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The difficulties of determining whether a permanent establishment has been created by the presence of a foreign company

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A research report submitted to the Faculty of Commerce, Law and Management in fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation).

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1. ABSTRACT

Information technology is a driving factor in the process of globalisation. Improvements in the early 1990s in computer hardware, software and telecommunications greatly increased people's ability to access information. (The Levin Institute, 2013).

Globalisation is not a new concept however the pace of integration of national economies and markets has substantially increased in recent years (OECD, 2013e: 7). It can be argued that 'globalisation' began with Christopher Columbus and Vasco da Gama (O'Rourke and Williamson, 2000), but the term has only been in existence since the 1960s (Jeffery, 2002).

It can be said that information technology has been the most recent major catalyst for global integration (The Levin Institute, 2013) which has enabled globalisation to change the way in which companies do business (PWC, 2013a).

In relation to the globalisation of the world's economies, the concept of 'a permanent establishment' has gained significant importance worldwide, due to the direct impact on the tax revenue generated (Nayyar, 2010).

In the current era of cross-border transactions and the increase in international trade and commerce among nations, there is a continuous movement of human capital across borders. One of the most significant results of globalisation is the noticeable impact of one country's domestic tax policies on the economy of another country. Double taxation has an adverse effect on trade and services. Taxation of the same income by two or more countries (juridical double taxation) would constitute an unfair burden on the taxpayer. (Aimurie, 2013). Many countries agree that in order to eliminate double taxation, a base of clear and predictable international tax rules must be applied in order to give certainty to both governments and businesses (OECD, 2013e: 7).

Hence the question of taxing rights is created. The possibility of creating a permanent establishment in a jurisdiction by a company or its employees or an agent arises as well as the taxing rights of the tax authorities.

This research report will examine the concept of a permanent establishment and its application in commercial business activities, the building and construction industry and in the activities of an agent.

KEY WORDS:

Article 5, Building Site, Construction, Dependent Agents, Fixed Place of Business, Independent Agent, Installation Project, OECD Model, Permanent Establishment, Taxation.

2. DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

_____

Antonia Andreou

28 May 2014

3. Dedication

I dedicate my research report to my husband, Astrino Nicoloudakis, whose words of encouragement and push for tenacity ring in my ears. I sincerely thank you for your love, support and encouragement during the writing of this research report.

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5. CHAPTER 1: INTRODUCTION

The concept of a permanent establishment was introduced in the 19th century. Initially the term was not used as a tax concept and was first mentioned in the Industrial Code of Prussia for other purposes. The concept later emerged in business legislation of the German Empire and was adopted to express the total space used for the conduct of business activities. In the middle of the 19th century, the permanent establishment concept emerged as a tax concept due to the necessity of preventing double taxation amongst the Prussian municipalities. (Skaar, 1991: 72).

The concept of a permanent establishment continued to develop and by 1909, a definition of the basic rule of a permanent establishment in internal German law had evolved to a level which was virtually kept unchanged until 1977 (Skaar, 1991: 74). Under domestic German law, the permanent establishment concept was applied to ensure the efficient allocation to the tax bases among Prussian municipalities and later among the German states. Thereafter, the states of the German Empire began to incorporate the concept of a permanent establishment into bilateral tax treaties which were concluded with other countries (IBFD, 2013a: 2).

Post World War I, the League of Nations, founded in 1920 (Spark Notes, 2013) initiated a tax treaty project which adopted the German domestic law permanent establishment definition. The League of Nations however was unable to reach a consensus on a common definition amongst the League members (IBFD, 2013a: 2).

With the dissolution of the League of Nations after World War II the leadership of the universal tax treaties project shifted to the Organisation for European Economic Co-operation ('OEEC') and later its legal successor the Organisation for Economic Co-operation and Development ('OECD') (IBFD, 2013a: 2).

The OEEC, which later become known as the OECD, came into being on 16 April 1948 and emerged from the Marshall Plan and the Conference of Sixteen. The purpose was to establish a permanent organisation to continue work on the joint recovery programme and to supervise the distribution of aid to European countries which had been left devastated after Wold War II (OECD, 2013a).

In September 1961, the OEEC was superseded by the OECD. By 1961, the OECD consisted of the European founding countries of the OEEC as well as the United States and Canada (OECD, 2013a).

Nowadays, the OECD member states include the following, Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States (OECD, 2013c).

The OECD, in 2007, offered a programme of 'enhanced engagement' to non-members namely, Brazil, China, India, Indonesia and South Africa. Further to this the OECD maintains co-operative relations with more than 70 non-members (OECD, 2013c). In addition, the OECD works alongside other key partners in order to oversee the strategic orientation of the OECDs global relations with non-members (OECD, 2013c).

Today, the purpose of the OECD has developed into assisting governments' further prosperity and to fight poverty through economic growth and financial stability (OECD, 2013d).

The first draft of what was to become the OECD Model Tax Convention (OECD Model) was issued in 1958 and served as the basis for the bilateral treaties to avoid double taxation and prevent tax avoidance. Currently, there are approximately 3000 treaties worldwide which are based on the OECD Model (OECD, 2013b). The main purpose of bilateral tax treaties is to deal with the tax treatment of cross-border transactions (Chetcuti, 2002). As mentioned above the concept of a permanent establishment was first incorporated into the bilateral tax treaties of the states of the German Empire later being adopted into the initial tax treaty project lead by the League of Nations which was superseded by the OECD (IBFD, 2013a: 2).

Although, globalisation is not a new concept, the pace of integration of national economies and markets has substantially increased in recent years (OECD, 2013e: 7) and with the introduction of the Digital Age, the international tax community saw the permanent establishment concept face its first major challenge (Chetcuti, 2002). Having regard to the recent sophistication of the manner in which multinational enterprises currently carry on their business and structure their supply chains, the topic of a permanent establishment has become a high priority item for both tax authorities and tax practitioners (IBFD, 2013b).

The significance of having a permanent establishment in a country is that it allows the country in which the permanent establishment is situated, the right to tax the permanent establishment under the domestic laws of that country, notwithstanding the fact that the permanent establishment is not considered a separate legal entity (Olivier & Honiball, 2011: 335).

The definition of a permanent establishment is provided for under Article 5 of each of the Model Tax Conventions, namely the OECD Model, the United Nations Model Tax Convention ('UN Model') and the United States of America Model Tax Convention ('US Model') (Vogel, 1997: 271 - 274). Although Article 5 contains the definition of a permanent establishment, this Article does not allocate taxing rights (Olivier & Honiball, 2011: 335).

Having specific regard to the OECD Model, the right to tax the profits derived by a permanent establishment is allocated in Article 7, 'Business Profits' (Vogel, 1997: 280). Article 7 allocates taxing rights by providing that the source State may tax the profits which are attributable to the permanent establishment (OECD, 2010: 92). Article 7 applies to ensure that business activities will not be taxed in a jurisdiction unless these business activities have created significant economic bonds between the enterprise and the jurisdiction (Vogel, 1997: 280).

From a high-level perspective, the definition of a permanent establishment in Article 5 of the OECD Model provides three different categories of qualifications pertaining to a permanent establishment (Rohatgi, 2002: 74). Firstly, the OECD Model provides the basic definition of a permanent establishment as follows:

> 'a permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on' (OECD, 2010: 24).

Secondly, a permanent establishment will exist where a building site, construction or installation project lasts for longer than 12 months (OECD, 2010: 25). This will be discussed in detail in this research report in Chapter 3 with specific consideration of the OECD Model.

The agency permanent establishment is the third category (Rohatgi, 2002: 77). Further consideration of the agency permanent establishment will be provided in Chapter 4 and specific consideration of a dependent agent versus an independent agent will be provided.

The concept of a permanent establishment is not only relevant in a tax treaty context as many countries have included this concept in their domestic law. South Africa specifically refers to the concept of a permanent establishment in section 1, section 9, section 9D, section 10(1)*(h)*, section 24I, section 25D, section 31, section 41, section 49D, section 50D, section 51D and paragraph 2 of the Eighth Schedule of the Income Tax Act 58 of 1962 (Olivier & Honiball, 2011: 335).

This research report will address the permanent establishment concept as a whole, followed by specific focus on a permanent establishment being created by a building site or construction or installation project as well as an agent acting on behalf of an enterprise.

5.1. The Research Problem

The Statement of the Problem

The main issue addressed in this research report will be to identify what the difficulties are of determining whether a permanent establishment has been created by the presence or activities of a foreign company, which is not resident for tax purposes with particular reference to building, construction and installation projects and activities of agents.

The Sub-Problem

- The first sub-problem to be addressed is the difficulty of determining whether a company (which is incorporated and tax resident in one jurisdiction) has created a permanent establishment in another jurisdiction (where the company is a non-resident for tax purposes) based on its presence and/or activities performed by the said company in terms of the general permanent establishment definition provided in Article 5 paragraph 1 and Article 5 paragraph 2 of the OECD Model.

- The second sub-problem to be addressed are the challenges faced in identifying whether a permanent establishment has been created as a result of a building site or construction or installation project carried out in a jurisdiction in which the contractor/sub-contractor is not a resident.

- A final sub-problem to be addressed will consider the intricacy of applying Article 5 paragraph 5 and Article 5 paragraph 6 of the OECD Model to the presence and/or activities of an agent (independent or dependent) who is acting on behalf of a non-resident company and the challenge of determining whether the presence and/or activities of said agent will create a permanent establishment of such a non-resident company in terms of the abovementioned Articles.

5.2. Research Methodology

The research method used for this qualitative study is achieved by an extensive literature review.

The extensive literature review includes, but is not limited to, the following sources:

- Books;
- Double Taxation Treaties;
- Cases;
- Electronic resources – internet and websites;
- Electronic databases; and
- Statutes.

5.3. Scope and limitations

Scope

This research report will consider the definition of a permanent establishment as defined in Article 5 of the OECD Model. It is important to note that the definitions provided in Article 5 of the US Model and the UN Model are similar to the definition provided in Article 5 of the OECD Model and therefore consideration of all three models would be repetitive.

Therefore, this research report will specifically consider Article 5 paragraph 1, Article 5 paragraph 2 and Article 5 paragraph 4 of the OECD Model under chapter 2. Chapter 3 will specifically consider Article 5 paragraph 3 of the OECD Model in relation to 'building site or construction or installation project' and chapter 4 will consider the agency permanent establishment as per Article 5 paragraph 5 and Article 5 paragraph 6 of the OECD Model.

Therefore, the main focus of this research report will only be on the OECD Model.

This research report will consider the aspects of a 'company' only as defined in terms of section 1 of the South African Income Tax Act 58 of 1962.

The following jurisdictions will be specifically considered in relation to case law:

- Canada;
- India;
- Russia;
- The Netherlands; and
- South Africa

The above mentioned jurisdictions have approached the respective courts in order to obtain a clearer understanding of the term 'permanent establishment' and correctly apply the consequences in the case that a permanent establishment has been created.

In addition, this research report has made extensive reference to the International Bureau of Fiscal Documentation commonly referred to as IBFD. IBFD is a leading provider of international tax expertise and independent research. It is a global tax database which specialises in providing tax practitioners with high-quality information and independent international tax research.

Limitations

This research report will not cover the following aspects:

- The US Model and UN Model. The OECD Model, UN Model and US Model are very similar in respect of Article 5 and consideration of the US Model and UN Model will be repetitive.
- The income tax implications which may arise in the case of a trust, partnership or individual.
- Article 7, Business Profits.

