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

THE PRINCIPLES GOVERNING 'PLACE OF EFFECTIVE MANAGEMENT' AND 'PERMANENT ESTABLISHMENTS' AND THEIR APPLICATION TO THE DIGITAL ECONOMY – A SOUTH AFRICAN PERSPECTIVE

Johannesburg, 2015.

1. ABSTRACT

The purpose of this research report is to consider the application of existing 'place of effective management' (POEM) and 'permanent establishment' (PE) principles to a company operating in a digital economy in order to determine its appropriateness and limitations.

This paper is broadly divided into four parts. The first part of the paper provides a brief background to the above taxing principles and the digital economy. The second part considers, in detail, the guidance and factors that are currently available on how the POEM and the creation of a PE for a company may be determined both internationally and from a South African tax perspective, including the role of the residency tie-breaker article and the PE article in most double taxation agreements (DTA's) with South Africa. The third part of the paper considers how these guidelines and factors may apply to the digital economy and the practical challenges which arise. Finally, the paper seeks to identify possible alternatives to overcome the pitfalls in the POEM and PE interpretations and to highlight aspects which require further consideration.

Key words: place of effective management, residency tie-breaker clause, key management and commercial decisions, hierarchy of tests, permanent establishments, double taxation agreements, the Organisation for Economic Cooperation and Development, the digital economy, base erosion and profit shifting, physical presence, auxiliary and preparatory activities, information and communication technology, anti-fragmentation.

2. DECLARATION

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

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31 March 2016

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3. CHAPTER OUTLINE

3.1 Chapter 1: Introduction

The introductory chapter will deal with the background to understanding the digital economy and the interplay of the POEM and PE concepts and all the related issues that will be studied in this research report. The introduction will further set out the research problem, sub-problems, scope and limitations, as well as the methodology adopted to conduct the study.

3.2 Chapter 2: How to determine the POEM of a company with a South African focus

Chapter 2 will analyse in detail the existing guidance, factors and principles to determine where a company has its POEM. It will consider all available South African literature, guides and tax case law on the matter and will compare these to the interpretation principles adopted by the Organisation for Economic Cooperation and Development ('OECD') in an international context. Determining the POEM of a company will, in turn, determine its tax residency and the taxing rights of the jurisdiction in which it is found to be a tax resident.

3.3 Chapter 3: How to determine whether a PE has been created with a South African focus

Chapter 3 will analyse in detail the existing guidance, factors and principles to determine when a company has created a PE in a jurisdiction, other than the jurisdiction in which it is a tax resident. This chapter will consider the South African literature, guides and tax case law in respect of PE's and will compare these to the interpretation principles adopted by OECD in an international context. Determining when a PE has been established will, in the context of most DTA's, grant the taxing right of the income attributable to such PE to the jurisdiction in which a PE is situated.

3.4 Chapter 4: Understanding the digital economy

Chapter 4 will provide an overview of the current trends in the evolution of the digital economy, with a specific focus on the information and communication technology sector. It will also provide valuable insight into more recent and future anticipated developments in the digital economy and technological advancements which may, once again, redefine what is broadly understood and included in the ever-expanding definition of the digital economy.

3.5 Chapter 5: Application of POEM guidelines to the digital economy and suggested solutions to practical challenges identified

Chapter 5 will seek to apply the guidelines established in chapter 2 to a company which conducts its business via the digital economy. This chapter will highlight the limitations and challenges South Africa and the international tax environment face in aligning the POEM principles to the digital economy. In addition, it will seek to identify possible alternatives the OECD and other jurisdictions maybe/or are considering to overcome the pitfalls in applying the POEM interpretations to the digital economy.

3.6 Chapter 6: Application of PE guidelines to the digital economy and suggested solutions to practical challenges identified

Chapter 6 will seek to apply the guidelines established in chapter 3 to a company which conducts its business via the digital economy.

This chapter will highlight the limitations and challenges South Africa and the international tax environment face in aligning the PE principles to the digital economy. In addition, it will seek to identify possible alternatives the OECD and other jurisdictions maybe/or are considering to overcome the pitfalls in applying the PE interpretations to the digital economy.

3.7 Chapter 7: Conclusion of the study

This chapter will draw conclusions from the study.

