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# **The Attribution of Profits to Permanent Establishments Created by Cross-border Pipelines**

**A mini dissertation submitted to the**

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**in fulfilment of the requirements  
for the degree of LLM (Taxation)**

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## ABSTRACT

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This study addresses the taxation issues arising from a cross-border pipeline. The first element that is addressed is the different possible classifications of a pipeline for tax purposes. The fact that the Organisation for Economic Co-operation and Development (“OECD”) does not provide a universal classification for a cross-border pipeline, leaves tax authorities in the various jurisdictions to interpret and classify the pipeline as they see fit. This lack of consistent classification may give rise to double taxation or even double non-taxation.

The study explores the definition of a permanent establishment (“PE”) and analyses the elements of the definition in terms of the OECD Model Tax Convention (“MTC”) and the OECD Commentary on Article 5. In this study the assumption is made that the classification of a cross-border pipeline is that it falls within the ambit of Article 5 and should therefore be treated as a PE.

If the cross-border pipeline is classified as a PE for taxation purposes the attribution of profits arising from the PE will be attributed in terms of Article 7 of the OECD MTC. In the study the attribution of profits relating to the PE created by the presence of a cross-border pipeline in various jurisdictions is analysed. The attribution of such profits can result in difficulties in determining the exact amount attributable to each of the jurisdictions which the pipeline spans.

The author considers the OECD Reports (2008 and 2010 Reports) on the Attribution of Profits to Permanent Establishments to comment on whether the reports provide adequate guidance for attributing profits to such a unique situation as that of a cross-border pipeline. It is also addressed whether the attribution of profits to a cross-border pipeline can be dealt with under the general principles of attribution. Case law is also considered, in particular, the German Pipeline Decision which determined whether an underground pipeline can constitute a PE under German domestic law and under the DTA between the Netherlands and Germany.

In the conclusion research indicates that there is room for development and further guidance from the OECD in its MTC and Commentary as this is a unique and potentially complex situation that cannot be placed under general provisions or left unaddressed. The current lack of guidance can result in different classifications of the cross-border

pipeline which effectively results in adverse tax consequences in different jurisdictions and uncertainty to the taxpayer.

# CHAPTER 1. INTRODUCTION

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## 1.1. Background

One of the important facets of international tax that arises is when an enterprise creates a taxable business presence in another jurisdiction, which is referred to as a permanent establishment ('PE'). The profits arising from these PEs have to be attributed, for tax purposes, to the jurisdiction in which the PE-related profits arise.

A PE is defined in Article 5 of the Organisation for Economic Co-operation and Development's ('OECD') Model Tax Convention<sup>1</sup> ('MTC') as '*a fixed place of business through which the business of an enterprise is wholly or partly carried on*'. There are many activities that can constitute a 'fixed place of business'<sup>2</sup> which may result in a PE, possibly including the presence of a cross-border pipeline, in a jurisdiction. Article 5 continues to specifically include and exclude certain places or activities from the PE definition, and each place or activity should be examined individually to determine if it falls within or out of the ambit of creating a PE.

The existence of a '*place of business*' refers to a facility or a premise while the term '*fixed*' refers to a degree of permanence relating to the business carried on. The words '*through which*' has a wide meaning and applies to any situation where business activities are carried on at a location that is at the disposal of the enterprise for that purpose.<sup>3</sup>

Article 7(1) of the OECD MTC addresses the taxation of business profits and determines that the profits of an enterprise in a Contracting State shall only be taxable in said State, except if the profits arise from a PE in the other Contracting State. Article 7 thus assigns the taxing rights to the Contracting State in which a PE is situated. It should be noted that the taxing rights only pertain to the profits arising from the PE and not all the profits of the enterprise. Each case should be examined individually to determine whether a PE is created by the

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<sup>1</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p23.

<sup>2</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*;  
Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town:  
SiberInk.

<sup>3</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p91.

enterprise's activities in the other jurisdiction, and the amount of profits arising from the PE which have to be attributed to that PE for taxation purposes.

The OECD assists in the determination of creation of a PE by publishing Commentary on Article 5, with examples of the certain activities and an indication of the general prevailing practice. There is unfortunately no internationally agreed approach provided in the OECD MTC<sup>4</sup> or OECD Commentary on the classification and taxation of a cross-border pipeline. This leaves these activities open for various jurisdictions' interpretation of Article 5 and its Commentary, which creates divergence. One jurisdiction may classify a cross-border pipeline to be a PE, while other jurisdictions may classify it as immovable property, in accordance with the applicable treaty between the Contracting States.

A further problem arises when determining what amount of tax is attributable to the sections of such a pipeline, especially if the cross-border pipeline stretches over more than one jurisdiction. The attribution of profits arising from a PE is regulated by Article 7 of the OECD MTC. Article 7 states that the profits arising from a PE will be taxable in the jurisdiction where the PE is located. However, the fact that the term '*attributable to*' referred to in Article 7(1) of the OECD MTC is not defined<sup>5</sup> gives rise to different interpretations and treatment of the attribution of the profits.

As more cross-border pipelines are being constructed to expand and improve enterprises' infrastructure, the question arises whether or not a PE is created, and what the tax treatment of such a pipeline would be, becomes more pertinent. For example, Iraq has recently indicated that they plan to construct a large oil export pipeline.<sup>6</sup> The envisioned 1 680 km pipeline will stretch from the southern Iraq region to the port of Aqaba in the Red Sea. This pipeline is envisioned to therefore stretch over three jurisdictions. Closer to home, Sasol has

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<sup>4</sup> The OECD Model Tax Treaty provides a treaty template for jurisdictions to use when negotiating and drafting their own tax treaties.

<sup>5</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p 23 & 26.

<sup>6</sup> Hydrocarbon Processing. (2013). *Iraq shortlists global contractors*. Available at <http://www.hydrocarbonprocessing.com/Article/3251422/Iraq-shortlists-global-contractors-to-build-18-billion-crude-oil-export-pipeline.html>.



also indicated that they intend building a pipeline stretching from South Africa to Mozambique in the next few years.<sup>7</sup>

The expansion of enterprises' cross-border pipelines may require extensive discussion and negotiation as there is no common internationally agreed approach on how to classify the cross-border pipelines for tax purposes. If the pipeline is classified to be a PE, it is also unclear how to attribute the profits arising from the pipeline to the relevant jurisdictions. Enterprises will find themselves asking the question: where will we be liable to pay tax for the presence created by the pipeline and how will the profits arising from the pipeline be taxed in each of the jurisdictions over which the pipeline stretches?

## 1.2. Problem statement

Firstly there is no universal classification of cross-border pipelines and it is therefore left to the various jurisdictions to interpret the OECD MTC and Commentary for the classification for tax purposes. This may give rise to confusion due to diverse interpretations and varied classifications of cross-border pipelines.

If the cross-border pipeline is classified as a PE, the attribution of profits relating to the PE (created by the presence of a cross-border pipeline in different jurisdictions) can result in difficulties. This is based on the determination of the amount attributable to each jurisdiction which the pipeline stretches across. The tax issue is especially problematic due to the fact that there is no generally accepted definition for the phrase '*attributable to*', which gives rise to interpretation problems amongst the different jurisdictions.

The method of calculating the attributing profits has been addressed in the previous 2008 OECD Report on Attribution of Profits to Permanent Establishments (the 2008 OECD Report).<sup>8</sup> However, the Report mostly provided general guidelines for determining the attributable profits and only addressed special guidelines for enterprises carrying on global trading of financial instruments and insurance companies. The aim of the 2010 OECD

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<sup>7</sup> Business Day. (2013). *Mozambican project to boost Sasol's capacity*, 26 November 2013.

<sup>8</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration.

Report<sup>9</sup> was to bring the Report in line with Article 7 of the OECD MTC, which governs the attribution of profits between the various jurisdictions.

The problem statement is therefore:

What is the correct classification of a cross-border pipeline for taxation purposes? If the pipeline is considered to create a PE in another jurisdiction, how are profits (which arise from a PE created by a cross-border pipeline) attributed to each jurisdiction over which the pipeline stretches if the jurisdictions apply different methods in determining the attribution of profits? Does the 2010 OECD Report's general approach provide sufficient guidance on how profits, which arise from a PE created by a cross-border pipeline, can be attributed to each jurisdiction over which the pipeline stretches?

There is also case law addressing this topic, which will be discussed in this study; in particular the 'German pipeline' decision<sup>10</sup> which determined whether an underground pipeline can constitute a PE under German domestic law and under the DTA between the Netherlands and Germany.

It is important to note that international case law forms part of South African common law and a comparison can be drawn between the international treatment of these pipelines and South Africa's treatment of the attribution of the profits arising from cross-border pipelines.<sup>11</sup> There have not been any recent South African tax cases on this specific subject but if one arises the court may consider the international tax treatments of cross-border pipelines.

These tax issues become more complex if a pipeline stretches over more than one jurisdiction and a presence is created in each jurisdiction. This is because a Double Tax Agreement is concluded between two jurisdictions and each of these agreements is

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<sup>9</sup> OECD. (2010). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration.

<sup>10</sup> Bundesfinanzhof vorn 30.10.1996, II R 12/92, BStB1 II 1997, S.12 (the 'German pipeline' decision).

<sup>11</sup> The Constitution of South Africa (1996) states in section 232 that international law forms part of the law in South Africa unless it is inconsistent with the Constitution or an Act of Parliament. Section 233 continues to state that when interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

negotiated between the two jurisdictions. Even though the DTAs are based on the same Treaty Model (e.g. OECD MTC), it does not mean that each DTA is exactly the same. Each relevant DTA must therefore be examined by the relevant Contracting States.<sup>12</sup> Without a common set of regulations on the tax treatment of cross-border pipelines, it is left to each jurisdiction's decided tax treatment of the pipeline, which will differ as each jurisdiction may have a different interpretation of the relevant DTA and regarding what the pipeline should be classified as for tax purposes.

Each jurisdiction also has their own domestic tax laws addressing the treatment of pipelines and the taxing thereof (e.g. South Africa provides for a deduction for pipelines in Article 12D of the Income Tax Act 58 of 1962 ('the Act')). There may even be pipeline agreements concluded between the relevant parties that regulate the taxation of the cross-border pipeline. The classification and taxation of a cross-border pipeline remain a complex tax issue. The interaction between the DTA, the jurisdiction's domestic law, and pipeline agreements are all factors that have to be considered in determining the taxation of a cross-border pipeline.

### **1.3. Research objective**

The research study will examine the PE definition and illustrate whether a cross-border pipeline can fall within the ambit of the definition. The different possible classifications of such a cross-border pipeline and the taxation consequences of such classifications will be highlighted to illustrate the lack of a universal classification of a cross-border pipeline.

The research study will review the OECD's recently issued 2010<sup>13</sup> and 2008<sup>14</sup> Reports on the attribution of profits to PEs and evaluate what they aim to achieve, their shortcomings, and how effective the general approach is in supporting the OECD's attempts to create unification between jurisdictions in their interpretation of the attribution of profits; specifically using the profits arising from cross-border pipelines as an application.

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<sup>12</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk., p 271-273.

<sup>13</sup> OECD. (2010). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration.

<sup>14</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration.

The research study will also review the international case law on the attribution of profits relating to cross-border pipelines and conclude whether the OECD MTC and Commentary and OECD Report succeed in addressing the interpretation problems arising from the attribution of profits, and whether a unified interpretation has been created for the taxation of cross-border pipelines.<sup>15</sup>

#### **1.4. Importance and benefit of study**

The study will indicate where there are inconsistencies in the tax treatment of cross-border pipelines and will illustrate the need for a common international approach relating to firstly, the classification of a cross-border pipeline for taxation purposes; and secondly, on how the profits arising from the pipeline should be attributed across jurisdictions.

The study will be of interest to tax specialists and practitioners, Tax Authorities, businesses that are in the process of constructing pipelines, and academics studying issues of attribution of profits and PEs.

#### **1.5. Assumptions**

Another popular treaty model considered by jurisdictions, mostly the USA, is the United Nations ('UN') model. The researcher will only address the OECD model's treatment in terms of pipelines, and will not draw a comparison between the UN model and the OECD model. The UN model is so similar to that of the OECD that it only indicates Articles that differ from the OECD model and only has Commentary on Articles where the UN model differs from the OECD Model.<sup>16</sup>

The researcher has made the assumption that cross-border pipelines should be treated as PEs. There will be a brief discussion on the different possible classifications of cross-border pipelines according to the OECD Model Tax Treaty and OECD Commentaries in Chapter 2.

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<sup>15</sup> See, for example, OECD. (2010). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration; OECD. (2010). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris: OECD.

<sup>16</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p275.

The study will then address the attribution of profits relating to cross-border pipelines classified as PEs.

## 1.6. Definitions and key terms

- ‘*OECD*’: The Organisation for Economic Co-operation and Development. The OECD is an international organisation that aids governments to increase in prosperity and fight poverty through economic growth and financial stability.<sup>17</sup> South Africa is not a member of the OECD but has ‘observer status’.<sup>18</sup>
- ‘*Permanent Establishment*’: A term defined in Double Tax Agreements as a fixed place of business through which the business of an enterprise is wholly or partly carried on.<sup>19</sup>
- ‘*OECD Model Tax Convention*’ (‘*OECD MTC*’): The OECD Model Tax Convention provides a treaty template for jurisdictions to use when negotiating and drafting their own tax treaties.
- ‘*Double Tax Agreement*’ (DTA): DTAs are agreements concluded between two jurisdictions where the main object is the avoidance of double taxation and the prevention of fiscal evasion.<sup>20</sup> Double Tax agreements are also referred to as double tax treaties.
- ‘*Cross-border*’ is defined in the Oxford Concise Dictionary as ‘involving movement or activity across a border between two countries<sup>21</sup> or more.’
- ‘*Pipeline*’: is defined in the Oxford Concise Dictionary as ‘a long pipe, typically underground, for conveying oil, gas, etc. over long distances.’<sup>22</sup>

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<sup>17</sup> OECD. (n.d.). *About*. Available at [www.oecd.org/about/whatwedoandhow/](http://www.oecd.org/about/whatwedoandhow/).

<sup>18</sup> OECD. (n.d.). *Tax Global*. Available at [http://www.oecd.org/ctp/taxglobal/South%20Africa\\_and\\_OECD\\_Global\\_Relations\\_Programme.pdf](http://www.oecd.org/ctp/taxglobal/South%20Africa_and_OECD_Global_Relations_Programme.pdf); Income Tax Act 58 of 1962, Practice Note 7 paragraph 3.2.

<sup>19</sup> OECD. (2010). *Model Tax Convention on Income and on Capital* (Condensed Version). Paris: OECD p 24

<sup>20</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p 276.

<sup>21</sup> Oxford Dictionary. (n.d.). *Definition. Cross-border*. Available at <http://www.oxforddictionaries.com/definition/english/cross-border?q=cross+border>.

<sup>22</sup> Oxford Dictionary. (n.d.). *Definition. Pipeline*. Available at <http://www.oxforddictionaries.com/definition/english/pipeline?q=pipeline>.

## 1.7. Research design and methods

An analytical approach will be adapted in this mini-dissertation. The current state of the attribution of profits to PEs created by cross-border pipelines will be analysed critically. The researcher intends to analyse the current legislation and regulations in place, *inter alia*, the OECD Model Tax Convention, OECD Commentaries, and the two OECD Reports on Attribution of Profits to Permanent Establishments (i.e. the 2008 & 2010 Reports).

