

**An analysis on the creation of a fixed place and agency
Permanent Establishment and how BEPS Action 7 will
change this**

**A mini - dissertation submitted to the
Faculty of Law**

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

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Date: October 2017

ACKNOWLEDGEMENTS

The completion of this research study would not have been possible without the presence of the spirit of God at work within me. I therefore would like to thank my Heavenly Father who gave me the strength to complete this project. To God be the glory.

My supervisor Charles S. Makola has been my mentor and inspiration these last few years. He was instrumental in ensuring that this research comes to completion.

To my parents, who have always supported me and gave me words of encouragement to help me finish what I started. Many thanks to you.

Lastly, to my husband Justin. Without you I would not have been able to finish this research project. Thank you for being my rock and my continuing support through everything.

ABSTRACT

This research study considers how BEPS Action 7 will change the creation of a fixed place PE and agency PE. The purpose of the study is to explore the current requirements of creating a fixed place PE and an agency PE and how BEPS Action 7 will change these requirements.

The importance of the PE concept was identified as it provides the global parameter to determine a right of a country to impose tax on a non-resident. The PE concept creates the necessary connection between where the country and the non-resident.

Certain international practical concepts were discussed to ensure an appreciation for the complex world in which PEs operate. The research study then moves to the discussion of the requirements to create a fixed PE or an agency PE. The requirements of both require a sufficient *nexus* before a source country may tax the profit of the non-resident.

As mentioned above, the purpose of this study is to explore how the proposed changes in BEPS Action 7 will change the current threshold of creating a fixed PE and agency PE. The development up until the final BEPS Action Package are discussed together with the MLI and how it is created to quickly and effectively change the current double tax agreements in force.

The relationship between South Africa and BEPS and its elections specifically relating to PEs are also discussed.

This research study concludes with recommendations by the Davis Tax Committee as well as the researcher's own recommendation on South Africa's election on the relevant articles in the MLI.

LIST OF ABBREVIATIONS

BEPS	Base Erosion Profit Shifting
DTA	Double Tax Agreement
DTC	The Davis Tax Committee
MLI	Multilateral Instrument
MNE	Multinational Enterprise
MTC	Model Tax Conventional
OECD	Organisation for Economic Co-Operation and Development
PE	Permanent Establishment
The Act	Income Tax Act No. 58 of 1962

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CHAPTER 1. INTRODUCTION

1.1 OVERVIEW

The emergence of multinational enterprises (MNEs) and growth in international trade and investment has called for permissive international tax standards to ensure that each country exercises its fiscal sovereignty without undue disturbance to the global growth and investment trajectory. The starting point in the development of these standards is the respect for each country's sovereignty to impose tax within its jurisdiction.¹

At a domestic level, countries would generally exercise the right to impose tax within their shores if there is a connection between the person earning the income and the country in question, or if the income stream in question is somewhat connected to that jurisdiction. The connection could for example be in the form of "source" (i.e. income is sourced in a country) or "residency" (i.e. the person earning the income is resident in the country in question).² The potential for double taxation would arise for example if the country of residence asserts its right to tax based on the residency of the taxpayer, whilst the other country asserts its rights to tax based on the fact that the income in question arises from its shores (source).³

It is in this context that the Permanent Establishment (PE) standard was developed to establish a global parameter to determine a right of a country to impose tax in the case of international business income.⁴ The PE concept creates a tax connection between a country where an entity carries on business and the entity itself.⁵

The PE standard is mainly incorporated in double taxation agreements (DTAs) entered into by a country with other countries. In certain instances, it is adopted by countries

¹ Dos Santos A.C. & Lopes C.M. 2016. 'Tax Sovereignty, Tax Competition and the Base Erosion and Profit Shifting Concept of Permanent Establishment'. *EC Tax Review*, 5-6. [Online] Available from: ResearchGate: https://www.researchgate.net/publication/310457873_Tax_Sovereignty_Tax_Competition_and_the_Base_Erosion_and_Profit_Shifting_Concept_of_Permanent_Establishment [Accessed: 2017-01-07]. Page 298.

² *Ibid.*

³ Olivier, L & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk. Page 6.

⁴ *Ibid.*, Page 335

⁵ Davis Tax Committee Interim Report: Addressing Base Erosion and Profit Shifting in South Africa. Annexure 7 Available from: http://www.taxcom.org.za/docs/New_Folder3/9%20BEPS%20Final%20Report%20-%20Action%207.pdf [Accessed: 2017-12-10]. Page 1.

in domestic laws as a domestic standard for taxing income earned by foreign enterprises within the shores of that country. For example, in the South African context, the PE standard is used both in domestic law⁶ and in the various DTAs⁷ to which South Africa is a signatory.⁸

As a general rule, the PE threshold provides that once an enterprise of a country establishes a PE in another country, a portion of its business is notionally segregated and effectively treated as an economic citizen of that country. The creation of PE in a country would usually require registration for tax, fiscal record keeping, tax filing, an expectation to pay income taxes in that country and other commercial administrative responsibilities.⁹

For a sufficient connection to exist between where the entity conducts business and the entity itself, the PE concept requires the following:

- (i) a fixed place of business,
- (ii) the place is at the disposal of an enterprise, and
- (iii) substantial (i.e. not preparatory or auxiliary) business activities are carried on in that space. This includes branches, offices, workshops, construction sites, or other business spaces.¹⁰

Another way for a PE to be created is through a dependent agent who acts on behalf of the business and habitually concludes contracts in the name of a business in a particular country.¹¹

With the rapid growth in cross border transactions and globalisation, over the years jurisdictions have tried to amend their own domestic tax systems by enacting anti-avoidance mechanisms. However, these actions have often failed to keep pace with the changing business environment.¹²

⁶ Section 1 of the Income Tax Act No. 58 of 1962.

⁷ Generally found in Article 5 of the DTAs entered into by South Africa.

⁸ Olivier, L & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk Page 335.

⁹ *Ibid.*, Page 9.

¹⁰ C.S. Makola. *Managing Permanent Establishment Risk Efficiently*. SAIT: TaxTalk. [Online] Available from: <http://www.thesait.org.za/news/308527/TaxTalk-Managing-Permanent-Establishment-Risk-Efficiently-.htm> [Accessed on: 2017-10-02].

¹¹ *Ibid.*

¹² Davis Tax Committee Interim Report: Addressing Base Erosion and Profit Shifting in South Africa. Available from: http://www.taxcom.org.za/docs/New_Folder/1%20DTC%20BEPS%20Interim%20Report%20-%20The%20Introductory%20Report.pdf [Accessed: 2017-12-10]. Page 11.

Over the last few years, stories surfaced where MNEs, through cleverly planned corporate structures, were paying little or no corporation tax in countries where they do business in. The stories sparked public outrage and a demand for action. During its 2012 summit, the national leaders of the G20 leaders expressed a need to prevent base erosion and profit shifting (BEPS).¹³

The Organisation for Economic Co-operation and Development (OECD) responded to the above concerns and in February 2013, it released a Report: 'Addressing Base Erosion and Profit Shifting' in which it was acknowledged that BEPS constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for all countries across the world.¹⁴ The OECD released 'Addressing Base Erosion and Profit Shifting Report', with 15 comprehensive actions during July 2013.

BEPS is explained by the OECD as actions relating to arrangements performed to specifically achieve low or no taxation by shifting profits out from jurisdictions where the activities creating those profits take place, or by exploiting gaps in the interaction of domestic tax rules where corporate income is not taxed at all.¹⁵

After two years of hard work, the OECD released its final 15-point Action Points addressing BEPS and aiming to ensure that profits are taxed correctly where the economic activities generating the profits are performed and where value is created.¹⁶

Action Plan 7 deals with '*Preventing the Artificial Avoidance of Permanent Establishment Status*'. This action plan calls for a review to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition. This plan is aimed at addressing certain tax avoidance strategies used to avoid the creation of a PE. It proposes changes to the PE definition of the MTC and the OECD's Commentaries on the MTC, in particular to Article 5(5) and 5(6) of the MTC, which deals with dependent and independent agents.¹⁷

¹³ Davis Tax Committee Second Interim Report on Base Erosion and Profit Shifting (BEPS) in South Africa: Introduction. Available from: http://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20-%20Introductory%20Report.pdf [Accessed: 2017-12-10]. Page 6.

¹⁴ *Ibid.*

¹⁵ *Ibid.*

¹⁶ Davis Tax Committee Interim Report. Page 20.

¹⁷ OECD/G20. 2015. *Base Erosion and Profit Shifting Project: Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report*. [Online] Available from: <http://www.oecd-ilibrary.org/docserver/download/2315341e.pdf?expires=1485929853&id=id&accname=guest&checksum=CF6327120C9E562CB6D96794D6F5A704> [Accessed: 2017-02-02].

BEPS Action Plan 15 calls for '*Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*'. The object and purpose of the MLI is to implement the BEPS measures swiftly and without too much administrative burden.¹⁸

1.2 PROBLEM STATEMENT

With the increase of MNEs and the growth of international trade and investment, being able to establish a sufficient connection between a country and business activities of a foreign enterprise within that country is essential.¹⁹ The significance of a foreign enterprise creating a PE in a source country, is that it gives the source country the right to tax the entity under its domestic laws, even though the PE has no separate legal existence in that specific country.²⁰

The PE concept is not only relevant in the international tax arena but many countries, including South Africa, have incorporated the concept into its domestic law. Section 1 of the Act, contains the definition of a PE and refers to the concept as defined in Article 5 of the OECD MTC.²¹

The problem statement is therefore:

How will BEPS Action 7 change the creation of fixed place PE and agency PE in the international tax arena?

This problem statement gives rise to the following research questions:

- a) What is the interaction between international tax and domestic tax?
- b) What are the requirements to create a fixed place PE and agency PE within a source country and how will BEPS Action 7 change current requirements of a fixed place PE and an agency PE?
- c) What is the purpose of the MLI in terms of Action Plan 15 and what was South Africa's response to the specific PE Articles contained in the MLI?

¹⁸ *Ibid.*

¹⁹ OECD/G20. 2015. *Base Erosion and Profit Shifting Project: Executive Summaries*. [Online] Available from: <https://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf> [Accessed: 2017-01-07]. Page 23.

²⁰ Olivier, L & Honiball, M. (2011) Page 335.

²¹ *ibid.*

1.3 RESEARCH OBJECTIVE

The objective of this dissertation is to examine the requirements of creating a fixed place PE and an agency PE as well as how the BEPS Action Plan 7 affects the current PE threshold. The research study will further examine South Africa's elections, specifically relating to the PE Articles in the MLI.

1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

The study will explore the importance of the PE concept, how a foreign enterprise can create a PE in a source country and how BEPS Action 7 is changing the threshold of creating a PE in a foreign country.

The study will be of interest to tax practitioners and authorities, businesses that are in the process of expanding cross-border and MNEs with their existing structures.

1.5 ASSUMPTIONS

This research study will not discuss or compare the UN Model with the OECD MTC. Due to the recent developments by the OECD, the researcher is concentrating only on the OECD MTC and its Commentary.