6. CHAPTER 2: THE BASIC DEFINITION OF A PERMANENT ESTABLISHMENT

Introduction

The significance of having a permanent establishment in a country is that it allows the country in which the permanent establishment is situated, the right to tax the permanent establishment under the domestic laws of that country, notwithstanding the fact that the permanent establishment is not considered a separate legal entity (Olivier & Honiball, 2011: 335). Therefore, the concept of a permanent establishment is central to the determination of a multinational company's global tax liability as it is important to determine tax certainty in respect of any cross-border investment (Ernst & Young, 2012).

The dynamic and diverse nature of an enterprise nowadays, means that it may be difficult to determine whether it meets the required level of permanence or fixedness to qualify as a permanent establishment (Ernst & Young, 2012). The concept of a permanent establishment marks the dividing line for businesses between merely trading with a country and trading in that country; if an enterprise has a permanent establishment, then its presence in that country is sufficiently substantial, indicating that it is trading in that country (Baker, 2012: 5-2).

Therefore in order to understand and correctly apply the definition of 'permanent establishment' one must first refer to the general definitions provided in the OECD Model under Article 3. Article 3 provides the 'General Definitions' to the OECD Model, as follows:

- The term 'person' includes an individual, a company and any other body of persons.

  The definition of 'person' is not exhaustive and is used in a very wide sense. The definition explicitly mentions individuals, companies and other bodies of persons. From the meaning assigned to the term 'company', it follows that, the term 'person' includes any entity that, although not incorporated, is treated as a body corporate for tax purposes. Therefore, partnerships may be considered to be 'persons' either because it falls within the definition of 'company' or because it constitutes a body of persons (OECD, 2010: 78).

- The term 'company' means any body corporate or any entity that is treated as a body corporate for tax purposes.

  The term specifically covers any taxable unit that is treated as a body corporate according to the tax laws of the Contracting State in which it is organised (OECD, 2010: 78).

- The term ‘enterprise’ applies to the carrying on of any business.

  The definition of the term ‘enterprise’ makes reference to the term ‘business’, and therefore the performance of professional services or other activities of an independent character must be considered to constitute an enterprise (OECD, 2010: 78).

- The term ‘enterprise of a Contracting State’ and ‘enterprise of the other Contracting State’ are defined respectively as

  > ‘an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State’ (OECD, 2010: 23).

- The term ‘business’ includes the performance of professional services and of other activities of an independent character. (OECD, 2010: 23).

  Previously, the term ‘business’ was dealt with under Article 14, ‘Independent Personal Services’, however Article 14 was deleted in the 2000 updated of the OECD Model and the term ‘business’ was inserted under Article 3. The term ‘business’ was specifically included in Article 3 of the ‘General Definitions’ to ensure that the term ‘business’ includes the performance of the activities which were previously covered under Article 14 and prevent the term ‘business’ being interpreted in a restricted way so as to exclude the performance of professional services, or other activities of an independent character.

Article 3 of the OECD Model groups together a number of general provisions required for the interpretation of the terms used throughout the OECD Model however, in certain circumstances the meanings of other important terms like ‘resident’ and ‘permanent establishment’ are defined in Article 4 and Article 5 respectively (OECD, 2010: 78).

Permanent Establishment Basic Definition

The OECD Model (2010), in Article 5 paragraph 1, states that the term ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on (OECD, 2010: 24).

Paragraph 1 provides the general definition of the term ‘permanent establishment’ which brings out the essential characteristics of a permanent establishment. The general definition implies the following conditions are required:

- The existence of a ‘place of business’, for instance there must be the use of a premises or in certain instances, machinery or equipment;

- This place of business must be 'fixed', for example the place of business must be established at a distinct place in terms of its location as well as have a certain degree of permanence from a duration perspective; and

- The carrying on of the business of the enterprise through this fixed place of business for instance persons, one way or another dependent on the enterprise, must conduct the business of the enterprise through the place of business (OECD, 2010: 92).

All of these conditions must be met for a taxpayer to have a permanent establishment in a foreign country (i.e. a country where it has no tax residence) (IBFD, 2013a: 4). The above mentioned essential characteristics of the permanent establishment definition will be examined below:

Place of business

The element of a 'place of business' is a significant feature of the permanent establishment definition as it emphasises the establishment of the enterprise as opposed to the source of the income (Skaar, 1991: 111). The determination of the 'place of business' is pertinent to the investigation of whether a permanent establishment exists because where no distinct place of business exists it can be said that no permanent establishment exists, irrespective of the length of time in which the business operations continue (Olivier & Honiball, 2011: 338).

The nature of the fixed place of business permanent establishment is very much that of a physical location, one must be able to point to a physical location at the disposal of the company through which the business is carried on (Baker, 2012: 5-2/2). The place of business is however, not required to be attached to the surface of the earth or visible above the ground, which therefore allows that an underground pipeline, mine or oil rig may constitute a permanent establishment (Olivier & Honiball, 2011: 336). In the German Federal Tax Court case, *Bundesfinanzhof vorn*[1], (hereafter referred to as the 'pipeline case') the taxpayer, a company incorporated and tax resident in the Netherlands, was in the business of transporting crude oil and crude oil products for other enterprises though its own underground pipeline situated in the Netherlands and parts of Germany (where the pipeline ended). The pipeline operated automatically via remote control from the Netherlands. In addition, the necessary pressure required for pumping the crude oil through the pipeline was generated by a pumping station also located in the Netherlands. The German authority took the view that the pipeline created a permanent establishment in Germany in terms of the permanent establishment definition contained in Article 2(a) of the Germany and

[1] *Bundesfinanzhof vorn* 30.10.1996, II R 12/92, BStB1 II 1997, s. 12.

Netherlands Income and Capital Tax Treaty (1959) (as amended through 1991) (hereafter referred to as the 'Germany and Netherlands Tax Treaty'). (IBFD, 2013h).

In Article 2(a), the German and Netherlands Tax Treaty provides,

> 'a permanent establishment means a fixed place of business in which an enterprise carries on all or part of its activities;
>
> (a) the following, in particular, shall be deemed to be permanent establishments:...
>
> (ff) a mine, a quarry or other place of extraction of natural resources...' (IBFD, 2013i).

As a result, the Federal Tax Court in Germany held that the pipeline qualified as a German permanent establishment within the meaning of the Germany and Netherlands Tax Treaty to the extent that it was situated in Germany. The definition of a permanent establishment in the Germany and Netherlands Tax Treaty did not require any installation on the surface of the ground nor any activities from the taxpayer's personnel in Germany and confirmed that the automatic installation was sufficient even though it was operated entirely outside of Germany. The court held that the permanent establishment was not used solely for auxiliary purposes because the transportation of crude oil for other enterprises was the core activity of the taxpayer's business. (IBFD, 2013h).

In conclusion, although the definition of a permanent establishment in the Germany and Netherlands Tax Treaty applicable in this above mentioned case, is different from the definition provided in the OECD Model, this case is consider to be an authority for purposes of both definitions (Olivier & Honiball, 2011: 338).

In relation to the element of 'place of business' this also covers both the property and other tangible assets used by the enterprise for carrying on the business. In certain circumstances, even one tangible asset can be considered sufficient (Vogel, 1997: 285).

Neither the OECD Model nor the OECD Commentary defines the term 'place of business' (IBFD 2013a: 4). The OECD Commentary provides that a 'place of business' includes any premises, facilities or installations used to carrying on the business of the enterprise whether or not they are used exclusively for that purpose (OECD, 2010: 93). Further, the size of the premises and equipment required to constitute a place of business depends on the nature of the business. It is irrelevant whether the premises is rented or owned. Further, the place of business may even be situated in the business facilities of another enterprise. (OECD, 2010: 93).

The specific inclusions listed in Article 5 paragraph 2 of the OECD Model, are regarded as sufficient to constitute a permanent establishment and include the following:

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop, and

f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

This list is not exhaustive and varies from treaty to treaty where some treaties add or substitute further examples. (Olivier & Honiball, 2011: 337).

A further in depth analysis of the above mentioned inclusions will be provided in 'Permanent Establishment Inclusions'.

Having regard to the above aspects required for a 'place of business' it appears that the OECD Commentary wishes for the 'place of business' test to be substantive as opposed to formal. The physical element and factual details of the taxpayer is crucial to the determination of a permanent establishment rather than the legal connection to the taxpayer. (IBFD, 2103a: 5).

Fixed

Following from the first requirement, the 'place of business' must be 'permanent' or 'fixed' in both time and place in order to be considered a permanent establishment (IBFD, 2013a: 7). There must be a connection between the place of business and a specific geographical position (OECD, 2010: 94). The facility does not need to be an integral portion of the plot of land on which it stands (Vogel, 1997: 286).

There are two main components to be met for a 'place of business' to be 'fixed', these include:

1 a specific geographical position has to exist, i.e. the location test sometimes referred to as the 'situs' test; and

2 a certain degree of permanence must exist at each geographical position, i.e. the duration test sometimes referred to as the 'nexus' test. (Olivier & Honiball, 2011: 337).

Location Test

The location test requires that the place of business is fixed or permanent in terms of place or locality. Therefore it can be considered that the place of business must be 'fixed', or connected to the soil. The location test therefore reinforces and complements the 'place of business' requirement. (IBFD, 2013a: 7). Further to this, the size of the premises and equipment necessary to constitute a place of business depends on the nature of the business (Olivier & Honiball, 2011: 336).

The traditional point of view was that the place of business has to be fixed to the soil, however today it is accepted that the place of business does not have to be actually fixed to the soil and that where a certain place is available for the performance of a business activity is sufficient, for example a market place (Skaar, 1991: 126). The OECD Commentary provides that it is immaterial how long a business of a Contracting States operates in the other Contracting State, if it does not operate from a distinct place, however this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. The OECD Commentary confirms that it is sufficient that the equipment remains on a specific site. (OECD, 2010: 94).

Vogel states, that a relationship or a connection to a geographical area as opposed to a fixed point, will be sufficient to create a permanent establishment if the activity is regularly repeated over a long period of time in the same location, if the work is being performed for the same principle as parts of one project, or if particularly large or complex equipment is used for example drilling rigs (Vogel, 1997: 286).

Therefore the fixed location test requires that the place of business is located at a specific, constant geographical place within the taxing jurisdiction of the candidate permanent establishment state. This will therefore satisfy the OECD Commentary's requirement that a link has been created between the place of business and a specific geographical point. (IBFD, 2013a: 7).

A strict understanding of the location test may imply that the place of business cannot move or be moved, however the OECD chose not to take this strict approach as it seemed too limiting on source jurisdictions' taxing rights (IBFD, 2013a: 7).

In certain circumstances there are places of business that, by nature, are not connected to the soil as well as certain places of business which are beneath the surface of the soil for example, mines or beneath the seabed for example, fixed drilling rigs. It is clear that both these examples of places of business, still satisfy the fixed place of business requirement. (IBFD, 2013a: 7).

In some instances the nature of the business activities carried on by an enterprise are such that the activities are often relocated between various locations which may make it difficult to determine whether there is a single place of business. The single place of business will generally be considered to exist where, in light of the nature of the business; a particular location within which the activities are moved, may be identified to represent a coherent whole commercially and geographically in relation to that business. (OECD, 2010: 94).

When applying the 'location test' it is vital that the nature of the business concerned is understood and that the business commercially and geographically consists of a coherent whole (Olivier & Honiball, 2011: 338).