The aim is to illustrate that with the global expansion of enterprises and the increased number of cross-border pipelines, there is a need for a globally unified approach to the treatment and taxation of cross-border pipelines. A comparative review will be undertaken to illustrate the different treatments of these pipelines in case law arising in different jurisdictions, which is discussed in Chapter 6.

## 1.8. Outline of the research

- Chapter 1: Introduction.

This chapter will introduce the research problem regarding the attribution of profits relating to PEs. The research problem will be explained, and a brief synopsis will be supplied regarding what will be discussed in each chapter to, in the end, reach the conclusion.

- Chapter 2: The creation of a permanent establishment and the characterisation of cross-border pipelines.

In this chapter the study will analyse Article 5 of the OECD Model Tax Convention<sup>23</sup> to illustrate how PEs are created. The researcher will also discuss the definition of a

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<sup>23</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD.

'Permanent Establishment'<sup>24</sup> and list the deemed activities that would constitute a PE that is specifically included in the definition.

The chapter will highlight where a DTA fits into the domestic law and indicate how the DTA and the OECD Commentary should be interpreted with reference to case law.<sup>25</sup> Reference will be made to the OECD Commentary on Article 5,<sup>26</sup> where the OECD provides guidance on the interpretation of Article 5. Reference will also be made to definitive text on international law (Skaar;<sup>27</sup> Vogel;<sup>28</sup> Edwardes-Ker;<sup>29</sup> Oliver & Honiball<sup>30</sup>) to illustrate which aspects should be considered when determining a PE.

- Chapter 3: The characterisation of cross-border pipelines.

The researcher will comment on the different possible classifications of cross-border pipelines in terms of a DTA, to illustrate the varied treatments of pipelines for tax purposes. As stated under section 1.5 above, it is assumed that the appropriate classification of a cross-border pipeline is a PE. The remainder of the chapters will be based on the assumption that a cross-border pipeline will create a PE in the relevant jurisdictions, where it creates a business presence.

- Chapter 4: Determining the attribution of profits relating to cross-border pipelines.

In this chapter, Article 7 of the OECD MTC (relating to Business Profits) will be discussed. Reference will be made to the OECD Commentary on the taxing of 'business profits', highlighting the taxing rights contained in Article 7 pertaining to the attribution of profits.

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<sup>24</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD.

<sup>25</sup> SIR v Downing 37 SATC 249.

<sup>26</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD.

<sup>27</sup> Skaar, A.A. (1991). *Permanent Establishment – Erosion of a Tax Treaty Principle*. The Netherlands: Kluwer Law and Taxation Publishers.

<sup>28</sup> Vogel, K. (1997). *Klaus Vogel on Double Taxation Conventions* (Third Edition). UK: Kluwer Law International.

<sup>29</sup> Edwardes-Ker, M (1995 looseleaf). *Tax Treaty Interpretation*. Dublin: In-Depth Publishing,

<sup>30</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk.

The introduction to the calculation of the attribution of profits and the arm's length principle will be addressed as a preview to the discussions on the OECD Reports discussed in Chapter 5.

- Chapter 5: The 2010 OECD Report on 'The Attribution of Profits to Permanent Establishments'.

This chapter will highlight the necessary changes made to the 2010 OECD Report in relation to the 2008 OECD Report. The aims of the 2010 OECD Report are discussed, as well as its pitfalls and effectiveness in achieving this aim in the attempt to unify various jurisdictions' interpretation of the attribution of profits in terms of Art 7. A conclusion will be drawn as to whether the attribution of profits to cross-border pipelines are sufficiently covered in the general approach to the attribution of profits in the 2010 Report.

- Chapter 6: 'Germany's pipeline' decision and other case law.

The 'German pipeline' decision<sup>31</sup> provided a judgment on whether a pipeline can give rise to a PE, by comparing the German domestic law relating to the creation of a PE to the DTA between Germany and the Netherlands (the pipeline stretched across Germany and the Netherlands.) It is clear from the case that there may be different interpretations and treatments of PEs arising from a jurisdiction's domestic law than that which is contained in the specific DTA which is based on the OECD MTC.

In this chapter other international and local case law will also be discussed to illustrate that pipelines that are viewed as a 'fixed place of business' and therefore create a PE.

- Chapter 7: Conclusion.

The conclusion will summarise the findings of the research, and the impact thereof on the interpretation and treatment of the attribution of profits arising from a PE created by pipelines.

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<sup>31</sup> Bundesfinanzhof vom 30.10.1996, II R 12/92, BStB I 1997, S.12 (the 'German pipeline' decision).



The conclusion will also address whether the OECD has achieved its aim to diminish the different interpretations of the attribution of profits. Recommendations will be made on how the tax issues related to the attribution of profits to different tax jurisdictions may be addressed more concisely.

## **CHAPTER 2. THE CREATION OF A PERMANENT ESTABLISHMENT AND THE CHARACTERISATION OF CROSS-BORDER PIPELINES**

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### **2.1. Introduction**

A Permanent Establishment ('PE') is a well-known term in international tax. It creates, in brief, an additional tax burden for an enterprise in an 'Other Contracting State' created by the enterprise's physical taxable presence in that Other Contracting State. The taxation of a PE is governed in the Double Tax Agreement ('DTA') between two Contracting States.

This chapter introduces the PE term by addressing the basic principles relating to PEs and by explaining how a PE is created. In the research a cross-border pipeline is used as a case study to illustrate the PE treatment. The different possible DTA classifications of cross-border pipelines will be considered in the chapter, concluding that a cross-border pipeline should be treated as a PE.

### **2.2. Basic principles relating to PEs**

As discussed in Chapter 1, a PE created by an enterprise in the other Contracting State effectively creates a taxable presence for the enterprise in that jurisdiction.<sup>32</sup> The enterprise's physical presence in the Other Contracting State may even result in double taxation. The operation may be taxable in the jurisdiction where the enterprise is incorporated and operates in the jurisdiction where the enterprise has a taxable business presence (with the PE that the enterprise has in the Other Contracting State). The objective of DTAs is to avoid double taxation, by assigning specific taxing rights to the Contracting States.

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<sup>32</sup> Bundesfinanzhof vorn 30.10.1996, II R 12/92, BStB1 II 1997, S.12 (the 'German pipeline' decision), p6.

The Organisation for Economic Co-operation and Development Model Tax Convention ('OECD MTC') serves as a treaty model that is adopted by jurisdictions that are members of the OECD or countries, like South Africa, that are not members but have 'OECD observer status'.<sup>33</sup> Most of the South African Development Community ('SADC') countries<sup>34</sup> DTAs are based on the OECD MTC and have similar, if not identical, Articles in the concluded jurisdictions. The OECD MTC designates which jurisdiction will have the taxing rights of the profits arising from PE.<sup>35</sup> It is important to note, however, that the DTA, which follows the OECD MTC, does not itself create the taxing rights, as these rights are contained in the jurisdictions' domestic law. South Africa is currently not a member of the OECD, but has 'observer status'. Consequently, South Africa generally follows the OECD guidelines and virtually all SA's DTAs are based on the OECD MTC.

Previously the term 'permanent establishment' was a term only defined in DTAs. The term has since evolved to be included in some jurisdictions' local legislation referring to the definition contained in the OECD MTC. With effect from 1 January 2011, a 'permanent establishment' is defined in the South African Income Tax Act as follows:<sup>36</sup>

*'... means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development...'*

If there is no DTA between in place between two jurisdictions (e.g. there is no DTA concluded between SA and Mali)<sup>37</sup> the taxation of the enterprise with a presence in the other Contracting State will be 'source based'. This means that the enterprise will only be taxed on profits arising from the source from where the profits arise. For example, there is no DTA

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<sup>33</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p270.

<sup>34</sup> The SADC countries consist of Angola, Botswana, Democratic Republic of the Congo, Lesotho, Malawi, Mauritius, Mozambique, Seychelles, South Africa, Swaziland, Tanzania, Zambia, Zimbabwe. Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p5.

<sup>35</sup> Article 5 and Article 7 of the OECD MTC.

<sup>36</sup> Section 1 of Income Tax Act 58 of 1962.

<sup>37</sup> SARS. (n.d.). *International Treaties Agreements*. Available at <http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/default.aspx>.

between South Africa and Kenya.<sup>38</sup> If a South African enterprise has operations in Kenya they will effectively be taxable in Kenya as soon as they start operating there as they will be taxed at the source.

South Africa, for example, has a resident based tax system, which implies that resident enterprises are subject to tax on their worldwide income at a rate of 28%.<sup>39</sup> A company is regarded as resident in South Africa if it is incorporated, established or formed in the Republic, or if it has its place of effective management<sup>40</sup> in South Africa. Subject to the provisions of a DTA, non-residents are subject to South Africa tax to the extent that they derive income from a South African source. If no DTA exists, the non-residents will only be taxed on their South Africa sourced income. As mentioned earlier, the lack of a DTA may result in double taxation as the taxing rights are not specifically assigned to the Contracting States. As per the example above, a lack of a DTA between South Africa and Kenya may result therein that the South African enterprise suffer double taxation, being taxed in South Africa on its worldwide income and being taxed in Kenya on a source basis.

It is understandable that the management of enterprises should be cautious in not creating a PE in other jurisdictions that may lead to additional tax liabilities. To avoid creating a PE in another Contracting State, an enterprise has to fully comprehend the definition of a PE and acknowledge which type of enterprise activities may result in the creation of a PE.

### **2.3. How a Permanent Establishment is created**

A PE is defined in Article 5 of the OECD MTC. This Article specifically lists what is included and excluded from the definition of a PE, and it states that certain activities in a jurisdiction will not give rise to a PE. For example, activities that are preparatory or auxiliary in character do not create a PE. A PE is defined in Article 5(1) of the OECD MTC as:

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<sup>38</sup> SARS. (n.d.). *International Treaties Agreements*. Available at <http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/default.aspx>.

<sup>39</sup> Section 9 of the Income Tax Act 58 of 1962.

<sup>40</sup> Place of effective management – there is no universal definition for a place of effective management ('POEM') but South Africa follows the 'continental approach' whereby a POEM is the place where the company is managed on a day-to-day basis, irrespective of where the overriding control is located or here the board of directors' meetings are held.

*'... a fixed place of business through which the business of the enterprise is wholly or partly carried on.'*<sup>41</sup>

Analysing the above definition provides a clearer understanding of what the attributes to the creation of a PE are. To provide further guidance on the application of Article 5, the OECD also issued the OECD Commentary,<sup>42</sup> along with examples to serve as a guide in determining whether the enterprise's actions will give rise to a PE. The OECD Commentary therefore assists with the application of the PE definition in Article 5 by explaining the terms used in the PE definition.

### 2.3.1 'Place of business'

The existence of a '*place of business*' refers to a facility or a premise such as a place of management, branch, office, shop or factory.<sup>43</sup> The term could also include the presence of machinery or equipment. The list is not exhaustive and even though SA's DTAs generally follow the OECD MTC's list of places of business, some DTAs (such as the SA/UK DTA or SA/US DTA) add to the list, '*an installation or structure used for exploration of natural resources*', criterion.<sup>44</sup>

It should be noted that a place of business may also exist where no facilities are available or required for conducting the business of the enterprise. The enterprise may merely have a space at its disposal which will constitute a place of business. No formal legal right to use this space is required, such as ownership or lease or rental agreements. An entity can create a PE even if the enterprise is illegally occupying a certain location where it carries on its business.<sup>45</sup>

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<sup>41</sup> Article 5(1) of the OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD p24.

<sup>42</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD p92

<sup>43</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD p44

<sup>44</sup> Art 5(2) of SA/UK DTA; Art 5(2) of SA/US DTA.

<sup>45</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD p93

Skaar<sup>46</sup> states that an important feature of the '*place of business*' is that it serves the business activity and is not merely subject to the business activity. This is an important concept when distinguishing whether there is a place of business which may lead to the creation of a PE.<sup>47</sup>

### 2.3.2 '*Fixed*'

This is often referred to as the 'fixed test'. The term '*fixed*' refers firstly to a degree of permanence relating to the business carried on, and secondly, to a specific geographical position.<sup>48</sup> According to the OECD Commentary, the length of a Contracting State enterprise's operations in the other Contracting State is irrelevant if it is not performed at a distinct place. This does not mean, however, that the equipment that constitutes the place of business has to be actually fixed to the ground. It would be adequate that the equipment remains on a particular location.

### 2.3.3 '*Through which*'

The words '*through which*' has a wide meaning and apply to any situation where business activities are carried on at a location that is at the disposal of the enterprise for that purpose.<sup>49</sup> The PE through which a business is carried on should physically carry on a business, and not only serve the main enterprise's business.<sup>50</sup>

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<sup>46</sup> Skaar, A.A., (1991). *Permanent Establishment – Erosion of a Tax Treaty Principle*, p112.

<sup>47</sup> See Chapter 6, the 'German pipeline' case.

<sup>48</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p337.

<sup>49</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD p94.

<sup>50</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p340.

### 2.3.4 'Carry on business'

The OECD Commentary on Article 5 states that in most cases, the business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise; e.g. the personnel.<sup>51</sup>

Subsections 2 to 3 under Article 5 of the OECD MTC continue to list what is specifically included and excluded under the definition of a PE. Article 5(2) is included under the definition of a PE as a place of management, a branch, an office, factory, workshop, and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.<sup>52</sup> As mentioned earlier in section 2.3.1 ('place of business'), this list is not exhaustive and each concluded DTA may add more inclusions to the PE definition.

Article 5(3) contains the so-called 'duration test'. The OECD MTC addresses the circumstances where a building site or construction or installation project will constitute a PE. The duration of the construction project and building site is taken into account.<sup>53</sup> The MTC states that a PE will be created only if the construction project or building site continues for more than 12 months.

The OECD Commentary on Article 5(3) states that experience has shown that these types of PEs can give rise to specific complications in the attribution of profits in terms of Article 7 of the OECD MTC.<sup>54</sup> This may be due to the fact that the nature of a construction or installation project may be that the contractor's activity has to be relocated continuously or from time-to-time depending on the project's progress. The Commentary states that this would be the case where roads or canals are being constructed, or where pipelines are being laid.<sup>55</sup> These activities performed at each particular spot form part of a single project, and that project must be regarded as a PE if, as a whole, it lasts more than 12 months.<sup>56</sup>

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<sup>51</sup> OECD. *Commentary on Art 5 – Permanent establishments*, p49.

<sup>52</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p24.

<sup>53</sup> Baker, P. (2010). *Double Taxation Conventions*. UK: Sweet & Maxwell, p144.

<sup>54</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p140.

<sup>55</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p101.

<sup>56</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p101.

Article 5(5) addresses the instances where an enterprise employs a dependent agent to act on behalf of the enterprise in the Other Contracting State. This dependent agent habitually exercises and has the power to conclude contracts in the name of the enterprise in the Other State. Article 5(5) regulates that in such instances, the enterprise will be deemed to have a PE in that Other State, due to the activities of the dependent agent who has the power to conclude contracts on behalf of the enterprise. If the dependent agent's activities are, however, limited to those listed in Art 5(4), (in other words the agent's activities are auxiliary and preparatory activities)<sup>57</sup> and are performed through a fixed place of business, the agent's activities do not give rise to a deemed PE for the enterprise.<sup>58</sup>

In terms of Article 5(6), if an independent agent (or broker)<sup>59</sup> is employed by the enterprise in the Other Contracting State, and such independent agent is acting in the ordinary course of their business, the independent agent's activities will not be deemed to create a PE for the enterprise.<sup>60</sup>

Finally, Art 5(7) states that the mere fact that a company in a Contracting State controls a company in the Other Contracting State does not give rise to a PE in that Other Contracting State. International group structures would be overly complicated in terms of tax implications if a holding company creates a PE for in each jurisdiction that it has a subsidiary. The taxing hereof is addressed in South Africa in the domestic Controlled Foreign Companies ('CFC') legislation, Section 9D.<sup>61</sup>

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<sup>57</sup> See 2.4: What kind of activities constitute PEs for a discussion of Art 5(4).