The researcher has made the assumption that the UN Model will also implement the OECD MTC changes to its Model and Commentary. Should the proposed changes also be adopted by the UN Model, these two models are likely to be very similar.²²

1.6 DEFINITIONS AND KEY TERMS

- *'The OECD'*: The Organisation for Economic Co-Operation and Development. The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems.²³ South Africa is not a member of the OECD but has 'observer status'.²⁴

²² Olivier, L & Honiball, M. (2011) Page 275.

²³ OECD Website. About. [Online] Available from <http://www.oecd.org/about/> [Accessed: 2017-07-14].

²⁴ OECD. Global Forum on Transparency and Exchange of Information for Tax Purposes. [Online] Available from: <http://www.oecd.org/tax/transparency/about-the-global-forum/members/> [Accessed: 2017-07-16].

- *‘OECD Model Tax Convention’ (‘OECD MTC’)*: The OECD MTC provides a treaty template for jurisdictions to use when negotiating and drafting their own treaties.
- *‘OECD Commentary’*: The OECD Commentary provides explanations and examples of the OECD MTC Articles.
- *‘Double Tax Agreement (‘DTA’)*: DTAs are agreements concluded between two countries where the main object is the avoidance of double taxation and the prevention of fiscal evasion.²⁵
- *‘Base Erosion and Profit Shifting (‘BEPS’)*: BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.²⁶

1.7 RESEARCH METHODOLOGY

The research methodology applied in this study is of a qualitative nature. The researcher will review secondary data and will explore the current requirements of creating a fixed place PE and agency PE in terms of Articles 5(1), 5(2), 5(5) and 5(6) of the OECD MTC and its Commentary. An analytical approach will be adapted towards the proposed changes to Article 5(5) and 5(6) through BEPS. Lastly, the researcher discusses South Africa’s election of the MLI Article specifically relating to fixed place PE and agency PE.

²⁵ Olivier, L & Honiball, M. (2011) Page 276.

²⁶ International Tax Review (2016).

1.8 OUTLINE OF RESEARCH AND CHAPTER OUTLAY

Chapter 1: Introduction

This chapter introduces the research problem regarding how the BEPS Action 7 will change the fixed place definition of a PE and that of dependent agent in the relevant subparagraphs of Articles 5.

The chapter briefly discusses the overview of the mini-dissertation, including the purpose, problem statement, research questions, the research objective and the importance thereof.

Chapter 2: The interaction between international tax, domestic tax and the Permanent Establishment concept

In this chapter the study provides a discussion on the principles of sovereign taxation and double taxation. The South African domestic legislation and the importance of DTAs are analysed. The chapter further explores the origin of the PE concept as well as the South Africa's position.

Chapter 3: The importance of the PE concept

The chapter of the study discuss and explore the definition and requirements to create a fixed place PE or an agency PE in a source country in terms of Article 5 of the OECD MTC. South Africa's interpretation of the OECD MTC and international case law are illustrated by referring the case of AB LLC and BD Holdings LLC

Chapter 4: BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

Firstly, this chapter discusses the development of the BEPS Actions from 2012 until 2017. The chapter further examines the BEPS Action Plan 7 changes relating to Article 5(5) and 5(6) of the current OECD MTC and its commentaries.

Chapter 5: BEPS Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

This chapter explores the purpose of the MLI in terms of Action 15, how it should be applied according to the OECD. The chapter further discusses South Africa's published reservations and notifications in terms of the MLI Articles and whether it affects the current threshold of creating a PE in South Africa.

Chapter 6: Conclusion and Recommendations

The conclusion summarises the finding of the research and the impact thereof on the interpretation of the definition a PE in the proposed multilateral convention.

CHAPTER 2. THE INTERACTION BETWEEN INTERNATIONAL TAX, DOMESTIC TAX AND THE PERMANENT ESTABLISHMENT CONCEPT

2.1 INTRODUCTION

Even though, codified and standardised international tax laws do not currently exist, due to globalisation and the expansion of businesses across borders, the concept of international tax has never been more important.²⁷ It is because of the increase in cross border transactions that the concept of a PE in international tax has also become vital to source countries to become more vigilant on taxing non-residents on income derived within their borders. The PE concept provides the threshold for a source country to tax non-residents deriving profits within its jurisdiction.²⁸

Before the concept of PE can be analysed, important practical considerations for cross-border businesses first need to be understood. These concepts are concerned with how the tax systems of particular countries apply income-earning activities as well as how countries can resolve their competing interest with respect to a shared tax base.²⁹

Although, taxation is a classical attribute to State sovereignty, taxation by a sovereign becomes increasingly difficult in isolation. Contracting States and taxpayers are forced to cooperate due to the integrated economic world of globalisation, the permanent interaction of fiscal systems and increasing tax planning policies by MNEs.³⁰

²⁷ Olivier, L & Honiball, M. (2011) Page 1.

²⁸ L. Hart & S. Wilkie, *Policy Forum: The History of Tax Treaty Provisions – And Why Is It Important To Know About It*. Canadian Tax Journal/Revue Fiscale Canadienne. (2006) Volume 54(4) Page 910.

²⁹ *Ibid*.

³⁰ A.C. dos Santos & C.M. Lopes. *Tax Sovereignty, Tax Competition and the Base Erosion and Profit Shifting Concept of Permanent Establishment*. EC Tax Review. 2016/5-6. Page 296.

2.2 THE PRINCIPLES OF SOVEREIGN TAXATION

2.2.1 The power to tax through sovereignty

Based on the philosophical basis of a social contract entered into between the State sovereign and its individuals³¹, the State sovereign not only has the power to apply its tax laws in its borders but also has the power to apply foreign tax law.³²

Sovereignty that is applied within a territorially limited area is known as internal sovereignty. When the sovereignty is applied between different areas, outside this territory limits and on an international level, it is describe as external sovereignty.³³ In essence, one cannot possess internal sovereignty without possessing external sovereignty as the same time.³⁴ Dos Santo and CM Lopes state that: *'The power of a jurisdiction to import (or not) taxes is one of the classical features of tax sovereignty, which also implicates the power to negotiate and to conclude or not, tax agreements'*.³⁵

States have started to recognise the necessity for international rules that will ensure mutual respect between the sovereignty of States. The foundations were laid for the emergence of a body of norms governing the relations between sovereign states; international law.³⁶

A paradoxical relationship exists between state sovereignty and international law. The very rules and laws of the international law system, created by the state sovereign, are also the rules that limit them.³⁷ The main function of international law is to delimit the boundaries of state sovereignty and to apply across territories.³⁸

2.2.2 The interaction between State sovereignty and jurisdiction

The difference between sovereignty and jurisdiction is explained by Jeffery as: *'sovereignty refers to the bundle of rights and competences which go to make up*

³¹ Legislative History of United States Tax Convention (1923) Volume 4(1) Page 18.

³² A.C. dos Santos & C.M. Lopes. Tax Review Page 298.

³³ S. Gadzo. *Nexus requirements for taxation of non-residents' business income: a normative evaluation in the context of the global economy*. Unpublished doctoral dissertation. 2016. [Online] Available: https://www.academia.edu/31765430/Nexus_requirements_for_taxation_of_non-residents_business_income_a_normative_evaluation_in_the_context_of_the_global_economy [Accessed: 2017-04-10] Page 19.

³⁴ *Ibid.*

³⁵ A.C. dos Santos & C.M. Lopes. Tax Review Page 298.

³⁶ S. Gadzo. 2016. Page 19.

³⁷ *Ibid.*, Page 20.

³⁸ *Ibid.*, Page 21.

*the Nation State. Jurisdiction refers to particular rights from that bundle, namely a State's right of regulation.'*³⁹

Even though jurisdiction is closely related to the concept of sovereignty, jurisdiction is a narrower concept of sovereignty, but still wholly dependent on it. The relationship is particularly important, since a state's jurisdiction cannot extend outside the limit of its sovereignty.⁴⁰ The norms of international law regulate the State's law-making or law-enforcing power in each case.⁴¹

Under the international law, there are two generally recognised principles for jurisdiction; nationality and territory. The principle of territoriality is based on the link between a set of facts and its territory, while the principle of nationality is based on the special relationship between the state and its people.⁴²

2.3 THE NEXUS REQUIREMENTS

A country may only tax when a qualifying connection between the state wishing to tax and the set of relevant facts, exists. This qualifying connection is labelled the '*nexus*'.⁴³ The required *nexus* could be created by the person who receives the income that is connected to the country or if the activities that give rise to the income are connected to the country.⁴⁴ The domestic laws of a country lay down this required *nexus*.⁴⁵ These connecting factors, referred to as 'residence jurisdiction'⁴⁶ and 'source jurisdiction',⁴⁷ are closely linked to the principle of sovereignty. The importance of the *nexus* requirement is acknowledged by well-known experts in the field of international tax law.⁴⁸

³⁹ *Ibid.*, Page 23.

⁴⁰ *Ibid.*

⁴¹ *Ibid.*

⁴² *Ibid.*, Page 27.

⁴³ *Ibid.*

⁴⁴ Croom, B., Oguttu, A., Muller, E., Legwaila T., Maeve K., Williams RC., Louw C. (2013). *Tax Law: An Introduction*. Cape Town: Juta. Page 26.

⁴⁵ Olivier, L & Honiball, M. (2011) Page 10.

⁴⁶ A resident, for the privilege and protection of residence, can justly be called upon to contribute towards the costs of good and order and government of the country that shelters him. De Koker, AP *et al.* 2010.

⁴⁷ The equity of the levy rests on the assumption that a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live. De Koker, AP *et al.* 2010.

⁴⁸ S. Gadzo. 2016. Page 40.

2.4 DOUBLE TAXATION

2.4.1 Double Taxation

Double taxation arises when the same income of the same person is taxed more than once in more than one country. Double taxation could be created when a person earns income from outside their country of residence, both the residence and source country claim taxing rights on the same income. In order to eliminate double taxation, countries enter into double or multilateral agreements.⁴⁹

It is in this context that a PE standard was developed to establish a global parameter to determine a right of a country to impose tax in the case of international business income.⁵⁰ The PE concept creates a tax connection between a country where an entity carries on business and the entity itself.⁵¹

2.4.2 The origin of the PE concept in the MTC

The PE concept, as it stands in the OECD MTC of today, could be traced back to the first model tax treaties from the League of Nations after World War I. During this stage, the allocation of taxing rights as we currently know it, already emerged. This allocation of rights had a fundamental bias in favour of capital-exporting countries otherwise known as 'residence countries' in a DTA context.⁵²

The choice of allocation in the first model tax treaties were based on the notion of 'economic allegiance', which appeared in the 'Economist's Report' of 1923. This idea recognised that both source and residence are valid to create an economic allegiance.⁵³

Multilateral negotiations were launched in 1925 with national governments of major industrialised economies playing the main roles.⁵⁴ During these negotiations, two competing principles emerged: 1) the source principle (focusing on the right to tax the

⁴⁹ T. Legwaila. *Permanent establishment on the furnishing of services*. 2016 TSAR 822.

⁵⁰ *Ibid.*, Page 335

⁵¹ Davis Tax Committee Interim Report. Page 1.

⁵² S. Gadzo. 2016. Page 133.