4. CHAPTER 1: INTRODUCTION

4.1 Context of the study

The 'digital economy' can be defined as the global network of economic and social activities that has been developed through digital technologies, services and content. Internet commerce, commonly known as 'e-commerce' is one of the many aspects of the digital economy. Through the internet, consumers are enabled to purchase goods and services in a marketplace which is globally borderless. (The Department of Broadband, Communications and the Digital Economy, 2009).

The 'digital economy' arguably consists of the three main components (Mesenbourg, 2001). These components can be summarised as follows:

- Supporting infrastructure (hardware, software, telecoms, networks etc.).
- E-business (how business is conducted, any process that an organisation performs using computer-engineered networks).
- E-commerce (transfer of goods and services, for example, online shopping).

The current catch phrase in the international tax world is Base Erosion and Profit Shifting (BEPS). As its name suggests, it relates primarily to situations where the interaction of different tax rules leads to double non-taxation or low taxation by shifting profits from one jurisdiction to another. Generally, the shifting of profits aligned with legitimate business and value creation is not a concern from a tax policy perspective: rather, it is practises that artificially separate profit from the activities generating it. Here the gaps in the interaction of different tax systems and the applications of DTA's contribute to tax inequality. (OECD, 2013a:10).

One of the specific concerns where BEPS has been raised is in the context of the digital economy. (OECD, 2013a:10).

The OECD Action Plan on BEPS (OECD, 2013a:10) states the following with regard to e-commerce and the digital economy: '*The spread of the digital economy also poses challenges for* *international taxation. The digital economy is characterised by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes. At the same time, the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation is not per se an indicator of defects in the existing system. It is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS.*' (emphasis added)

Two international tax concepts which may be impacted by the widespread use and growth of the digital economy are POEM and PE's.

POEM is an international tax principle used in various jurisdictions across the world as a means of determining the tax residency of a legal entity. More specifically, it is one of the factors used in the South African Income Tax Act 58 of 1962 (the Act) to determine the tax residency of a person, other than a natural person.[1] It is also used in Article 4 of the OECD Model Tax Convention (OECD MTC) which forms the basis of most DTA's as the tie-breaker criteria for dual resident companies. The term POEM has no universal meaning ascribed to it and countries, including South Africa and member countries of the OECD, ascribe different meanings to it. Generally it refers to the place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made (Olivier & Honiball, 2011: 25 and the commentary included in the OECD MTC (OECD Commentary[2])).

Similarly, a PE is also an international tax principle used in various jurisdictions to determine when a resident of a so-called Contracting State (as referred to in a DTA) has, in another Contracting State, a fixed place of business through which the enterprise is wholly or partly carried on. The creation of a PE in the other Contracting State generally carries with it the right of such other

[1] Section 1 definition of a 'resident' in terms of the Act.
[2] The OECD Commentary referred to is this study is based on the condensed version of the OECD MTC issued on 17 July 2008.

Contracting State to tax the profits attributable to or sourced by the PE, notwithstanding the fact that the PE is not considered a separate legal entity (Olivier & Honiball, 2011: 335). The PE concept is included in Article 5 of the OECD MTC. Once again the term PE has no universal meaning and so many countries interpret the creation of a PE differently although, generally, countries adopt the interpretation of a PE referred to in the OECD Commentary.

Although POEM and PE's are well established principles, their application to the digital economy, as is evident from the BEPS action plan, is not straightforward. These principles came about at a time when the economy of the world was based on traditional, physical and tangible businesses. In current times, commerce is increasingly driven by the internet, social media and various other digital computing technologies which do not rely on physical presence.

The first action plan under BEPS is titled: '*Address the tax challenges of the digital economy*' and is explained as follows by the OECD: *'Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.'* (emphasis added) (OECD, 2013a: 14, 29)

Based on the above, it is clear that there are various tax aspects, including both direct and indirect tax consequences, which affect the digital economy and which require detailed consideration and analysis. The purpose of this study is, however, to focus on the highlighted section above which is most closely linked to the POEM and PE principles and encapsulates the research theme of this study – '*The ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules.*'

The above 'significant digital presence in the economy of another country' created by the operation of a digital economy, first needs to be considered in the light of the POEM rules in order to determine whether such presence and the current manner in which the digital business is conducted could cause it to be a tax resident of the 'other country'. Where it is held that the tax residency of the business is not impacted by this digital presence but rather by other factors, the next question is whether a PE has been established in that 'other country'.

