufficiently insignificant or auxiliary in nature so as to justify disregarding them in this regard). The source of the income is accordingly located in the jurisdiction where the main or dominant activities are performed, in terms of the “source rules”.

Provided the “dominant cause” (and consequently the source) of the non-resident multinational company’s income is located within South Africa, a DTA would, in terms of the “permanent establishment rules” confirm South Africa’s right to tax such income in the event that, *inter alia*, such company performs business activities within

South Africa which are essential (and not merely preparatory or auxiliary in nature) to the non-resident multinational company's business as a whole. In order to make such determination, the "permanent establishment rules" also require cognisance of the factual matrix.

Both the "source rules" and the "permanent establishment rules" are applied to the factual matrix for the purpose of identifying the activities which produce the income in question. Both the "source rules" and the "permanent establishment rules" require that income producing activities be performed within South Africa by the non-resident multinational company, which are of a sufficiently essential nature, in order to attract a South African tax liability. Activities which are insignificant or auxiliary in nature would not attract or confirm a South African tax liability, in terms of the "source rules" or the "permanent establishment rules" respectively.

Although the principles described above are similar in appearance, it should be noted that it is not entirely clear how the dominant or main activities are distinguished from the insignificant or auxiliary activities in terms of the "source rules". For the purpose of making such distinction in order to determine the source of income, the courts have, in the past, taken into account the nature of the taxpayer's business or the sequence of events leading up to the production of the income, depending on the factual matrix. There do not, however, appear to be universal guidelines in this respect, as the courts have followed different approaches for the purpose of distinguishing between the activities which are dominant in nature and those which are not. In addition to the fact that different approaches are followed by the courts in this regard, the courts are generally silent as to the exact grounds on which they disregard certain activities for the purpose of locating the source of income (they are, however, clearly disregarded on the basis that courts consider the source of income to be wholly located where the dominant activities are performed). It is inferred that the courts consider the aforementioned activities insignificant or auxiliary in nature in view of the production of the income in question, but on which exact basis the courts come to such conclusion is not apparent.

By contrast, in terms of the "permanent establishment rules", activities which are essential in view of the taxpayer's overall business are distinguished from activities

which are preparatory or auxiliary in nature, with reference to a very clear and precise set of rules, applicable on an universal basis.

5.3 Contradictions between the “source rules” and the “permanent establishment rules”

Whilst the “source rules” are similar to the “permanent establishment rules” in that they disregard business activities which are insignificant or auxiliary in nature when determining South Africa’s right to tax the income of a non-resident, they differ from the “permanent establishment rules” on the following grounds:

In terms of the “permanent establishment rules”, a DTA specifically provides for the sharing of a taxing right between the two jurisdictions which are party to the relevant DTA, as explained in Chapter 4.

The sharing of a taxing right between two jurisdictions, which is provided for in terms of the “permanent establishment rules”, is not provided for in terms of the “source rules”. The “source rules” seem to suggest an “all or nothing” approach. South Africa would generally be afforded the right to tax the income of the non-resident multinational company in the event that the dominant or main activities, giving rise to the income in question, are performed within South Africa. In the event that the dominant or main activities, giving rise to the income, are not performed within South Africa, the “source rules” would afford South Africa no right to tax the income (or any part thereof) of the non-resident multinational company. The “source rules”, as they currently stand, do not provide for the apportionment of income between two different sources which are located in two different jurisdictions (assuming, for the purposes of this thesis, that the income is derived from manufacture and sale).

Although the courts have in the past considered apportioning income between two sources, located in two different jurisdictions, and although the modern-day court would in all likelihood revisit such consideration favourably, such consideration has, to date, been restricted to *obiter dicta* and has accordingly not yet been incorporated into the “source rules”. Rather than apportioning the income, the courts, to date, appear to endeavour to identify the activities which can, in the courts’ view, be

considered to be the dominant or main activities which produced the income in question. The courts consider the source of the income to be wholly located where such activities were performed. It is inferred that the courts regard the remainder of the activities to be insignificant or auxiliary in nature. It is ironic that the courts have been reluctant to date to apportion income on this basis. It appears to be a logical solution to the problem which arises when a taxpayer performs income-producing activities in two jurisdictions, where the activities in one of the jurisdictions cannot easily be dismissed on the grounds of being insignificant or auxiliary in nature. The view has been expressed in the South African courts that the source of income should be determined from the perspective of “a practical man”. It is difficult to see, in the modern age where multinational enterprises are prevalent, how “a practical man” would remain loyal to this reluctance to apportion income between two or more sources, located in different jurisdictions.