⁵³ *Ibid.*

⁵⁴ Genschel P & Rixen T. *The International Tax Regime: Historical Evolution and Political Change*. 2012: June. [Online] Available from http://nefgv.com.br/files/upload/2014/09/11/09-22-2014-international-legal-order_-historical-evolution-political-change-genschel-and-rixen.pdf [Accessed on 2017-04-10]. Page 9.

source country) and 2) the residence country (assigning the right to tax exclusively to the residence country).⁵⁵

The PE *nexus* also exhibits advantages from an administrative perspective and it also provides the taxpayer with a level of certainty in structuring their international operations.⁵⁶

2.5 SOUTH AFRICA

Arguably, the most influential MTC of the 21st century is the OECD MTC. Even though the OECD MTC and its commentary are not legally binding, when South Africa enters into a DTA based on the OECD MTC, the provisions of the DTA are binding on both the two contracting states.⁵⁷

2.5.1 Domestic legislation and DTAs

With effect from 1 January 2001, South Africa moved away from the principle of source taxation to the principle of residence taxation.⁵⁸ Section 1 of the Act⁵⁹ included the definition of 'gross income' which stipulates that South African tax residents are taxed on their worldwide income and persons who are not residents, will be taxed based on the income derived from a South African source.⁶⁰

Even though South Africa is not a member of the OECD, it gained observer status in 2004⁶¹ and every DTA that South Africa has entered into captures the essence of Article 5 of the OECD MTC.⁶²

⁵⁵ *Ibid.*, Page 10.

⁵⁶ *Ibid.*

⁵⁷ A.W. Oguttu *The Challenges of Taxing Profits Attributed to Permanent Establishment: A South African Perspective* (2009) 21 SA Merc LJ Page 774.

⁵⁸ De Koker, AP *et al.* 2010.

⁵⁹ Income Tax Act, No. 58 of 1962.

⁶⁰ "Gross Income", in relation to any year or period of assessment, means –

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

⁶¹ A.W. Oguttu (2009) 21 SA Merc LJ Page 787.

⁶² M. Honiball. 2016 *South Africa: Permanent Establishments* [Online] Available at: www.ibfd.org [Accessed: 2017-03-10].

The term ‘permanent establishment’ was introduced with the Income Tax Bill, 1997.⁶³ During 2001, the definition was moved to section 1 of the Act⁶⁴ and currently the term as follows:

*“‘permanent establishment’ means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on the Income and on Capital of the Organisation for Economic Co-Operation and Development...’*⁶⁵

The principle objective of a DTA is the avoidance of double taxation and the prevention of fiscal evasion. The enabling legislation is section 108(1) of the Act.⁶⁶

Once brought into operation a DTA has the effect of law. Its legal effect was described by Corbett JA in *Secretary for Inland Revenue v Downing* 1975 (4) SA 518 (A) at 523A: *‘[A]s long as the convention is in operation, its provisions, so far as they relate to immunity, exemption or relief in respect of income tax in the Republic, have effect as if enacted in Act 58 of 1962.’*⁶⁷

DTAs effectively allocate taxing rights between the contracting states where the taxation of business profits of PEs are concerned. The DTA would allocate the taxing rights of these business profits to the country in which the permanent establishment is created, the source country.

The South African Constitution⁶⁸ states that all international agreements, including DTAs, must be adopted in accordance with certain formalities in order to be incorporated as part of South African law.⁶⁹ Section 231(2) read in conjunction with

⁶³ SARS Website. Explanatory memorandum on the Income Tax Bill, 1997. [Online] Available from: <http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-1997-02%20-%20%20Explanatory%20Memorandum%20Income%20Tax%20Bill%201997.pdf>. [Accessed on 2017-10-02]. Page 3.

⁶⁴ SARS Website. Explanatory memorandum on the Taxation Laws Amendment Bill, 2001. [Online] Available from: <http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2001-02%20-%20%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202001.pdf> [Accessed on 2017-10-02]. Page 16.

⁶⁵ Inserted by section 5(g) of Act No 5. Of 2001 and amended by section 6(1)(v) of Act No. 7 of 2010 deemed to have come into operations as from the commencement of years of assessment commencing on or after 1 January 2011.

⁶⁶ **‘108 Prevention of or relief from, double taxation**

(1) The National Executive may enter into an agreement with the government of any other country, whereby arrangements are made with such governments with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the Republic and of such other country, of tax in respect of the same income, profits or gains, or tax imposed in respect of the same donation, or to the rendering of reciprocal assistance in the administration of an the collection of taxes under the said laws of the Republic and such other country.

(2) As soon as may be after the approval by Parliament of such agreement, as contemplated in section 231 of the Constitution, the arrangements thereby made shall be notified by publication in the *Gazette* and the arrangements so notified shall thereupon have effects as if enacted in this Act.’

⁶⁷ *Commission for the South African Revenue Service v Tradehold Ltd* [2012] 3 All SA 15 (SCA). [Online] Available from: <https://www.mylexisnexis.co.za/Index.aspx> [Accessed: 201-03-21] Paragraph 16 at Page 21.

⁶⁸ Act No. 108 of 1996 as amended.

⁶⁹ Section 231 of the Constitution of the Republic of South Africa, 1996. [Online] Available from: <https://www.mylexisnexis.co.za/Index.aspx> [Accessed on 2017-01-07].

section 231(4) of the Constitution, sets out the requirements to bind South Africa to the international agreement.⁷⁰

2.5.2 The Right to tax by DTAs

Relief from double taxation is found for taxpayers by either unilateral relief found in its residence country's domestic laws or under the provision found in the DTA entered into by the two countries concerned. It is in the latter that the term PE is significant.⁷¹

Boruchowitz AJA held in *Commission for the South African Revenue Service v Tradehold Ltd* that:

*'The principle objectives of the DTA are the avoidance of double taxation and the prevention of fiscal evasion. Once brought into operation a double tax agreement has the effect of law. Double tax agreements effectively allocate taxing rights between the contracting state where broadly similar taxes are involved in both countries, and modify the domestic law and will apply in preference to the domestic law to the extent that there is any conflict.'*⁷²

A DTA only permits a source country to tax the business profits derived by a non-resident from its source or deemed source within its borders if the non-resident created a PE in that source country. The DTA provides for taxing rights of business profits of a PE to be allocated to the source country wherein the PE is created.⁷³

Judge Vally, while delivering judgement in the matter of *AB LLC and BD Holdings LLC v CSARS*, discussed the nature and purpose of DTAs in more detail:

*'To deal with this problem, double taxation treaties were concluded between countries, and as a result a paradigmatic shift in international tax occurred... These agreements tend to be bilateral in nature. It is said that the purpose of Double Taxation Agreements is to ensure that there is a free flow of trade and investment across countries, as well as a recognition that taxation is not avoided by the latitude afforded by the flow of free trade and investment. To achieve this purpose the two countries that are party to the Double Taxation Agreement agree that one of them will forego revenue...'*⁷⁴

⁷⁰ Olivier, L & Honiball, M. (2011) Page 303.

⁷¹ L. Olivier. (2002) SALJ Page 867.

⁷² [2012] 3 All SA 15 (SCA). [Online] Available from: <https://www.mylexisnexis.co.za/Index.aspx> [Accessed: 2017-03-21] Paragraph 16 at Page 21.

⁷³ L. Olivier. (2002) SALJ Page 866.

⁷⁴ *AB LLC and BD Holdings LLC v CSARS* 2015 ZATC 2 (15 May 2015) [Online] Available at: <http://www.saflii.org/za/cases/ZATC/2015/2.html> [Accessed: 2017-02-21] Paragraph 4 at Page 5.

2.5.3 South African consequences

South Africans are tax based on their worldwide income, therefore PEs of South African resident companies in other source countries are subject to the normal income tax rate of 28% in the hands of the South African resident company.⁷⁵

Should a non-South African resident company create a PE in South Africa, the PE would also be subject to South African normal income tax at 28% in the hands of the non-resident.⁷⁶

South African domestic tax legislation has made provision should foreign taxes be paid on income attributable to a foreign PE of a South African resident. It is important to note that the same relief is not available for a foreign enterprise creating a PE in South Africa, due to the PE being taxed on the source principle.⁷⁷

2.6 CONCLUSION

Due to globalisation and the expansion of businesses across borders, the concept of international tax has never been more important.⁷⁸ It is because of this increase in cross border transactions that the concept of PE in international tax has also become vital to source countries so as to become more vigilant on taxing non-residents on income derived within their borders. The PE concept provides the threshold for a source country to tax non-residents deriving profits within its jurisdiction.⁷⁹

However, before the concept of PE can be researched other important concepts pertaining to international tax and cross-border activities need to be understood. The concept of tax sovereignty and how its application could lead to double taxation on the same income is essential for MNES. The OECD MTC and its purpose together with South Africa's position on international tax are just a few of these important concepts.

⁷⁵ M. Honiball. 2016 Page 9.

⁷⁶ *Ibid.*

⁷⁷ *Ibid.*

⁷⁸ Olivier, L & Honiball, M. (2011) Page 1.

⁷⁹ L. Hart & S. Wilkie, *Policy Forum: The History of Tax Treaty Provisions – And Why Is It Important To Know About It*. Canadian Tax Journal/Revenu Fiscale Canadienne. (2006) Volume 54(4) Page 910.

CHAPTER 3. THE IMPORTANCE OF THE PERMANENT ESTABLISHMENT CONCEPT

3.1 INTRODUCTION

As a general rule, the PE threshold provides that once an enterprise of a country establishes a PE in another country, a portion of its business is notionally segregated and effectively treated as a citizen of that country pertaining to its economic activities. The creation of PE in a country would usually require registration for tax, fiscal record keeping, tax filling, an expectation to pay income taxes in that country and other commercial administrative responsibilities.⁸⁰

The significance of the PE concept is revealed in the interaction between Article 7⁸¹ and Article 5. The PE concept is used as the *nexus* requirement for a source country to tax the income derived by a non-resident.⁸²

Article 7(1) of the OECD MTC allocates the taxing rights of business profits as follows:

*'1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.'*⁸³

A detailed discussion of Article 7 and allocation of business profits fall outside the scope of this study and this chapter will continue to focus on the requirements of creating a PE within a source country.

3.2 CURRENT MEANING OF THE PE CONCEPT

Article 5 provides the outline of the minimum level of activity that an enterprise must conduct within a source country to have the taxing right on the business profits derived therein. It is a well-known concept within the international tax arena, that the articles

⁸⁰ Olivier, L & Honiball, M. (2011). *International Tax: A South African Perspective*. Cape Town: SiberInk Page 335.

⁸¹ The general rule for allocation of a taxing right to the source state, is found in Article 7 of the OECD MTC, which is also referred to as the distributive rule.

⁸² S. Gadzo. 2016. Page 126.

⁸³ OECD. (2010) *Model Tax Convention on Income and Capital (Condensed Version)*. Page 26.

of the OECD MTC does not create a taxing right for the source country, if such rights do not exist in the domestic tax laws of that country.⁸⁴

Article 5 contains the threshold of the PE concept, which illustrates the multi-level structure contained therein. Three types of PEs exist:

1. The 'fixed PE', which is generally defined in article 5(1);
2. The 'construction PE', contained generally in article 5(3); and
3. The 'agency PE' defined in article 5(5).⁸⁵

The first two types of PEs contain the requirements of a territorial connection between a country and an enterprise. On the other hand, the agency PE requires a connection between a person and a country, meaning that a person should conduct significant business activities within a country.⁸⁶

For the purpose of this research, subparagraphs (1),(2),(5) and (6) of article 5 is discussed in detail below. Even though, the remainder of article 5 is not discussed in this chapter, the importance thereof should not be ignored.