<sup>58</sup> Baker, P. (2010). *Double Taxation Conventions*. UK: Sweet & Maxwell, p148.

<sup>59</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p107 describes independent agents as follows:

*'An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.'*

<sup>60</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD, p107.

<sup>61</sup> Article 9D of the Income Tax Act 58 of 1962.



## 2.4. The activities that constitutes a PE

With a clearer understanding of the definition of a PE, and the regulations contained in the subsections in Article 5 of the OECD MTC, these regulations can now be applied to the activities of the enterprise to determine whether business activities constitute the carrying on of business in a fixed place of business.

Article 5(4) of the OECD MTC is an important subsection as it lists a number of business activities which are exceptions to the general definition of a PE. These business activities are thus not treated as PEs, even if the activity is carried on through a fixed place of business. The reasons for the exceptions are that the activities are viewed to be auxiliary or preparatory in nature and do not have a direct link to the main business of the enterprise.

Therefore, not all business activities conducted by an enterprise in the other Contracting State will give rise to a PE.<sup>62</sup> *Minor business activities* may contribute to the enterprise, but they do not form a vital part of the enterprise's core business and therefore do not qualify as a PE. Examples of such auxiliary activities would be research, advertising, storage, maintenance and marketing. An enterprise may therefore satisfy the PE definition in terms of Article 5(1) but be exempted from PE tax treatment under Article 5(4), due to the fact that the activities performed in the Other Contracting State are auxiliary or preparatory in nature.

It is a subjective test to determine whether or not certain business activities form part of the core of the main business. An analysis of the enterprise's business activities is required to establish if a PE is created. It has to be determined whether the activities are quantitatively important for the enterprise's existence and core business activities.<sup>63</sup> The OECD Commentary states that the decisive criterion in determining whether an activity is preparatory or auxiliary in nature, or whether it forms part of the core business of the enterprise, is to determine whether the activity in itself forms an essential and significant part of the enterprise as a whole.<sup>64</sup> If the activity does not form an essential and significant part of the enterprise, the activity can be viewed to be auxiliary in nature and will therefore not

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<sup>62</sup> Skaar, A.A., (1991). *Permanent Establishment – Erosion of a Tax Treaty Principle*.

<sup>63</sup> Skaar, A.A., (1991). *Permanent Establishment – Erosion of a Tax Treaty Principle*, p290; OECD Commentary, p26.

<sup>64</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD, par 24.

create a PE. However, where the activity forms part of the enterprise as a whole and plays a significant and essential part in the enterprise's business, it will be classified as a PE.

## 2.5. Interpretation of Double Tax Agreements

The interaction of the OECD MTC and Commentary with the domestic law of a specific country is an important consideration for the interpretation of DTAs. Double taxation agreements are effectively brought into the South African tax legislation with Section 108 of the Act.<sup>65</sup> Section 108 states that the National Executive may enter into an agreement with other jurisdictions' governments which contain arrangements for the prevention, mitigation or discontinuance of the levying of tax on the same gains, profits or income.<sup>66</sup>

Subsection 2 states that once such agreement has been approved by Parliament in terms of section 231 of the Constitution,<sup>67</sup> the arrangements shall be published in the *Government Gazette* and thereafter the concluded arrangement shall have the effect as if it had been enacted into the Act. In other words, all the DTAs concluded by South Africa with other jurisdictions are effectively brought into the Income Tax Act, therefore forming part of South African legislation.

Article 3(2) of the OECD MTC states that in the application of the treaty by a Contracting State, any term not defined in the treaty shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies; any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.<sup>68</sup>

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<sup>65</sup> Section 108 Income Tax Act 58 of 1962.

<sup>66</sup> Section 108 Income Tax Act 58 of 1962.

<sup>67</sup> Section 231 of the Constitution provides that the negotiating and signing of all international agreements is the responsibility of the National Executive. It further also provides that any international agreement becomes law in the Republic when it is enacted into law by national legislation. However, a self-executing provision of an agreement that has been approved by Parliament is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament.

<sup>68</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD, p23.

The DTAs are included in South African tax legislation, which leads to the fact that South African courts are bound by such legislation. However, the OECD Commentary does not fall within the ambit of section 108 as it is not an arrangement between two jurisdictions, does not form part of the South African legislation, and has no 'binding factor' amongst the courts. The OECD Commentary merely serves a guideline to the interpretation of the DTAs.

In the case of *SIR v Downing 37 SATC 249*, the court upheld that, in terms of interpreting DTAs, South Africa is bound to consider OECD Commentary for guidelines on the concepts utilised in the OECD MTC.<sup>69</sup> The facts of the case were that a Swiss resident owned portfolio shares in listed South African companies. These shares were administered by a South African stockbroker and the question arose as to whether the activities constituted a PE in terms of the SA/Swiss DTA, which would mean that South Africa would be entitled to tax the share dealings. The court held that the stockbroker conducted business as an independent agent, therefore not creating a PE in South Africa for the Swiss resident. The Court had to, *inter alia*, examine the meaning of the words in Article 5(6) of the South Africa/Switzerland DTA which refers to the activities of the agent to be '*acting in the ordinary course of business*' of the agent,<sup>70</sup> although the OECD Commentary does not formally form part of South African legislation and has no binding power on the courts. However, as illustrated in the *Downing* case, the OECD Commentary may still be utilised to assist the courts with the interpretation of the terms in the DTA.

In the interpretation of an Act the content of the sections should be read with the intentions of the Legislature in mind. Only once the wording of a section becomes ambiguous and the intention of the Legislature is unclear will the ordinary meaning of the words take effect. This principle is confirmed in the *Thoroughbred Breeders' Association* case<sup>71</sup> where the court stated the following:

*'We cannot agree with the approach of the Court a quo to the interpretation of the Act. It entailed isolating s 1(1)(a) and attempting to accommodate contractual claims within what was said to be the plain language of the provision.'*

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<sup>69</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk.

<sup>70</sup> Edwardes-Ker, M (1995 looseleaf). *Tax Treaty Interpretation*. Dublin: In-Depth Publishing, Article 5, p63.001.

<sup>71</sup> *Thoroughbred Breeders' Association of South Africa v Price Waterhouse* (2001) 4 All SA 161 (A).

The Court in the *Thoroughbred Breeders' Association* case also made reference to the *University of Cape Town v Cape Bar Council* 1986 (4) SA 903 (A) at 914D-E, where the court held that if the wording of an Act appears to be unambiguous it should be read in the light of the subject-matter with which the Act is concerned. Only when that is done can one arrive at the true intention of the Legislature.

Therefore, when interpreting Article 5 of the relevant DTA, the relevant passages should be read with the intention of the OECD MTCs. The ordinary meaning of the words can therefore not be interpreted with merely the ordinary meaning of the words. The Article must be read in the context of the subject matter to arrive at the intention of the Legislature.

For example, the ordinary meaning of the term '*fixed*' means fastened securely in position in terms of the Oxford Dictionary.<sup>72</sup> If this term is literally applied to the PE definition it will exclude any places of business which are not secured in one place, which is not the intention of the OECD MTC. The term '*fixed*' in the OECD MTC refers to a place with a degree of permanence relating to the business carried on, and secondly, to a specific geographical position. The term is much wider than the ordinary meaning of the word, and as illustrated in Chapter 6, even a ship moving in territorial waters (i.e. not fixed in one specific position) can constitute a PE.

In the case of *Commissioner for SARS v Airworld CC and Another*,<sup>73</sup> the court stated that in recent years the courts have placed emphasis on the Legislature's purpose in enacting the relevant provision. The Court supports that legislation should be '*interpreted purposively and holistically*'<sup>74</sup> and the provisions of the Act should be given a clear meaning whenever plausible.

Therefore, to best interpret DTAs based on the OECD, it is advisable that the OECD Commentary is considered with the specific Article, as the Commentary offers guidance on the intention of the OECD MTC and offers examples and elaborates on specific inclusion and exclusions and would not have been implied in the Article if only the ordinary meaning of the word had been applied.

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<sup>72</sup> Oxford Dictionary. (n.d.). *Definition. Cross-border*. Available at <http://www.oxforddictionaries.com/definition/english/cross-border?q=cross+border>.

<sup>73</sup> (2007) 70 SATC 48.

<sup>74</sup> *Commissioner for SARS v Airworld CC and Another* (2007) 70 SATC 48.

Also, the Commentary on the OECD MTC represents the collective view of the OECD members. If an OECD Member State disagrees with any part of the OECD MTC, they may make an ‘observation’ to this effect. Alternatively, the Member State may make a ‘reservation’ on a specific part of OECD MTC. Both observations and reservations held by Member States are published with the OECD Commentary.<sup>75</sup>

## 2.6. Conclusion

Most multinational companies try to avoid creating a taxable presence in another country in which they operate, and it is important to advise such companies whether they are at risk in creating such a presence, based on their activities in that jurisdiction. The activities should therefore be analysed and compared with the regulations in Article 5 of the relevant DTA and commentaries such as the OECD Commentary. Both Skaar<sup>76</sup> and Vogel<sup>77</sup> can be consulted to determine whether or not a PE has been created.

The concept of a PE is complex, and each individual situation should be examined separately. In other words, the PE definition should be analysed and applied to each situation and if all the elements of the definition are not present, a PE is not created in the other jurisdiction. However, it is of importance that the relevant DTA be consulted as each DTA specifically includes an extensive list of examples that are included in the PE definition; for example, branches, offices or a place of management.<sup>78</sup> An intricate part of the PE concept is determining whether the business’ activities qualify as being auxiliary in nature or not. The OECD Commentary provides guidance, but it is still left to the tax authorities to determine whether the activities of the business in the other Contracting State create a PE or not. Practically, a cross-border pipeline is such a large and costly project that it seems improbable that an entity will have a cross-border pipeline that is merely auxiliary in nature and which does not serve as part of the main business of the entity.

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<sup>75</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD; Edwardes-Ker, M (1995 looseleaf). *Tax Treaty Interpretation*. Dublin: In-Depth Publishing.

<sup>76</sup> Skaar, A.A., (1991). *Permanent Establishment – Erosion of a Tax Treaty Principle*.

<sup>77</sup> Vogel, K. (1997). *Klaus Vogel on Double Taxation Conventions* (Third Edition). UK: Kluwer Law International.

<sup>78</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD, p98.

## CHAPTER 3. THE CHARACTERISATION OF CROSS-BORDER PIPELINES

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### 3.1. Introduction

Characterisation is a common problem arising in the field of international tax. This can be prescribed to numerous factors, e.g. different interpretations of treaties by various jurisdictions. Added hereto is the lack of a definition in the treaties or OECD Commentaries of the terms '*business*', '*enterprises*' and '*immovable property*'.<sup>79</sup>

The classification of a cross-border pipeline is therefore of particular importance for tax purposes, and depending on the characterisation in the DTA, different tax treatments of the pipeline may arise. There is unfortunately no international uniform classification and tax treatment for cross-border pipelines.<sup>80</sup> This leaves it open to interpretation and each jurisdiction may differ in the classification of cross-border pipelines. This may result in adverse tax consequences for the enterprise as the classification is unpredictable and inconsistent.<sup>81</sup> The OECD MTC and its Commentary in particular, are unclear in its recommendations regarding cross-border pipelines. This may potentially lead to uncertainty between jurisdictions and even give rise to disputes between jurisdictions.

Using an example, assume a pipeline crosses the borders of State A and B. If both the States classify the pipeline as a PE, the profits will be split between the two States, based on the income that is allocated in State A and B. This will result in appropriate taxation in both State A and State B. However, if State A characterises the pipeline in State B as merely a transport facility that is auxiliary in nature, the income from the pipeline arising in State A and B will be taxable in State A. If, in the same example, State B characterises the pipeline as a PE, the income arising from the pipeline in State B will be taxable in State B, resulting effectively in double taxation.

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<sup>79</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD.

<sup>80</sup> International Fiscal Association (IFA) Congress, 2002.

<sup>81</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD.

This example illustrates the importance of characterisation of a cross-border pipeline for taxation purposes.

### **3.2. Possible characterisation of cross-border pipelines and their tax implications**

In Olsen's study of the different classifications of cross-border pipelines, he found that in terms of the OECD MTC and OECD Commentaries, no less than eight possible classifications for cross-border pipelines exists; each resulting in a different tax treatment.<sup>82</sup>

The following possible classifications that exist in the OECD MTC for cross-border pipelines; each of which will result in different tax treatments of the pipeline:

- Article 5(1) – PE
- Article 5(3) – a building site, or construction, or installation project
- when a pipeline is built or removed (taxable presence even if still building the pipeline)
- Article 5(4)(a) – Transportation facility
- Article 5(4)(e) – Auxiliary/preparatory in nature
- Article 5(4)(f) – Combination of transport and auxiliary activities
- Article 6 – Immovable property
- Article 5(1) – Passive income
- Article 21 – Other income not mentioned above

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<sup>82</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD.

### 3.2.1 *Characterisation as a PE*

The first two of the above listed classifications would result in the cross-border pipeline being a PE, but for different reasons and over different periods of time. If the cross-border pipeline is classified as a PE, the profits arising will be allocated and be taxable in terms of Article 7. The OECD's Transfer Pricing guidelines, viz. 2010 Attribution of Profits to Permanent Establishments Report, will be utilised to attribute the profits in the prescribed manner, and the authorised OECD approach which is discussed in detail in Chapter 5.

### 3.2.2 *Characterisation as a building site, or construction, or installation project*

Article 5(3) provides that a building site that generally continues for a period of more than 12 months will effectively create a PE. This may result therein that even before the cross-border pipeline is utilised, and while it is still being assembled, the enterprise may create a taxable presence in the other State. This will be treated as a PE, as discussed above.

### 3.2.3 *Characterisation as a transportation facility*

Article 5(4) lists the exceptions to the general definition of a PE. If a cross-border pipeline is characterised to fall within Article 5(4), the pipeline cannot be regarded as a PE. The transportation of oil or gas in a pipeline may fall under Article 5(4)(a) (storage or delivery of goods); Article 5(4)(e) (for the purpose of carrying on any other activity of a preparatory/auxiliary character); or Article 5(4)(f) (any combination of activities that are preparatory/auxiliary in character).<sup>83</sup>

Oil and gas pipelines have tanks that form part of the entire transport system. These tanks can be used for storage, but it would seem unpractical and undesirable to split an asset for taxation purposes, as this may give rise to a complex tax situation (e.g. the tanks are characterised as auxiliary in nature, while the pipeline itself is characterised as something different for taxation purposes). Additionally, there is no specific indication in Article 5 of the

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<sup>83</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.



OECD MTC that suggests that an asset may be split (Article 5(4)(a)) and the pipelines may have to be considered as a whole, which will include the storage tanks.