Take for example – Alibaba – arguably the world's largest online commerce company. Its three main sites (Taobao, Tmall and Alibaba.com) have millions of users, merchants and businesses. The founder of Alibaba is Chinese born Jack Ma and, although his initial focus was on the Chinese market, Alibaba is now accessible all over the world. It is a network of inter-connected products and services which is constantly looking for ways to innovate and remain market leaders. It is available on mobile, it has a mapping service, it acts as a bank, a shipping company, as well as a search engine. (Wall Street Journal, 2014). Alibaba handles more business than any other e-commerce company and is one of the most successful e-commerce businesses in the world. (101eCommerce, 2015).

In South Africa, although on a much smaller scale, this can be compared to the likes of Superbalist.com, Spree, Nutreat and Mantality. All of these South African-based companies which were announced as being part of the top fifty e-commerce sites for the 2015 eCommerce Awards hosted by uAfrica, provide for a platform where goods can be exchanged among users, merchants and suppliers, not just in South Africa but in other countries too. (Ventureburn, 2015).

The question of taxation in these examples is very relevant, especially where a digital company is growing and expanding beyond the jurisdiction where the business was first established. Further complications to this is where the company decides to relocate core functions of its business (like its web server and customer data) to another jurisdiction for legal, commercial and business reasons.

Where a company can no longer isolate its profits or its value creation to one region but operates in a borderless market, one needs to determine where the company's POEM is and whether as a result of its growth, it has established PE's elsewhere. As referred to in the OECD BEPS action plan, the rights of taxation in the digital economy should flow from where the real value is created. The difficulty and actual question are whether the current tax principles of POEM and PE will correctly identify and determine what and where this value creation arises in order to allocate the taxing rights appropriately.

Much literature is available and much research has been conducted on this topic. More recently, the OECD released its final report on the action plan '*Addressing the Tax Challenges of the Digital Economy*' on 5 October 2015.

This study aims to address the POEM and PE concepts applicable to a company from a broadly international and South African tax perspective, followed by a specific focus of its application to the fast paced digital economy.

4.2 Statement of the research problem

The research problem which this report seeks to address and understand is whether the current guidelines and factors available to determine a company's POEM and the creation of a PE are suitable and can be applied toallocate taxing rights correctly in the digital economy.

4.2.1 Sub-problems

The first sub-problem to be addressed is the difficulty of determining whether a company (which is incorporated in one jurisdiction) has its POEM in another jurisdiction, based on the key management and commercial decisions made in respect of that company, having regard to the understanding and application of the POEM principles in (1) South African tax law and literature; (2) the views of the South African Revenue Service (SARS); and (3) the interpretation generally adopted in the international context and Article 4 of the OECD MTC.

The second sub-problem to be addressed is the difficulty in determining whether a company (which is incorporated and tax resident in one jurisdiction) has created a PE in another jurisdiction (where the company is a non-resident for tax purposes) based on its presence and/or the activities performed by the said company, having regard to the understanding and application of PE principles in (1) South African tax law and literature; (2) the views of SARS and (3) the interpretation generally adopted in the international context and Article 5 of the OECD MTC.

The third sub-problem to be addressed is the challenges and limitations in applying the above principles and guidelines to determining whether a company whose business is conducted over e-commerce and other digital technologies could potentially have its POEM or could have created a PE in another jurisdiction, as a result of its significant digital presence in that jurisdiction.

The final sub-problem is identifying the possible alternatives to overcome these pitfalls in the POEM and PE interpretations and to highlight aspects which require further consideration.

4.3 Delimitations of the study

This study is limited to a review and analysis of the POEM and PE principles of a company which conducts its business and transacts in a digital economy. The focus is also on the interpretation adopted from a South African tax perspective and highlights the differences to the interpretation broadly adopted by the OECD in the international context, without making reference to any specific jurisdiction.

This paper is not intended to and does not consider any indirect tax issues, the classification of transactions and where the different income streams are sourced, the allocation of income in the context of a PE (once established), the impact of 'controlled foreign company' rules, the application of transfer pricing principles, the respective legal framework governing the industry and, specifically, intangible property, and all other tax policy and administration issues posed by the digital economy. These aspects fall outside of the scope of this research report.