3.2.1 Article 5(1) of the OECD MTC: The fixed PE

The general definition of a PE is found in article 5(1):

*'1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.'*⁸⁷

The fixed PE's main characteristic is the requirements of a physical presence of an enterprise in a country found in: *'fixed place of business.'*⁸⁸

3.2.2.1 Requirements of a fixed PE

According to the OECD Commentary, article 5(1) gives the general definition of the term PE and provides the following conditions:

- 1) The existence of a place of business;

⁸⁴ De Koker, AP *et al.* 2010.

⁸⁵ S. Gadzo. 2016. Page 176.

⁸⁶ *Ibid.*

⁸⁷ OECD. (2010) Page 24.

⁸⁸ S. Gadzo. 2016. Page 129.

- 2) This place of business must be fixed: A place of business (e.g. premises or even machinery or equipment) should exist; and
- 3) The carrying on of the business of the enterprise through this fixed place of business.⁸⁹

In order to illustrate the complexity of the PE requirements and what needs to be present before a source country may tax income from a foreign enterprise, each of the above fixed PE conditions are discussed in detail below.

- Place of business

The first condition in the definition of a fixed PE is that a place of business needs to exist. The word 'place' could imply a certain portion of space, including either the soil and what is below it. This leads to all forms of tangible property included, being it movable or immovable, used to carry on the business.⁹⁰

- Carrying on of *business of an enterprise*

The phrase 'business of an enterprise' could be interpreted as consisting of both business and enterprise.⁹¹ Article 3(1)(c) of the OECD MTC determines '*that enterprise applies to the carrying on of any business*'.⁹² However, business and enterprise are not defined in the Act and therefore, the meaning of the words must be determined by its ordinary meaning.⁹³

The word business has a very wide meaning as was held in the Canadian case of *Smith v Anderson* [1880] 15 ChD 247, where it was decided that business means 'anything which occupies the time and attention and labours of a man for profit'.⁹⁴

- *Fixed* place of business

The concept of a fixed PE indicates a territorial *nexus* with a country. The requirement that the place of business should be fixed, is best illustrated with the requirement that

⁸⁹ OECD. (2010) *Commentaries*. Paragraph 2 on Article 5(1). Page 92.

⁹⁰ S. Gadzo. 2016. Page 36.

⁹¹ L. van Schalkwyk & R. van Schaik. *A critical analysis of the concepts 'Permanent Establishment' and 'Foreign Business Establishment'*. Journal of Economic and Financial Sciences April 2012 5(1) Page 74.

⁹² *Ibid.*

⁹³ *Ibid.*

⁹⁴ *Ibid.*

the enterprise should be linked to a specific geographical point within the source country's territory.⁹⁵ In the interpretation of this requirement, two aspects surfaced:

1. The geographical aspect ('*location test*'); and
2. The temporal aspect ('*duration test*').⁹⁶

In the interpretation of the above two aspects, it has been pointed out that both is inherent to use of the term permanent. This is also confirmed by the OECD Commentary: '*Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature.*'⁹⁷

1. *The location test:*

The interpretation of this geographic element should not be interpreted too broadly or too narrowly and the 'commercial and geographic coherence' theory could be used when interpreting the location test. When the business activities of the enterprise can detect a particular area within which the pertinent activities are moved around and this area constitutes a coherent whole commercially and geographically, then the location test could be deemed satisfied.⁹⁸

2. *The duration test:*

The duration test does not stipulate that a place of business should exist indefinitely, but a specific minimum threshold also does not exist.

Stjepan Gadžo, in his Doctoral Dissertation, refers to two arguments exist when testing the duration test. First, Vogel supports the indefiniteness of the duration test and argues: '*Whether the place of business meets this test of performance must be judged against the background of all circumstance constituting each individual case.*'⁹⁹

Gadžo refers to Reimer view and argument '*(...) the interpretation of the performance requirement in Article 5(1) of the OECD MTC should follow the 183 day rule for all sectors of business, There are only rare cases which make it compelling to deviate*

⁹⁵ S. Gadzo. 2016. Page 137.

⁹⁶ *Ibid.*

⁹⁷ *Ibid.*

⁹⁸ *Ibid.*

⁹⁹ *Ibid.*, Page 140.

*from this absolute standard, and to apply relative standards.*¹⁰⁰ Reimer seems to draw a parallel between the application of the duration test to recurrent activities and the application of the ‘geographical and commercial coherence theory’ with regard to the location test.¹⁰¹

Even the OECD Commentary refrains from providing a definite answer. In paragraph 6 on article 5(1) of the OECD Commentary mentions that a PE may be created even if the place of business exists for a short period. The duration test may be fulfilled due to the nature of the business being such that it will only be carried out for a short period of time. The OECD acknowledges that the duration test is not applied consistently by all countries, but experience have shown that a PE would normally be created where a business has been carried on in a country for more than six months.¹⁰²

The duration test would also remain unaffected by a temporary suspension of business activities.¹⁰³ The OECD Commentary suggests and the practice of some countries seems to confirm this view, that *‘(...) in such cases each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years)’*.¹⁰⁴

- Wholly or partly through this fixed place

For the ‘business activity test’ to be satisfied and create a PE under article 5(1), a specific kind of presence for an enterprise is necessary in a source country. The physical presence of an enterprise is enough, it should carry on its business wholly or partly through this fixed place.¹⁰⁵

The OECD Commentary confirms that the interpretation of the word ‘through which’ should be given a wide meaning so as to apply to any situation where business activities are carried on at particular location that is at the disposal of the enterprise for that purpose.¹⁰⁶

¹⁰⁰ *Ibid.*

¹⁰¹ *Ibid.*, Page 141.

¹⁰² OECD. (2010) *Commentaries*. Paragraph 6 on Article 5(1). Page 95.

¹⁰³ S. Gadzo. 2016. Page 141.

¹⁰⁴ OECD. (2010) *Commentaries*. Paragraph 6 on Article 5(1). Page 95.

¹⁰⁵ S. Gadzo. 2016. Page 141.

¹⁰⁶ OECD. (2010) *Commentaries*. Paragraph 4.6. Page 94.

1. *The disposal test:*

The OECD Commentary provides a further requirement inherent to the ‘basic-rule PE’. This requirement is not as obvious as the other requirements but requires that the fixed place of business must be at the disposal of the taxpayer.¹⁰⁷ The OECD Commentary uses the meaning of this word to signify a specific kind of relationship between the place of business and the taxpayer.¹⁰⁸

The court held in the case of *Knights of Columbus versus Her Majesty the Queen* that the disposal test requires more than just having a key to a premises, it is necessary to show an independent right of disposition in the principal.¹⁰⁹

Arnold supports the wide interpretation of the OECD and concludes that a liberal interpretation would be the better view: *‘In effect, “through” should be interpreted to include business activities occurring in, on, at or through the fixed place of business.’*¹¹⁰

The OECD Commentary emphasise the importance of ‘through’ in paragraph 7 the following:

*‘For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it... Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.’*¹¹¹

From the OECD Commentary and interpretations of these requirements in the definition of a PE, it is evident that a PE cannot exist until every requirement contained in article 5(1) has been satisfied.¹¹²

3.2.2 Article 5(2) of the OECD MTC

Article 5(2) of the OECD MTC contains a list of places that could constitute a PE. This list is not exhaustive. This subparagraph of article 5 is not self-standing, meaning that

¹⁰⁷ S. Gadzo. 2016. Page 143.

¹⁰⁸ *Ibid.*

¹⁰⁹ Tax Interpretations. *Knights of Columbus v. The Queen*, 2008 DTC 3648 [Online] Available from: <https://taxinterpretations.com/content/351971> [Accessed on: 2017-10-03]. Paragraph 40. Page 8.

¹¹⁰ *Ibid.*

¹¹¹ OECD. (2010) *Commentaries*. Page 97.

¹¹² S. Gadzo. 2016. Page 141.

the requirements of article 5(1) must also be met. Article 5(2) merely provides an illustrative list.¹¹³

3.2.3 The interaction between Articles 5(1) and 5(2) of the OECD MTC: AB LLC and BD Holding LLC case¹¹⁴

Even though the court had to decide whether furnishing of services could create a PE, the court discussed in detail the interaction between article 5(1) and 5(2) and therefore it is included in this discussion.

Summary of facts

AB LLC and BD Holding LLC (jointly referred to ‘appellant’) entered into an agreement with Company X to provide strategic and financial advisory services. These services were provided between February 2007 and May 2008. The appellant made 17 of its employees available to come to South Africa when required. Three employees formed part of the core aspect of the projects and they were in South Africa in a rotational basis for three weeks at a time.

During 2007, the appellant’s employees were in South Africa for a period exceeding 183 days. These employees were also granted space on the premises of Company X from where it conducted its activities. The employees only had access to the premises on weekdays and during working hours. The nature of the work provided, which was consultancy services on a daily basis, required these employees to be based at the premises of X. During 2007, at all times there were employees working in the space provided by Company X.

SARS assessed the appellant’s income earned in South Africa during 2007, 2008 and 2009 and the assessment was based on article 7(1), 5(1) and 5(2)(k) of the DTA between South Africa and the United States of America (‘US’). The appellant appealed against the assessments.

¹¹³ Davis Tax Committee Interim Report. Page 12.

¹¹⁴ AB LLC and BD Holdings LLC v CSARS. [Online] Available from: <http://www.saflii.org/za/cases/ZATC/2015/2.pdf>. [Accessed on 2017-12-10].

Appellant's argument¹¹⁵

According to the appellant, once the requirements of article 5(2) are met, the focus should shift to article 5(1) and its requirements. It is only if the requirements of article 5(1) are met, that it can be concluded that the existence of a PE has been proven.

The appellant's submission was that even though it met the requirements of article 5(2)(k) it still had to satisfy the requirements of article 5(1). According to the appellant, it did not have a 'fixed place of business through which its business was wholly or partly carried on' and therefore it did not create a PE in South Africa and did not have a tax liability on the income received in South Africa.

Respondent's argument¹¹⁶

SARS submits that once it was found that the requirements of article 5(2)(k) were met, a PE is automatically created. In the alternative, it contented that if the court favoured the interpretation of the Appellant, the Appellant did comply with the requirements of article 5(1) and has a tax liability on the income received.

Considerations of the court

The court confirmed the value of the Commentary when interpreting articles in DTAs. The court further referred to the importance of our basic rules of interpretation discussed in *Commissioner, South African Revenue Service v Tradehold Ltd.*¹¹⁷

'The need to interpret international treaties in a manner which gives effect to the purpose of the treaty and which is congruent with the words employed in the treaty is well established...