Unlike the “source rules”, the “permanent establishment rules”, however, seek to tax proportionately the income of a multinational company in the event that *some* of the activities, which give rise to the income in question, are performed within South Africa. Unlike the “source rules” the “permanent establishment rules” do not necessarily require the activities, performed within South Africa, to constitute the dominant or main activities which collectively give rise to the income in question. As is evident from the examples used in Chapter 4, the “permanent establishment rules” would confirm South Africa’s right to tax the income of the non-resident multinational company, even if the business activities performed within South Africa only comprise forty per cent of the company’s business activities as a whole.

However, as discussed, a DTA cannot create a taxing right, it can only alter, where appropriate, an existing taxing right by sharing or allocating it between the jurisdictions which are party to the DTA. In the event that the source of income is not considered to be located within South Africa as a result of an application of the “source rules”, a DTA cannot in itself afford South Africa the right to tax such income, even if essential business activities, giving rise to such income, are performed within South Africa. Provided, therefore, the income earned by the non-resident multinational company is captured by the “source rules”, South Africa would be awarded its “fair share” of the tax revenue relating to the income earned by the non-

resident multinational company (on the basis that the “permanent establishment rules” would confirm South Africa’s taxing right in proportion to the profits attributable to the company’s permanent establishment located within South Africa, if applicable).

Conversely, it does not appear as though South Africa would be awarded its “fair share” of the tax revenue in the event that the income earned by the non-resident multinational company is not captured by the “source rules”, whilst *some* (but not necessarily the dominant or main part) of the essential business activities giving rise to the income, are performed within South Africa. This submission can be explained as follows:

In terms of the examples used in the discussions pertaining to Articles 5 and 7 of the OECD Model Tax Convention (in Chapter 4), the following was determined:

- (i) Forty per cent of the non-resident multinational company’s functions (in other words, activities), assets and risks were found to be performed, utilised and assumed within South Africa via the non-resident multinational company’s permanent establishment, located inside South Africa.

- (ii) As a result of an application of the profit attribution rules contained in Article 7 of the OECD Model Tax Convention, forty per cent of the non-resident multinational company’s profits were found to be attributable to its permanent establishment in South Africa, and accordingly subject to tax in South Africa.

In view of the “source rules”, South Africa would generally only be afforded the right to tax the income earned by the non-resident multinational company referred to above, in the event that the functions, assets and risks referred to in (i), constitute the “dominant cause” of the income under consideration. Should this be the case, the relevant DTA would alter such taxing right by limiting South Africa’s taxing right to the income referred to in (ii) above. In view of such scenario, South Africa would accordingly be afforded the right to tax the company’s income in proportion to the income derived by the company within South Africa via its permanent establishment.

On the other hand, should the functions, assets and risks referred to in (i) above, not constitute the main or dominant cause of the income under consideration, the “source rules” would afford South Africa no right to tax the income of the non-resident multinational company. The fact that, in terms of the “permanent establishment rules”, forty per cent of the non-resident multinational company’s profits are attributable to its permanent establishment located within South Africa, would not alter the outcome of an application of the “source rules”. South Africa would accordingly be left with no right to tax the income of the non-resident multinational company (or any part thereof).

The above brings to mind the following submission of Stratford CJ in *Kerguelen Sealing and Whaling Co Ltd v CIR* (1939 AD 487, 10 SATC 363):

...In my opinion the word source is used to convey the idea... that if the natural resources of... South Africa or the activities of its inhabitants produce the wealth, that wealth must be taxed, and this view accords with the notion of the equity of the tax. (own emphasis)

In view of Stratford CJ’s submission, the scenario described above, therefore, appears to deprive South Africa of tax revenues to which it is duly entitled. Certainly the functions, assets and risks referred to in (i) above would, at least at some point, involve “the natural resources of... South Africa or the activities of its inhabitants”.

The reason for the adverse nature of the “source rules” (from the perspective of the South African *fiscus*) may be the fact that the “source rules” were in essence formulated by the courts during a time when-

- a source-based taxation system (as opposed to a residence-based taxation system) existed in South Africa; and
- the economy of South Africa largely functioned in isolation from the rest of the world due to the political regime existing in South Africa at the time.