Duration Test

As mentioned above, the place of business must be 'fixed' from a specific geographical position as well as have a certain degree of permanence which must exist at such geographical position (Olivier & Honiball, 2011: 337). The 'duration test' deals with the time element in the requirement that a permanent establishment must be 'permanent' (IBFD, 2013a: 13). Vogel states,

> 'The term 'fixed' implies that a certain length of time is required for such business activities. The place of business must have been designed to serve the enterprise with a certain degree of permanence rather than merely temporarily.' (Vogel, 1997: 287 - 288)

There is no certain rule on the amount of time that must pass before a place of business becomes 'fixed' and this often depends on the nature of the business activities. It is however immaterial how long the business operates in another country if the business does not operate from a distinct place i.e. the location test must be satisfied. (HMRC, 2013).

The term 'permanent' should not be understood as 'everlasting' because even in the case of complex building sites and natural resource extraction, which may last for many years, their existence is always limited to the time it takes to complete their goal. (IBFD, 2013a: 13).

In the South African court case, *Transvaal Associated Hide and Skin Merchants v CIT (Botswana)*[2], the word 'permanent' in 'permanent establishment' is used in contradiction to merely a temporary use of premises for purposes of trade (Olivier & Honiball, 2011: 339).

Having regard to the *Transvaal Associated Hide and Skin Merchants v CIT (Botswana)*[3], the activity of curing the hides was performed at rented premises which were made available to the

[2] *Transvaal Associated Hide and Skin Merchants v CIT* (Botswana), 1967 BCA, 29 SATC 97.
[3] *Transvaal Associated Hide and Skin Merchants v CIT* (Botswana), 1967 BCA, 29 SATC 97.

South African resident taxpayer in Botswana. The shed was initially placed at the disposal of the South African resident by the abattoir authorities in consideration of a fixed fee. It was held, that the processes carried out in Botswana in preparing the hides for sale and delivery were the dominant factors in the accrual of the South African taxpayer's income derived from the sales of the hides affected in South Africa and the source of that income was therefore to be found in Botswana. Maisels JA stated:

> 'It is to my mind clear that the activities of the appellant went beyond the mere purchase of goods or the storing of goods in a warehouse for the convenience of delivery. As to whether the appellant had a permanent establishment in Botswana, I think the word 'permanent' is used in contradistinction to a merely temporary or occasional use of premises for purposes of trade or business. So looked at, the fact that since 1954 the appellant occupied a shed at a rental first established by way of a premium on the hides purchased by it, and since 1961, at a rental of R1 200 per annum, establishes, to my mind, that the appellant's occupation of the premises was not temporary or occasional, but was permanent.'

The decision was based on the fact that the taxpayer's regular occupation of the shed at an annual rental, proved that its occupation of the premises was permanent and not temporary or occasional and could be regarded as continuing indefinitely (Olivier & Honiball, 2011: 339).

As mentioned above there are no certain rules about the amount of time that must pass before a place of business becomes 'fixed', also the practise of the different OECD Member States are not consistent in so far as time requirements are concerned (HMRC, 2103), the OECD Commentary (2010) in relation to Article 5 paragraph 1 states that experience has generally revealed the following with regard to degree of permanence:

- where the business is carried on for less than six months, a permanent establishment normally would not exist;
- where the business is carried on for a period of longer than six months, but less than twelve months, a permanent establishment possibly exists; and
- where a business is carried on for a period of longer than twelve months, a permanent establishment is likely to exist. (Olivier & Honiball, 2011: 338 - 339).

In addition, paragraph 6 of the OECD Commentary on Article 5 provides two exceptions to the above mentioned general rule (Olivier & Honiball, 2011: 339). The first exception relates to where the business activities are of a recurrent nature. In such case, each period of time which the place is used must be considered in combination with the number of times which that place has

been used. This may extend over a period of a year. (HMRC, 2013). Seasonal and recurrent activities may trigger a permanent establishment for a foreign enterprise. The treatment of seasonal and recurrent business is different from the treatment of an otherwise continuous business that is unusually interrupted. (IBFD, 2013a: 14). Skaar states that interruptions are considered working time and are not examples of the seasonal use of a place of business. It is irrelevant whether the interruptions are seasonal, for example weather conditions, or as a result of temporary shortage of materials, or the occurrence of a strike. (Skaar, 1991: 225).

The second exception relates to where the business activities are carried out exclusively in the source country, where even though the business may carry on for a short duration as a result of its nature, since it is wholly carried out in that country, the connection to that country is stronger, therefore giving the source country the right to tax the income. (Olivier & Honiball, 2011: 339). Temporary breaks of business activities do not cause the permanent establishment to cease to exist (HMRC, 2013).

It is important to note that where a place of business is initially set-up to be used for a short period of time so as not to create a permanent establishment but in fact remained in existence for such period of time that it can no longer be considered temporary, the 'place' will constitute a fixed place of business and can thus retrospectively be a permanent establishment (HMRC, 2013).

The duration test is calculated from the time the activities start in the place of business, regardless of the nature of the activities, however the duration cannot be calculated before the place of business itself is in place. The time stops when the business terminates its business activities that are conducted through the place of business, otherwise a permanent establishment will cease to exist if one of the other tests is no longer satisfied. (IBFD, 2013a: 14).

Right of use

The purpose of the 'right of use' usually implies that the facilities are at the disposal of the business (Farmer & Hoare, 2011) and the mere presence of an enterprise at a specific location does not necessarily mean that that location is at the disposal of the business (OECD, 2010: 93), further Vogel states that the fixed place of business must be more than just temporarily at the business' disposal (Vogel, 1997: 286). Although no formal legal right of use to a particular location is required for a place to constitute a permanent establishment (OECD, 2010: 93) the right of use test is satisfied when the business has a legal right to use the place of business as an owner or a lessee. In addition, the right of use test will also be satisfied in the case where the business does not have the exclusive right to use the premises. (Skaar, 1991: 157). This could

arise where a business carries on their activities from the premises of another business and has space put at its disposal (Farmer & Hoare, 2011).

The right of use test is deliberated in the Indian court case, *Rolls Royce Plc. v DIT*[4]. The taxpayer, a United Kingdom tax resident company, Rolls Royce Plc, was engaged in the business of supplying parts and equipment to its customers in India (Mehta, 2013a). A subsidiary of Rolls Royce Plc, Rolls Royce India Limited, a United Kingdom tax resident company, had a representative office in India that provided support services to Rolls Royce Plc including developing business in India as well as providing technical support. Rolls Royce India Limited was compensated by Roll Royce Plc for the services provided as well as the maintenance costs associated with maintaining the office facilities in India. Further to the above mentioned services performed by Rolls Royce India Limited, employees of Rolls Royce Plc made frequent visits to India and used the offices which were maintained by Rolls Royce India Limited. (Farmer & Hoare, 2011).

The Indian Income Tax Appellate Tribunal found that Rolls Royce Plc had created a permanent establishment in India in terms of Article 5 paragraph 1 of the India and United Kingdom Income Tax Treaty (1993) by virtue of a having a fixed place of business, i.e. Rolls Royce Plc had a right of use of the Rolls Royce India Limited premises in which to carry on its business. (Farmer & Hoare, 2011).

Carry on a business (business connection or business activities)

Following from the basic permanent establishment definition requirements, the enterprise must wholly or partly carry on the business of the enterprise through this fixed place of business (OECD, 2010: 92) as a permanent establishment cannot exist unless the foreign enterprise is engaged in business activities. The mere physical presence in a foreign jurisdiction will not be considered sufficient to tax that company even if such physical presence is permanent. (IBFD, 2013a: 8). A permanent establishment must have a productive character; i.e. must contribute to the profits of the enterprise (OECD, 2010: 92).

Further to this, if the business activities are conducted 'though' a fixed place of business this may trigger the creation of a permanent establishment. These business activities need to be relatively significant in relation to the nature of the business of the enterprise because Article 5 paragraph 4 indicates that auxiliary or preparatory activities are not enough to trigger a permanent

[4] *Rolls Royce Plc. v Deputy Director of Income Tax*, (30 August 2011), Income Tax Appeal No. 493.2008. (Income Tax Appellate Tribunal (Delhi)).

establishment however the activities do not have to include any human presence or effort. (IBFD, 2013a: 8). The type of business that the enterprise is engaged in is irrelevant and the place of business does not need to even contribute directly to the profits of the enterprise. All the business must do is to serve the enterprise's overall purpose through an 'activity'. The 'activity' performed in the fixed place of business cannot be the mere transportation of oil or similar product through a pipeline nor the conduction of electricity through cables as these examples would not qualify as 'activities' and would therefore not create a permanent establishment. This is however not considered the case where fully automated pumping stations and similar facilities operate within the Contracting States. (Vogel, 1997: 289). This aspect is dealt with above in relation to the pipeline case.

Having regard to the above requirement, the carrying on of the business activities are not considered to be sufficient activities if they are to be preparatory or auxiliary in nature. This aspect is clearly discussed in the Indian case of *K.T. Corporation v Director of Income Tax*[5]. K.T. Corporation, the taxpayer, was a company incorporated and tax resident in Korea and had set-up a Liaison Office in India to facilitate communication between the taxpayer's head office in Korea and relevant Indian companies. A Liaison Office has strict statutory provisions set out by the Reserve Bank of India also, even though the Liaison Office may be a fixed place, the business activities conducted by the Liaison Office are restricted to preparatory or auxiliary activities only. In the above case, the Liaison Office performed the following activities for K.T. Corporation (i) arranging seminars, conferences, (ii) receiving trade enquiries from customers, (iii) advertising for K.T. Corporation and (iv) collecting feedback from prospective customers, trade organizations and so forth. Thus the court held that the services and work performed by the Liaison Office qualified as preparatory and auxiliary in nature and in terms of the India and Korea Income Tax Treaty (1985) the Liaison Office cannot be said to have created a permanent establishment. (KPMG, 2009).

Contrary to the K.T. Corporation matter, the *Jebon Corporation India Liaison Office* v *Deputy Director of Income Tax*[6], the taxpayer, a company incorporated and tax resident in Korea established a Liaison Office in India with the approval of the Reserve Bank of India (IBFD, 2013l) The Liaison Office was involved in promoting, marketing and sales of electronic components such as printed circuit boards and liquid crystal displays, in addition the Liaison Office engineers were identifying potential clients on the basis of their past sales experience (KPMG, 2009).

[5] *K.T. Corporation v Director of Income-tax* (2009-TIOL-12-ARA-IT).
[6] *Jebon Corporation India Liaison Office v Deputy Director of Income Tax*, (30 April 2009) Income Tax Appeal Number No. 1106/Bang/08 (Income Tax Appellate Tribunal).

Subsequently, the Indian tax authorities surveyed the premises of the Liaison Office and identified that the Liaison Office was engaged in commercial activities and the Liaison Office had full autonomy in its operations (IBFD, 2013l). Having regard to the fact that the Liaison Office was allowed to carry out any activity which was of a trading, commercial or industrial nature (IBFD, 2013l) the Indian tax authority held that the Liaison Office had created a permanent establishment in India for the taxpayer (KPMG, 2009).