4.4 Research methodology

This study has been performed using a qualitative approach and aims to provide clarity on the problem statement by conducting an extensive literature review. This will include a detailed review of relevant academic books, professional articles, international guides, DTA's, the Act, tax case law and electronic resources on the subject matter.

5. CHAPTER 2: HOW TO DETERMINE THE POEM OF A COMPANY WITH A SOUTH AFRICAN FOCUS

5.1 Relevance in South African tax

South African residents are subject to tax locally on their worldwide income, unless specific exemptions apply[3]. In the case of any person other than a natural person, a resident is defined in section 1 of the Act as any person which is:

[3] Section 1 'gross income' definition read with exemptions provided for in section 10 of the Act.

'incorporated, established or formed in the Republic or which has its place of effective management in the Republic.' (emphasis added)

It is, therefore, possible for a company incorporated outside of South Africa to be regarded as a South African tax resident, if the company's POEM is in South Africa.

5.2 Meaning of the term POEM

The POEM term made one of its first appearances in South African tax law in the Fifth Interim Report issued by the Katz Commission in 1997, which dealt with the proposed changes in South Africa's tax base, i.e. moving from a source-based system to a residence-based system of taxation. (Olivier & Honiball, 2011: 27). Paragraph 6.1.2.1 of the report stated *inter alia 'The Commission recommends that the concept of effective management as referred to in Article 4(3) of the OECD Model Tax Convention be used consistently to designate the tax residence of persons other than natural persons. This may perhaps be best achieved through an appropriate definition in Section 1 of the Income Tax Act. Again, the change will have the benefit of employing international and, therefore, commonly understood terminology.'* (emphasis added)

The term POEM was subsequently included in the definition of the term 'resident' in section 1 of the Act. The term POEM is also used in a number of DTA's entered into by the South African government. Unfortunately, the Act did not and still does not contain a definition of the term POEM nor has the meaning been considered in a South African court of law.

Prior to the issue of Interpretation Note No. 6 by SARS on 26 March 2002 (Interpretation Note 6), SARS had not expressed a view on what it considered to be the POEM of a company. Consequently, in the past, the term was interpreted exclusively with reference to international precedents and guidelines and in the context of the residency tie-breaker clause in DTA's. (Olivier & Honiball, 2011: 25).

Interpretation Note 6 sets out SARS' views on the meaning of the term. It should be noted that an interpretation note is not law and SARS' interpretation may be challenged in the South African courts[4]. This was also confirmed by SARS on their website stating (with reference to interpretation

[4] SARS sometimes publishes Practice Notes and Interpretation Notes which explain their interpretation of certain provisions of the various acts. These Practice Notes and Interpretation Notes do not have the force of law as they merely represent SARS' interpretation of these provisions. Some Interpretation Notes, for

notes) '*They are intended for research and reference purposes only and should not be relied on to make decisions on current legislation*'.

The meaning of the term POEM in Interpretation Note 6 is not consistent with the meaning ascribed to it in international guidelines and precedents.

5.3 International guidelines and precedents

Most of the DTA's entered into by the South African government are based on the OECD MTC. Therefore, when interpreting the term POEM in the context of a DTA entered into by South Africa with a foreign country, a local court would be bound to consider international guidelines, as presented in the OECD Commentary for the interpretation of DTA concepts which are not defined under South African law.

This principle was also confirmed by the Appellate Division in *CIR v Downing*[5]. The court upheld the dicta of the lower court that South Africa was bound to take cognisance of the guidelines for interpretation contained in the OECD Commentary on concepts utilised in the OECD MTC as South Africa had adopted that model and framework for its DTA's. Furthermore, South African courts will apply customary international law rules and practice as confirmed by our courts and by section 231 of the Constitution of the Republic of South Africa Act 108 of 1996 (the Constitution). Therefore, to the extent that there are OECD guidelines on the interpretation of the term POEM or other international commentaries which express the commonly accepted meaning of the phrase as utilised in DTA's worldwide, it is submitted that our courts would take cognisance of such guidelines and commentaries to interpret the meaning in the context of a DTA.

Accordingly, the OECD's interpretation of the term POEM would be relevant from a South African tax perspective. In the OECD's Commentary, it is stated in Article 4, paragraph 3 that:

> '*the place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the enterprise's business are in substance made.*' (emphasis added) (OECD, 2008:24).[6]

example Interpretation Note No. 47, are published as binding class rulings in terms of section 78 of the Tax Administration Act 28 of 2011 and as such have more authority. (UNISA Tutorial Letter, 2015: 6).