In vast contrast to the time during which the “source rules” were formulated (as described above), South Africa now partakes in the global economy, in which multinational enterprises perform their business activities throughout the world. In

the modern age it appears as though the terms of the “source rules” (which focus on the “dominant cause” of income only) may clearly deprive the South African *fiscus*, under certain circumstances, of tax revenues to which it is duly entitled.

In contrast to the “source rules” the “permanent establishment rules” were formulated in light of the current economical, political and social circumstances with which South Africa and the rest of the modern world are currently faced.

For example, the “permanent establishment rules”-

- consider an enterprise’s business in its entirety (income producing transactions are not viewed in isolation);
- acknowledge the fact that each essential facet of an enterprise’s business (albeit located in different countries) contributes to the enterprise’s profits (on the basis that the “permanent establishment rules” attribute taxable profits to business activities which are considered essential in light of the enterprise’s business as a whole).

In order to emphasise the shortcomings of the “source rules” in light of the modern age in which the South African economy now exists, they will be compared to the characteristics of the “permanent establishment rules” listed above.

The “permanent establishment rules” consider an enterprise’s business in its entirety

On an application of the “source rules”, only the transactions which gave rise to the income under consideration (usually the income contended by the revenue authorities to be derived from a source located within South Africa) have been taken into consideration by the courts in the past. See for example *Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes, Southern Rhodesia* (1938 AD 282, 9 SATC 363), in which Stratford CJ held the following:

At the outset counsel submitted that ...profit...if it was derived from the business then that business was clearly in London where the companies resided and where all the transactions were completed. ...the argument... ignores the distinction between the general business of a

person and one of his profitable business transactions, which may or may not be part of his main or general business. A company can, of course, carry on business in more places than one and in places where it has no residence (see *Rhodesian Railways and Others v Commissioner of Taxes* (1925, A.D. 438) 1 SATC 133) and, of course, the businesses may be of different kinds and unconnected with one another. (own emphasis)

In that case the court disregarded the taxpayer's normal or general business activities which were performed in London and only took into consideration the business transactions with which the income under consideration was directly concerned for the purpose of locating the source of the income (for the purpose of determining the right to tax such income). Such transactions took place in Rhodesia. Consequently, the source of the income was held to be wholly located in Rhodesia. Had the court acknowledged that the income was produced by all the taxpayer's business activities collectively, in accordance with the view expressed in the "permanent establishment rules", the court may have come to a different conclusion (in other words, it may have apportioned the income between all the activities which produced the income).

In *Transvaal Associated Hide and Skin Merchants v COT* (1967 (BCA), 29 SATC 97) the court had to determine the source of income derived from the sale of hides which were purchased and cured in Lobatsi, Botswana. Even though the taxpayer was registered in South Africa and purchased approximately only twenty per cent of its hides in Lobatsi (and the remainder in South Africa), the court focussed only on the taxpayer's activities concerned with the hides purchased in Lobatsi (and sold in South Africa) for the purpose of determining the source of the income in question. The court disregarded the other business activities performed by the taxpayer and clearly did not acknowledge that the income was produced by all the taxpayer's business activities collectively. Had the court acknowledged as much, it may not have considered the source of the income to be located in Botswana, on the basis that the taxpayer may have performed the bulk and, in view of its overall business, the most essential part of its business outside Botswana.

In *ITC 432* (1939, 10 SATC 437) the taxpayer was engaged in the sale and erection of lifts. One contract of sale involved the sale and erection of a lift in Rhodesia. When the court had to determine the location of the source of the income derived from the

contract (and accordingly the right to tax such income), the court only took into consideration the activities involved with that specific contract. The court ignored any other contracts of sale to which the taxpayer may have been party.

Clearly expressing the view underlining the “source rules” in this regard are the following remarks aired in *ITC 1491* (53 SATC 115):

...there is nothing inconsistent or improper in determining different sources for different categories of income accruing to one business...

... In coming to this conclusion we have not lost sight of the fact, the importance of which is not to be understated, that the appellant had acquired the incorporeal property in South Africa and the further facts that its business is based in Port Elizabeth and that the major portion of its research is done there. (own emphasis)

Unlike the approach followed by the South African courts in the past (including the cases on which the South African courts have relied), as discussed above, the courts in Hong Kong appear to be of the view that the source of profits is generally located where the taxpayer carries on his principal business.