*'the term must be given a meaning that is congruent with the language of the DTA having regard to its object and purpose.'*¹¹⁸

The court referred to articles 5(1) and 5(2)(a) – 5(2)(f) which are identical to the OECD MTC. The OECD Commentary confirmed that the relationship between article 5(1) and

¹¹⁵ *AB LLC and BD Holdings LLC v CSARS* Par 16. Page 12 – 13.

¹¹⁶ *Ibid.*, Par 20. Page 15.

¹¹⁷ 2013 (94) SA 184 (SCA) at Par 21. Page 10.

¹¹⁸ *AB LLC and BD Holdings LLC v CSARS* . Par 23. Page 16.

5(2)(a) – 5(2)(f) are that the examples found in 5(2)(a) – 5(2)(f) are examples to be seen against a background of the general definition in article 5(1).¹¹⁹

It is assumed the list in articles 5(2)(a) – 5(2)(f) is interpreted in such a way that such place of business constitute a PE only if they meet the requirements of article 5(1). The court held that the list in articles 5(2)(a) – 5(2)(f) does not expand the definition of PE but illustrates what a PE is.¹²⁰

3.2.4 Article 5(5) of the OECD MTC: The ‘agency PE’

An enterprise could still create a PE in a source country, even if it does not have a fixed place of business but has persons who act on its behalf in the host country.¹²¹ Article 5(5) of the OECD MTC contains a ‘deeming rule’, which functions as an alternative to the fixed rule of article 5(1).¹²²

Article 5(5) of the OECD MTC significantly expands the PE concept as follows:

*‘5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.’*¹²³

Under the deeming provision, a person acting on behalf of an enterprise needs to have the authority to conclude contracts on behalf of the enterprise and habitually exercise that authority within the source country before they can constitute as a dependent agent.¹²⁴ The meaning of dependent agent must be contrasted with independent agent, which will be discussed in detail below.

This deeming rule establishes that an enterprise could still create a PE in a source country, even if it does not satisfy the basic requirements of article 5(1).¹²⁵

¹¹⁹ *Ibid.*, Par. 17. Page 13.

¹²⁰ *Ibid.*, Par. 18. Page 14.

¹²¹ Olivier, L & Honiball, M. (2011) Page 345.

¹²² S. Gadzo. 2016. Page 131.

¹²³ OECD. (2010) Article 5(5) Page 25.

¹²⁴ Olivier, L & Honiball, M. (2011) Page 345.

¹²⁵ S. Gadzo. 2016. Page 145.

3.2.4.1 Requirements of an 'agency' PE

- Individual or company

The wording of article 5(5) uses the term 'person' in relation to agents as PEs. This creates the question as to which person, acting as an agent, can be deemed as a PE of another person.

Article 5(5) establishes a subjective scope of the agency PE rule. This results in that an agency PE could be found with not only individual, corporation and non-corporate entities, but also associations or partnerships.¹²⁶

The OECD Commentary also confirms the subjective scope and states: '*...such persons may either be individuals or companies and need not be residents or, nor have a place of business in, the State in which they act for the enterprise...*'¹²⁷

- Agent's activity

Concerning the deeming rule, an enterprise could still create a PE in a source country without a fixed place of business. Therefore, the whole concept of an agency PE is based on the 'activity related' approach to determine what kind of agent's activities would activate the deeming rule.¹²⁸

The OECD Commentary emphasises that the treatment of an agency PE should be limited to persons who, in view of the scope of their authority or the nature of their activity, involve the enterprise to a particular extent in business activities in the source country.¹²⁹

In order to satisfy the deeming rule and create an agency PE in the source country, one must determine against these two criteria whether the enterprise is involved to a substantial degree in the economy of the source country.¹³⁰

1. Authority to conclude contracts

The OECD Commentary specifies clearly:

¹²⁶ *Ibid.*, Page 147.

¹²⁷ OECD. (2010) *Commentaries*. Paragraph 32. Page 105.

¹²⁸ S. Gadzo. 2016. Page 148.

¹²⁹ OECD. (2010) *Commentaries*. Paragraph 32. Page 105.

¹³⁰ S. Gadzo. 2016. Page 148.

*‘...paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise’s participation in the business activity in the State concerned.’*¹³¹

The authority to conclude contracts requirement should not be interpreted strictly and in a literal manner. The application also applies to an agent who concludes contracts, which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. It is the lack of involvement by an enterprise in those transactions that may be indicative of the agent’s authority to conclude contracts.¹³²

What stands out from the OECD Commentary is the significance placed on the authority given to the agent to negotiate all elements and details of the contract and that those are binding on the enterprise.¹³³

In the application of article 5(5), it is vital that the actions of the agents are legally binding upon the enterprise as oppose to factually or economically. The agent would not be deemed to create a PE for an enterprise if his authority is limited to activities, which does not amount to the enterprise’s core business.¹³⁴ The OECD Commentary also supports this with: *‘The authority to conclude contracts must cover contracts relating to operation which constitute the business proper of the enterprise.’*¹³⁵

2. *Habitually exercising the authority*

The underlying principle of article 5(5) is that the agent must habitually exercise its authority to conclude contracts.¹³⁶ The OECD Commentary stipulates that *‘The extent and frequency of activity necessary to conclude that the agent is “habitually exercising” contracting authority will depend on the nature of the contracts and the business of the principal.’*¹³⁷ The subjective interpretation, based on the facts of the case, comes strongly forward here.

¹³¹ OECD. (2010) *Commentaries*. Paragraph 32. Page 105.

¹³² *Ibid.*

¹³³ S. Gadzo. 2016. Page 148.

¹³⁴ *Ibid.*, Page 150.

¹³⁵ OECD. (2010) *Commentaries*. Paragraph 33. Page 106.

¹³⁶ OECD. (2010) *Commentaries*. Paragraph 33.1 Page 106.

¹³⁷ *Ibid.*

The habitual exercising of the agent's authority needs to establish a territorial nexus between the enterprise's agent and the source country. It is important that a mere physical presence is not enough, but require the agent to exercise authority therein.¹³⁸ In other words, the geographical element can be deemed satisfied if the agent is physically present in the source state at the time when the critical decision pertaining to the contracts are made.¹³⁹

The meaning of 'dependent agent' needs to be contrasted with that of an 'independent agent'.¹⁴⁰

3.2.5 Article 5(6) of the OECD MTC: The independent agent

Article 5(6) of the OECD MTC reads:

*'An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business'.*¹⁴¹

The OECD Commentary requires two conditions to be fulfilled for an agent to be deemed independent:

1. The agent must be independent of the enterprise both legally and economically; and
2. The agent must act in the ordinary course of his business when acting on behalf the enterprise.¹⁴²

1. Legally and economically independent

For an agent to fall under the exclusion of article 5(6), the agent needs to fulfil independent from both a legally and economically perspective. From a legal perspective, the contractual terms between the agent and the enterprise are important. The focus shifts to the manner in which the agent conducts his business when determining the economic independence, to the manner in which the agent

¹³⁸ S. Gadzo. 2016. Page 151.

¹³⁹ *Ibid.*

¹⁴⁰ ¹⁴⁰ L. Olivier. (2002) SALJ Page 875.

¹⁴¹ OECD. (2010). Page 26.

¹⁴² OECD. (2010) *Commentaries*. Paragraph 37. Page 107.

conducts his business paired with the functions performed and risks assumed by the agent.¹⁴³

The OECD Commentary provides the following consideration in determining independence:

- a. The degree of control over the enterprise and whether the agent is subject to significant control from the enterprise;
- b. The allocation of entrepreneurial risks between the agent and the principle; and
- c. The number of principals the agent represents.¹⁴⁴

Should an agent act on behalf of one principle and be subjected to significant control and detailed instructions, he would not satisfy the requirements of article 5(6) and considered an independent agent.¹⁴⁵

2. *In the ordinary course of business*

The second requirement to be deemed independent is that the agent should act in the ordinary course of his business. The OECD Commentary states that:

*'persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations'.*¹⁴⁶

This test should be applied subjectively and on a fact-to-fact basis. Only when the agent is truly legally and economically independent and acts in the ordinary course of his business, would he be deemed independent and not create a PE for an enterprise in a source country.

3.2.6 The relationship between Article 5(5) and 5(6)

When it comes to the application of article 5(5) and 5(6), the researcher support the so-called 'integration theory' based on the wording of article 5(5). This theory argues that article 5(6) should first be applied and only if the activities of the agent do not

¹⁴³ S. Gadzo. 2016. Page 154.

¹⁴⁴ OECD. (2010) *Commentaries*. Paragraph 38.6. Page 108.

¹⁴⁵ S. Gadzo. 2016. Page 155.

¹⁴⁶ OECD. (2010) *Commentaries*. Paragraph 38. Page 108.

satisfy the requirements of article 5(6), should article 5(5) be applied.¹⁴⁷ Gadžo refer to Pijl's theory as follows:

*'Clearly, the hyphenized phrase – “other than an agent of an independent status to whom paragraph 6 applies”- means that it is first necessary to consider whether or not the person that may theoretically constitute a PE under article 5(5)'s further conditions is “an agent of an independent status to whom paragraph 6 applies”. Consequently, if the person is “an agent of an independent status to whom paragraph 6 applies”, further access to article 5(5) of the OECD Model is denied and no PE arises. If the agent is not “an agent of an independent status to whom paragraph 6 applies”, article 5(5) permits further exploration as to whether or not the conditions for the constitution of an agency PE are met.’*¹⁴⁸

3.3 CONCLUSION

The PE threshold provides that once an enterprise of a country establishes a PE in another country, a portion of its business is notionally segregated and effectively treated as a citizen of that country pertaining to its economic activities.

The fixed PE requires the location, duration and disposal tests to be satisfied before a non-resident could create a PE in the source country. It has been confirmed that the fixed PE has a territorial connection between the country and the enterprise that must be satisfied for the PE to exist and an agency PE contains requirements, which are connected to a person.

¹⁴⁷ S. Gadzo. 2016. Page 153.

¹⁴⁸ *Ibid.*

CHAPTER 4. BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS

4.1 INTRODUCTION

Over the last few years, MNEs have moved away from decentralised operating models to centralised operating models.¹⁴⁹ These centralised operating models have resulted in a negative impact on tax bases where profits are shifted out of higher taxed countries into lower taxing countries.¹⁵⁰ Non-resident taxpayers could derive substantial profits from transactions with customers located in another country and questions are raised as to whether the current rules ensure a fair allocation of taxing profits on business profits, especially where the profits from such a transaction go untaxed anywhere.¹⁵¹

Corporate tax structures of MNEs resulting in them paying little or no corporation tax in countries wherein they do business have come to light in recent year. These structures illustrated what could be achieved within the legal parameters and when a mismatch between domestic legislation and international tax are taken advantage of. In light of these developments, the national leaders of the G20 countries during its 2012 summit, expressed the need to prevent these harmful activities.¹⁵²

4.2 THE GLOBAL NEED FOR CHANGE

4.2.1 2013 OECD Report¹⁵³

As a response to the global plead, the OECD and G20 governments started on the most significant re-write of the international tax rules, probably since its inception.¹⁵⁴ The OECD/G20 had ambitious goals: to revise the current rules and align them with

¹⁴⁹ International Tax Review (2016).