[5] 1975(4) SA 518 (A).

[6] Page 77 of the 2008 OECD Commentary.

The OECD Commentary goes on to state that this will normally be the place where senior persons make decisions or where the actions to be taken by the company are determined. However, the OECD Commentary also recognises that determining a company's POEM is a factual enquiry. In this regard, it states that all the relevant facts and circumstances must be taken into account in determining the POEM of a company. It confirms that '*An entity may have more than one place of management, but it can have only one place of effective management at any one time.*' (emphasis added) (OECD, 2008:24).[7]

Klaus Vogel, in his commentary on Double Taxation Conventions, states that the German domestic term 'place of management' is very similar to the treaty term POEM. According to German case law, a place of management is the place where the management's important policies are actually made. Vogel states that '*what is decisive is not the place where the management directives take effect, but rather the place where they are given*'. This is the place where the persons authorised to represent the company carry on their business managing activities, or the centre of top level management.

The OECD Commentary further recognises that some countries are of the view that the existence of dual resident persons (which is rare) should be dealt with on a case-by-case basis by the relevant authorities of each jurisdiction. This is also the so-called approach which should be followed in determining the POEM in the context of the new communication technology era. This was confirmed in the report issued by the Technical Advisory Group to the OECD in 2001 titled '*The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule*' (refer section 8 (chapter 5) below for a detailed discussion on the contents of this report).

The OECD Commentary clarifies that that for purposes of the OECD MTC, it is expected that the following factors should be taken into account when determining the POEM of an entity:

- Where the board meetings are held;
- Where the chief executive officer (CEO) and other senior executives usually carry on their activities;
- Where the senior day-to-day management is carried on;
- Where the entities' headquarter are located;
- Which country's laws govern the legal status of the entities and

[7] Page 77 of the 2008 OECD Commentary.

- Where are the accounting records kept.

(OECD, 2008:24.1).[8]

Based on the above extracts the POEM in the OECD context should be determined with reference to the following circumstances:

- The place where the 'real' board of directors (as opposed to those directors merely appointed on paper) actually make/take decisions on important business affairs of the company as opposed to the place where they are formally resolved. In this regard, the place of residence of the real directors could be an important factor and
- The place where more important management decisions are taken, as opposed to day-to-day administrative management.

International guidelines place the emphasis on the place where the important decisions of the company are taken, and not necessarily the place where such decisions are ***implemented.***

It is important to focus on the top level management as opposed to the day-to-day operating management since one company could have places of management and divisions of a company in several countries. The place of day-to-day management may also in some instances coincide with the top level management.

The place where the board of directors holds its meetings may be of relevance but is not necessarily conclusive to determining the POEM since the 'top management' needs to be identified. The place where the top management (i.e. CEO, Chief Financial Officer (CFO) and Chief Operations Officer (COO)) have their office would be important. The top management would typically tend to 'interfere' with the usual conduct of the business, although not necessarily with the day-to-day affairs. Furthermore, top management would tend constantly to be informed of the transactions of the business and their decisions would have a decisive influence of how the transactions are ultimately arranged (see Klaus Vogel).

In summary, the place where the board of directors meets represents the POEM of the company provided, the board has the real authority and sufficient involvement in and knowledge of the business transactions of the company to be in a position to make the principal decisions for the company. If not, the POEM is inferred by the top or senior management of the company.

[8] Page 77 and 78 of the 2008 OECD Commentary.

5.4 South African context

As mentioned above, in March 2002 SARS issued Interpretation Note 6 considering its interpretation of POEM in the context of a legal person. In SARS' view, POEM is not the same as shareholder control or control by the board of directors but, rather, is driven by management in the furtherance of the company's business and purpose.[9]

SARS distinguishes between three levels of management, namely: [10]

- The central management and control exercised by the board of directors;
- The execution and implementation of policy and strategy by senior management and
- The day-to-day running of the business.

SARS further adopts a 'general approach' and the 'practical application' of the so-called general approach.