In terms of the cross-border pipeline being characterised as a transportation facility, Article 5(4) states that there is no PE if the use of the facility is solely for the purpose of delivery of goods or merchandise belonging to the enterprise, and thus it will be considered to be auxiliary in nature. However, if the pipeline it utilised for the delivery of goods that do not belong to the enterprise, the pipeline may be considered to create a PE or immoveable property.<sup>84</sup> If, in accordance with the OECD's view, the transport is incidental and is the transport of the property of the enterprise, the pipeline will be auxiliary in nature. However, if the transport is not incidental and forms a significant part of the enterprise as a whole, it cannot be seen to be auxiliary in nature.<sup>85</sup>

#### 3.2.4 *Characterisation as auxiliary or preparatory in nature*

Article 5(4)(e) may characterise a cross-border pipeline as auxiliary in nature, but it will then have to meet the necessary requirements:

- The activity should not form part of the enterprise's core business;
- The transportation is only of goods belonging to the enterprise; and
- The economic bonds are loose.<sup>86</sup>

The OECD Commentary acknowledges the difficulty in distinguishing between activities which have a preparatory or auxiliary character and those activities that are not auxiliary or preparatory in character. The OECD states that the decisive criterion for determining

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<sup>84</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5; OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD p103.

<sup>85</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD. Commentary on Article 5(4):  
'...a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise does not exercise a preparatory or auxiliary activity'.

<sup>86</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.

whether or not the activity of the fixed place of business forms part of the core activity of the enterprise as a whole.<sup>87</sup>

### 3.2.5 *Characterisation as a combination of transport and auxiliary activities*

Even if there is a combination of the transport of goods and they are of an auxiliary nature, the activities may not establish a PE, and the overall activity will be deemed to be auxiliary in nature.<sup>88</sup> It, however, is arguable if one examines the enterprise's business that a pipeline seems unlikely to merely present a 'supportive' activity to the core business of the enterprise as there are such high risks and costs involved in operating a pipeline. From a practical point of view it would therefore seem improbable that a pipeline will normally be auxiliary in nature.<sup>89</sup> There are, however, numerous advantages and disadvantages to a pipeline being characterised to be auxiliary in nature.

The advantages are that there would not be an issue of allocating profits as the profits arising from the pipeline will be taxable in the country in which the enterprise that owns it is a tax resident.<sup>90</sup> This will give rise to the fact that there will not be any transfer pricing issues nor the risk of double taxation. The disadvantage is that the source rule would not be applied. The source rule gives the State in which the pipeline is located the right to tax the pipeline. If the pipeline is only taxable in the State of which the owner of the pipeline is a tax resident, it deprives the source State from taxing rights, which may lead to erosion of the source State's fiscal base.<sup>91</sup>

### 3.2.6 *Characterisation as immovable property*

In the case of the pipeline being characterised as immovable property, Article 6 of the OECD MTC will apply. Article 6 states that the State where the immovable property is located has

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<sup>87</sup> OECD. (2012). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD, p102.

<sup>88</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.

<sup>89</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.

<sup>90</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.

<sup>91</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.

the right to tax the immovable property.<sup>92</sup> Article 6 does, however, provide in the Commentaries for the income from immovable property derived from a PE that the income be taxed under Article 7 (Business Profits). It is, however, clear that income derived from immovable property is to be taxed in the source State.<sup>93</sup> For a PE to be determined, one will have to firstly consult Article 5, but unfortunately the OECD Commentary does not specify the hierarchical rank between Articles 5 and 6, which may lead to difficulty in characterisation of the pipeline.<sup>94</sup> It is important to note the hierarchy between these Articles, and in the instance that they are in conflict, the prevailing Article will be ranked higher than the other Article and will enjoy preference.

The OECD MTC states in Article 6 that the term 'immovable property' shall have the meaning that it has under the law of the Contracting State in which the property in question is situated.<sup>95</sup> The OECD, however, suggests in the Commentary on Article 5 that pipelines would constitute immovable property under the domestic legislation of the Contracting State's domestic law.<sup>96</sup> A disadvantage of a cross-border pipeline being characterised as immovable property would be that it is unclear whether a pipeline considered to be immovable property could be auxiliary in nature or not.

It is also not clear what the hierarchical rank is between Article 6 and Article 7.<sup>97</sup> For example, Article 7 does not make any reference immovable property in terms of Article 6, only to PEs as per Article 5. Article 6 also makes no reference to the allocation of income in terms of Article 7.<sup>98</sup>

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<sup>92</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD.

<sup>93</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD, 2010 p128.

<sup>94</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.

<sup>95</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD p 26.

<sup>96</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: ECD, par p103.

<sup>97</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.

<sup>98</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD p26.

### 3.2.7 *Characterisation as passive income*

‘Passive income’ is a term that refers to income that an entity acquires that is derived from operating of the entity business; for example, dividends and interest are generally classified to be passive income. To determine whether a cross-border pipeline can be classified as passive income, each individual situation will have to be examined separately. For example, if the enterprise rents out the pipeline to another enterprise without continuing to maintain or operate the pipeline, the rental amounts received may be classified to fall under passive income and not under business profits.<sup>99</sup>

### 3.2.8 *Characterisation as other income*

Article 21 in the OECD MTC serves to be the net that catches all other income that does not fall within the other specific Articles of the treaty. Article 21 states that if any income is not dealt with in the foregoing articles of the tax treaty, the income shall only be taxable in the resident State.<sup>100</sup> The Article is most likely not very relevant, as most States will characterise a cross-border pipeline to fall within the ambit of either Article 5 or Article 6.<sup>101</sup>

In addition to these possible characterisations, some of the pipeline agreements concluded between the relevant parties may also contain a clause addressing the tax treatment of the specific pipeline. This may also be a factor in considering how the pipeline will be classified for taxation purposes. The legal hierarchy of the DTAs and the agreements will have to be explored to determine which of these reign sovereign in prescribing the taxing of the cross-border pipelines. Generally, the contracts signify an agreement between parties and do not have the same legal status of domestic or international law. Treaties, which form part of international law, will therefore generally prevail over pipeline agreements.<sup>102</sup>

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<sup>99</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.

<sup>100</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD p 33

<sup>101</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.

<sup>102</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 4.

One can conduct an in-depth study of the above characterisations and draw a comparison between the tax treatments arising from the different characterisations of a cross-border pipeline. This study has, however, assumes that the tax characterisation of a cross-border pipeline should be a PE.<sup>103</sup>

### 3.3. OECD Commentary on taxation of pipelines

In terms of the taxation of cross-border pipelines, the OECD Commentary makes little comment in relation to these types of pipelines. The Commentary briefly addresses the taxation of income derived by the owner or operator of the pipelines that cross the territories of a country.<sup>104</sup> According to the OECD Commentary, the income derived by the owner or operator from the use of the pipeline by other enterprises, is covered by Article 6 (immovable property) where the pipeline is deemed to constitute immovable property.<sup>105</sup> Under Article 6 income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.<sup>106</sup>

The Commentary however, raises the question of whether Article 5(4)(a) would be applicable in certain instances.<sup>107</sup> Where enterprises utilise these cross-border pipelines to transport the enterprise's own property, one can consider Article 5(4)(a), which states that the term 'permanent establishment' shall be deemed not to include the use of facilities solely for the purpose of storage, display, or delivery, of goods or merchandise belonging to the enterprise. Article 5(4)(a) will be applicable even if the transport of the enterprise's

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<sup>103</sup> See 'assumptions' under Chapter 1.

<sup>104</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*. Paris: OECD, par 26.8.

<sup>105</sup> Article 6(2) of the OECD MTC:  
*'The term 'immovable property' shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.'*

<sup>106</sup> Article 6(1) of the OECD MTC.

<sup>107</sup> Art 5(4)(1): *'Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include:*

a) *the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise.'*

belongings are auxiliary in nature in relation to the enterprise's core business. Therefore, in terms of the OECD Commentary, if an enterprise owning the cross-border pipeline uses it to transport and finally deliver their own belongings, it will not constitute a PE. If, however, the cross-border pipeline is utilised to transport the property of a another enterprise, Article 5(4)(a) will not be applicable and the pipeline may well be considered to create a PE.

The above Commentary creates confusion as, in one paragraph it states that a pipeline should be treated as immovable property, but also states in the same paragraph that that the pipeline, in accordance with Article 5(4), can be a transport facility of auxiliary or preparatory nature. In other words, the Commentary provides advised tax treatment for a pipeline transporting property of the owner of the pipeline and an alternative tax treatment for a pipeline transporting the property of enterprises that do not own the pipeline.

The Commentary adds to the confusion further by stating that a pipeline could not constitute a PE for the customer of the operator of the pipeline. In such instances, the Commentary advises that the enterprise (i.e. the customer) is merely obtaining transmission or transportation services provided by the operator of the pipeline and does not have the pipeline at its disposal. Consequently, the pipeline cannot be considered to create PE for the customer.

The Commentary is, however, silent on the correct tax treatment specific to pipeline due to the physical presence of a cross-border pipeline in a specific jurisdiction. There is also no commentary on situations where the owner of the pipeline leases the use thereof to other enterprises, but also uses the pipeline to transport its own property.<sup>108</sup> If there is not a unified interpretation provided in the OECD Commentary or relevant DTA regarding the tax treatment of a cross-border pipeline, the matter will be left to the courts to provide clarification. The courts will most likely consult the OECD Commentary and treaties for guidance on interpretation. The lack of a universal tax treatment for pipelines, once again, may result in different interpretations and possibly different tax treatments by the courts in the different jurisdictions. An example is the 'German pipeline' case,<sup>109</sup> where it was found by the court that the underground pipeline constituted a PE. (This case is discussed in more

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<sup>108</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 2.

<sup>109</sup> Bundesfinanzhof vorn 30.10.1996, II R 12/92, BStB1 II 1997, S.12.

depth in Chapter 7.) This judgment is in conflict with the OECD Commentary which, as illustrated above, states that a cross-border pipeline should not constitute a PE but should be treated as immovable property.

It is interesting to note that the OECD Commentary states, under Article 5 (relating to PEs), that the OECD views the cross-border pipeline to be immovable property, but in Article 6 (relating to immovable property) no mention is made in the Commentary that cross-border pipelines should be taxable under this Article. It would seem more appropriate to have added the above commentary under the appropriate Article addressing the tax treatment which the OECD views to be correct.<sup>110</sup>

### **3.4. Conclusion**

PEs are complex concepts in international tax as there are numerous factors to consider in determining whether an enterprise has created one in another jurisdiction. A PE can be described as an unwanted taxable presence, created by the physical presence of an enterprise in the Other Contracting State. The OECD attempts to assist in determining when a PE is created, but does not provide clear guidance on the classification of such, nor on the preferred tax treatment of cross-border pipelines.

The assumption in this mini-dissertation is that the physical presence of a pipeline in a country should be taxable as it is utilising sources (such as the land) in the other Contracting State. If tested against the PE definition, a pipeline can be viewed to create a PE, depending on the business activities of the enterprise utilising the pipeline. According to Article 5(3) of the OECD MTC, a PE will be created if the construction period stretches over more than 12 months. An enterprise may therefore be at risk of creating a PE, even when constructing the pipeline.

For illustrative purposes, assume a South African oil company (Company X) builds a cross-border pipeline to one of its subsidiaries in Tanzania for the purpose of transporting oil to the subsidiary. The cross-border pipeline will stretch over three countries; including Zimbabwe,

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<sup>110</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 7.

Zambia and Malawi. If tested against the PE definition, the pipeline is a fixed (attached to the ground) place of business (space is available for the pipeline) through which the enterprise carries on business. As it is Company X's core business to trade in oil, the transportation of the oil to Tanzania will most probably be considered to form part of the main business.

If one analyses the situation, the pipeline is significant for Company X's investment, as well as the operating and maintenance costs. The pipeline also gives rise to profits. It will probably be considered to form part of the core business of the oil business. Such transportation could not be considered as mere preparatory or auxiliary activities as, in most cases, such the transportation would form part of the corporation's core business activity.<sup>111</sup> The pipeline is a major investment with high maintenance and operating costs. There are also significant risks and profits created for the enterprise with the presence of the pipeline stretching over more than one jurisdiction. These factors all point towards the fact that a pipeline will only, in rare circumstances, be considered to be an auxiliary activity.<sup>112</sup>

In the above example all the requirements for creation of a PE are thus met, as a taxable presence is created by the pipeline in each of the countries it crosses. However, there is no specific classification or tax treatments provided in the OECD Commentary, and as illustrated in Olsen's study<sup>113</sup> on the different possible characterisations of a cross-border pipeline in the DTA, there are numerous variables which can affect the classification of cross-border pipelines. With these numerous possible characterisations, it is safe to say that the more borders the cross-border pipelines cross, the more complex the tax treatment thereof becomes.

For this study it is assumed that a cross-border pipeline should be treated as a PE. Once established that a PE has been created, the profits arising from the cross-border pipeline have to be attributed to the relevant jurisdictions.

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<sup>111</sup> *UAE Exchange Centre Ltd v Union of India*, WP(c) No. 14869/2004, 13 Feb. 2009. *Delhi High Court, India*. In the case the Court found that the transportation of oil and gas in a pipeline is too significant to be characterised as an activity in aid or in support of an enterprise's business. Such transportation should be considered to form part of the enterprise's core business.

<sup>112</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 5.

<sup>113</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 2.



## CHAPTER 4. DETERMINING THE ATTRIBUTION OF PROFITS RELATING TO CROSS-BORDER PIPELINES

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### 4.1. Introduction

Once it is established that a cross-border pipeline has created a PE in terms of Article 5 OECD MTC, the next step is to consult Article 7 ('Business Profits') to determine how the business profits of an enterprise arising from a PE in a jurisdiction will be taxable in that jurisdiction.<sup>114</sup> As mentioned in Chapter 2, while Article 5 is relevant in establishing whether a PE has been created, the Article does not itself allocate taxing rights.<sup>115</sup> These taxing rights are assigned in terms of Article 7.<sup>116</sup>

Experience has shown that there is not a universal interpretation for the general principles established in Article 7. Several efforts were made in the past by one of the OECD's committees, the Committee on Fiscal Affairs, to develop such a universal interpretation of Article 7 by changing the wording of the OECD MTC and the OECD Commentary. Interpretations, however, continued to vary,<sup>117</sup> so the Committee decided to issue a report (the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations)<sup>118</sup> which was adopted in 1995. The Guidelines indicated that further work is required to address the 'arm's length' principle in relation to PEs. These shortcomings in the Guidelines eventually led to the publishing of a 2008 Report on the Attribution of Profits to Permanent

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<sup>114</sup> Baker, P. (2010). *Double Taxation Conventions*. UK: Sweet & Maxwell, p177.

<sup>115</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p115.

<sup>116</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p330.

<sup>117</sup> OECD. (2010). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy & Administration, p8.

<sup>118</sup> OECD. (2010). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris: OECD.

Establishments.<sup>119</sup> This Report was aimed at formulating a preferred approach to attributing profits to PEs, taking into consideration modern-day multinational operations.<sup>120</sup>

It was noted by the OECD that the conclusions in the Report differed from the interpretation of Article 7 and the OECD Commentary on Article 7. The Committee on Fiscal Affairs decided to amend Article 7 of the OECD MTC and the OECD Commentary to bring them in line with the principles laid down in the 2008 Report. These changes were implemented in 2010 during the 2010 update of the OECD MTC.<sup>121</sup>

Following the introduction of the 'new' Article 7, a revised version of the Report on Attribution of Profits to Permanent Establishments was published in 2010.<sup>122</sup> The Report and the new Article 7 of the OECD MTC are therefore in line with one another, specifically regarding the attribution of profits.

As with Article 5, referred to in Chapter 2, it is important to analyse Article 7 and refer to the OECD Commentary to understand and interpret the application thereof. Once the underlying principles have been established, the stipulations in Article 7 can be applied to each individual case; i.e. the attribution of profits arising from PEs created by cross-border pipelines.