The Income Tax Appellate Tribunal held that the Liaison Office was a permanent establishment in India for the Korean taxpayer in terms of Article 5 of the India and Korea Income Tax Treaty (1985), which states that a 'permanent establishment', means a fixed place of business through which the business of the taxpayer was wholly or partly carried on (IBFD, 2013k) by the Liaison Office in India (IBFD, 2013l). The Income Tax Appellate Tribunal found that the Liaison Office was performing a portion of the trading activity in respect of supplies made to Indian customers which therefore continued the trading activity of the taxpayer i.e. there was a 'business connection' in India and therefore the income arising from such business connection should be subject to tax in India. In addition, the Income Tax Appellate Tribunal found that the business activities carried out by the Liaison Office could not be classified as preparatory or of an auxiliary character because the Liaison Office had full autonomy in its operations. (IBFD, 2013l).

Accordingly, the Income Tax Appellate Tribunal allowed the appeal of the Indian tax authority and concluded that the Liaison Office was a permanent establishment in India on account of the trading activities carried on by it (IBFD, 2013l).

Normally a Liaison Office will not constitute a permanent establishment in India as long as the activities performed are auxiliary or preparatory, however as identified in the case of *Jebon Corporation India Liaison Office v Deputy Director of Income Tax*[7], a Liaison Office will be considered to constitute a permanent establishment where the business of the taxpayer is wholly or partly carried on (IBFD, 2013k) by the Liaison Office in India (IBFD, 2013l).

When considering the third requirement of a permanent establishment Olivier and Honiball make reference to Skaar who states that an important feature of the 'place of business' is that the purpose of the 'place of business' must be to serve the business activity and not to be subject to business activities (Olivier & Honiball, 2011: 340). Further to this, Vogel adds that the place of business

[7] *Jebon Corporation India Liaison Office v Deputy Director of Income Tax*, (30 April 2009) Income Tax Appeal Number No. 1106/Bang/08 (Income Tax Appellate Tribunal).

must have been designed to specifically serve the enterprise with a certain degree of permanence as opposed to being merely temporarily (Vogel, 1997: 288).

Mainly the business of an enterprise is carried on by the entrepreneur or persons who are in a paid-employment relationship with the enterprise, however the OECD Commentary states that a permanent establishment may exist if the business of the enterprise is carried on mainly though automatic equipment. Therefore to determine whether a permanent establishment will exist where employees of the company set-up or install gaming or vending machines in a foreign jurisdiction will depend on whether the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment will not be triggered where the enterprise sets up the machines in the foreign jurisdiction and then leases the machines to another business however, a permanent establishment may exist where an enterprise sets up the machines and also operates and maintains them for its own account. (OECD, 2010: 98). It is illustrated in the above example that in certain instances the presence of individuals may be required for the set-up of the permanent establishment however their on-going presence is not required (Olivier & Honiball, 2011: 340).

The permanent establishment will come into existence from the moment the enterprise commences to carry on its business through such fixed place of business. The period of time during which the fixed place of business itself is being set-up by the enterprise will not be included in the duration of the permanent establishment's existence as long as the activities differ significantly from the activity which the place of business will serve permanently. The permanent establishment will come into existence once the enterprise has prepared, at the place of business, the activity for which the place of business is to serve permanently. The permanent establishment will cease to exist upon the disposal of the fixed place of business or with the cessation of any activities through it, this will include when all acts and measures connected with the business activities of the permanent establishment are terminated. Temporary interruptions cannot be regarded as closure or termination of the permanent establishment. (OECD, 2010: 96).

Permanent Establishment Inclusions – The 'Positive List'

Article 5 paragraph 2 of the OECD Model lists specific inclusions that will constitute a permanent establishment (IBFD, 2013a: 5).

> 'The term 'permanent establishment' includes especially:
>
> a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop, and

f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.' (OECD, 2010: 24).

This list, referred to as the 'positive list', consists mainly of places of business (Skaar, 1991: 113). Article 5 paragraph 3 is said to give substance to the basic permanent establishment concept (Vogel, 1997: 295).

This Article has universally been interpreted to mean that any of the above mentioned will automatically trigger permanent establishment treatment. This Article states that the items listed will constitute a permanent establishment and can be understood to eliminate the enquiry of the general definition provided in Article 5 paragraph 1 (IBFD, 2013a: 5).

The OECD takes the view that the terms listed in Article 5 paragraph 2 still need to be interpreted in a manner that will ensure that all the other 'tests' will be met before the permanent establishment treatment will be triggered (IBFD, 2013a: 5). Skaar confirms that the other requirements have to be met, such as the taxpayer has to have right of use to the place of business and perform a business activity through it (Skaar, 1991: 113).

It is important to bear in mind that although the above list does provide 'places of business' a permanent establishment does not exist until other conditions of Article 5 paragraph 1 are met (Skaar, 1991: 113). In other words, a place of business expressed in the 'positive list' cannot constitute a permanent establishment unless it meets the requirements of the general permanent establishment definition provided under Article 5 paragraph 1 (Vogel, 1997: 295).

This Article will now be analysed under the following sub-headings:

The place of management

As mentioned above the place of management must still meet the requirements under the basic rules (Skaar, 1991: 116).

A 'place of management' is a place where the business of the enterprise is wholly or partly conducted. Business decisions which are taken at the place of management must be significant to

the business as a whole. (Vogel, 1997: 296). The performance of business activities or ownership of property does not qualify for a 'place of management' but rather, the place of management must have the authority to make important decisions. (Skaar, 1991: 117).

The branch

The term branch is usually used to accentuate the fact that a place of business is unincorporated (IBFD, 2013a: 5). A branch is a legally dependent division of an enterprise however it has a certain degree of economic and commercial independence to carry on the business of the enterprise. The activities of the branch are not limited to a preparatory or auxiliary nature. A branch will maintain its own separate books and records. (Vogel, 1997: 297).

In most jurisdictions a permanent establishment will need to be formally registered in order to be recognised. A permanent establishment will typically be registered under the corporate identity of a branch or representative office. (High Street Partners, 2012).

The office

An office is defined in The Oxford English Dictionary (2013)

> '1. A room, set of rooms, or building used as a place of business for non-manual work;'

There is not much information written about the application of an office qualifying as a permanent establishment however, Vogel states that an 'office' signifies a facility that is used for handling the administrative side of the business and that requires neither any degree of independence nor any particular internal organisation (Vogel, 1997: 297).

Factories and workshops

A factory and a workshop is a facility where goods are manufactured or processed. Similarly to the other facilities listed in the positive list a factory and a workshop need to satisfy the requirements as defined under the basic permanent establishment list. (Vogel, 1997: 297 - 298).

Mine, an oil or gas well, a quarry or any other place of extraction of natural resources

A mine, an oil or gas well, a quarry or any other place of extraction of natural resources will also only qualify as a permanent establishment upon satisfying the general requirements under the basic permanent establishment definition. The term 'place of extraction of natural resources' includes solid, liquid and gaseous substances extracted for commercial purposes and is also inclusive of all forms of on-shore and off-shore extraction. (Vogel, 1997: 289). Skaar states that the mere ownership of a place of extraction of natural resources is not enough for a permanent

establishment status and only if the taxpayer pursues the extraction business through the place will the place of extraction of natural resources constitute a permanent establishment. (Skaar, 1991: 119).

Permanent Establishment Exceptions – The 'Negative List'

Paragraph 4 of Article 5, lists a number of business activities which are regarded as exceptions to the general definition of a permanent establishment, even if these activities are carried out through a fixed place of business. The common feature of these activities is that they are all considered to be preparatory or auxiliary in nature. (OECD, 2010: 101). These activities are often referred to as the 'negative list' and are not exhaustive (Skaar, 1997: 279). The purpose of these exceptions is to carve out from 'business activities', certain specific non-core business activities and preparatory or auxiliary activities (IBFD, 2013: 9). This exemption is justified by the difficulties of determining the attribution of profits from such minor business activities. (Skaar, 1997: 279).

Article 5 paragraph 4 of the OECD Model states the following:

> 'Paragraph 4 notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
>
> a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
>
> b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
>
> c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
>
> d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
>
> e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
>
> f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. (OECD, 2010: 25).

The business activities of the fixed place of business must in itself form an essential and significant part of the business activities of the enterprise as a whole, if the activities cannot be

said to form an essential part of the business activities as a whole then these activities will be considered to be preparatory or auxiliary in nature. For example, where the activities of the fixed place of business are identical to that of the whole enterprise, such activities, will be considered to be core business activities. (OECD, 2010: 102). IBFD goes further to clarify that the business activities performed by the fixed place of business that will trigger a permanent establishment must be the core, central, significant and traditional business activities (IBFD, 2013a: 9).

In the instance that an excluded activity is combined with a core business activity performed through the same place of business, it can be said to have triggered a permanent establishment. (Skaar, 1997: 280).

Having regard to the above and in relation to the recent Russian case, *Case N#40-58575/11-129-248*[8], 2 August 2012 of the Federal Arbitration Court, the taxpayer, a Swiss company incorporated and tax resident in Switzerland performed import and export activities of machinery, medicine and dental systems which were sold in Russia. The taxpayer registered a representative office in Russia which only carried out the above mentioned activities in Russia. The Russian tax authority considered that a permanent establishment was created by activities of the representative office in Russia. The Russian tax authority had regard to the OECD Commentary of Article 5 paragraph 4 which provides that if the main purpose of the permanent place of business is similar to the main purpose of the taxpayer's company outside of Russia then such permanent place of business should not be treated as carrying out auxiliary and preparatory activities.

The Federal Arbitration Court was in agreement with the Russian tax authority that the representative office had created a permanent establishment as a result of the fact that the representative office carried out regular business activities in Russia because the director and the accountant, of the representative office were entitled to sign and execute all the contracts and invoices on behalf of the taxpayer. The Federal Arbitration Court held that the activities of the representative office were not auxiliary and preparatory in nature considering that the activities of the representative office were identical to the main activities. (IBFD, 2013m).

Machinery and equipment

When deliberating the practical aspects of identifying a permanent establishment, machinery and equipment pose an interesting case. Machinery and equipment lack the classical business 'premises', of bricks and mortar or cement that symbolises the traditional places of business. Although machinery and equipment are not listed in the 'positive list' of Article 5 paragraph 2

[8] *Case N #40-58575/11-129-248*, 2 August 2012 (Russian Federal Arbitration).

machinery and equipment are however specifically referred to in the OECD Commentary as the existence of a 'place of business'. (IBFD, 2013a).

In general the practise differs from jurisdiction to jurisdiction but normally significant machinery and equipment may be considered a 'place of business' as opposed to light, portable machinery or equipment which will not be considered a 'place of business'. For example, drilling rigs, significant vehicles, ships or aircraft, which are similar to business premises and are not being contained within other business premises, are usually considered to be places of business. In additional, the determination whether the machinery or equipment are "fixed" would be particularly important. (IBFD, 2013a).

A 'place of business' can be immovable property for example real estate and property of all kinds but may also arise from movable property such as machinery and equipment (Skaar, 1991: 120). The OECD Commentary explains that the existence of a 'place of business' will arise if certain conditions are met of which the OECD Commentary specifically mentions 'in certain instances, machinery and equipment' (OECD, 2010: 92). Skaar comments that the use of the term 'certain instances', implies reservations in the commentaries and suggests that this statement should probably be understood to mean that only machinery and equipment of a certain significance can be considered a 'place of business' (Skaar, 1991: 120).

The activities do not need to be performed by a human being and a permanent establishment can be created by machinery and equipment as long as the enterprise is carrying on business activities beyond the mere installation of such (Vogel, 1997: 290).

Electronic commerce – E-commerce

Introduction

Electronic commerce or e-commerce has the potential to be one of the biggest economic developments of the 21st century. This new way of doing business is based on the recent improvement and developments of information and communication technologies and can open up a number of opportunities to improve global quality of life and economic well being. (OECD, 1998).