¹⁵⁰ *Ibid.*

¹⁵¹ OECD/G20 2015 Final Report on Action. Paragraph 1 at Page 13.

¹⁵² International Tax Review (2016).

¹⁵³ Davis Tax Committee Second Interim Report on Base Erosion and Profit Shifting (BEPS) in South Africa: Introduction. Page 6.

¹⁵⁴ Davis Tax Committee Interim Report. Page 1.

¹⁵⁵ OECD/G20 Base Erosion and Profit Shifting. 2015 Final Report. Information Brief. [Online] Available from: <https://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf> [Accessed 11-12-2017].

the current status and global activities of the 21st century, and to ensure that the profits are taxed where the corresponding economic activities are carried on.¹⁵⁵

During February 2013, the OECD/G20 released its initial Report: *Addressing Base Erosion and Profit Shifting*. The report emphasised that no single rule or provision cause BEPS. It is caused by domestic laws and rules which are not coordinated across borders, international standards that have not developed with the changing global business environment and partnered with a worrying lack of information at revenue authorities.¹⁵⁶

In this Report, BEPS is explained as specifically calculated actions designed to achieve low or now taxation by shifting profits out from jurisdictions where the activities creating those profits take place, or by exploiting gaps in the interaction of domestic tax rules where corporate income is not taxed at all.¹⁵⁷

The Report acknowledged that BEPS constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for all countries across the world.¹⁵⁸

4.2.2 2013 OECD Action Plan¹⁵⁹

After its initial Report, the OECD/G20 released its *Action Plan on Base Erosion and Profit Shifting* (Action Plan) during July 2013. The Action Plan identified 15 comprehensive actions along three fundamental pillars:

- Actions that introduce coherence in the domestic rules that affect cross-border activities;
- Actions to reinforce substance requirements in the existing international standards; and
- Actions to improve transparency as well as certainty.¹⁶⁰

¹⁵⁵ *Ibid.*

¹⁵⁶ *Ibid.*

¹⁵⁷ Davis Tax Committee Second Interim Report on Base Erosion and Profit Shifting (BEPS) in South Africa: Introduction. Page 7.

¹⁵⁸ *Ibid.*

¹⁵⁹ Davis Tax Committee Interim Report: Addressing Base Erosion and Profit Shifting in South Africa. Annexure 7 Available from: http://www.taxcom.org.za/docs/New_Folder3/9%20BEPS%20Final%20Report%20-%20Action%207.pdf [Accessed: 2017-12-10]. Page 1.

¹⁶⁰ Davis Tax Committee Second Interim Report on Base Erosion and Profit Shifting (BEPS) in South Africa: Introduction. Page 20.

4.2.2.1 BEPS Action Plan and PE

In its 2013 Report, the OECD/G20 noted that the PE concept is a crucial element of the model treaty, which is designed to limit a source country's tax jurisdiction over foreign businesses. As a result of its recognition of the importance of PEs and the abuse it was taking, the OECD/G20 developed BEPS Action 7, dealing with the artificial avoidance of PE status.¹⁶¹

This Action recommends changes to the definition of PE in order to prevent artificial avoidance of a PE status and to address the current BEPS strategies.

4.2.3 2015 BEPS Package

After two years of hard work, the OECD/G20 completed the 15 actions. The BEPS Package represents the most substantial renovation of international tax rules in almost a century. The package was designed to be implemented via changes in domestic law and practices, and via treaty provisions.¹⁶²

Below follow the changes in terms of Action 7 to Article 5 of the OECD MTC and its Commentary as it specifically relates to a fixed PE and agency PE.

4.3 BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS

4.3.1 Changes to Article 5(5): The 'agency' PE¹⁶³

The OECD proposed amendments to article 5(5) of the OECD MTC as follows¹⁶⁴:

'5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise, in doing so habitually concludes contracts, or habitually plays the principle role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are

a) In the name of the enterprise, or

b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

¹⁶¹ Davis Tax Committee Interim Report: Addressing Base Erosion and Profit Shifting in South Africa. Annexure 7. Page 27.

¹⁶² OECD/G20 Base Erosion and Profit Shifting Project. Preventing the Artificial Avoidance of Permanent Establishment Status. Action 7: 2015 Final Report. [Online] Available from: <http://www.oecd.org/ctp/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm> [Accessed: 2017-07-19].

¹⁶³ OECD/G20 2015 Final Report on Action. Page 16.

¹⁶⁴ The **bold** words are the additions to Article 5(5) by OECD/G20 2015 Final Report on Action 7.

c) For the provision of service by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4, which if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.’¹⁶⁵

Emphasis added on the activities

The threshold of creating an agency PE has been significantly lowered and the emphasis is now placed on the nature of the activity instead of the agent having authority.

Paragraph 32 of the OECD Commentary has been extended to include the requirement that:

‘persons habitually concluding contracts that are in the name of the enterprise or that are to be performed by the enterprise, or habitually playing the principal role leading to the conclusion of such contracts which are routinely concluded without material modification by the enterprise’.¹⁶⁶

It is not necessary that the agent acts with an authority to conclude the contracts but does so habitually. The nature of the agent’s activity would lead to the enterprise having sufficient business activities in the source country. This could be either by concluding contracts in the name of the enterprise or if the contracts are concluded as a direct result of the actions performed by that person.¹⁶⁷

Additional requirements of Article 5(5)

The OECD in its commentary on article 5(5) added new requirements that should be met before an agent could be classified as dependent. The additional requirements are as follows:

‘32.1 For paragraph 5 to apply, all the following conditions must be met:

- A person acts in a Contracting State on behalf of an enterprise;*
- In doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and*

¹⁶⁵ OECD/G20 2015 Final Report on Action. Page 16.

¹⁶⁶ *Ibid.*, Page 17.

¹⁶⁷ *Ibid.*, Paragraph 32 at Page 17.

- *These contracts are either in the name of the enterprise or for the transfer of ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.’*¹⁶⁸

Each of the above conditions is discussed in detail in the addition to the OECD Commentary.

1. Acting on behalf of an enterprise

Paragraph 32.3 of the Commentary requires that an agent should involve the enterprise to a particular extent in business activities in the State concerned. For example: an agent acting for a principal, partner acting for a partnership, director acting for a company or an employee acting for an employer.¹⁶⁹

2. Habitually concluding contracts or playing a principal role leading to the conclusion of contracts, without material modifications by the enterprise

The contract should be considered to be concluded by a person in terms of the relevant law governing contracts of the specific Contracting State.¹⁷⁰ The essential requirements for a valid and enforceable contract should be present.¹⁷¹

The added paragraph 32.4 to the Commentary affirms that a contract could still be concluded, even if the contract was signed outside the State by another person. An agent could negotiate all the elements and details of a contract and bind the enterprise to the contract. This will however depend on the relevant State’s domestic contract law.¹⁷²

An example provided by paragraph 32.4 is where the conclusion of the contract results from the acceptance, by a person acting on behalf of an enterprise, of an offer to enter into a contract made by a third party, it does not matter that the contract is signed outside that State.¹⁷³

¹⁶⁸ *Ibid.*, Page 18.

¹⁶⁹ *Ibid.*

¹⁷⁰ *Ibid.*, Paragraph 32.4 at Page 18.

¹⁷¹ A discussion on the specific requirement of a valid and enforceable contract in terms of contract law, falls outside the scope of this research.

¹⁷² OECD/G20 2015 Final Report on Action 7. Page 18.

¹⁷³ *Ibid.*, Page 19.

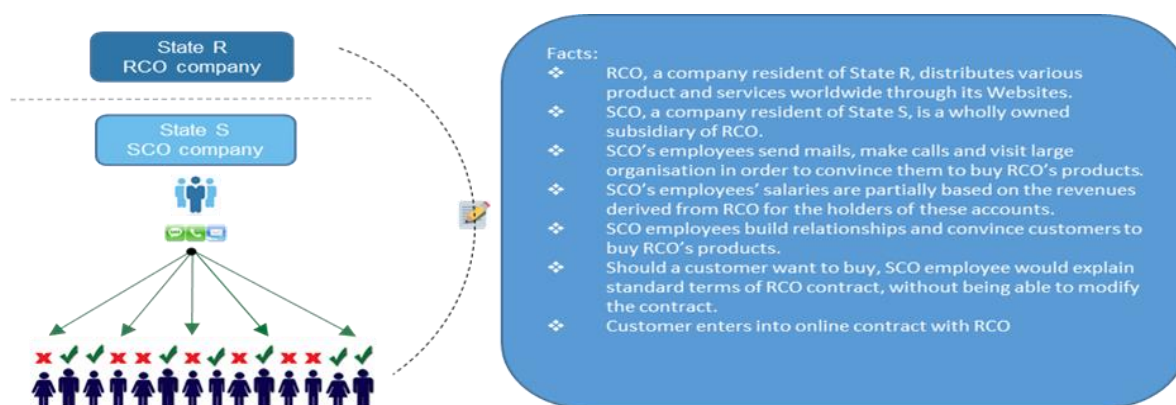
Paragraph 32.5 discusses the phrase *'habitually plays the principal role leading to conclusion of contracts that are routinely concluded without material modification by the enterprise'*.¹⁷⁴

Situations arising from above would be where actions of the person in a Contracting State directly results in the conclusion of the contract. The OECD found it necessary to supplement the well-known 'concluding contracts' test with activities taking place in one State where the conclusion of the contracts is clearly the direct result of these activities. This phrase should be interpreted to include situations where the activities that a person exercised in a State are performed with the intention to result in the regular conclusion of contracts to be performed by a foreign enterprise.¹⁷⁵

The changes to article 5(5), results in the activities of the agent becoming an essential focus. It would no longer be necessary for the agent to have the authority to conclude the agreement.¹⁷⁶ The new threshold rests in whether the agent habitually concludes contracts or plays a principle role in the conclusion of a contract.

A person would be deemed to play a principle role leading to the conclusion of the contract if the actions of that person convinced a third party to enter into a contract with the enterprise.¹⁷⁷

The illustration below is based on paragraph 32.6 of the OECD Commentary¹⁷⁸:



¹⁷⁴ *Ibid.*

¹⁷⁵ *Ibid.*

¹⁷⁶ Rödl & Partner. 'Final OECD-Report on BEPS Action 7 to Prevent the Artificial Avoidance of Permanent Establishment Status. [Online] Available from http://www.roedl.com/services/tax/transfer_pricing/beps_oecdg20_project_against_base_erosion_and_profit_shifting/beps_action_7_prevent_artificial_avoidance.html [Accessed on 2017-07-06].

¹⁷⁷ *Ibid.*

¹⁷⁸ *Ibid.*

**Drawing by researcher based on provided OECD example in paragraph 32.6 of OECD Commentary*

From the above, the SCO employees play a principal role leading to the conclusion of the contracts. These activities of SCO's employees result in the contracts entered into between RCO and the in-country customer. Even though the SCO employees cannot change the terms of the contract, it does not mean that the conclusion of the contract is not the direct result of the activities they perform on behalf of RCO.¹⁷⁹

3. In the name of the enterprise, for transfer of ownership, granting of a right to use property owned by the enterprise or the enterprise to use property, or provision of services by that enterprise

This requirement is concerned with the creation of rights and obligations in terms of the contract between the customer and the enterprise. The person should act on behalf of the enterprise in creating rights and obligations with a third party.