Focusing firstly on the general approach, SARS places emphasis on the '*place where the company is managed on a regular or day-to-day basis by the directors or senior managers*'. SARS further states that the '*Management by these directors or senior managers refer to the execution and implementation of policy and strategy decisions made by the board of directors*' (emphasis added). In SARS' opinion, the POEM could also be referred to as the 'place of implementation'.[11]

With reference to the three levels of management listed above, SARS regards the POEM of a company as the place where the senior management *implement* the decisions which were made by the board of directors (i.e. they focus on the second level of management, as opposed to the first level of management) (Olivier & Honiball, 2011: 25).

The United Kingdom Revenue Manuals also distinguishes between 'central management and control' (by the board of directors) and 'senior management' but states that these levels of management will often coincide. Senior management is normally referred to as the CFO, CEO and sales directors of a company who make the business 'tick'. Since these executives are often on the board of directors, the POEM will only differ from the central management and control if POEM is inferred from the place where the board of directors actually reside (i.e. where they are on a day-to-

[9] Section 3.1 of Interpretation Note 6.
[10] Section 3.1 of Interpretation Note 6.
[11] Section 3.2 of Interpretation Note 6.

day basis) and the place where the board of directors convene meetings. (Olivier & Honiball, 2011: 26).

Since SARS places emphasis on 'implementation', it is important to consider what constitutes 'implementation'. SARS does not provide any guidance on this and as a result, in certain instances the so-called place of implementation is unclear. For example, the CFO of a company needs to raise financing from a foreign bank and so makes a phone call whilst based in South Africa. However, once the financing has been approved by the bank, the CFO flies to the foreign jurisdiction to finalise the arrangement and sign all documentation. The question of 'implementation' is not certain. The decision to raise financing was made in South Africa, yet the documentation to formally enter into such financing was made in a foreign jurisdiction. To avoid any doubt, advisors recommend that *all* decisions made in respect of a company are made in the desired POEM. Practically however, especially in the context of fast moving industries and multi-nationals, this is not always possible or commercially viable. (Olivier & Honiball, 2011: 27).

Focusing secondly on the practical application, SARS adopts a three tiered waterfall approach:[12]

- In the first instance, the POEM is where the management functions are executed/implemented (this is in line with the general approach).
- Should the implementation be in multiple locations, then the POEM would be the place where the day-to-day operational management and commercial decisions are taken.
- Should the day-to-day operational management decisions be taken in multiple locations, the POEM will ultimately vest in the place where the strongest economic nexus lies.

SARS acknowledges that there is no single rule to the determination of the POEM and that all relevant facts and circumstances must be considered. The factors listed below (which are non-exhaustive) are included in Interpretation Note 6 as important in the context of a POEM determination:[13]

- Where the centre of top level management is located;
- Where the headquarters are and the functions performed there;
- Where all the business operations are conducted and the nature and extent of such business operations;

[12] Section 3.3 of Interpretation Note 6.
[13] Section 3.4 of Interpretation Note 6.

- Where the controlling shareholders make key management and commercial decisions in relation to the company;
- The legal factors such as the place of incorporation, formation or establishment and location of the registered office, public officer, company secretary, whether bank accounts have been opened etc;
- Where the directors or senior managers (or other) who are responsible for the day-today management reside;
- Where the board of directors meetings are held and the frequency of these;
- The experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity as well as the authority granted to them;
- The actual activities and location of senior employees;
- The scale of onshore as opposed to offshore operations and
- The nature and purpose of the authority granted to representatives of an entity and the manner in which such authority is exercised.

The critical difference between the international guidelines and Interpretation Note 6 is the emphasis of the latter on the place where important decisions are implemented, as opposed to where such decisions are taken. Furthermore, the Interpretation Note emphasises day-to-day management, whereas international guidelines emphasise top-level and strategic management.

Having regard to the above, as a belts and braces approach, in order to manage a company's POEM so that a taxpayer is able to defend any contention by SARS that a foreign company is effectively managed in South Africa, the steps listed below should be taken.

- Analyse the nature of the company's business and the transactions it is party to and identify the management decisions that it is required to make. Steps should then be put in place to ensure that the implementation of these management decisions takes place out of South Africa.
- The non-resident directors or employees of the foreign company should have the appropriate authority to implement the management decisions offshore, such as powers to conclude agreements, signing powers on the company's bank account and authority to liaise with and conclude contracts with sub-contractors and service providers.
- The majority of directors of the foreign company should be non-South African resident individuals.