There is no one definition for e-commerce or e-business however it may be defined as performing business activities through electronic information and communication technologies and/or selling electronic products. This may include connecting the value chains between businesses in order to improve sales and services efficiencies, reduction of costs, creating new distribution channels or even creating entirely new markets. This can facilitate centralisation and integration of the

business whereby multinational corporations can regionalise their sales and marketing functions and globalise manufacturing and research and development activities. (IBFD, 2013n).

E-commerce comprises the electronic sale by online stores of downloadable merchandise which can be referred to as 'soft merchandise' which includes music, e-books, e-newsletters, photos and video recordings, software and documents (direct e-commerce), electronic ordering of tangible products (indirect e-commerce), online securities transactions as well as the provision of financial or other services. In addition e-commerce includes the subscription to and use of an internet service provider or online service provider, and also includes electronic data interchange, electronic fund transfers and all credit and debit card activity. E-commerce facilitates transactions between both businesses as well as between businesses and the consumer. (Chetcuti, 2002).

Without hindering the development of the new technologies, tax administrations throughout the world, face the formidable challenge of protecting their revenue base (Rao, 2003). E-commerce presents a major challenge for tax administrations because of the multi-jurisdictional nature of the transaction and the potential anonymity of the parties (Pinsent Mason, 2013). Under the common threat (OECD, 1998) numerous governments and fiscal organisations and institutions (for example, the OECD) have focused on addressing the issue in a spirit of collective co-operation (Rao, 2003) and the first reaction was to retain the existing concepts of tax and attempt to apply them to the new challenges (IBFD, 2013n). Under the direction of the OECD, discussions between OECD member states, business and non-OECD members took place to consider, amongst other things, the international tax implications as a result of e-commerce and to determine how to apply the current rules of tax to the taxation of business profits, the characterisation of payments related to e-business transactions and the concept of permanent establishment. (IBFD, 2013n).

The OECD takes the view that the general requirements of a permanent establishment must be satisfied and provides that a distinction needs to be made between computer equipment which may be set-up at a location and the data and software which is used by or stored on the equipment. For instance, a website which is composed of both software and electronic data, does not in itself constitute tangible property and therefore does not have a location that can create a 'place of business'. In relation to the above mentioned requirements a facility such as premises' or in certain circumstances machinery or equipment can constitute a 'place of business', however an internet website composed of software and electronic data does not have a location in order to satisfy this requirement. Alternatively, the server on which the website is stored, is equipment and this server will have a physical location which may constitute a 'fixed place of business'. The distinction between the website and the server is important because the business which operates

the server may be different to the business that carries on business through the website. Although, the website company which carries on their business through the website will pay a fee to the internet service provider which hosts the server, it does not necessarily mean that the server and its location are at the disposal of the website and as a result the website will not be considered to have a physical presence at the location of the server as the website is not tangible. Alternatively, in the case where the enterprise which carries on their business through a website owns or leases the server and operates the server on which their website is stored and used then such server will be considered to be at the enterprises disposal and where that server is located could create a permanent establishment for the enterprise if the other requirements of Article 5 paragraph 1 are satisfied. (OECD, 2010: 111).

A server will need to be located at a certain place for a sufficient period of time in order to constitute a fixed place of business. In addition, it would need to be determined whether the business of the enterprise is wholly or partly carried on at such location where the enterprise holds equipment i.e. the server is at its disposal. (OECD, 2010: 111).

Computer equipment based at a fixed location may constitute a permanent establishment even in the case where no personnel of the enterprise are required to operate the computer equipment from such fixed location; therefore the presence of personnel is not required to determine whether the computer equipment is wholly or partly carrying on the business of the enterprise. This conclusion specifically applies to electronic commerce and other machinery which operates automatically. (OECD, 2010: 111).

In addition, a permanent establishment cannot exist where the electronic commerce operations which are carried on through the computer equipment at a fixed location are restricted to auxiliary and preparatory activities. Such services specifically include:

- providing a communication link i.e. a telephone line between the supplier and the customers;
- advertising goods or services;
- transmitting information through a mirror server for security and efficiency purposes;
- gathering market information for the enterprise; and
- supply of information.

In the case that the activities form an essential and significant part of the business activities of the enterprise as a whole or where these core functions of the enterprise are carried on through the computer equipment, these activities may be considered to go beyond the auxiliary and

preparatory activities covered by Article 5 paragraph 4 and therefore if the equipment constitutes a fixed place of business of the enterprise a permanent establishment would be said to have been created. (OECD, 2010: 111 - 112).

Having regard to the recent developments, it could be said that there is a general move towards the introduction of a virtual permanent establishment concept. In 2012 Spanish Dell case, the concept of an 'online permanent establishment' was introduced for the first time. The Spanish court ruled that an online store could qualify as an online permanent establishment even though the server was located outside of Spain and no human activities were performed or assets located in Spain. In addition, the French government has announced that it intends to push digital economy related measures such as a virtual permanent establishment concept to be inserted in the OECD Model in order to target information technology giants like Google, Amazon and Facebook. This will link with the current work being performed in relation to base erosion and profit shifting being performed by the OECD Committee of Fiscal Affairs. (PWC, 2013b).

Intangibles

The 'tangibility' requirement is not decisive in all cases as this would result in the view that all intangible assets, which are of increasingly important and valuable assets could not be considered as places of business due to their lack of traditional physicality and local fixedness. In practise this is the likely result, for instance, the OECD Commentary clarifies that securities and bank accounts cannot be places of business. (IBFD, 2013a).

Software presents a more difficult case because software is usually used in conjunction with hardware and therefore the enterprise which uses the hardware or other physical elements such as offices, computers, and/or factories will have a permanent establishment and this will not be as a result of the software. It is important to note that the mere licensing of software in a foreign jurisdiction does not amount to a business activity through the flow of the digitised elements alone. (IBFD, 2013a).

Recent Developments

Tax authorities in various jurisdictions are taking more aggressive positions and companies are having to deal with a number of tax disputes. The change in the manner in which companies operate their businesses globally adds to this complexity and raises new questions which were not anticipated when the international tax law concepts were first establishment. (PWC, 2013b). In recent times it has been found that the manner in which cross-border activities take place has been significantly impacted by the free movement of capital and labour, the shift of manufacturing

basis from high-cost to low-cost location, the gradual removal of trade barriers, technological and telecommunications developments, and the ever increasing importance of managing risks and developing, protecting and exploiting intellectual property (OECD, 2013e: 7).

Globalisation however has increased trade and foreign direct investment in many countries which resulted in economic growth, the creation of jobs, the promotion of innovation and reduction of poverty (OECD, 2013e: 7). Having regard to the increasing interconnectivity of the world, it was identified that national tax laws were not keeping pace with global corporations, fluid capital and digital economies. This may result in tax loopholes which could be exploited by companies to avoid taxation in their jurisdictions of residence by moving activities abroad to low tax or no tax jurisdictions, the effect of this would undermine the fairness and integrity of tax systems. The response to this was the introduction of Base Erosion and Profit Shifting (commonly known as BEPS). The purpose of BEPS is to consider whether the current rules allow for the allocation of taxable profits to locations different from those where the actual business activity takes place. (OECD, 2013f).

In July 2013, at the request of the G20 Finance Ministers, the OECD launched an Action Plan on Base Erosion and Profit Shifting which identified 15 specific actions which need to be implemented in order to equip government with the domestic and international instruments to address BEPS. The OECD Action Plan recognises the importance of addressing the borderless digital economy and will develop a new set of standards to prevent double non-taxation. (OECD, 2013f).

7. CHAPTER 3: BUILDING SITE OR CONSTRUCTION OR INSTALLATION PROJECT PERMANENT ESTABLISHMENT DEFINITION

Article 5 paragraph 3 of the OECD Model expressly separates the building site or construction or installation project permanent establishment from the general permanent establishment definition.

Article 5 paragraph 3 provides a special rule for building sites, construction and installation which is probably best seen as a limitation on the general provisions in Article 5 paragraph 1 (Baker, 2012: 5-2/1).

Article 5 paragraph 3 of the OECD Model states,

> 'a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.' (OECD, 2010: 25).

According to Rohatgi, Article 5 paragraph 3 is a *lex specialis* and therefore overrides the basic rules provided under Article 5 paragraph 1 of the general permanent establishment definition. Article 5 paragraph 3 replaces the permanence test specified in Article 5 paragraph 1 with a 'duration test'. (Olivier & Honiball, 2011: 343). In an important Dutch decision taken by the Supreme Court on 9 December 1998, *BNB 1999/267c**, VN 1998/60.5[9], it was decided that a building or construction project only needs to fulfil the twelve month requirement laid down in the Netherlands tax treaty with Germany. The court further held that the requirements provided in the basic permanent establishment definition do not need to be fulfilled. (IBFD, 2013d: 25). This is further reiterated by Baker that the OECD Commentary to Article 5 paragraph 3 does not contain wording which indicates that the basic definition permanent establishment requirements of Article 5 paragraph 1 must be fulfilled as specifically mentioned in Article 5 paragraph 2 of the OECD Commentary (Baker, 2012: 5-2/1).

The OECD Commentary states that a building site or construction or installation project will constitute a permanent establishment if it last for more than 12 months, however any of those items which do not meet the condition of twelve months does not in itself constitute a permanent establishment even where construction activities are performed within an installation, as listed in the positive list, for instance an office or a workshop. (OECD, 2010: 99). This aspect is applied in the Indian court case of *BKI/HAM V.O.F. C/O Arthur Anderson & Co. v Additional*

[9] *BNB* 1999/267c*, VN 1998, at 5145 (Hoog Raad Supreme Court).

Commission of Income Tax[10]. BKI/HAM V.O.F. C/O Arthur Anderson & Co., the taxpayer, was resident in the Netherlands for tax purposes and entered into a sub-contract agreement with another foreign company for the dredging of a trench for a pipeline project. On 16 December 1993, the taxpayer imported the required dredging equipment into India and established a project office on site. The project office was closed down and the dredging equipment removed from India on 8 June 1994 i.e. the project lasted approximately 5 months and 24 days. In addition, the taxpayer established a 'support office' in Mumbai. (Mehta, 2013b). In terms of Article 5 paragraph 3 of the India Income and Capital Tax Treaty (as amended through 2012) with the Netherlands, a building site or construction, installation or assembly project will constitute a permanent establishment only where such site or project continues for a period of more than six months (IBFD, 2013f). Having regard to the India and Netherlands Income and Capital Tax Treaty, the taxpayer was of the view that they did not have a permanent establishment in terms of Article 5 paragraph 3 (Mehta, 2013b).

The Indian tax authority took the position that the taxpayer had a fixed place permanent establishment in India, in terms of the positive list, provided in Article 5 paragraph 2 subparagraph (c) of the treaty, as a result of the project office and support office that the taxpayer had set-up in India. The Indian tax authority held that it was therefore not necessary to deliberate the provisions of Article 5 paragraph 3 of the treaty. (Mehta, 2013b).

In the first appeal, the Commissioner of Income Tax (Appeals) held against the taxpayer based on the above position however the Income Tax Appellate Tribunal held that the taxpayer in fact did not have a permanent establishment in India. (Mehta, 2013b).

The Income Tax Appellate Tribunal reached their conclusion on the basis that the project office on site came into existence on 27 December 1993 when dredging commenced, the project office was closed on 8 June 1994 and by 12 June 1994, all the taxpayer's plant and machinery were completely demobilised, therefore the project did not exceed the 6 month requirement in terms of Article 5 paragraph 3 of the treaty. (Mehta, 2013b).