Relevant to the core business of enterprise

The contracts referred to above must cover transactions relating to operations which constitute the core business of the enterprise. For example, should the core business of the enterprise be distribution of goods, the person would not create a PE if he concludes an employment contract on behalf of the enterprise.¹⁸⁰

The underlying principle of article 5, that the presence which an enterprise maintains, should be more than merely transitory if the enterprise is to be regarded as creating a PE,¹⁸¹ remains throughout the rest of the OECD commentary.

4.3.2 Changes to Article 5(6): Independent agent

BEPS Action 7 also added and removed wording of article 5(6) of the OECD MTC to read as follows:

'6. a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprise to which it is closely related, that person shall not be

¹⁷⁹ *Ibid.*, Page 20.

¹⁸⁰ *Ibid.*, Page 21.

¹⁸¹ *Ibid.*, Page 22.

considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

b) For the purpose of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise'.¹⁸²

From the above, it is evident that the meaning of an independent agent has been expanded to result in a more strict and narrow application to each set of circumstances.

Independence test

Paragraph 37 of the current OECD Commentary has been completely struck out and replaced. The added paragraphs explain that the exceptions of paragraph 6 would only apply in circumstances where a person acts on behalf of an enterprise in the course of carrying on a business as an independent agent.¹⁸³

The likelihood of an individual having independent status would be less likely if the activities of that individual are performed exclusively or almost exclusively on behalf of an enterprise or closely related enterprise.¹⁸⁴

Paragraph 38.7 of the OECD Commentary has been completely amended to affirm that paragraph 6 requires the person carrying on a business as an independent agent. This action should also be in the ordinary course of its business. Independent status is less likely if the activities of the person are performed wholly or almost wholly on behalf of only one enterprise (or a group of enterprises that are closely related to each other) over the lifetime of that person's business or over a long period of time.¹⁸⁵

¹⁸² *Ibid.*, Page 18.

¹⁸³ *Ibid.*, Page 23.

¹⁸⁴ *Ibid.*

¹⁸⁵ *Ibid.*, Page 25.

It is important to note that where a person's activities on behalf of an enterprise to which it is not closely related or when it does not represent a significant part of that person's business, that person will not qualify as an independent agent.¹⁸⁶

The legally and economic independency tests, still remain. However, the addition of 'acting exclusively or almost exclusively' and 'to which it is closely relate' have added additional requirements.

All the facts and circumstances would need to be taken into account to determine whether a person's activities constitute the carrying on of a business as an independent agent.¹⁸⁷

Closely related to an enterprise

It is crucial that the 'closely related to an enterprise' be distinguished from 'associated enterprises' found in article 9 of the OECD MTC. Even though these two concepts overlap, they are not the same.¹⁸⁸

Article 5(6)(b) contains the general definition. It presents that a person is closely related to an enterprise if one has control of the other or both are controlled by the same persons.¹⁸⁹ Each situation should be judged based on all the relevant facts and circumstance.

If either a person or an enterprise possesses directly or indirectly more than 50 per cent beneficial interest in each other, they would automatically be considered 'closely related to an enterprise'. Should a third person possess directly or indirectly more than 50 per cent of the beneficial interest in both the person and the enterprise, then this would also be regarded as 'closely related to an enterprise'.¹⁹⁰ Below is an illustration of the closely related parties.¹⁹¹

¹⁸⁶ *Ibid.*, Page 26.

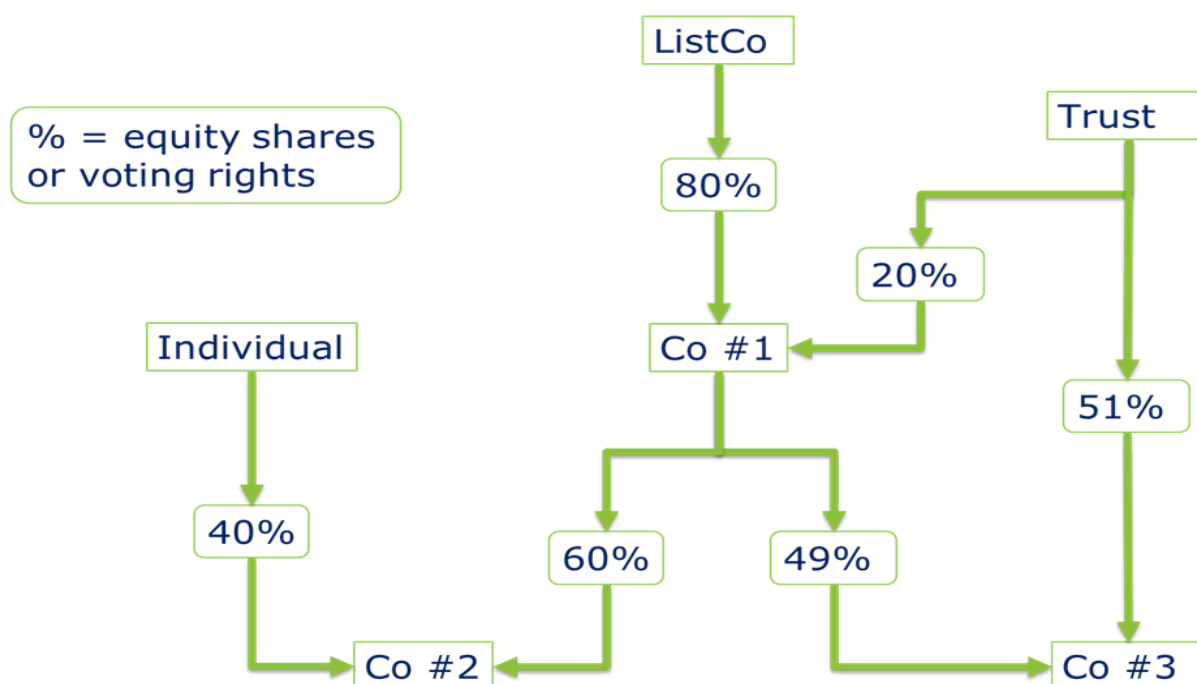
¹⁸⁷ *Ibid.*

¹⁸⁸ OECD/G20 2015 Final Report on Action 7. Paragraph 38.9. Page 26.

¹⁸⁹ OECD/G20 2015 Final Report on Action 7. Paragraph 38.10 Page 26.

¹⁹⁰ OECD/G20 2015 Final Report on Action 7. Paragraph 38.11. Page 26.

¹⁹¹ South African Institute for Tax Professionals. *Transfer Pricing Compliance Programme*. Connected Persons presented by PJ Nel on 15 February 2017.



It is essential to note that the amendment of article 5(6) does not restrict the scope of article 5(7), regulating the relationship between a parent and a subsidiary company.¹⁹²

4.6 COMMENTS RECEIVED ON THE BEPS ACTION 7 DRAFT

The OECD asked for comments on the revised amendments. Many experts on the international tax and PE fields have provided their concerns on the practical aspects in their comments. It seems that the experts have a few common concerns pertaining to the amendments.

The first common concern is the amount of small PEs that would be created. This would lead to administrative difficulties for both Tax Authorities (source countries) and MNEs (resident countries).¹⁹³ With the increase of more PEs, the volume of work would increase and a greater demand would be placed on tax administrations' resources to cope.¹⁹⁴

¹⁹² OECD/G20 2015 Final Report on Action 7. Paragraph 38.12. Page 26.

¹⁹³ OECD: Comments Received on revised discussion draft. *BEPS Action 7: Prevent the Artificial avoidance of PE Status*. [Online] Available from: <http://www.oecd.org/tax/treaties/public-comments-revised-beps-action-7-prevent-artificial-avoidance-pe-status.htm> [Accessed on 2017-05-30]. Page 5.

¹⁹⁴ *Ibid.*, Page 9.

There is another risk that article 5(5) could be interpreted differently in different jurisdictions. This difference in interpretation could lead to unnecessary disputes and compliance requirements for tax payers and tax authorities.¹⁹⁵

The obligations imposed and the administration burden placed on tax authorities, would not lead to a material difference in collection of tax, but would only create more tax disputes.¹⁹⁶

It seems a consensus exists that additional guidance on the wording added to article 5(5), 5(6) and the Commentaries was needed. The experts request further explanations on what is meant with certain words, for example '*habitually*' should be further expanded that it refers to a permanent, large or ongoing level of activity.¹⁹⁷ With the addition of new words, undefined concepts were created that substantially lower the existing threshold of creating a PE.¹⁹⁸

From the comments received, it seems that a significant number of practical concerns exist. These practical concerns can only be laid to rest with time.

4.7 CONCLUSION

Over the last few years, the way of doing business has changed and it has become possible for non-residents to derive substantial profits from customers located in another country.¹⁹⁹ Corporate tax structures of MNEs not paying any or very little corporation tax in the countries they do business have sparked public outrage and a call for action.

National leaders of the G20 countries called for action during its 2012 summit and the OECD answered in February 2013 with its Report: Addressing Base Erosion and Profit Shifting. This report was followed with the 2013 OECD Action Plan, which ultimately lead to the OECD/G20 BEPS Package.

¹⁹⁵ *Ibid.*, Page 8.

¹⁹⁶ *Ibid.*, Page 9.

¹⁹⁷ *Ibid.*, Page 81.

¹⁹⁸ *Ibid.*, Page 248.

¹⁹⁹ OECD/G20 2015 Final Report on Action 7. Paragraph 1. Page 130.

BEPS Action 7 deals with preventing the artificial avoidance of permanent establishment status and it proposed certain changes to article 5(5) and 5(6) of the OECD MTC and its Commentary.

Certain practical concerns exist pertaining to these amendments. It seems that the biggest concern is that a massive amount of small PEs would be created, which would lead to an administrative burden on both taxpayers and tax authorities.

CHAPTER 5. BEPS ACTION 15: DEVELOPING A MULTILATERAL INSTRUMENT TO MODIFY BILATERAL TAX TREATIES

5.1 INTRODUCTION

The global endorsement of the OECD Action Plan illustrated the willingness of countries across the globe to adapt and change the current international tax system. Current tax treaties are based on a set of common principles designed to eliminate double taxation. However, the network of bilateral tax treaties dates back to the 1920, resulting in some features facilitating BEPS that needed to be addressed.²⁰⁰

5.2 NEED FOR A GLOBAL INSTRUMENT

The OECD/G20 recognised that to update the sheer number of bilateral treaties makes updating the current tax treaty network highly burdensome. Without a mechanism to swiftly implement the changes, the gap between the content of the models and the content of actual tax treaties would only become wider. This would clearly contradict the political objective to strengthen the current system by putting an end to BEPS.²⁰¹

The need for an instrument to not only tackle BEPS, but also ensure the sustainability of the consensual framework to eliminate double taxation was expressed. It is for this reason that governments agreed to explore the possibility of a multilateral instrument (MLI), having the same effect as simultaneously renegotiating thousands of bilateral tax treaties.²⁰²

BEPS Action 15 provided an analysis of the tax and public international law issues relating to the development of a MLI. This would enable countries to implement measures developed in the course of the work on BEPS and amend the bilateral tax

²⁰⁰ OECD/G20 Base Erosion and Profit Shifting Project. *A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS*. Action 15: 2015 Final Report. [Online] Available from: <https://www.oecd.org/ctp/beps-action-15-mandate-for-development-of-multilateral-instrument.pdf> [Accessed on 2017-05-27]. Page 9.