- An effort should be made to avoid the appointment of professional directors who act as independent service providers, who have no direct involvement with the company's business and merely follow instructions from another person. SARS has indicated that they would regard such appointments as evidence of effective management elsewhere, i.e. in South Africa.
- It is important that such directors actually take the final decisions outside of South Africa. They should not merely rubber-stamp arrangements which have effectively been finalised in South Africa. The board should meet outside of South Africa to make such decisions. The place where the board meets should be carefully considered so as not to create a taxable presence for the company elsewhere, i.e. in the United Kingdom.
- From a practical perspective, the public officer and company secretary appointed would normally be independent individuals resident in the country of incorporation of the company, with the necessary qualifications to fulfil such functions. This should not jeopardise effective management.
- All relevant documentation (for example, board resolutions, agreements, sub-contract agreements, etc) should reflect that all relevant decisions were taken and implemented outside of South Africa to further support the contention that the POEM is outside South Africa.
- It is important that the documents for the board meetings (the board packs) are not discussed, prepared and settled in South Africa and then merely considered and approved at the relevant board meeting held outside of South Africa with the implementation left to professional directors to attend to. This could indicate that:
    - Firstly, the management decisions are actually taken in South Africa and then merely approved on paper at the board meetings; and
    - Secondly, implementation of the decisions is performed on instruction from South Africa by appointed straw men or professional directors.
- Where certain functions of the foreign companies are sub-contracted, it is important that the sub-contract arrangements are concluded outside of South Africa by directors or personnel authorised to negotiate and conclude the sub-contract arrangements. The directors or personnel must then also be responsible for monitoring the sub-contractor and complying with the foreign entity's obligations in terms of the sub-contract arrangement.

- Whilst aspects of the day-to-day business operations of a foreign company can be sub-contracted or outsourced without affecting the tax residence of the company from a South African perspective, the effective management of a company cannot be outsourced. The effective management of a company must be performed by directors or personnel with the necessary skill, qualification, expertise, accountability and authority to manage the company's business offshore.

It is no secret that SARS' Interpretation Note 6 has been severely criticized. This has even been acknowledged by SARS itself in the SARS Discussion Paper on Interpretation Note 6 which was issued for comment in September 2011 (the SARS Discussion Paper).[14]

The SARS Discussion Paper was spurred on by the introduction of the headquarter regime and the concern raised that the foreign subsidiaries held by the headquarter companies may be South African tax residents due to the application by SARS of Interpretation Note 6.[15]

There are four areas of criticism highlighted in the SARS Discussion Paper which are summarised below:[16]

- Interpretation Note 6 on POEM focuses on the place of execution and implementation of decisions, as opposed to the place where the decisions and policies are actually taken. The latter approach is more in line with international standards.
- Interpretation Note 6 uses inconsistent terminology in the 'general approach' and the 'practical application', blurring the lines between differing levels of management.
- Interpretation Note 6 results in inconsistency when comparing the 'general approach' and the suggested guidelines to measure it.
- Interpretation Note 6 provides no guidance in the instance of passive holding companies and intermediary holding companies.

With reference to the international interpretation of POEM, the SARS Discussion Paper refers to two main interpretations which carry broad consensus. The first regards the POEM as the place

[14] Section 6 of the SARS Discussion Paper.
[15] Section 1 of the SARS Discussion Paper.
[16] Sections 5 and 6 of the SARS Discussion Paper.

where the board of directors meets, the so-called 'board-centric' approach. The second regards the POEM as the place where the senior or top level management operates.[17]

The SARS Discussion Paper states that the board-centric approach was reflected in the 2000 OECD Commentary on the OECD MTC and has also been criticized by many commentators on the basis that it has failed to keep pace with changes in the way in which business operates in the modern world. This is especially so in light of communication capability, the technology revolution and increased mobility. As a result, the traditional factors and interpretation in the 2000 OECD Commentary on the OECD MTC may be open to manipulation and may not result in a clear determination of the POEM, producing results which do not accord with the true policy intention for which the tie-breaker rule was originally introduced. [18]

Suggestions were made by the OECD's Technical Advisory Group in 2001 in their draft document titled '*The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule*' (refer section 8, chapter 5 below for a detailed discussion on the contents of this report), including either making the determination for POEM on the basis of predominant factors or applying a weighting to various factors. The 2000 OECD Commentary is based on three predominant factors:[19]

- The first factor – where the key management and commercial decisions are in substance made.
- The second factor – where the most senior persons or group makes their decisions.
- The third factor – where the actions to be taken for the enterprise as a whole are made.