Further the Income Tax Appellate Tribunal disagreed with the Indian tax authority's argument that the taxpayer had a permanent establishment in terms of Article 5 paragraph 2 of the treaty on account of the support office and therefore no consideration was required in terms of Article 5 paragraph 3 of the treaty. The Income Tax Appellate Tribunal reiterated that Article 5 paragraph 3 is a specific provision which will override the general provision of Article 5 paragraph 1 and

[10] *BKI/HAM V.O.F. C/O Arthur Anderson & Co. v ACIT*, 849 (Income Tax Appellate Tribunal (Delhi) 8 November 1999).

paragraph 2. (Mehta, 2013b). As per the OECD Commentary, the taxpayer could not be said to have created a permanent establishment in India as a result of construction activities taking place in an office.

Duration Test

One of the most noteworthy features of Article 5 paragraph 3 of a modern tax treaty, is that the 'permanence test' of the basic rule provided under Article 5 paragraph 1 is replaced by a 'duration test' (Skaar, 1991: 343). A building site cannot be permanent and it is not intended to last for an uncertain period of time. A building site by its very nature is intended to be temporary and the most obvious difference from the basic rule is therefore the modification of the 'permanence test' of the basic rule (Skaar, 1991: 344).

The period of time necessary for the construction site to constitute a permanent establishment may vary from one jurisdiction to another, however 12 months is considered to be the standard. Tax treaties between developed and developing countries often apply a '6 month test' and in some cases a '3 month test' (Skaar, 1991: 344). Having regard to the OECD Model, 12 months is the minimum length of time a building site or construction or installation project must last in order to constitute a permanent establishment. A permanent establishment will be deemed to exist from the outset of the 12 month period rather than beginning to exist once the 12 months have passed i.e. the decisive point is whether the time limit was in fact exceeded. It is irrelevant to the duration test whether the activities carried on for more than one calendar year or one assessment period. In addition, the duration of the project should begin only when proper work has commenced as opposed to the outset of the preparatory work, therefore the signing of contracts and registrations are not part of the project and are not to be included in the calculating of duration. (Vogel, 1997: 307 - 308). This is however challenged in the OECD Commentary where the commentary provides that the site will exist from the date on which the contractor commences his work, including any preparatory work performed in the country where the intended construction is to be established for example the time taken for the erection of a planning office will be included in the contractors minimum time. (OECD, 2010: 100).

The duration period will cease to exist once the work is completed or permanently abandoned, and cannot be considered to have come to an end where work has in fact been temporarily interrupted. Seasonal and temporary interruptions must be included in the duration of the project or site. Seasonal interruptions include interruptions on account of bad weather and temporary interruptions can be caused by a shortage of materials or labour difficulties. (OECD, 2010: 100).

Additional unavoidable interruptions include personnel i.e. weekends off or leave, technical interruptions i.e. time needed for certain materials to dry. (Vogel, 1997: 309).

The twelve month test applies to each individual site or project and cannot be determined based on the time previously spent by the contractor on other sites or projects which are unrelated to the particular site. The building site must be considered a single site, even if it is based on a number of contracts, provided that it forms a coherent whole commercially and geographically. The building site must be considered a single unit even if contracts have been divided up into several parts each covering a period of less than twelve months and attributed to a different company which is owned by the same group or to subcontractors. (OECD, 2010: 100).

The aspect of multiple contracts is considered in the Indian court case, *Valentine Maritime (Mauritius) Ltd. v Assistant Director of Income Tax*[11]. Valentine Maritime (Mauritius) Ltd, the taxpayer, was a company incorporated and tax resident in Mauritius. The taxpayer was engaged in the business of marine and general engineering and construction work. During the relevant tax year under review by the Indian tax authority, the taxpayer concluded three different contracts in India. The details of the contract follow below:

- Contract A: Replacement of main deck with temporary deck which would continue for a period of 100 days;
- Contract B: Charter of hook up/accommodation barge; and
- Contract C: Charter of barge for power project which would continue for a period of 225 days.

The taxpayer argued that all the contracts should be considered separately. The duration of time spent for Contract A would not create a permanent establishment in India because the contract did not exceed the 9 month threshold (IBFD, 2013e: 60) as per the India and Mauritius Income Tax Treaty in Article 5 paragraph 2 subparagraph (i) (IBFD, 2013g: 4). Similarly the same was argued for Contract C. In addition, the taxpayer contended that the revenues from Contract B were not attributable to a permanent establishment and therefore not taxable in India. (IBFD, 2013e: 60).

The Indian tax authority disagreed with the taxpayer's position and held that there was no good reason to believe that the contracts would be considered individually on a stand-alone basis. The Indian tax authority concluded that the aggregate duration of all three contracts would exceed the

[11] *Valentine Maritime (Mauritius) Ltd. v Assistant Director of Income Tax*, (5 April 2010), Income Tax No. 1532/Mum/05 (Income Tax Appellate Tribunal).

9 month threshold. (IBFD, 2013e: 61). Aggrieved by the Indian tax authority's approach, the taxpayer appealed to the Commissioner of Income Tax (Appeals).

It was decided by the Commissioner of Income Tax (Appeals) that the income in question was neither taxable as business profits under Article 7 of the India and Mauritius income tax treaty, nor could the amounts be taxed as royalties (this is a separate issue which will not be dealt with in this research report). The Indian tax authority took the matter to the Income Tax Appellant Tribunal. (IBFD, 2013e: 61).

The Income Tax Appellant Tribunal held that the taxpayer did not create a permanent establishment in India in terms of Article 5 paragraph 2 subparagraph (i) of the India and Mauritius income tax treaty.

The Income Tax Appellant Tribunal based this decision on the two main observations (Mehta, 2103c). Firstly, the Income Tax Appellant Tribunal held that there were no findings by the Indian tax authority which implied that the three contracts concluded by the taxpayer in India were inextricably interconnected and interdependent so that they could be viewed as a coherent whole in conjunction with each other. (KPMG, 2010). Secondly, upon consideration of the actual activities to be performed in terms of each contract, it was clear that all three of the contracts were for three different purposes. (Mehta, 2013c).

In addition the Income Tax Appellant Tribunal held the following:

- For the purpose of determining the threshold for the duration test of a construction permanent establishment, it was not accurate to aggregate the time spent by the taxpayer on different unrelated project or sites.

- In addition, the duration of time cannot be aggregated merely based on the fact that the taxpayer carried out work for the same principal/customer or where work relating to different projects was performed in the same geographical area. Even, in the case that the said projects were:

  - commercially coherent in the sense that the projects were being performed for the same organisation directly or indirectly through a sub-contractor, and;

  - geographically coherent in the sense that the projects were being carried on in nearby locations.

It is not correct to aggregate such project's duration based on the above commercial and geographical instances.

- That the true test was based on the interconnection and interdependence of the contracts as well as the geographical proximity and commercial nexus. (Mehta, 2013c).

Subcontract

A particular problem is created by the relationship between the general contractor and the subcontractor, when attempting to identify the time spent by the general contractor. (Skaar, 1991: 346). The OECD Commentary provides that where a general contractor has undertaken the performance of a comprehensive project and subcontracts a portion of the project to a sub-contractor, the time spent by the sub-contractor in performing the sub-contracted portion of the project must be included as the time spent by the general contractor on the building project. The sub-contractor may in itself create a permanent establishment at the site if such activities last for a period of more than 12 months. (OECD, 2010: 100).

Relocation of Site

A building site or construction project usually has an indisputable location, for instance the location where a building is to be erected, however the construction of a road or the laying down of pipelines will not be performed at one specific location as the site will move as the work proceeds. The movement of the site will however not deprive the construction work of its fixed location in relation to the 'fixed place' requirement for a permanent establishment. (Skaar, 1991: 345).

The OECD Commentary provides that the very nature of a construction or installation project may require the relocation of the site, continuously or from time to time as the project progresses. The OECD Commentary reiterates in the instance where roads and canals are being constructed or pipelines are laid down or a substantial structure such as an offshore platform which is assembled at various locations within a jurisdiction and is moved to another location within the jurisdiction for final assembly will be considered to constitute a single project. (OECD, 2010: 101).

Building site or Construction

Skaar explains that a building site or construction or installation project consists of, in the broadest sense, all projects relating to the erection of buildings, the construction of roads, bridges and canals, the laying of pipelines and excavating and dredging (Skaar, 1991: 343). The OECD

Commentary specifies that a building site or construction or installation project includes renovations, however, such renovations must involve more than just the mere maintenance or redecoration of buildings (OECD 2010: 99). Further, building site or construction or installation projects, include not only the building or construction work specifically, but also all work necessary to complete the building or construction project, including related installation and assembly work. In addition, Vogel further provides that the building site or construction or installation project also includes demolition and clearing operations which do not need to necessarily be connected to a subsequent building or construction project. (Vogel, 1997: 306).

Installation project

An installation project is not limited to an installation in connection with a construction project but also includes the installation of new equipment i.e. a complex machinery to be installed in an existing building or outdoors (OECD, 2010: 100).

An installation project specifically refers to the putting together or grouping of prefabricated components, such as the erection of steel scaffolding or units of production. The final assembling of parts of movable objects is also covered by the term 'installation project'. (Vogel, 1997: 306)

When determining the minimum period which the installation or assembly project has existed one must take into account trial runs for testing the installed or assembled device. A trial run to ensure that the device is in good working order is an integral part of the delivery of an installation and forms part of its assembly. (Vogel, 1997: 308).

In the case of after sales service, a distinction must be made between services which are sufficiently connected to a building, installation or assembly works and auxiliary services subsequent to a fully completed assembly or installation project. In order to make such a distinction, the formal acceptance or delivery of the building works or installation can take place, this usually happens when the building work or installation has been completed and found to be free from defects. Therefore such repairs and maintenance works performed after such a formal acceptance or taking delivery cannot actually be said to be associated with the original building or installation works. In this instance the repairs and maintenance work performed will not be included when determining the duration of the project for a permanent establishment duration test. (Vogel, 1997: 308).

The determination of whether the repairs and maintenance services performed will constitute a permanent establishment is a separate matter (Vogel, 1997: 308).

Having regard to the Indian court case of *GIL Mauritius Holdings Ltd. v ADIT*[12], GIL Mauritius Holdings Ltd, the taxpayer, was a company incorporated and tax resident in Mauritius which had entered into a contract with an Indian consortium for the transporting and installation of a pipeline in an oil field which was located in an offshore area in India. The taxpayers used a vessel to move within the area of the oil field. The project lasted for just less than nine months and therefore the taxpayer did not consider themselves to have created a permanent establishment in India. (IBFD, 2013o).

The Indian tax authority concluded that the vessel which was at the disposal of the taxpayer had created a fixed place permanent establishment in India in terms of the general permanent establishment definition of Article 5 paragraph 1 of the India and Mauritius Income Tax Treaty (1992) and hence it was irrelevant whether the taxpayer had an installation permanent establishment in India in terms of Article 5 paragraph 2(i). (IBFD, 2013o).