²⁰¹ *Ibid.*

²⁰² *Ibid.*

treaties quickly. The goal of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures.²⁰³

In terms of its 2014 Report: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, the OECD is of the view that the MLI can address treaty-based BEPS issues while still respecting sovereign autonomy in tax matters. This is achieved by the MLI recognising the tax sovereignty concerns and focusing on implementing treaty measures.²⁰⁴

One of its advantages is that a MLI would facilitate fast action and innovation. It will implement agreed treaty measures over a reasonably short time while simultaneously preserving the bilateral nature of DTAs.²⁰⁵

The OECD further states that the MLI is possible because legal mechanisms exists to achieve a balanced instrument that addresses the technical and political challenges.

5.3 ACTION 15: THE MULTILATERAL INSTRUMENT

The text of the MLI and its Explanatory Statement were developed through negotiations, involving more than 100 countries and jurisdictions. The completed work was adopted during 2016. The MLI offers concrete solutions to close the gaps on existing international tax rules, incorporating the OECD/G20 BEPS Package into bilateral tax treaties worldwide.²⁰⁶

The recommendations of Action 7 of the BEPS Package was incorporated into the MLI under *Part IV: Avoidance of Permanent Establishment Status* in article 12 to article 14.

5.4 SOUTH AFRICA

5.4.1 South Africa and BEPS

Since South Africa rejoined the global economy after its democratic elections in 1994, there has been an increased international interest in South Africa, which has

²⁰³ *Ibid.*

²⁰⁴ OECD/G20 2015 Final Report on Action 15. Page 16.

²⁰⁵ *Ibid.*

²⁰⁶ OECD. Multilateral Convention to Implement Tax Treaty Related Measures to prevent BEPS. [Online] Available from: <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm> [Accessed on 2017-11-12].

encouraged its citizens to actively participate in, and become reintegrated into, the global economy. With the heightened global trade competition and the mobility of capital in the world, it have encouraged South African residents to make considerable investments offshore and to look for ways of minimising their global tax exposure. It is still, difficult to reach a solid conclusion about how much BEPS actually occurs in South Africa.²⁰⁷

South Africa is the only African country that is a member of the G20. Although it is not a member of the OECD and only has OECD Member status, it is a member of the OECD BEPS Committee. It is important that South Africa is seen as a leader in the BEPS debates in Africa and to use its membership of the G20 and OECD BEPS Committee to set the tone in Africa around the key OECD recommendation on BEPS. It is also important to that South Africa play a key role to ensuring a consistent African view of the BEPS issues.²⁰⁸

5.4.2 South Africa's elections and reservations of the MLI

On 7 June 2017, over 70 countries were presented by its Ministers and high-level representatives to participate in the signing ceremony of the MLI. The signatories included jurisdictions from across the globe with all levels of development.²⁰⁹

As a G20 country and a member of the OECD BEPS committee, South Africa is supportive of the work on the MLI and is a signatory of the MLI. On 19 July, the National Treasury published the Status of List of Reservations and Notifications at the Time of Signature.²¹⁰

In terms of the publication, South Africa elected the following regarding the relevant PE Articles in the MLI²¹¹:

Article 12: Artificial Avoidance of Permanent Establishment through Commissionaire Arrangements and similar strategies.	Reservation: Pursuant to Article 12(4) of the Convention, RSA reserves the right for the entirety of Article 12 not to apply to its Covered Tax Agreements.
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²⁰⁷ Davis Tax Committee Second Interim Report on Base Erosion and Profit Shifting (BEPS) in South Africa: Introduction. Page 26.

²⁰⁸ *Ibid.*, Page 18.

²⁰⁹ *Ibid*

²¹⁰ National Treasury. [Online] Available from: <http://www.treasury.gov.za/> [Accessed on 2017-12-11].

²¹¹ *Ibid.*

Article 13: Artificial Avoidance of Permanent Establishment through the Specific Activity Exemptions	Notification of choice of optional provisions: Pursuant to Article 13(7) of the Convention, RSA hereby choose to apply Option A under Article 13(1).
Article 14: Splitting up of contracts	Reservation: Pursuant to Article 14(3)(a) of the Convention, RSA reserves the right for the entirety of Article 14 not to apply to its Covered Tax Agreements.

No explanation was provided as to why South Africa chosen to adopts only article 13 and not the rest of the PE relevant articles.

5.5 THE DAVIS TAX COMMITTEE RECOMMENDATIONS

South Africa' Act defines the PE concept with reference to the OECD definition. Since the OECD recommendations have become a globally accepted standard and as a member of the G20 and OECD BEPS Committee, it is important for South Africa to work together with the international community.²¹²

The DTC recommends that when addressing the BEPS concerns, the unique circumstance of South Africa have to be taken into consideration. BEPS concerns and challenges that other countries face may not be necessarily the concerns and challenges of South Africa. The DTC goes further and states that any BEPS remedy from the South Africa perspective needs to be supported by a fact base that sheds light on how big the relevant BEPS problem is in South Africa so that a legal response can follow. The DTC acknowledges that not all the solutions to BEPS are legislative in nature, some solutions require political intervention.²¹³

The DTC further recommended that South Africa should acknowledge its economic and socio-geopolitical special circumstances before making elections on which articles in the MLI to accept. The fact that South Africa has signed treaties with some countries that are based on the OECD MTC and other based on the UN MTC, should not be ignored.²¹⁴

²¹² Davis Tax Committee Final and Second Report on Base Erosion and Profit Shifting. Page 99.

²¹³ *Ibid.*

²¹⁴ *Ibid.*

5.6 CONCLUSION

With the support and acceptance of the BEPS Packages, the OECD/G20 recognised that to update the sheer number of bilateral treaties makes updating the current tax treaty network highly burdensome. A mechanism was necessary to swiftly and with the least amount of effort, implement the changes to combat BEPS activities.

Action 15 was created with the goal of streamlining the implementation of the tax-treaty BEPS measures. The text of the MLI and its Explanatory Statement were developed through negotiations involving more than 100 countries and jurisdictions. The completed work was adopted and on 7 June 2017, over 70 countries participated in the signing ceremony of the MLI.

The DTC recommended in its Second and Final Report on BEPS that South Africa should acknowledge its economic and socio-geopolitical special circumstances before making elections on which articles in the MLI to accept. The fact that South Africa has signed treaties with some countries that are based on the OECD MTC and other based on the UN MTC, should not be ignored.²¹⁵

On 19 July, the South Africa's National Treasury published the Status of List of Reservations and Notifications at the Time of Signature.²¹⁶ In terms of its selection, South Africa opted to only apply article 13 to its current DTAs. Explanations on its selections still need to be provided by the National Treasury.

²¹⁵ *Ibid.*

²¹⁶ National Treasury. [Online] Available from: <http://www.treasury.gov.za/> [Accessed on 2017-12-11].

CHAPTER 6. CONCLUSION AND RECOMMENDATIONS

6.1 SUMMARY OF FINDINGS

The summary of findings details the elements identified in each chapter in response to the problem statement and research questions.

The problem statement identified in Chapter 1 raised the question of how BEPS Action 7 will change the creation of a fixed place PE and agency PE in the international tax arena. The chapter also provided the three research questions and the methodology followed to answer them.

As illustrated in Chapter 2, with the increase of cross-borders transactions, the importance of the PE concept has increased dramatically for source countries. This research study further explored in Chapter 3 the requirements of creating either a fixed place PE or agency PE together with their accompanying requirements. It is only after these requirements are understood can BEPS Action 7 be discussed as done in Chapter 4 together with the recommendations and comments.

Chapter 5 ends this research study with a discussion on the mechanism that was necessary to implement the proposed changes of the BEPS Package. The purpose of the MLI are discussed together with South Africa's election on the relevant PE articles contained in the MLI.

6.2 CONCLUSION

Because of the increase in cross border transactions, the concept of PE has become essential to source countries who need become more vigilant on taxing non-residents on income derived within their borders. The importance of the PE concept rests in that it provides the necessary connection for a source country to tax non-residents deriving profits within its jurisdiction.

However, before the concept of a PE can be researched, other important concepts pertaining to international tax and cross-border activities need to be understood. The concept of tax sovereignty and how its application could lead to double taxation on the

same income is essential for MNEs. The OECD MTC and its purpose together with South Africa's position on international tax are just a few of these important concepts.

The PE threshold provides that once an enterprise of a country creates a PE in another country, a portion of its business is notionally segregated and effectively treated as a citizen of that country pertaining to its economic activities.

The fixed PE has a territorial connection between the country and the enterprise that must be satisfied for the PE to exist and an agency PE contains requirements, which are connected to a person.

Over the last few years, the way of doing business has changed. It has become possible for non-residents to derive substantial profits from customers located in another country. Corporate tax structures of MNEs not paying any or very little corporation tax in the countries they do business have created public outrage and a call for action.

National leaders of the G20 countries called for action during its 2012 summit and the OECD answered in February 2013 with its Report: Addressing Base Erosion and Profit Shifting. This report was followed with the 2013 OECD Action Plan, which ultimately lead to the OECD/G20 BEPS Package.

BEPS Action 7 deals with preventing the artificial avoidance of permanent establishment status and it proposed certain changes to article 5(5) and 5(6) of the OECD MTC and its Commentary.

With the support and acceptance of the BEPS Package, the OECD/G20 recognised that a mechanism is needed to swiftly and with the least amount of effort, implement the changes to combat BEPS activities. Action 15 was created with the goal of streamlining the implementation of the tax-treaty BEPS measures. The text of the MLI and its Explanatory Statement were developed through negotiations involving more than 100 countries and jurisdictions.

The completed work was adopted on during 2016 and on 7 June 2017, over 70 countries participated in the signing ceremony of the MLI.

On 19 July, the South Africa's National Treasury published the Status of List of Reservations and Notifications at the Time of Signature. In terms of its selection, South Africa opted to only apply article 13 to its current DTAs. No explanation has been provided yet as to its selections.

6.3 SUMMARY OF RECOMMENDATIONS

South Africa is a developing country and its basis of taxation is severely affected by foreign investors artificially avoiding creating PEs within its borders. The researcher agrees with the DTC recommendation that South Africa should be actively involved in the BEPS movement and accept more of the proposed changes in BEPS Action 7. The researcher recommends that South Africa accepts articles 12 and 14 of the MLI to lower the PE threshold for foreign enterprises creating a PE in South Africa. This would lead to more fiscal revenue being received from PEs becoming liable for tax.

The researcher also suggest that South Africa elaborate on PEs in its domestic legislation, including its definition and establishing a threshold. More attention should be given to activities of agents conducted in South Africa as well apply the lowered threshold of what constitutes an independent agent. This could happened through amending the domestic source rules to be more in line with the OECD recommendations. These changes could assist the South African Revenue Authority to capture more income that is derived by non-residents from goods or services used or consumer in South Africa.

Word count: 17 742

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