The above submission is supported by the judgment delivered by the Privy Council in *CIR v HKT-VB International Ltd* (Judicial Committee of the Privy Council, 20 July 1992). According to David Clegg, in his article entitled, *The enterprise test* (page 149) the facts of the said case are as follows:

- A Hong Kong company sourced recordings of entertainment events and licensed them to customers in a number of countries.
- The licences referred to above, were entered into by representatives sent from Hong Kong abroad to solicit the business and to negotiate with potential customers.
- License fees were agreed upon by correspondence in the form of letter or telex with the Hong Kong head office.
- Certain films were dubbed onto video cassette for licenses. This activity was performed in Hong Kong.

- The duration of the licenses were generally for a period varying between six to twelve months.
- There was no particular pattern as to the place where the license agreements were signed.

It is further noted in the article, *The enterprise test*, that the Privy Council, which had to determine the source of the profits (derived from the above activities) observed that the transactions which produced the profit in question were the following:

- “[T]he acquisition of the exclusive rights of granting sub-licenses together with the relevant films”; and
- “[T]he grant of the above sub-licenses by contract to individual customers”.

It is furthermore submitted in the said article that the “evidence showed that HKT-VB’s business was carried on along the following lines”:

- HKT-VB’s organisation which acquired the films and the exclusive foreign rights in them was located in Hong Kong.
- HKT-VB’s sales organisation was located in Hong Kong and the representatives who were sent abroad were part of that organisation.
- Sub-licenses were drawn up in Hong Kong and in accordance with Hong Kong law and despatched from Hong Kong.
- The films were either delivered in or despatched from Hong Kong. At the expiry of the sub-license the films were either returned to Hong Kong or destroyed.
- Payments for the grant of the sub-licenses were due and payable in Hong Kong.

In deciding the source of the profits under consideration, the court held the following:

What emerges is that HKT-VB, a Hong Kong based company, carrying on business in Hong Kong, having acquired films and rights of exhibition thereof, exploited those rights by granting sub-licenses to overseas customers. The relevant business of TVBI was the exploitation of film rights excisable overseas and it was a business carried on in Hong Kong. The fact that the rights which they exploited were only exercisable overseas was irrelevant in

the absence of any financial interest in the subsequent exercise of the rights by the sub-licensee.

The court held that the source of the profits was located in Hong Kong, where the taxpayer's principal business was conducted and considered the fact that the rights, which the taxpayer exploited, were only exercisable in jurisdictions outside Hong Kong, to be irrelevant.

From a South African perspective, David Clegg, in his article entitled, *The enterprise test* (pages 148-151), expressed the view that a South African court also finally broke away from the old approach (in terms of which focus is only placed on the transactions which are directly responsible for the earning of the income, whilst ignoring the taxpayer's principal business) in *First National Bank of Southern Africa Ltd v Commissioner for SARS* (64 SATC 245) (a case heard in 2002). On page 148 he remarked that whilst the court approved of the basic rules (namely the "universal guidelines" which were discussed earlier) formulated in *CIR v Lever Brothers & Unilever Ltd* (1946 AD 441, 14 SATC 1), the court in *First National Bank of Southern Africa Ltd v Commissioner for SARS* (*supra*) observed that the factual matrix presented by a commercial bank (namely First National bank in that particular case) was utterly different to that faced by the court in *CIR v Lever Brothers & Unilever Ltd* (*supra*). In determining the basic, essential and real cause of First National Bank's interest income arising, the court expressed the view that it was not the advancement of credit of the particular loan in New York, but rather the multiplicity of activities that comprised the business of banking, which were performed in South Africa. Accordingly Smalberger ADP held as follows:

Apart from the fact that contractually the foreign currency was made available to the borrowing client in New York and had to be repaid there, all the... important factors which caused the interest income to arise (and which constituted the dominant cause of the receipt of the interest) had their origin in South Africa and flowed from the appellant's business activities and operations here. The narrow view taken by the appellant focuses only on where the funds were made available and has to be repaid. It overlooks the need to have regard to the essence of the whole transaction which generated the interest with a view to determining the location of its source.

In David Clegg's view the court considered the location of the interest income in question to be located where the taxpayer's principal business was conducted.

The applicability of the above views, expressed by David Clegg in his article, *The enterprise test* is, however, limited to the determination of the source of interest income (on the basis that *First National Bank of Southern Africa Ltd v Commissioner for SARS (supra)* only concerned interest income). The views do not offer an authoritative approach which can be followed in respect of income which is derived from business activities other than that of money-lending, for example the business of manufacture and sale.