The Income Tax Appellate Tribunal held that the taxpayer did not have a permanent establishment in India on account of the fact that the project did not last longer than the 9 month duration (IBFD, 2013o). The Income Tax Appellate Tribunal based their decision on the following facts:

- The putting together of pieces of a pipeline in a desired manner amounted to 'assembly' and therefore Article 5 paragraph 2(i) of the treaty applied;

- The Income Tax Appellate Tribunal rejected the Indian tax authority's approach that once the taxpayer had qualified to have a fixed place permanent establishment in terms of Article 5 paragraph 1of the treaty, the deliberation of Article 5 paragraph 2(i) of the treaty in relation to an installation/assembly permanent establishment was overridden. The Income Tax Appellate Tribunal's held that Article 5 paragraph 2(i) of the treaty specifically dealt with assembly/installation projects and therefore the existence of the taxpayer's permanent establishment must be examined under Article 5 paragraph 2(i) of the treaty. Therefore the Income Tax Appellate Tribunal held that the assembly project lasted for a period shorter than nine months and the taxpayer would not be said to have a permanent establishment in India. (IBFD, 2013o).

The above conclusion highlights the fact that installation and assembly projects will constitute permanent establishments for the taxpayer in the jurisdiction where the installation and assembly projects took place as long as the project lasts for the specified duration. In addition the case

[12] *GIL Mauritius Holdings Ltd. v ADIT*, (16 September 2011), Income Tax Appeal Number 5686 (Income Tax Appellate Tribunal (Delhi)).

highlights that the building site, construction or installation project provisions contained in the treaty will override the general permanent establishment provisions even in the case of an assembly or installation project.

Planning and Supervisory activities

Planning and management of a construction project will often be carried out but the general contractor himself, however it is not uncommon for that a construction project is separated into an 'intellectual' and a 'physical' portion. This is common in the case where a construction project is being carried out in a developing country which may be short of know-how. In such instances a domestic company will perform the physical part of the erection under the management or supervision of a foreign contractor that possesses the necessary know-how. (Skaar, 1991: 405).

There has always been some disagreement on whether the performance of supervisory service will constitute a permanent establishment. The German approach provides that supervision does not necessarily belong to the term 'construction' even if supervision is performed by the general contractor and thus supervision of construction work would, in all cases, need to be expressly stated in the treaty text. Contrary to the German approach other writers have applied a commercial approach, leading to the conclusion that intellectual construction activities must be included in the concept of construction. Therefore the question of whether planning and supervision activities will constitute construction work will depend on the text provided in the treaty. (Skaar, 1991: 405 - 406).

As noted above, the consideration of whether the mere planning and supervision of building works constitutes a permanent establishment is a moot point in terms of the OECD Model and OECD Commentary, however according to the OECD Commentary planning and supervision is included in the term 'building site or construction project' only if such activities are carried out by the general contractor himself. If planning and supervision activities are carried out by a separate enterprise i.e. not the general contractor, such activities will not be included in the term 'building site or construction project'. An enterprise which merely performs supervisory or planning activities could, at most, constitute a permanent establishment under the basic definition. (Vogel, 1997: 306).

Planning and supervision of construction work performed by the general contractor forms part of the general contractor's responsibility even if the physical work is performed entirely by another company or sub-contractor. (Skaar, 1991: 408).

8. CHAPTER 4: THE AGENCY PERMANENT ESTABLISHMENT DEFINITION

Dependent Agent

An important exception to the basic rule is the deemed permanent establishment that a dependent agent can trigger for its principal (IBFD, 2013a: 16). Article 5 paragraph 5 of the OECD Model stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it, even though the enterprise may not have a fixed place of business in that jurisdiction within the meaning of Article 5 paragraphs 1 and 2. The purpose of Article 5 is to provide, the state in which the agent will be carrying on the business activities on behalf of the enterprise, the right to tax. Persons whose activities may create a permanent establishment for the enterprise are so called dependent agents for example, persons (OECD, 2010: 105) (specifically includes individuals, companies or body-corporates) (Vogel, 1997: 330) whether or not employees of the enterprise, who are not independent agents in terms of Article 5 paragraph 6. In addition the individuals or companies do not need to be residents of or have a place of business in the jurisdictions in which they will act on behalf of the enterprise. (OECD, 2010: 105).

The purpose of the agency clause is to consider the situation where a foreign enterprise chooses to appoint a domestic or foreign agent to perform its business activity in a foreign jurisdiction where the enterprise does not have a right to use a fixed place of business. Without the agency clause provided in Article 5 paragraph 5 it would be too easy to circumvent unwanted permanent establishment taxation if no permanent establishment fiction applied to the use of a foreign agency. A permanent establishment is thus created based on the relationship between an agent and a principal and the activities performed by the agent, regardless of whether the agent or the principal has a place of business in the foreign jurisdiction. The agent will therefore constitute an agency permanent establishment for the principal. (Skaar, 1991, 463 - 464).

Similarly to the exception in Article 5 paragraph 3 the focus of this exception is on the business activities rather than on the physical element as is the case for Article 5 paragraph 1 of the basic rule permanent establishment. In this case it is, however, not the nature of the activities but rather the form of the activities that grants this special treatment. Since it is strongly believed that abuses will arise, the general approach is that the source jurisdiction will tax the income earned by the agent who has significant authority to perform business activities in the source jurisdiction. (IBFD, 2013a: 16 - 17).

Article 5 paragraph 5 states the following:

> '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.' (OECD, 2010: 25).

Vogel highlights the main features of Article 5 paragraph 5 as follows:

A permanent establishment shall be deemed to exist where:

- A person – other than an independent agent in terms of Article 5 paragraph 6 applies;
- Acts in one contracting state on behalf of an enterprise which is resident in another contracting state;
- Has authority to conclude contracts which bind the enterprise; and
- Habitually exercises such authority (Vogel, 1997: 330) i.e. on a regular basis or at least repeatedly and not merely in isolated cases (IBFD, 2103a: 17).

The activities performed by the agent must not be limited to the activities of a preparatory or auxiliary character which are listed in the negative list of Article 5 paragraph 4 (Vogel, 1997: 330).

Authority to conclude contracts

It is not the existence of the agency relationship which triggers a deemed permanent establishment for the dependent agent's principal but the authority of the agent to conclude contracts on behalf of the principal. Therefore the authority to conclude contracts on behalf of the foreign enterprise is vital to the application of this extraordinary (agency) permanent establishment provision. (IBFD, 2103a: 17).

The agent must have the authority to conclude contracts in the name of the enterprise which he is acting on behalf of (Vogel, 2997: 331), however the OECD Commentary provides that the phase 'authority to conclude contracts in the name of the enterprise' does not limit this requirement to an agent who enters into contracts literally in the name of the enterprise but 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. The OECD Commentary considers that the lack of active involvement by an enterprise in transactions may be an indication of the authority being granted to an agent. For instance the agent may have the authority to conclude contracts where the agent solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse where goods are delivered and where the foreign enterprise routinely approves the transactions. (OECD, 2010: 105 - 106).

In addition, the agent must exercise such authority whilst located in the jurisdiction of the candidate permanent establishment (IBFD, 2013a: 17).

When determining if the person has the authority to conclude contracts the actual behaviour of the contracting parties must be considered and not only on the aspects of private law (the law of contracts) which would make it quite possible to prevent an agent from being deemed a permanent establishment even where the agent is rigorously engaged in the enterprises' business. For instance in the case where the agent is authorised to negotiate all elements and details of a (IBFD, 2103a: 18) contract to a point where the contract is finalised and ready to be signed but the final signature is reserved to a person at the enterprise's headquarters in the jurisdiction in which the enterprise is based. This type of formal split of business responsibilities on the one hands and legal authority on the other, is considered to constitute a case of 'tax circumvention', where substance should prevail over form. In such a case a permanent establishment should therefore be deemed to exits irrespective of what formal arrangements have taken place. (Vogel, 1997: 332).

In the instance that an enterprise reserves the right to conclude contracts itself, for example, where major contracts are involved, the agent may not be considered to have the authority to conclude the contracts however in the case where mass contracts based on standard forms are merely signed by a person at headquarters without any indication that the contracts have been scrutinised by the signatory himself, the agent can be assumed to have taken the ultimate decision and can be considered to have had the authority to conclude contracts. (Vogel, 1997: 332).

Therefore having regard to the above, the test for determining whether the agent has the authority to conclude contracts is a substantive test. The enterprise will be said to have a permanent establishment in the jurisdictions in which the agent was located when the agent performs the actual business activities and meaningful negotiations related to the contract and not where the contract was literally signed. The mere presence of and some negotiation activities in the candidate's permanent establishment jurisdiction would not be sufficient to trigger a permanent establishment. (IBFD, 2013a: 17).

The requirement that the agent has the authority to conclude contracts, in the name of the enterprise, must be proven in each individual case (Vogel, 1997: 331).

In the case where the agent's authority to conclude contracts is restricted to a specific line of business within the enterprises' overall business activities, the permanent establishment activities will therefore be restricted to business contracted by the agent and any direct transactions by the enterprise would have to be disregarded in connection with the permanent establishment's tax liability. (Vogel, 2997: 331).

In addition the activities of the agent or the contracts to which the agent binds the principal must be part of the core business activities of the foreign enterprise i.e. the principal (IBFD, 2013a: 17).

Habitual exercise of the contracting authority

The agent must also habitually exercise the conclusion of contracts within the source jurisdiction (IBFD, 2013a: 18). This requirement that an agent must 'habitually' exercise an authority to conclude contracts in the name of the enterprise reflects the underlying principal of Article 5 that the presence which an enterprise maintains in a jurisdiction should be more than simply temporary if the enterprise is to be regarded as maintaining a permanent establishment, and subject to tax on the income sourced in that jurisdiction (OECD, 2010: 106). The habitual conclusion of contracts can be considered the connection to the source jurisdiction that grants the taxation rights and factually the only connection to such jurisdiction. This connection does not depend on the more substantial, general concepts of residence, nationality and bricks and mortar, but rather on the human connection created by the presence of people. Specifically in this case, it is not the mere presence of people or the services performed in the jurisdiction that matters, but rather, uniquely, the authority of the agent to conclude contracts on behalf of a principal habitually in the jurisdiction. (IBFD, 2013a: 18).

For this connection to be established, the agent must be physically present in the source jurisdiction at this critical time, for instance, when the most imperative agreements and decisions relating to the critical terms are taken (IBFD, 2013a: 18).

In order to determine the extent and frequency of activity necessary to substantiate that the agent is 'habitually exercising' contracting authority, will be based on the nature of the contracts and the business of the principal (OECD, 2010: 106).

Activities of a preparatory or auxiliary nature

Within Article 5 paragraph 4, the negative list excludes the existence of a permanent establishment if exercised in connection with a place of business however; the negative list also excludes the existence of a permanent establishment if any such activities are performed by an agent. In the case that the agent's activities are restricted to only the activities listed in Article 5 paragraph 4, a permanent establishment will not exist even where the agent has the authority to conclude contracts in the name of the enterprise. (Vogel, 1997: 333 - 334).

Alternative Test

It is important to note that Article 5 paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a particular jurisdiction (OECD, 2010: 106 - 107). It is therefore the practical approach that one would adopt in an examination of whether or not a permanent establishment is constituted by or though an agent by first considering Article 5 paragraph 1 through to paragraph 4, if a permanent establishment is found to exist under those rules then there is no need to proceed to test whether a permanent establishment would be triggered under Article 5 paragraph 5. In addition, a dependent agent may constitute a permanent establishment even where the requirements of Article 5 paragraph 1 are not satisfied by the enterprise (Baker, 2012: 5-2/12).

Independent Agent

The exclusion of the independent agent as a permanent establishment has been specified twice in the permanent establishment clause under Article 5 paragraph 6 (Skaar, 1997: 505).