## **4.2. Article 7(1) – The general rule for the attribution of profits**

The aim of Article 7(1) is to limit the taxation rights of a Contracting State to tax the profits arising in the Other Contracting State that are attributable to the PE in the Other Contracting State. Article 7(1) determines that the profits of an enterprise established in a Contracting State shall only be taxable only in that State, unless that enterprise carries on business in the other Contracting State through a PE situated in the other Contracting State. If the

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<sup>119</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Centre for Tax Policy and Administration.

<sup>120</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p8.

<sup>121</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p8.

<sup>122</sup> See Chapter 5 for a full discussion of this Report.

enterprise carries on business as aforesaid, the profits attributable to the PE may be taxed in that other State. This paragraph is, however, subject to paragraph 2 of Article 7 which is discussed below.<sup>123</sup> This implies that, in a practical example, that an enterprise established in SA which carries on business in Mozambique through a PE situated in Mozambique, will only be taxed in Mozambique on the profits arising from the PE located there.

This paragraph 1 of Article 7 is important as it demonstrates the worldwide accord between jurisdictions that an enterprise will only be considered to participate in the economic life of another State (i.e. be taxable on its profits) once it has created a PE in that other State.<sup>124</sup> The second part of the paragraph lays down the principle that one can only tax the profits arising from a PE in the State in which the PE exists.

Paragraph 1 of Article 7 also limits States from taxing the enterprise in the other State on profits not attributable to the PE in that other State. This principle is adapted in DTAs to ensure that the tax authorities in one State have to look at the separate sources of profit that the enterprise derives in the other State and should apply the PE test to each case, subject to the application of the other articles in the DTA.<sup>125</sup>

The term for the phrase '*attributable to*' in paragraph 1 of Article 7 has no generally accepted definition, nor is it defined in the OECD MTC or Commentary for purposes of Article 7. As no definition exists, the ordinary definition is applied to the phrase. The word '*attribute*' is defined in the Oxford Dictionary as '*regard something as being caused by*'.<sup>126</sup> If profits are attributable to a PE, it implies, in the ordinary meaning of the word, that profits are '*caused*' by the presence of a PE. The lack of a generally accepted definition of the term is one of the reasons that gives rise to interpretation problems amongst the different jurisdictions, as each has their own interpretation of the term, especially in the context of Article 7.

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<sup>123</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p26.

<sup>124</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p132.

<sup>125</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p133.

<sup>126</sup> Oxford Dictionary. (n.d.). *Attribute*. Available at <http://www.oxforddictionaries.com/definition/english/attribute>.

### 4.3. Article 7(2) – Rules for determining the profits attributable to a PE

Article 7(2) of the OECD MTC states the following:

*‘For the purposes of this Article (and Article 23A and 23B) the profits that are attributable in each Contracting State to the PE referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.’<sup>127</sup>*

Article 7(2) governs the attribution of profits to a PE. The basic rule is that only the profits that *‘might be expected’* to arise from a PE as if it were a separate enterprise engaged in similar activities under similar conditions are attributable. The PE is thus fictitiously treated as an independent and separate enterprise for determining the attribution of profits to the PE.<sup>128</sup> The OECD Commentary highlights that paragraph 2 does not seek to apportion the total profits of the entire enterprise to the PE, but rather prescribes that the profits attributable to a PE should be determined as if it were a separate and independent enterprise.<sup>129</sup>

The 2010 OECD Report prescribes the calculation for determining the attribution of profits to a PE (this calculation will be discussed in detail in Chapter 5). Once the profits which are attributable to a PE have been established in terms of Article 7(2), the domestic law of each Contracting State shall determine whether or not, and in what manner, such profits should be taxed. It is, however, important to note that the Contracting States should both be compliant with the requirements of Article 7(2) and the rest of the articles in the DTA. The domestic laws may prescribe the inclusion of the profits in the enterprise’s gross income, but may also prescribe certain deductions or exemptions of expenses.

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<sup>127</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*.

<sup>128</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p332.

<sup>129</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p133.

Although the PE concept has been introduced into SA law (section 31 of the Income Tax Act and in the Eighth Schedule for CGT purposes), the Article 7 principle (the attribution of profits arising from PEs) has not been introduced into SA domestic law. This, as stated earlier, may give rise to interpretation problems for term ‘*attributable to*’ for capital gains tax (‘CGT’) purposes.<sup>130</sup>

It should also be considered that Article 5(3) provides a special rule that a fixed place of business that constitutes a building site or a construction or installation project constitutes a PE if it lasts more than 12 months. It is difficult to attribute profits in terms of Article 7 to these PEs where goods are provided or services are performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. The OECD Commentary suggest that in such instances, one has to focus on the general principle that income is attributable to a PE only when it results from activities carried on by the enterprise through that PE.<sup>131</sup>

Article 7 and Articles 23A & 23B interact with one another as Article 7 allocates taxing rights to the State from which profits arise attributable to the PE in that State, which Article 23A and 23B obliges the other State to provide relief from double taxation.<sup>132</sup> If jurisdictions do not also regard these Articles in the DTA it will lead to double taxation of the same profits.<sup>133</sup>

#### **4.4. Article 7(3) – Adjustments to the profit attribution**

As mentioned in the Introduction of Chapter 3, Article 7 went through significant changes in 2010 with amendments, deletions of paragraphs, and even the introduction of a new paragraph.<sup>134</sup> These changes were aimed at addressing uncertainties that may result in different interpretations of Article 7, which may eventually result in double taxation.<sup>135</sup> The

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<sup>130</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk., p 335 and 336.

<sup>131</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p140.

<sup>132</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p143.

<sup>133</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p143.

<sup>134</sup> Bennett, M.C. (2010). *ITC 2010 – Article 7- New OECD Rules for Profit Attribution of Permanent Establishments*.

<sup>135</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p143.

OECD has endeavoured to address these different interpretations and treatments in the 2010 OECD Transfer Pricing Report and the newly revised Article 7.<sup>136</sup>

Article 7(3) states that if a Contracting State adjusts the profits that are attributable to a PE of an enterprise in the other Contracting State and taxes these profits accordingly, which has been charged to tax in the other State (in terms of paragraph 1 and 2), the other State shall, to the extent needed to eradicate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In other words, if the PE's profits have been taxed in the Contracting State, the other Contracting State shall make an appropriate adjustment to the amount they tax to ensure that there is no double taxation of the PE profits. The OECD MTC aims to 'balance out' any double taxation that may arise from the different treatments of the profits attributable to a PE by the two Contracting States. If a Contracting State therefore adjusts the profits attributable for tax purposes, the taxes that are charged in the State where the PE is located shall, to this extent, make a similar adjustment to avoid any double taxation arising to the taxpayer.<sup>137</sup>

Paragraph 3 does not specify the method to be used in determining how the corresponding adjustment has to be made, but states that no adjustments should be made to the profits in order to reach a different result if the taxpayer has indicated profits attributable to the PE and both of the Contracting States agree that the taxpayer has done so in accordance with paragraph 2 as interpreted by the Report.<sup>138</sup> Where the initial adjustment is made by the State in which the PE is situated, the adjustment provided for by paragraph 3 could be granted in the other State through the adjustment of the amount of income that must be exempt under Article 23 A or by the credit that must be granted under Article 23 B.

It is provided in the Commentary that if a dispute arises between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure ('MAP') provided for in Article 25 should be implemented.<sup>139</sup> The Contracting States will then enter into an agreement by which they reach a mutual agreement on the tax treatment of the profits attributable to the relevant PE and the appropriate adjustments to be made to the profits for taxation purposes.

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<sup>136</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p143.

<sup>137</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p143.

<sup>138</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p144.

<sup>139</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p148.

Article 7(3) states further that where required, the competent authorities in each Contracting State shall consult each other if necessary to determine the extent of these adjustments.

#### **4.5. Article 7(4) – Relationship with other Articles addressing taxation of income**

Article 7(4) states that where profits include items of income which are dealt with separately in other Articles of OECD MTC, then the provisions of those Articles shall not be affected by the provisions of Article 7. The Commentary indicates that the term ‘*profits*’ are not defined in the OECD MTC, but that the term when used in this Article, and elsewhere in the OECD MTC, has a broad meaning, including all income derived from carrying on an enterprise.<sup>140</sup>

Article 7(4) governs the business profits that are not specifically addressed in any of the other Articles of the OECD MTC, and, in addition, applies to income under Articles 10(4) (dividends tax arising from a PE), Article 11(4) (interest arising from a PE), Article 12(3) (tax on royalties arising from a PE) and Article 21(2) (other income arising from a PE).<sup>141</sup> In other words, dividends, interest or royalties arising from a PE are dealt with under Article 7 and not under the relevant Articles pertaining to dividends, interests or royalties. It is therefore of the utmost importance to establish whether a PE has been created, as it determines under which DTA article the profits may be taxed.

The rule does not prescribe or govern the domestic laws’ classifications of income. For example, a Contracting State may for its own domestic tax purposes classify the income as it wishes, provided that the classification is not in contravention with the provisions of the OECD MTC. The Contracting State may therefore, in accordance with their own domestic law, characterise income as business profits or as a specific category of income for tax purposes and allow appropriate expense deductions.<sup>142</sup>

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<sup>140</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p149.

<sup>141</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p149.

<sup>142</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p150; Section 12D of the Income Tax Act.

## 4.6. Introduction to the calculation of the attribution of profits and the arm's length principle

Neither the OECD MTC nor the UN MTC offer a preferred method for calculation profits.<sup>143</sup> Prior the 2010 updated OECD MTC, there were only vague guidelines provided on the method of calculating the allocation of profits, as seen in Article 7(2) to Article 7(6) of the OECD MTC. Article 7(2), for example, applies a 'separate entity' approach as the paragraph states that the enterprise and the PE should be regarded as distinct and separate enterprises engaged in the same activities under the same or similar circumstances dealing wholly independently.<sup>144</sup> Prior to the 2010 Report, the OECD, however, failed to provide the taxpayer with guidelines on the method of calculation of profits in this 'separate entity' approach.

It is also of importance to note that Article 7 in the OECD MTC does not specifically refer to the application of the arms' length principle, but it is mentioned in the OECD Commentary that the arm's length principle is applicable.<sup>145</sup> The arm's length principle refers to the principle that commercial and financial relations between the contracting parties are determined by external market forces.<sup>146</sup> An example of an arm's length transaction would be a transaction where the buyer and the seller act independently from one another and have no relationship with one another;<sup>147</sup> i.e. are not connected persons. If the parties are connected to one another (e.g. the father is the seller and the son is the buyer) the transaction may not have the same terms and conditions that an independent sale would have. For example, the father may give his son a large discount on the sale's price which would not have happened if the father was selling to an independent party. The result of a

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<sup>143</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p 348.

<sup>144</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p137 – 138.

<sup>145</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)* Art 7: '...any transactions with associated enterprises attributed to the permanent establishment are priced in accordance with the guidance of the OECD Transfer Pricing Guidelines and these Guidelines are applied by analogy to dealings between the permanent establishment and the other parts of the enterprise of which it is a part. The process involves the pricing on an arm's length basis'.

<sup>146</sup> OECD. (2010). *OECD Transfer Pricing Guidelines for Multi National Enterprises and Tax Administrations*. Paris: OECD Chapter 1

<sup>147</sup> Investopedia. (n.d.). *Arm's length*. Available at <http://www.investopedia.com/terms/a/armslength.asp>.



transaction not being concluded at arm's length may provide a distorted image of the enterprise's tax revenue.<sup>148</sup> If the transaction is not concluded at arm's length, an adjustment will be made to the price to present an arm's length price to display the commercial and financial relations expected in an independent transaction concluded under similar circumstances,<sup>149</sup> for example, an adjustment to the transaction price to display a market value price. In other words, the price is determined and adjusted to portray an enterprise's true taxable profits to ensure the enterprise is correctly taxed thereon.<sup>150</sup>

In a practical example, there are three possibilities when determining the arm's length principle for a cross-border pipeline:<sup>151</sup>

- Where a company transports the oil or gas by means of the pipeline to an unrelated party, (a party who is not a 'connected person' in relation to the company transporting the gas) the transaction will be at arm's length.
- Where there is comparable data that illustrates similar companies transporting oil or gas and the arm's length price that they charge for transportation of the oil or gas.
- Where the transaction takes place between connected parties (e.g. PE) and there is no comparative data to indicate a proper arm's length price, a functional and factional analysis has to be completed to determine what assets, risks, and free capital relate to the PE.

Even though the 'separate entity' approach requires that the PE be seen as an independent enterprise, wholly independent from the enterprise, operating under similar or the same circumstances, the arm's length principle will still be applicable. The OECD has confirmed that the arms' length principle is applicable to Article 7 of the OECD MTC in the 2008

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<sup>148</sup> OECD. (2010). *OECD Transfer Pricing Guidelines for Multi National Enterprises and Tax Administrations*. Paris: OECD, Chapter 1.

<sup>149</sup> OECD. (2010). *OECD Transfer Pricing Guidelines for Multi National Enterprises and Tax Administrations*. Paris: OECD, Chapter 1.

<sup>150</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p 647.

<sup>151</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 7.

amendments. This view was also confirmed in the OECD's 2010 updates to Article 7.<sup>152</sup> The OECD Commentary states that both the 'separate entity' approach and the arm's length principles on which Article 7(2) are based had already been incorporated in MTC.<sup>153</sup> Vogel states that only the profits that are derived from a PE and which can be economically attributable to that PE must be attributed to the PE.<sup>154</sup> A distinction must therefore be made between the profits arising from the PE and from the enterprise's head office or other areas of the enterprise.<sup>155</sup>

In the 2008, when the OECD updated *inter alia* Article 7 of the MTC and the Commentary, a 'two-step approach' was introduced in terms of the interpretation of Article 7(2). This approach offers a practical solution in determining the profits attributable to the PE with the arm's length principle, and in determining whether any adjustments are required due to the application of the arms' length principle (e.g. if the head office had made a loan to the PE with a very low or no interest rate).<sup>156</sup>

The first step of the 'two-step approach' requires that the PE activities be identified by way of a functional and factual analysis.<sup>157</sup> A functional analysis is an essential process in which it is determined whether a transaction is relevant for comparison purposes during the examination of a related-party transaction. The analysis inspects the specific economic activities inherent in the specific related party transaction being compared.<sup>158</sup> The OECD Commentary on Article 7 states that this functional analysis will *inter alia* lead to the appropriate attribution of profits to the PE of the rights and obligations that arises from transactions between the enterprise which the PE forms part of and a separate enterprise,

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<sup>152</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p349.

<sup>153</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p129.

<sup>154</sup> Vogel, K. (1997). *Klaus Vogel on Double Taxation Conventions* (Third Edition). UK: Kluwer Law International, Art 7 Par 32.

<sup>155</sup> Vogel, K. (1997). *Klaus Vogel on Double Taxation Conventions* (Third Edition). UK: Kluwer Law International, Art 7 Par 32.

<sup>156</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p350.

<sup>157</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p350.