In view of the trade of manufacture and sale with which the non-resident multinational company is, in the example in the thesis, concerned with, the "source rules", as they currently stand, fail to take into consideration the business activities of an enterprise as a whole, for the purpose of determining the source of its income and accordingly the right to tax such income (from South Africa's perspective). As explained, on an application of the "source rules", the transactions which directly give rise to the income under consideration are viewed in isolation, whilst the principal business of an enterprise is ignored (unless the income is directly attributable to the principal business).

The "permanent establishment rules" acknowledge the fact that each essential facet of an enterprise's businesses (albeit located in different countries) contributes to the enterprise's profits.

On the basis that, on an application of the South African "source rules", an "all or nothing" approach appears to be followed in that the source of income is determined to be located wholly within a jurisdiction or wholly outside, the rules do not acknowledge the fact that each essential facet of an enterprise's business contributes to the enterprise's profits. As explained earlier, as a general rule, and with specific reference to the hypothetical non-resident multinational company, the "source rules" do not provide for the apportionment of income between two or more sources. In terms of the "source rules" the source of income is considered to be wholly located where the "dominant cause" of the income is located. The "source rules" therefore

dismiss the consideration that the activities giving rise to the income (albeit essential), which do not constitute the “dominant cause” of the income, also contribute to the production of the income in question.

5.4 Conclusion

In view of the discussions above and in the light of the modern-day global economy, in which multinational enterprises trade across borders, the principles underlining the “source rules” appear to be outdated. As illustrated the “source rules” are no longer sufficiently effective in affording the South African *fiscus* taxing rights under all circumstances when South Africa’s resources and infrastructure are utilised and/or the activities of its inhabitants are called upon. As explained, South Africa can only be afforded a taxing right in terms of an application of the “source rules” where non-residents are concerned. Unless the main or dominant activities giving rise to income of a non-resident are performed within South Africa, South Africa would be afforded no right to tax the income, even if the income is partly produced through essential (but not the main or dominant) business activities, performed within South Africa.

The “permanent establishment rules”, on the other hand, clearly provide positively for global trade and a fair attribution of taxing rights between the jurisdictions which are party to a DTA (on the basis that the “permanent establishment rules” attribute taxable profits to all the essential business activities of an enterprise, wherever it may be located). Had the “source rules” been formulated on the same principles as the “permanent establishment rules”, the South African *fiscus* would not suffer the potential tax revenue deprivation which the “source rules” may create as a result of their disregard of all activities which do not constitute the dominant or main activities, giving rise to the income in question.

A solution to the deprivation of taxing rights which the “source rules” create under certain circumstances would be to provide a definition for the term “source” in section 1 of the Act, such definition being based on the “permanent establishment rules”. Unlike the “source rules”, the “permanent establishment rules” are clear, clinical and universally applicable. Unlike the “source rules”, when applicable, they leave no room for uncertainty on the relevant non-resident’s part as to his tax position. As they

currently stand, the “source rules” do not determine South Africa’s taxing rights with reference to clear, clinical and universal rules. Often the “source rules” are vague and apparently illogical with reference to the exact manner in which the source of income is determined, leaving the non-resident “practical man” uncertain as to his tax position (in the event that he performs income producing activities within South Africa).

Even if a modern-day court adopts the principle of apportionment into the “source rules” (which is likely to be the case), there is no certainty as to the manner in which such apportionment would be applied. There is no clear authority which suggests that the courts would suggest or approve of an apportionment methodology which is in line with the “permanent establishment rules”, especially in the absence of a relevant DTA. In the presence of a relevant DTA South Africa’s taxing right (afforded under the above hypothesised circumstances, where the concept of apportionment is incorporated into the “source rules”) would most likely, and in most cases, be brought in line with the taxing right envisaged in the DTA, by virtue of section 108 of the Act. In the event that the court, however, suggests or approves of an apportionment methodology which leaves South Africa with the right to tax a smaller amount than that envisaged in the DTA, South Africa’s taxing right would most likely not be brought in line with the principles underlining the “permanent establishment rules”, on the basis that the rules of a DTA cannot increase a taxing right, as explained earlier. Consequently, even if the courts incorporate the concept of apportionment into the “source rules”, the non-resident, who conducts income-producing activities within South Africa, would remain in an uncertain position as to his tax position in South Africa, especially in the absence of a relevant DTA. Clearly defining the term “source” in the Act with reference to the “permanent establishment rules” would alleviate such uncertainty.