Specifically it states that an agent cannot be a permanent establishment if he is:

- A broker, general commission agent; or
- Any agent of an independent status,

provided that such person is acting within their ordinary course of business. (Skaar, 1997: 505).

Article 5 paragraph 6 states,

> '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.' (OECD, 2010: 25)

Therefore where a foreign enterprise carries on business through a broker, general commission agent or any other agent of an independent status, the foreign enterprise cannot be taxed in the

foreign jurisdiction in respect of those dealings if the agent is acting in the ordinary course of his business (OECD, 2010: 107).

An agent will be considered to be independent in nature and not constitute a permanent establishment of the foreign enterprise who he is acting on behalf of, if:

- He is independent of the enterprise both legally and commercially; and
- He acts in the ordinary course of his business when acting on behalf of the foreign enterprise. (OECD, 2010: 107).

The independence of an agent performing services on behalf of a foreign enterprise is dependent on the agent's obligation to the foreign enterprise (Vogel, 1997: 344). An agent cannot be considered independent from the enterprise where that agent's commercial activities are subject to detailed instructions or comprehensive control by the enterprise. (OECD, 2010: 107).

When determining whether an agent, acting on behalf of an enterprise, is considered to be an agent of independent status the following considerations should be borne in mind. (OECD, 2010: 107).

Control

It is not likely that an independent agent will be subject to detailed instructions or significant control from his principal in respect of the manner in which the agent carries out their work. Even in the case that the agent is responsible to his principal for the final results of his work it does not imply that he is in fact dependent on the principal. A good indication that an agent is acting as an independent agent is clear in the case where the principal relies on the specialised skill and knowledge of such agent. (OECD, 2010: 107).

Limitation of scope

By limiting the scope of business which the agent may conduct clearly affects the scope of the agent's authority. Such limitations are not relevant to dependency which is actually determined having regard to the extent to which the agent exercises freedom when conducting business on behalf of the principal within the scope of the authority conferred by the agreement. (OECD, 2010: 107).

Provision of substantial information

In the case where an agent concludes an agreement with a principal and is required to provide substantial information in relation to the business conducted in terms of the agreement, it cannot be considered sufficient criterion to conclude that an agent is dependent. In the instance, that the

information provided by the agent to the principal is provided for the purpose of seeking approval from the principal for the manner in which the business or activities have been conducted, then this may imply that the agent is in fact dependent in nature. It should be borne in mind that the provision of information which is simply intended to ensure the smooth running of the agreement and continued good relationship with the principal should not be mistaken for dependency. (OECD, 2010: 108).

Number of principals

Having regard to the number of principals which the agent acts on behalf of is a clear indication of the independence status of the agent. An independent agent is less likely to provide activities wholly or almost wholly, on behalf of only one enterprise over the lifetime of the business or for an extended period of time, this alone however is not in itself determinative and when determining the independence status of an agent all facts and circumstances must be considered to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. (OECD, 2010: 108).

Ordinary course of business

An independent agent will not be deemed to create a permanent establishment for the principal if he is acting in the ordinary course of his business (Vogel, 1997: 346). A person cannot be said to be acting in the ordinary course of his business where he performs activities which economically belong to the enterprise as opposed to his own business operations. This may be the case where an agent, acting as a commission agent, sell goods or merchandise on behalf of the enterprise and also has the authority to conclude contracts in the name of the enterprise, this will result in the agent not acting in the ordinary course of his business which will deem the agent to be a permanent establishment for the principal. (OECD, 2010: 108).

An independent agent such as a broker or a general commission agent is deemed to be dependent if his activities are not performed within the ordinary course of his business (Skaar, 1997: 515). It has been thought that the special paragraph on the permanent establishment status of independent agents is not necessary (Skaar, 1997: 505), however the OECD Commentary has specifically mentioned that Article 5 paragraph 6 has been included in the OECD Model for the 'sake of clarity and emphasis' (OECD, 2010: 107). An example of an independent agent acting outside of his ordinary course of business is where an agent sells stock of goods in his own name and habitually concludes contracts in the name of a foreign company; this will therefore constitute an agency permanent establishment for the principal. (Skaar, 1997: 515).

In the case where an enterprise carries on business through an agent in a particular jurisdiction and the agent has a stock of merchandise owned by his principal from which he regularly fills orders for customers, such enterprise will be deemed to have a permanent establishment in the jurisdiction. In the Canadian case of *Enterprise Foundry (NB) Limited v Minister of National Revenue*, 64 DTC 660 Tax Appeal Board[13], the Tax Appeal Board applied the agency permanent establishment rule, which held that a sales agent had general authority to conclude contracts for his principal where the agent had taken orders at fixed prices, even though he had no authority to quote special prices. In contrast, in an earlier case *Ronson Art Metal Works (Canada) Limited v Minister of National Revenue*, 56 DTC 440[14], the Tax Appeal Board held that a sales representative did not give rise to a permanent establishment for the principal because the representative had no stock in the jurisdiction from which he could fill orders and although he could take orders from existing customers he could not open new accounts, the Tax Appeal Board interpreted this as the absence of a general authority to conclude contracts. (IBFD, 2013p: 27).

Having regard to the South African court case of *Downing v Secretary for Inland Revenue*, 1975[15], the taxpayer was an individual who emigrated from South Africa to Switzerland and was no longer considered to be a South African income tax resident. In terms of South African exchange control regulations the taxpayer's capital assets consisting of listed shares had to remain in South Africa. A local stockbroker managed this share portfolio and a local advisor generally handled the taxpayer's South African financial affairs. The stockbroker only received a brokerage fee for managing the taxpayer's share portfolio, which involved the buying and selling of listed shares for which the stockbroker acted under his own authority to enter into such transactions on behalf of the taxpayer. The stockbrokers mandate was to manage the share portfolio to yield the greatest profit and was able to change the portfolio without obtaining prior approval from the taxpayer. The stockbroker would arrange with the taxpayer's South African financial advisor and banker for payment when shares were bought and remit to the South African financial advisor and banker proceeds from the sale of any shares. For the tax period under review the taxpayer realised profits on the sale of South African listed shares. The South African tax authority assessed him liable to income tax thereon, however the taxpayer rejected that the profits realised on the sale of South African listed shares were taxable in South Africa. The objection was upheld by the Natal Income Tax Special Court on the basis that the income was exempt from South African tax in terms of Article 7 paragraph 1 of the Double Tax Convention of 1967 between Switzerland and South

[13] *Enterprise Foundry (NB) Limited v Minister of National Revenue.*
[14] *Ronson Art Metal Works (Canada) Limited v Ministry of National Revenue.*
[15] *Downing v SIR* 1975 (4) SA 518 (A).

Africa, because the taxpayer's income did not arise from a permanent establishment located in South Africa. (IBFD, 2013q).

The South African tax authority appealed to the South African Appellate Division that the individual indeed had a permanent establishment in South Africa that was located in the offices of the stockbroker and financial advisor according to Article 5 paragraph 1 of the double tax convention between South Africa and Switzerland or in an alternate, the taxpayer has a deemed permanent establishment in South Africa by reason of the fact that his stockbroker acted as his dependent agent in terms of Article 5 paragraph 4 of the treaty. (IBFD, 2013q).

The South African Appellate Division had to decide whether the taxpayer:

i. Had a permanent establishment in South Africa in terms of the general provision under Article 5 paragraphs 1 and 2 of the double tax convention between South Africa and Switzerland as a result of the fact that the business of trading in listed shares had been carried on through a place of business located in the offices of his stockbrokers and financial advisors; or if not,

ii. Had a deemed permanent establishment in South Africa in terms of the agency provisions under Article 5 paragraph 4 of the double tax convention between South Africa and Switzerland as a result of the fact that the stockbroker is acting as an dependent agent of the individual and has been conducting the business of the individual through the trading of listed shares. (IBFD, 2013q).

Having regard to the interpretation of the term permanent establishment the court held that the taxpayer did not have a permanent establishment according to the provisions of Article 5 paragraph 1 and 2 of the double tax treaty between South Africa and Switzerland. The court argued that the taxpayer could be said to have a fixed place of business where occupation and control could be exercised by the taxpayer however this was not the case in this instance. (IBFD, 2013q).

The court further held that the stockbroker acted as an independent agent within the meaning of Article 5 paragraph 5 of the double tax convention and could not be deemed a permanent establishment. The facts presented to the court indicated that the stockbroker's management of the taxpayer's share portfolio fell within the scope of what a stockbroker normally does in carrying on business as a stockbroker. (IBFD, 2013q).

This case is considered to be a leading South African court case on the interpretation and application of double taxation treaties. The South African Appellate Division expressly

acknowledge the existence of an international tax language, which influences the interpretation of a double tax treaty's provisions as well as indicating clear authority for reliance on the OECD Model and its commentaries and international precedents as useful aids to interpret the meaning of provisions contained in double taxations treaties. (IBFD, 2013q).

9. CHAPTER 5: CONCLUSIONS AND RECOMMENDATIONS

As indicated throughout this research report, the significance of a having a permanent establishment in a country results in the country in which the permanent establishment is situated, being given the right to tax the permanent establishment under the domestic laws of that country, notwithstanding the fact that the permanent establishment is not considered a separate legal entity (Olivier & Honiball, 2011: 335). Therefore, the concept of a permanent establishment is central to the determination of a multinational company's global tax liability because it is important to determine the tax liability in respect of any cross-border investments (Ernst & Young, 2012) and as a result of this, multinational companies are spending an increasing amount of time on managing the existence of a permanent establishment as well as the allocation of income to a permanent establishment (PWC, 2013b). Having regard to the increasing interconnectivity of the world, it has however been identified that national tax laws were not keeping pace with global corporations, fluid capital and digital economies which has resulted in potential loopholes which could be exploited by companies to avoid taxation in their jurisdictions of residence by moving activities abroad to low tax or no tax jurisdictions, the effect of such would undermine the fairness and integrity of tax systems (OECD, 2013f).

Tax authorities have become far more aggressive when it comes to assessing the existence of a permanent establishment in their jurisdictions as a result of their ever increasing search for revenue. Even if companies apply arm's length pricing in their dealings with connected group companies, it does not seem to eliminate their exposure from discussions with the local tax authorities, which can be seen from quite a number of cases recently decided in the courts. It is advisable that companies perform regular audits, preferably on a country-by-country basis given the variance in approaches taken by different local tax authorities. (PWC, 2013b).

It was predicted by Skaar, in his observation that a trend had developed of dis-harmonization of the permanent establishment definition among OECD members as a result of their increasingly divergent interests, and resulted in the permanent establishment concept losing its force for new and mobile industries, deeming it inappropriate for a new economy. This trend as identified continued and the OECD in its attempt to fight the trend may have contributed the trend by infusing necessary flexibility to the OECD Commentary. To some extent it has been successful however there is still uncertainty on truly complex matters such as electronic commerce. Although some very fundamental issues have been settled by the OECD Commentary there are still however

other issues which have not and hence are left to particular treaties, domestic laws or courts. (IBFD, 2013a: 21 - 22).

Having regard to the new challenges faced by the OECD in relation to Base Erosion and Profit Shifting, the OECD has introduced the OECD Action Plan on BEPS of which one action of the 15 actions to be implemented by governments worldwide, is to update the definition of 'permanent establishment' in order to prevent abuses. Currently, this action only deals with the interpretation of the treaty rules on agency permanent establishments. (OECD, 2013e).

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