<sup>158</sup> US Transfer Pricing. (n.d.). *Functional Analysis*. Available at [http://www.ustransferpricing.com/functional\\_analysis.html](http://www.ustransferpricing.com/functional_analysis.html).

as well as the attribution of capital to the PE based on the assets (e.g. a cross-border pipeline) and risks attributed to the PE.<sup>159</sup>

The second and last step in the ‘two-step approach’ requires determining the remuneration arising from the dealings identified in step one by applying the arms’ length principle.<sup>160</sup> Under the second step, the OECD Commentary states that any transactions with associated enterprises attributed to the PE are priced according to the OECD Transfer Pricing Guidelines, as discussed in Chapter 5.<sup>161</sup>

There are two methods in determining the allocation of profits.<sup>162</sup> The ‘direct method’ requires that the profits of the PE are determined as if the PE is an independent enterprise. The ‘indirect method’ is utilised when the total profits of the enterprise is applied and then split via a specific formula to determine the profits relating to, for example, head office and the profits relating to the PE.<sup>163</sup> The 2008 and 2010 OECD Report on the Attribution of Profits to Permanent Establishments and the prescribed methods for attribution income in terms of the Reports will be discussed in more detail in Chapter 5.

#### **4.7. The attribution of profits arising from a PE created by a pipeline**

One of the complex matters in the field of international taxation and transfer pricing is the allocation of profits and expenses of a business.<sup>164</sup> The allocation of income is an important aspect to be considered by multinational companies, such as petroleum enterprises, as it can have a significant impact on the enterprise’s total tax effect. This is due to the fact that large amounts of assets, risks, and functions are involved, and if tax authorities make even a slight adjustment to the taxable amount (e.g. due to the allocation of profits arising from a PE

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<sup>159</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p134.

<sup>160</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p350.

<sup>161</sup> OECD. (2010). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris: OECD.

<sup>162</sup> Vogel, K. (1997). *Klaus Vogel on Double Taxation Conventions* (Third Edition). UK: Kluwer Law International, Art 7 Par 442.

<sup>163</sup> Vogel, K. (1997). *Klaus Vogel on Double Taxation Conventions* (Third Edition). UK: Kluwer Law International, Art 7 Par 442.

<sup>164</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 7.

caused by the enterprise's cross-border pipelines) this may result in a significant difference in the enterprise's profit or loss.<sup>165</sup>

Article 7 of the OECD MTC allocates the taxing rights to the jurisdiction in which a PE is created, but does not prescribe the method in which these profits should be attributed for taxation purposes. The OECD have, however, published a OECD 2010 Report on the Attribution of Profits to Permanent Establishments, which illustrates the OECD's authorised approach as to how the profits arising from a PE should be determined.

Unfortunately, the 2010 Report and Article 7 Commentary are both silent on the specific treatment for the cross-border pipelines, specifically regarding the allocation of income and deduction of expenses. A cross-border pipeline is a unique asset, as it crosses more than one country border, which increases the difficulty in determining the profits arising from the pipeline. The lack of prescribed treatment in the OECD Commentary of Article 7 and in the 2010 Report means that the general principles and guides supplied should be interpreted and applied to a unique case, which will not necessarily fit the mould of the general principles.<sup>166</sup>

## 4.8. Conclusion

Article 7 of the OECD MTC is an important section in a DTA which allocates the taxation rights to the jurisdiction in which the profits arise from the business carrying on a PE in that jurisdiction through a PE.

The OECD has changed Article 7 over the years to address missing and unclear sections in the MTC and in the Commentary. The OECD has gone further to publish a 2008 Report on the Attribution of Profits to Permanent Establishments, and then later releasing an updated version in 2010. The amendments are positive changes to ease the burden of determining how profits have to be allocated to PEs; however, not all situations have been addressed and the unique situation of the allocation of profits relating to cross-border pipelines remains unanswered.

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<sup>165</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 1.

<sup>166</sup> *Ibid*, Chapter 7.

## CHAPTER 5. DETERMINING THE ATTRIBUTION OF PROFITS TO CROSS-BORDER PIPELINES

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### 5.1. Introduction

The practical determination of the attribution of profits arising from a PE is a matter that relates closer to the field of transfer pricing than to that of international tax. As mentioned in the previous Chapter, there are two approaches in allocating profits to the PE; i.e. the *'functionally separate approach'* and the *'relevant business activity approach'*.

The relevant business activity approach is not adapted by the OECD as it lacks clarity and practical problems arise with the administration of the approach.<sup>167</sup> The approach defines *'profits of an enterprise'* only as profits arising from the business activities, in which the PE had a degree of participation. This approach is not addressed in either the OECD MTC in Article 7 or in the OECD Commentary. It is mainly applied by jurisdictions when interpreting the phrase *'profits of an enterprise'*.<sup>168</sup>

The functionally separate approach defines the *'profits of the enterprise'* as the profits attributed to the PE as the profits that the PE would have earned at arm's length if it was a distinct and separate enterprise performing the same/similar functions under the same/similar conditions.<sup>169</sup> This approach ties in perfectly with the principle in Article 7(2),<sup>170</sup>

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<sup>167</sup> PWC. (2007). *Transfer Pricing in the context of a PE: The OECD view*.

<sup>168</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax policy and Administration, p23.

<sup>169</sup> PWC. (2007). *Transfer Pricing in the context of a PE: The OECD view*.

<sup>170</sup> Article 7(2) of the OECD MTC states the following:

*'For the purposes of this Article (and Article 23A and 23B) the profits that are attributable in each Contracting State to the PE referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise'*.

and the OECD has adopted this approach in determining the attribution of profits. This approach is also generally referred to as the Authorised OECD Approach ('AOA').<sup>171</sup>

In the process of developing and improving Article 7, the OECD issued a 2008 and thereafter a 2010 Report on the attribution of profits to Permanent Establishments. The reports are both aimed at assisting in applying the approach in attributing profits to a PE. It should be noted that the Report does not influence the determination of the existence of a PE (Article 5 of the OECD MTC), but only addresses the attribution of the profits arising from these established PEs.

A short summary of each Report will be discussed. Thereafter the changes from the 2008 Report to the 2010 Report regarding the general approach will be highlighted. Finally, this approach will be applied to profits arising from pipelines in order to determine whether these reports address such a unique situation adequately.

## **5.2. The 2008 OECD Report on the Attribution of Profits to Permanent Establishments (the '2008 Report')**

### **5.2.1 Introduction**

The 2008 Report was issued on 17 July 2008. The 2008 Report addresses specifically the general considerations when dealing with the attribution of profits to a PE, and also the special considerations for enterprises carrying on global trading of financial instruments and insurance companies.<sup>172</sup> The 2008 Report acknowledges that prior to the Report there was no consensus in the OECD member jurisdictions on the interpretation of Article 7.<sup>173</sup>

The 2008 Report conclusions are reflected in the new Article 7 and the new OECD Commentary on Article 7. It was envisaged by the OECD that the new Article 7 and its

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<sup>171</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration.

<sup>172</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration.

<sup>173</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p7.

Commentary be included in the next OECD MTC update, which was scheduled for 2010.<sup>174</sup> The AOA adopted by the OECD does not prescribe specifications impacting on domestic law and only sets a limit on the attributable profits that may be taxed by the jurisdiction where a PE exits.<sup>175</sup>

### 5.2.2 *The two-step analysis*

Under the AOA there is a two-step analysis required on the interpretation of Article 7(2). The first step requires a functional and factual analysis, which entails hypothesising that the PE is a separate enterprise operating under the same or similar conditions and performing the same or similar activities in these conditions. As seen between unrelated parties, a determination has to be made as to which enterprise owns the assets and which enterprise carries the risk. This is generally determined with the legal contracts concluded between the unrelated enterprises, stipulating all the legal arrangements as concluded between the parties.<sup>176</sup> However, with a PE there is no separate legal enterprise that bears the risk or owns the asset as the PE forms part of the main enterprise, and this legal analysis is not viable under these circumstances.

The AOA offers a solution in these instances as it attributes the risk relevant to the functions performed by people in the PE and also attributes the economic assets for the significant functions performed by people in the PE. The AOA further also attributes the capital, risk, and the assets that support the PE functions to the PE.<sup>177</sup>

### 5.2.3 *Attribution of an asset*

In determining the attribution of profits to assets in accordance with the AOA, it is important to determine which assets are economically owned by the PE and in which capacity these

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<sup>174</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p8.

<sup>175</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p12.

<sup>176</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p13.

<sup>177</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p14.

assets are utilised by the PE.<sup>178</sup> It has to be borne in mind that factually the enterprise owns the assets and that the PE merely forms part of the enterprise. However, for the AOA determination purposes, the PE is viewed as an independent and separate enterprise and assets that are economically owned by the PE will be attributed to the PE. The AOA examines all the facts and circumstances to determine how the assets are utilised by the PE in performing their functions. If found that an asset is economically owned by a PE, it will result in the attribution of capital, interest bearing debt, and the attribution of profits to the PE.<sup>179</sup>

#### 5.2.4 *Attribution of risk*

An important consideration in determining the attribution of profits is to determine whether the risk lies with the enterprise or the PE, as capital follows risk when capital is attributed to the enterprise to manage the risk.<sup>180</sup> The PE can assume risks, and depending on the enterprise's business, they may relate to risks regarding the loss in value of assets or risks relating to the PE's activities. An indication of the assumption of risk is the active decision-making in relation to the acceptance and transfer of this risk.<sup>181</sup> Examples of risk that can be borne by a PE, depending on the nature of the business activities of the enterprise, are inventory risk (where the PE makes active decisions relating to the inventory levels) and credit risk (where the PE makes an active decision to grant credit to a creditor).<sup>182</sup>

#### 5.2.5 *Attribution of free capital*

Free capital refers to funding that does not have a tax deductible return in the form of interest; e.g. an interest free loan. Under the arm's length principle, for purposes of the attribution of capital, the PE should have sufficient capital to support the functions undertaken by the PE and to also support the PE's assets and the risks assumed by the

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<sup>178</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p15.

<sup>179</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p15.

<sup>180</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p17.

<sup>181</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p15.

<sup>182</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p15.



PE.<sup>183</sup> The arm's length principle, discussed in Chapter 4, should be applied with the attribution of capital to ensure that a suitable amount of capital is allocated to the PE.<sup>184</sup>

#### 5.2.6 *Summary of the AOA two-step approach*

The AOA's aim is to draw a comparison between the dealings of the PE and the enterprise, which the PE forms part of, as if the two are completely independent from one another.<sup>185</sup> These dealings between the enterprise and the PE should be concluded at arm's length, as if the PE and the enterprise, which the PE forms part of, are separate enterprises. The arm's length principle can be tested by way of transfer pricing transaction methods.<sup>186</sup>

The first step of the AOA is a functional and factual analysis. The results of the analysis may result in the following attributions to the PE:<sup>187</sup>

- The attribution of any rights and obligations to the PE arising from transactions by the enterprise (which the PE forms part of) and a separate enterprise.
- The attribution of the economic ownership of the assets to the PE due to significant people functions performed by the PE relating to specific assets.
- The attribution of the risks assumed by the PE through significant people functions performed by the PE will be attributed to the PE.
- The attribution of capital, based on the risks assumed by the PE and the assets attributed to the PE.
- Identify 'dealings'<sup>188</sup> between the PE and the rest of the enterprise.

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<sup>183</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p17.

<sup>184</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p17.

<sup>185</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p20.

<sup>186</sup> The CUP (Comparable Uncontrolled Price) method, the resale price or the cost plus method are a few of the applicable traditional transaction methods.

<sup>187</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p20.

The second step is the pricing at arm's length of the dealings recognised in the functional and factual analysis by applying the 1995 Transfer Pricing Guidelines. Once the functional and factual analysis in step one has been completed and has postulated the PE as a functionally separate enterprise to attribute all the relevant assets, risk and capital to the PE, the second step is used to postulate the rights and obligations arising from transactions that should be attributed to the PE. The second step of the AOA is also aimed at identifying the different functions performed by the enterprise and by the PE, and the dealings are then postulated to effectively price those dealings.<sup>189</sup>

### **5.3. The 2010 OECD Report on the Attribution of Profits to Permanent Establishments ('the 2010 Report')**

#### *5.3.1 Introduction*

The 2010 Report resulted in a move towards a stricter application of the arm's length principle in comparison to any previous practices. To implement the principles laid down in the 2010 Report, an implementation was planned where the Commentary and text of Article 7 of the OECD be amended to provide more certainty to future treaties. The new Article 7 was prepared and was included in the 2010 update of the OECD MTC and the OECD Commentary to allow for the implementation of the AOA in future treaties concluded after this inclusion.<sup>190</sup>

#### *5.3.2 Changes to the 2010 Report*

The 2010 Report serves as the sanitised version of the 2008 Report, with minor changes and no changes to the 2008 Report's conclusions.<sup>191</sup> The most important change in 2010 was the update of Article 7 in the OECD MTC and the OECD Commentary. The 2010

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<sup>188</sup> A dealing is a real and identifiable event e.g. provision of service, transfer of stock or an asset. OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration.

<sup>189</sup> OECD. (2008). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration, p21.

<sup>190</sup> OECD (2010); Bennett, M.C. (2010). *Article 7 – New OECD rules for Profit Attribution of Permanent Establishments*. International Taxation Convention Mumbai 4 December 2010.

<sup>191</sup> OECD. (2010.). *Treaties*. Available at <http://www.oecd.org/ctp/treaties/oecdapprovesthe2010updatetotheoecdmodeltaxconvention.htm>.

Report reflects only the updated version of Article 7 but there are no substantive changes to conclusions of the 2010 Report.<sup>192</sup>

#### **5.4. The attribution of profits arising from pipeline according to the Reports**

Neither the 2008 nor that the 2010 Report have made reference to the unique situation that occurs with cross-border pipelines. Special provisions are made only for enterprises carrying on global trading of financial instruments and insurance companies. In such an instance, it appears that profits of a PE created by a cross-border pipeline should be attributed to the pipeline under the general provisions of the Reports.

To illustrate the application for attributing the profits to a PE an example is used. Assume that Company X, a resident company of France, owns a gas pipeline that stretches from the Northern France region to Germany and stretches over Belgium as well. The pipeline is utilised by Company X to transport gas to Company Z (a one way supply), a company based in Germany for the gas is sold and distributed in Germany. As with other pipelines that stretch over a great distance, there are storage tanks located along the pipeline that store some of the excess gas. Some of these tanks are located along the pipeline, including one in Belgium and one in Germany. For this example, assume that the pipeline has fulfilled all the requirements for creating a PE in terms of Article 5 of the France/Belgium DTA and France/Germany DTA.

The next step is to determine how the profits should be attributed to the cross-border pipeline. As neither the OECD MTC, its Commentaries on Article 7, nor the 2010 Report provide any guidance on the allocation of profits to pipelines, the general approach will be applied to the example.

The first step in the AOA is the fact and functional analysis to identify the significant economic activities and responsibilities undertaken by the PE.<sup>193</sup> The second step would be

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<sup>192</sup> OECD. (2010). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Centre for Tax Policy and Administration.

the pricing between the PE and the rest of the enterprise recognised as arm's length dealings. These analysis and determination of price at arm's length requires a much more in-depth look into the dealings of Company X in our example. We will therefore not apply each of these steps to the provided example as insufficient information is provided. The assumption is therefore made that the AOA steps have been properly completed as prescribed under the general approach. For the purpose of this example, the attribution of profits and expenses from pipelines characterised as PEs will be applied to the example for illustrative purposes.