The courts have expressed the view that the Legislature has been reluctant to supply a definition of “source”, on the basis that it would be a difficult task to formulate a definition which is applicable under all circumstances. Such difficulty has, however, been overcome to a large extent by the “permanent establishment rules”. Incorporating the principles underlining the “permanent establishment rules” into a definition of the term, “source”, in the Act, therefore appears to be appropriate and logical in view of the modern-day economy of which South Africa is a part. In so

doing, the South African *fiscus* would be afforded a taxing right whenever income-producing business activities, which are essential in nature, are performed within South Africa, and not only when the dominant or main activities giving rise to the income in question are performed within South Africa. In addition, the extent to which the income of a non-resident would be taxable in South Africa would also be ascertainable. This would enable a non-resident to determine his tax position in South Africa with a comfortable degree of certainty.

REFERENCE LIST

- Books:

Organisation for Economic Co-operation and Development Committee on Fiscal Affairs. 2005. **Model Tax Convention on Income and on Capital**. France, Paris: OECD Publications.

Organisation for Economic Co-operation and Development Committee on Fiscal Affairs. 2005. **Commentaries on the Articles of the Model Tax Convention**. France, Paris: OECD Publications.

De Koker, A. 2006. **Silke on South African Income Tax, Memorial Edition, Volume 1**. Durban: LexisNexis Butterworths.

Clegg, D, Stretch, R. 2006. **Income Tax in South Africa**. Durban: LexisNexis Butterworths.

Meyerowitz, D. 2006. **Meyerowitz on Income Tax 2005 – 2006**. Cape Town: The Taxpayer.

Emslie, TS, Davis, DM, Hutton, SJ, Olivier, L. 2001. **Income Tax Cases & Materials, Third Edition**. Cape Town: The Taxpayer.

Williams, RC. 2005. **Income Tax in South Africa, Cases & Materials, Second Edition**. Durban: LexisNexis Butterworths.

Brincker, E, Honiball, M, Olivier, L. 2004. **International Tax: A South African Perspective, Second Edition**. Cape Town: Siber Ink CC.

Vogel, K. 1997. Klaus Vogel on Double Taxation Conventions, Third Edition. London: Kluwer Law International Ltd

- Articles:

Organisation for Economic Co-operation and Development. 2006. **Report on the Attribution of Profits to Permanent Establishments**. Centre for Tax Policy and Administration.

Clegg, David. 2005. **The enterprise test**. Tax Planning.

- Cases:

Wensleydale's Settlement Trustees v CIR

CIR v Epstein (1954 (3) SA 689 (A), 19 SATC 221)

CIR v Lever Brothers & Unilever Ltd (1946 AD 441, 14 SATC 1)

Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes, Southern Rhodesia (1938 AD 282, 9 SATC 363)

Overseas Trust Corporation Ltd v CIR (1926 AD 444, 2 SATC 71)

Commissioner of Taxes v Dunn & Co. (1918 AD)

Millin v CIR (1928 AD 207, 3 SATC 170)

ITC 81 (1927, 3 SATC 136)

ITC 432 (1939, 10 SATC 437)

CIR v Black (1957 (3) SA 536 (A), 21 SATC 226)

Essential Sterolin Products (Pty) Ltd v CIR (1993 (4) SA 859 (A), 55 SATC 357)

Transvaal Associated Hide and Skin Merchants v COT (1967 (BCA), 29 SATC 97)

First National Bank of Southern Africa Ltd v Commissioner for South African Revenue Service (64 SATC 245)

CIR v Tuck (1987 (2) SA 219 (T), 49 SATC 28)

ITC 1104 (1967, 29 SATC 46)

Commissioner of Taxation v Kirk (1900, A.C. 588)

Lovell and Christmas Ltd. v Commissioner of Taxes (1907, A.C. 46)

Kerguelen Sealing and Whaling Co Ltd v CIR (1939 AD 487, 10 SATC 363)

ITC 1491 (53 SATC 115)

CIR v HKT-VB International Ltd (Judicial Committee of the Privy Council, 20 July 1992)

- Legislation

The Income Tax Act No. 58 of 1962

United Kingdom Income Tax and Corporation Tax Act of 1988