#### 5.4.1 Attribution of assets to a pipeline

In the performance of a functional analysis, the PE will be obliged to draw up a tax balance sheet containing the PE's tangible and non-tangible assets. The pipeline itself is of the utmost importance and would definitely be included in the tax balance sheet. However, a pipeline is a complex structure and does not only consist of the pipeline itself; it contains other elements such as power stations and storage tanks along the pipeline. These are essential elements to the pipeline but the problem arises if these elements are located in foreign jurisdictions. In the illustrative example, there is a storage tank located in Belgium. Company X would have effectively created a PE with the pipeline stretching across Belgium as well as Germany, and will have storage tanks in both these jurisdictions (which in itself cannot create a PE).<sup>194</sup>

The question now arises as to where these elements of the pipeline should be allocated. They are essential to the performance of the pipeline and attribute to the profits and losses of the pipelines, even though they are allocated in foreign jurisdictions.<sup>195</sup> These assets have to be added to the PE's balance sheet as it will influence the attribution of profits and losses. If these assets are merely allocated to the country in which they are present (e.g. a country where the enterprise does not have a PE) it will not reflect the PEs true economic value.

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<sup>193</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 7.

<sup>194</sup> Excluded from the definition of a PE in Article 5(3) is the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise.

<sup>195</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 7.

#### 5.4.2 *Attribution of risk to a cross-border pipeline*

The determination of the attribution of risk to a pipeline also serves as a challenge, as there are different kinds of risk that have to be taken into account; entrepreneurial risk, risk of pollution, or risk of damage.<sup>196</sup> As a cross-border pipeline is a major business activity, the risks associated with operating such a large operation will most likely increase and expand over the time that the pipeline is operated.<sup>197</sup> If, in the above example there is a gas explosion at the storage tank in Belgium, it will be important that the appropriate risk be allocated to that PE in Belgium

#### 5.4.3 *Attribution of 'free' capital to a cross-border pipeline*

From the 2010 Report it is required that the PE has sufficient capital to support its operations, the assets that the PE economically owns, and the risks assumed by the PE.<sup>198</sup> For a cross-border pipeline an enormous amount of capital will be required as there is a large sum of elements that are connected to the pipeline over long distances and substantial risks are associated with pipelines.<sup>199</sup>

### 5.5. Conclusion

The attribution of profits is a very complex process as it involves the domestic law of two or more jurisdictions, various DTAs, and transfer pricing issues that may result in disagreements between the jurisdictions on the taxation methods used, and many may even result in double or no taxation. A cross-border pipeline complicates matters even further as it is a unique type of asset that can stretch over more than one jurisdiction.<sup>200</sup>

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<sup>196</sup> An example of pollution risk would be the 2010 BP oil spillage off the Gulf of Mexico.

<sup>197</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 7.

<sup>198</sup> *Ibid*, para 5.2.4.

<sup>199</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 7.

<sup>200</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 7.

The developments towards issuing the 2010 Report indicate that the OECD has recognised that there is a lack of guidance for jurisdictions on the attribution of profits, which the OECD has since addressed in their 2008 and updated 2010 Report. Although the 2010 Report provides a more consistent approach to the attribution of profits to a PE,<sup>201</sup> there still remain unaddressed uncertainties and different interpretations relating to Article 7. Specifically, the 2010 Report does not provide for unique situations that arise where attribution of profits cannot be forced into the mould of the general Authorised OECD Approach ('AOA'),<sup>202</sup> as illustrated above with the example of the cross-border pipeline.

Although steps have been taken by the OECD to provide guidance on the attribution of profits to PEs, there remain numerous unanswered questions, especially as per the illustration above relating to cross-border pipelines.

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<sup>201</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 7.

<sup>202</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 7.

## CHAPTER 6. GERMANY'S PIPELINE DECISION AND OTHER CASE LAW

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### 6.1. Introduction

Case law is an important element to consider when analysing taxation issues as principles are laid down in court cases that may be applicable to the current situation. It is significant to understand the impact that each court judgment has on future cases. For example, a high court decision may be referenced to argue a certain point that is supported by the relevant court case judgement. An Appeal Court has a higher standing than a High Court, and an Appeal Court judgement creates a precedent, which means that future lower court judgments, where there are same or similar facts and conditions, are subject to the previous Appeal Court ruling. International case law forms part of the South African common law, and as per the Constitution,<sup>203</sup> reference can be made to international case law if it is relevant to the South African court's case at hand.

As mentioned in the previous chapters, the lack of a unified approach or interpretation of the OECD MTC and OECD Commentary leaves it to the courts to provide clarification of the tax treatment of a cross-border pipeline. It is therefore important to consider how the courts interpret the law for taxing cross-border pipelines. The cases discussed in this chapter arise from Germany, India and Italy. The cases are specifically discussed as they address important elements that have to be considered with the classification and taxation of cross-border pipelines. There have not been any recent South African court cases regarding income tax relating to a cross-border pipeline. One then refers to international tax case law to observe how foreign courts have treated these cases and what their rulings were regarding the creation of a PE and the attribution of profits to a cross-border pipeline.

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<sup>203</sup> The Constitution of South Africa (1994) states in section 232 that international law forms part of the law in South Africa unless it is inconsistent with the Constitution or an Act of Parliament. Section 233 continues to state that when interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

The 'German pipeline' case is the most significant case addressing these situations. There is also international case law discussed in this Chapter that pertain to determining whether a PE had been created with a pipeline.

## 6.2. The 'German pipeline' decision<sup>204</sup>

### 6.2.1 *The Judgment*

This judgement granted by the German Federal Court in 1997 is of importance to international tax practice and to this study as the court had to specifically address whether a cross-border pipeline that stretched over the Netherlands and Germany created a PE in Germany for a Netherlands company, and whether Germany had the right to tax the pipeline that stretched over Germany.

The facts of the case are as follow:

A Netherlands company operated a transport system for the transport of other parties' crude oil. The company transported this oil to Germany by way of an underground pipeline that stretched over hundreds of kilometres in Germany. This pipeline also had fully automatic pumping stations along the pipeline, two of which were based in Germany (at a later stage during the pipeline operations the two German based pumping stations were removed). The Netherlands' company had no employed personnel present in Germany to assist with the maintenance of the pipeline and pumping stations. The pipeline was operated, controlled, and maintained from the Netherlands.

It was determined in the 'German pipeline' decision that it is not required that the place of business be physically connected to the ground or visible above ground.<sup>205</sup> The court held that the concept of a PE does not require a base above ground and the underground pipeline could still constitute a PE as it is using German resources (e.g. the ground) to operate. The court held that an underground pipeline constitutes a place of business and concluded that the underground pipeline created a PE for the Dutch company in Germany.

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<sup>204</sup> Bundesfinanzhof vorn 30.10.1996, II R 12/92, BStB1 II 1997, S.12.

<sup>205</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk.



The Court considered Section 12AO of the General Tax Code 1977<sup>206</sup> of Germany which defines a PE as every fixed base of a business which serves the activity of the business entity. A base is a physical object which may lay the foundation of a business activity. In terms of Section 12AO, a base is deemed to serve a company's business if the company uses the base for a significant period of time for business purposes. The pipeline had been maintained for a significant period of time and the pipeline had been designed for long-term use. The Court held that the cross-border pipeline had met the requirements of the General Tax Code and it therefore constituted a base that served the Dutch company's business.

In the 'German pipeline' decision, a distinction was made between a PE 'serving an enterprise' and one 'through which' the enterprise's business is carried on.<sup>207</sup> The mere ownership of a fixed asset is not enough to constitute a PE.<sup>208</sup> The court held that the pipeline served the Dutch company's business as it enabled the company to distribute crude oil to Germany. In order to 'serve' an enterprise, a PE's activity can form part of the company's core activities, or the PE's activity may be auxiliary in nature.<sup>209</sup>

#### 6.2.2 *Commentary on the 'German pipeline' decision*

When analysing the 'German pipeline' decision, one has to take note of the risk of arriving at different interpretations when translating the case from German to English. The words '*Geschäftseinrichtung*'<sup>210</sup> and '*Anlage*'<sup>211</sup> specifically used in section 12AO of the General Tax Code differ from the English interpretation of the words used in the OECD. Therefore, based on the difference in interpretation of the words, the 1997 judgement in the German pipeline case is contrary to the amended 2010 OECD Commentary of Article 5 of the OECD MTC. The 'German pipeline' case held that even though there were no Dutch employed personnel present in Germany maintaining and controlling the pipeline, the fact that the pipeline was a fixed base that served the enterprise for a significant period of time is sufficient to create a PE in Germany. The German terms are broad and include fully

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<sup>206</sup> Abgabenordnung of 16 March 1976, Bundesgesetzblatt 1976, I.

<sup>207</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk. p340.

<sup>208</sup> Skaar, A.A. (1991). *Permanent Establishment – Erosion of a Tax Treaty Principle*, p112.

<sup>209</sup> Federal Tax Court. Bundessteuerblatt 1960, I p 468.

<sup>210</sup> German for 'place of business'.

<sup>211</sup> German for 'investment'.

automatic facilities; in other words no personnel of the enterprise were required to effectively create a PE.<sup>212</sup>

In contrast, the OECD Commentary<sup>213</sup> states that where an enterprise merely uses transportation services by way of a pipeline supplied by the operator and the enterprise does not have the pipeline at its disposal (i.e. ownership or right of use), there will be no PE. Basically, the OECD requires that there has to be some form of human intervention to create a PE.<sup>214</sup>

There had been an earlier pipeline decision in Germany in 1977 ('the 1977 pipeline case')<sup>215</sup> which the Federal Tax Court in this case did not grant much attention to. The Federal Tax Court did not regard the '1977 pipeline' case to have created a precedent.<sup>216</sup> In the '1977 pipeline case', the issue being addressed was the apportionment of revenue amongst municipalities arising from pipelines in another municipality's territory, and the court held that no PE was created. Critics of the 'German pipeline' case find it questionable as to why the Federal Court did not consider the '1977 pipeline' case.

The Federal Court in the 'German pipeline' case argued that the '1977 pipeline' case was not applicable to the case at hand as it addressed only the domestic concept of a PE and was based on a section in an Act which had since been repealed. Critics of the 'German pipeline' case are of the opinion that the Federal Tax Court should have given more attention to the '1977 pipeline' case. It is arguable whether the '1977 pipeline' case had created a precedent which the court would have been obliged to follow in the judgement of the 'German pipeline' case.<sup>217</sup>

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<sup>212</sup> *Commentary on the Pipeline Decision*. Available at <http://home.germany.net/101-274850/pipecomm.html>.

<sup>213</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, par 26.1.

<sup>214</sup> Olivier, L. & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk, p340.

<sup>215</sup> Federal Tax Court of 12 October 1977, docket no. I R 226/75, *Bundessteuerblatt* 1990, II, page 111.

<sup>216</sup> *Commentary on the Pipeline Decision*. Available at <http://home.germany.net/101-274850/pipecomm.html>.

<sup>217</sup> *Commentary on the Pipeline Decision*. Available at <http://home.germany.net/101-274850/pipecomm.html>.

Edwardes-Ker makes reference to another German case<sup>218</sup> which precedes the 'German pipeline' case. The facts of this case were similar to that of the 'German pipeline' case: a Netherlands company owned an underground pipeline that was operated and controlled by computers and technical staff in the Netherlands. There was no human intervention with the pipeline in the present case. The court held that in terms of German domestic law and the Germany/Netherlands DTA, that a PE was created in Germany by the pipeline. Edwardes-Ker expresses his view that although a pipeline is 'permanent' in nature, it is still questionable if it is a place of business in which an enterprise's activities are carried out.<sup>219</sup> It therefore seems that the 'German pipeline' case rather followed the argument presented in this particular case, as opposed to the '1977 pipeline' case, which held that the pipeline did not create a PE.

The 'German pipeline' case is therefore of major interest as its findings are contrary to the OECD MTC and Commentary. In the 'German pipeline' case it is held that only a taxable business presence is required with a pipeline to create a PE and that no human interaction is required. This may impact future decisions in Germany for non-resident telephone companies or non-resident internet service providers that have telephone lines stretching across Germany or who have servers in Germany.<sup>220</sup> The 'German pipeline' case may serve as a precedent for these cases and the non-resident companies that may run the risk of creating a PE in Germany even if they do not have any form of human intervention, with for example, the telephone lines or servers in Germany.<sup>221</sup>

### **6.3. Other case law pertaining to the creation of a PE**

#### **6.3.1 *GIL Mauritius Holdings Ltd v Assistant Director of Income Tax (IT) [TS-546-ITAT-2011(Del)]***

In this case heard by the Indian Appeal Court in Delhi, GIL Mauritius Holdings Ltd ('GIL') was a tax resident of Mauritius that entered into an agreement with BG India Ltd ('BG') a company that had its principle office in India. The BG was nominated by three co-ventures

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<sup>220</sup> Edwardes-Ker comments that the 'German pipeline' case may have potential tax implications for electronic commerce ('e-commerce'), for example the internet. Edwardes-Ker, M (1995 looseleaf). *Tax Treaty Interpretation*. Dublin: In-Depth Publishing, Article 5 page 46.5005.

<sup>221</sup> *Commentary on the Pipeline Decision*. Available at <http://home.germany.net/101-274850/pipecomm.html>.

to provide services to GIL relating to offshore transportation and installation of pipelines. GIL would lay the pipeline in the territorial waters of India and the work was performed from a ship, which remained in the territorial waters for the length of the work being performed.

The Indian Tax Authorities were of the opinion that the profits arising from the services would be taxable in India. GIL submitted that the services were performed in less than a nine month period and that they therefore fell short of the required period, as per the India/Mauritius DTA, to have created a PE. GIL argued further that the profits from laying the pipeline were business profits that would not be taxable in India as GIL does not have a PE in India. The Assessing Officer disagreed with GIL's argument and held that there was a PE created in India as the PE definition's requirements of Article 5(1) of the India/Mauritius DTA were met. The Assessing Officer raised 25% of GIL's total revenue for taxation purposes in India. The matter was appealed by GIL.

The Appeal Court examined the work performed by GIL (the laying of pipelines) for purposes of determining whether GIL had created a PE in India with the assembly of the pipelines. The Appeal Court held that the term 'fixed place of business' in Article 5(1) does not refer to a point in space but an area in space; in this case it refers to the space available to GIL to enable GIL to lay the pipelines.

Article 5(2)(i) specifically requires that for an assembly or construction project to be included in the definition of a PE, that the project has to last over a period of nine months or longer. The words 'assembly' and 'construction' are undefined in the India/Mauritius treaty and the ordinary meaning of the words should therefore apply. The Appeal Court found that the word 'assemble' means to 'join or fit together the parts of a machine'. The word 'construct' in terms of immovable property refers to 'building or making of something'. The court held that in terms of Article 5(1) the pipelines were assembled by GIL and that GIL was carrying on business by way of assembling pipelines in India and a PE was therefore created.

An important consideration of the Appeal Court in this case was the interaction between Article 5(1) (the PE definition) and Article 5(2)(i) (specific inclusions in the PE definition which relates to construction and assembly projects). They referred to the *Furgo Engineers*

*BV* - case<sup>222</sup> where the Court held that if the requirements of Article 5(1) are met, Article 5(2)(i) does not have to be considered. The Appeal Court in this case disagreed with this view and stated that if Article 5(2)(i) was not considered, all assembly or construction projects will have a fixed place of business. The Appeal Court held that it is intended by the DTA that Article 5(1) and Article 5(2) are read together and are not considered in isolation. The Appeal Court confirmed, however, that Article 5(2) does not override Article 5(1) and a fixed place of business does not require existence for a length of time. However, where the fixed place of business is moving (e.g. construction of a road, laying offshore pipelines from a ship), the period of existence becomes a consideration.<sup>223</sup>

In this case, even though GIL had complied with all the requirements of Article 5(1) of the PE definition, they were excluded from creating a PE in terms of Article 5(2)(i) as the assembly of the pipelines did not exceed the period of nine months. The court found that there was no PE created and GIL's appeal was allowed.

### 6.3.2 *Furgo Engineers BV v ACIT (OCD) [2008-26-SOT-78-TDEL]*

In another case in India, *Furgo Engineers BV* ('Furgo'), a Dutch company, carried out services for Indian companies 'C', 'G' and ONGC. The services consisted of testing the Indian soil or Indian territorial waters for the purpose of exploration or prospecting and were conducted from a ship that remained in the territorial waters of India. *Furgo's* work for all three companies lasted for 91 days for which *Furgo* had a presence in India. *Furgo* did not include its revenue received from the companies in its total income as *Furgo* did not have a PE in India, based on Articles 5 and 7 of the Netherlands/India DTA. *Furgo* argued that the Article 5(2)(i) of the DTA requires that an installation for exploration of natural resources will constitute a PE if the activity continues for more than 183 days, and that *Furgo* was only present in India for 91 days.

The Assessing Officer in India rejected this view and held that the income was taxable in India at 10%. The Assessing Officer's argument was that there is no length of time prescribed in Article 5(1) of the Netherlands/India DTA and therefore if a fixed place of

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<sup>222</sup> *Furgo Engineers BV v ACIT (OCD) [2008-26-SOT-78-TDEL]*.

<sup>223</sup> OECD. (2010). *Model Tax Convention on Income and on Capital (Condensed Version)*, p 94, 99-101.

business is available to the taxpayer to carry on its business, it will constitute a PE. The Court held that Article 5(2)(i) will not be applicable as there was no installation or structure used for exploration in the case at hand; therefore the prescribed period of time in Article 5(2)(i) will not be applicable.

The Court referred to an Advanced Ruling A. No. P-11,<sup>224</sup> where a Singapore incorporated company rendered services in the Indian territorial waters by burying pipelines. The Authority in the Ruling held that the ship from which the work was carried out constituted a place of business, even though it did not remain in one place throughout the process of the laying of the pipelines. The Authority held that in this case there was an installation or structure for purposes of exploration of natural resources, but that the prescribed time period was not met. Therefore, the Singapore company did not create a PE in India with the laying of the pipeline. The Court, in the case of *Furgo*, stated that the advanced ruling differed from the case at hand as the Court held that there was no installation for exploration in *Furgo*'s case.

The Court thereafter considered the OECD Commentary on a 'fixed place of business', which required a link between the place of business and a geographical point. The Court held that that a 'place of business' covers any facilities, premises or exploration. It is immaterial whether these facilities or premises are used exclusively for the purpose of a premise or facility, and the Court held that a drilling ship constituted a PE.<sup>225</sup> The Court held that Article 5(1) of the DTA does not prescribe a time period for qualification as a PE. In other words, if the Article 5(1) requirements are met and the taxpayer has a 'fixed place of business' the taxpayer will have created a PE, regardless of the period of time this fixed place of business is utilised in the Other State.

### 6.3.3 *DIT v. LG Cable Ltd. [2011-TII-02-HC-DEL-INTL]*

In yet another case in India, LG Cable Ltd ('LG') is a South Korean based company which was awarded two contracts by Power Grid Corporation of India Limited, a company ('PGCIL') based in India. Contract 1 required the installation of an onshore fibre optic

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<sup>224</sup> Advance Ruling A No. P-11 of 1995.

<sup>225</sup> Olsen, K. (2012). *Characterisation and Taxation of cross-border pipelines*. The Netherlands: IBFD, Chapter 6.

cabling system. Contract 2 was for offshore services relating to the supply of equipment and offshore services.

For Contract 1, LG set up a project office in India through which LG provided the onshore cabling system. LG treated the project office as a PE and offered tax in terms of Article 5 and 7 of the South Korea/India DTA.

In regard to the offshore contract (Contract 2), LG argued that the entire contractual services were rendered in Korea and no income arose in India. The Assessing Officer did not accept LG's argument and relied on a local Advanced Ruling<sup>226</sup> which held that the offshore supply of material resulting from construction contracts and engineering procurement is taxable in India.

In relation to the PE created by LG for Contract 1, it was held by the court that the PE was merely used to enable LG to perform the onshore services as per Contract 1 and that the PE was not involved in the transaction of the offshore supply of equipment. The existence of a PE was therefore irrelevant for the taxing of the offshore supplies. The two contracts must therefore be dealt with in isolation, and the Court held that the income from offshore supply of equipment cannot be taxed in India, merely based on the fact that the contracts are interlinked with the performance of the onshore contract.

6.3.4 *Resolution 282 of 11 December 1995, Ministry of Finance, Department of Revenue Affairs Legal Serv. VII*

In this Italian ruling by the Italian Tax Authorities, it was held that a cross-border railway and train station that stretched over Italy constituted a PE in Italy and the company from Switzerland was obliged to submit an annual statement of income relating to the PE, even in the absence of any income. The facts of the Ruling briefly are as follow:

The Rhaetia Railway runs from Switzerland across Italy, and the Tax Authorities held in the Ruling that the railway fulfilled the requirements of a PE in the Italy/Switzerland DTA.<sup>227</sup>

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<sup>226</sup> Ishikawajima-Harima Heavy Industries Co. Ltd [2004] 271 ITR 193 (AAR),  
<sup>227</sup> Article 5(1) of the Italy/Switzerland DTA.

Although rails and railway stations are not specifically included in the definition of a PE in Article 5(2) of the Italy/Switzerland DTA, the Article 5(2) list of specific inclusions in the PE definition is not exhaustive. If the rails and the railway station comply with the PE definition it may be regarded as creating a PE.

## 6.4. Conclusion

The case law discussed in this chapter addresses elements that are important considerations with cross-border pipelines. The most definitive case would be the 'German pipeline' case (1997) as the case specifically addressed the issues highlighted in the previous chapters on whether a cross-border pipeline would create a PE.

Although there is criticism on the German pipeline case's judgment, there are valid points made in the case and it highlighted that a pipeline could meet the requirements set out in Article 5(1) of the OECD MTC and may therefore create a taxable presence for the owner of the pipeline by way of a PE. The OECD, however, requires a form of human intervention for the creation of a PE, whilst the German Court held that no human intervention was required - the mere presence of the pipeline without the pumping stations or any of the Netherland's company's employees maintaining the pipeline still created a PE in Germany.

The Court failed, however, to distinguish between a cross-border pipeline that forms part of a company's core business and a cross-border pipeline that is auxiliary in nature. This is an important distinction as an auxiliary activity will not create a PE in terms of Article 5(4) of the OECD MTC. A balance should be maintained between the local legislation (in this case, which did not require such a distinction) and the OECD MTC and the relevant DTA.

In essence, the 'German pipeline' case presented more questions than answers as it highlighted discrepancies between the OECD MTC, local legislation, and case law (in reference to the 1977 pipeline case). This begs for clarification as currently there is no prescribed universal treatment of cross-border pipelines.

The *GIL Mauritius Holdings Ltd* case highlighted the interaction between Article 5(1) and Article 5(2) of the OECD MTC. The articles cannot be considered in isolation as this will, as in this case, result therein that all construction projects create a PE in terms of Article 5(1) if the prescribed time period prescribed in Article 5(2) is not considered. This error was made



in the *Furgo Engineers BV* case, but the case is of importance as it highlighted the principle that a fixed place of business can be on a moving vessel such as a ship, and does not have to be fixed in one geographical spot. If the construction of a cross-border pipeline exceeds the prescribed construction period, a PE can be created in that jurisdiction, based only on the construction thereof. This principle was also confirmed in the Italian Ruling regarding the Rhaetia Railway.<sup>228</sup>

To illustrate further, if a cross-border pipeline is being built from the Netherlands across Germany and the construction period of the pipeline exceeds the subscribed time period (e.g. six months) a PE will be created. The fact that the builders of the pipeline do not remain in one geographical spot at all times during the construction, but move through Germany, does not mean that they do not have a fixed place of business, which was illustrated in the *GIL Mauritius Holdings Ltd* case.

The *LG Cable Ltd* case illustrated the structuring of the two separate contracts and how the Tax Authorities treated the two contracts. The income from the offshore supply per Contract 2 cannot be taxed in India merely because it is linked to the services performed onshore under Contract 1. Therefore only the profits arising from activities of the PE (Contract 1) can be attributed to the PE.

If a Dutch-owned pipeline created a PE in Germany, and the Netherlands enterprise concludes a contract in Germany for a different type of service delivery, the profits of the service delivery in Germany cannot be attributed to the pipeline and be taxed in Germany.

The cases discussed in this chapter are all ones that address elements that are essential to consider with cross-border pipelines, from the construction of the pipeline<sup>229</sup> to the classification of the pipeline for taxation purposes.<sup>230</sup>

The 'German pipeline' case is the prime example of the fact that previously there was no prescribed tax treatment for a cross-border pipeline in 1997 and it was left to the Courts to

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<sup>228</sup> Resolution 282 of 11 December 1995, Ministry of Finance, Department of Revenue Affairs Legal Serv. VII.

<sup>229</sup> *GIL Mauritius Holdings Ltd v Assistant Director of Income Tax (IT)* [TS-546-ITAT-2011(Del)].

<sup>230</sup> Bundesfinanzhof vorn 30.10.1996, II R 12/92, BStB1 II 1997, S.12.

interpret. The OECD Commentary has since introduced Commentary in 2010 which seems to be in conflict with the 'German pipeline' case's judgment.

The OECD Commentary, however, still lacks proper guidance for the Courts and taxpayers as to the correct tax treatments of a cross-border pipeline. This will impact future cases addressing the tax treatment of cross-border pipelines as there is no universal method in taxing cross-border pipelines. In effect, it is left to the Courts to interpret the local legislation, the relevant DTA, and the OECD Commentary for these purposes.

## CHAPTER 7. CONCLUSION

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### 7.1. A brief summary of the study and its findings

The problem statement identified in Chapter 1 of this study raises the question of how profits, which arise from a PE created by a pipeline, are attributed to each jurisdiction over which the cross-border pipeline stretches if the jurisdictions apply different methods in determining the attribution of profits. The study also raised the question as to whether the 2010 OECD Report provides sufficient guidance on how profits, which arise from a PE created by a cross-border pipeline, should be attributed.

The study identifies the classifications of cross-border pipelines and examines the creation of a PE. It is also considered in this study whether a cross-border pipeline could fulfil the requirements for the creation of a PE, as set out in the OECD MTC and OECD Commentary.<sup>231</sup>

The PE definition can include a cross-border pipeline as the enterprise's business can be carried on by way of a fixed place of business by way of the cross-border pipeline. As illustrated in Chapter 2, the OECD Commentary in paragraph 26.1 does not provide sufficient guidance and is confusing as it leaves an open question to the taxpayer as to the classification of a cross-border pipeline; e.g. it may be classified as immovable property, preparatory or auxiliary activities, or in certain instances, as a PE. The lack of proper guidance by the OECD Commentary or even the OECD MTC leaves many questions unanswered as to the classification of a cross-border pipeline. The assumption was made in this study that the correct classification of a cross-border pipeline is that it creates a PE in the countries over which the pipeline stretches for the enterprise that owns the pipeline.

### 7.2. Recommendations based on the study

The first issue highlighted in this study is the lack of a universal classification of a cross-border pipeline by the OECD and OECD Commentary which is clear and concise on the tax

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<sup>231</sup> See Chapter 2.

treatment of such a cross-border pipeline. This study has indicated that Article 5 PE requirements can be met by a cross-border pipeline and supports the view that a cross-border pipeline should, as a general rule, be universally classified to constitute a PE for taxation purposes.

The secondly problem highlighted in this study is how the attribution of profits should take place if the cross-border pipeline is classified as a PE. The 2010 OECD Report and Article 7 have been amended to correspond with one another, but both lack proper classification on how profits, risk, and assets should be attributed to a unique and complex asset such as a cross-border pipeline.

Certain recommendations will offer a long-term solution to the two problems raised in this study. However, a short-term solution should also be considered to manage the problem for the interim.

#### *7.2.1 Recommendation 1*

One of these short-term recommendations is that the taxpayer regulates the attribution of profits relating to the pipeline in their concluded pipeline agreement. This may prove challenging as it may complicate the agreement negotiations and the taxation of the pipeline is not always considered at the time of the conclusion of the agreement. The agreement may be regarded as an 'after thought' by companies negotiating agreements for cross-border pipelines.

#### *7.2.2 Recommendation 2*

Another short-term recommendation would be to face the problem head on and anticipate that the relevant jurisdiction's Tax Authorities may classify the cross-border pipeline as a PE. The enterprise owning the pipeline can elect to set up a legal entity in each jurisdiction where they may create a possible taxable presence with the pipeline. In other words, the owner of the pipeline may embrace the possible taxable presence and then choose to manage his tax affairs by creating a legal entity in the jurisdiction. The enterprise can, for example, then register as a VAT vendor, to ensure that the enterprise can claim input VAT. This will enable the entity to plan and manage their taxable presence in each jurisdiction and the legal entity will be a low-risk service provider.

However, this recommendation also has its challenges. The jurisdiction may have local incorporation laws that require that large amounts of capital that have to be advanced before a foreign entity can be registered or they may require local ownership. This recommendation is conservative as it does not really offer a solution and may create more considerations and possible complications for the owner of the pipeline.

### 7.2.3 *Recommendation 3*

The optimal recommendation in relation to this study is to provide a long-term solution that addresses the problems raised in this study. Therefore the recommendation for a long-term solution is that the OECD MTC and Commentaries should be updated to address cross-border pipelines specifically, and even cross-border cables, that stretch over more than one jurisdiction. This update is required to avoid uncertainties, disputes, and possible double taxation or non-taxation.

Article 5 of the OECD MTC and its Commentary should assign a specific classification for a cross-border pipeline and should clarify when a fixed place of business will constitute a PE. Attention should be given to paragraph 26.1, which should either be deleted or updated as it currently only adds confusion regarding the correct treatment of a cross-border pipeline.

### 7.2.4 *Recommendation 4*

In relation to the allocation of profits to a cross-border pipeline, for a long-term solution, it is recommended that the OECD update their 2010 OECD Report to address complex assets such as cross-border pipelines. The OECD Report should address allocating assets, risk, and capital to these pipelines, which may be laid on or offshore and stretch over more than one jurisdiction. It is therefore recommended that the OECD issue specific guidelines for the attribution of income to such cross-border pipelines.

The study also advises that Article 7 OECD Commentaries should define the term 'attributed to' as the lack of a universal definition increases confusion upon interpretation of the Article and the attribution of profits to PEs.

### **7.3. Conclusion**

Based on the findings of this study, a conclusion is drawn that there remain uncertainties regarding the classification and taxation of cross-border pipelines. These unique and intricate assets that stretch over more than one jurisdiction require that domestic tax law and DTAs should be considered when determining the taxation of these pipeline profits. However, as illustrated in the study, there is no universal prescribed tax treatment for cross-border pipelines. It is left to the interpretation of each jurisdiction, which may result in double taxation or a double non-taxation of the taxpayer owning the pipeline.

The development of technology is propelling the world forward into a digitalised era. The OECD have recently noted the problems that will arise for VAT purposes with the new e-commerce, a modern world phenomenon, where taxpayers purchase goods over the internet from foreign enterprises, but no VAT is paid on the purchases. The OECD is taking serious steps to update the OECD MTC and Commentaries to address these problems arising with VAT and e-commerce. The OECD should, however, also consider taking similar steps to address cross-border pipelines, which are set to become more popular in the future in the search for alternative resources and the expansion of enterprises' businesses globally.

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