Where the application of the above three predominant factors does not result in a single POEM, additional factors should be considered, however, there can be no definitive rule since a POEM determination will always be a factual enquiry. Additional factors could include the location of the company headquarters; information on where the central management and control of the company is, having regard to legal documents; the company's place of incorporation/registration; relative importance of functions in the various states and where the majority of the directors reside. These are, however, only secondary factors.[20]

[17] Section 7 of the SARS Discussion Paper.
[18] Section 7.1 of the SARS Discussion Paper.
[19] Section 7.2 of the SARS Discussion Paper.
[20] Section 7.2 of the SARS Discussion Paper.

In 2003 alternate proposals were put forward by the OECD's Technical Advisory Group. One suggestion entailed an expansion to the POEM explanation in the OECD Commentary; the other suggestion entailed changing the basis of the tie-breaker route to a hierarchy of tests.

The first suggestion considers instances where the key management and commercial decisions are made in one place by certain individuals but are formally finalised somewhere else. In that instance, depending on the facts and circumstances, it is recommended that the POEM could be as follows:[21]

- Where the board of directors formalises in State A, the key decisions which were in substance made in State B, the POEM will be in State B.
- If there is a so-called controlling interest holder (i.e. a parent company) that effectively makes the decisions of its subsidiary company, the POEM will be determined by the controlling interest holder. This would, however, only be the case where the parent company gets involved in the actual business of the subsidiary (i.e. acts beyond what is generally expected from shareholder involvement).
- Where the board of directors routinely approves commercial and strategic decisions made by executive officers, the place where the executive officers perform their function would be regarded as the POEM (as opposed to where the directors provide their approval). In this regard, it is important to distinguish between where the decision is made versus approved. In that case, it is suggested that the place where advice on recommendations or options were developed and issued also be taken into account.

In 2008 the OECD Commentary was revised. The 2008 OECD Commentary does not, however, include any of the suggested alternatives put forward by the OECD Technical Advisory Group. The reason given is that a majority of the member countries were of the view that the alternatives still gave undue priority for the POEM to be where the board of directors would meet, over the place where the senior executives would make key decisions.

The 2008 OECD Commentary removed all reference to board of directors and provides countries to deal with dual residency in the context of legal entities on a case-by-case basis, stating that as a minimum, the following factors are expected to be taken into account: (1) where the board of directors meet; (2) where the CEO and other senior executives usually carry on their activities; (3) where the senior day-to-day management is carried on; (4) where the person's headquarters are

[21] Section 7.2 of the SARS Discussion Paper.

located; (4) the laws governing the legal status of the person; and (5) where its accounting records are kept.

Subsequent to this, two cases from the United Kingdom dealing with the issues surrounding a 'board-centric' approach were heard (i.e. *HMRC v Smallwood*[22] and *Laerstate BV v HMRC*[23] where emphasis was placed on the substance of where the decisions relating to the business were ultimately made).[24]

Based on the analysis above, it is clear that a formalistic board-centric approach is not favoured in the international market, nor is it favoured locally by SARS in the context of Interpretation Note 6.

In essence, the SARS Discussion Paper suggests that the tentative proposal by SARS should be to reduce uncertainty. They suggest that the aim should be to refine the 'general approach' but to place continued focus on the 'second level of management' i.e. those 'top' personnel who 'call the shots' and exercise 'positive management'. [25] Areas of decision making which are extraordinary matters (i.e. major acquisitions, disposal, new borrowings) which are normally dealt with by the board of directors would not form part of the senior management team. Similarly, junior management focusing on the day-to-day operational decisions of the business would also fall outside of this ambit. They also suggest deleting reference to 'implementation' to align the principles of POEM more closely to international norms[26].

SARS recognises in the SARS Discussion Paper that, although distinguishing between these three levels of management may be easy in most instances, in the context of *bona fide* intermediary holding companies, there may be little need for junior managers and the board of directors may be responsible for both the responsibilities of a typical board, as well as the management of the company.[27]

SARS also suggests inserting certain terminology (for example, senior management, head office, passive holding company etc.)[28] and clarifying the relevant facts and circumstances which should be taken into account (for example, deletion of legal factors, clarifying reference to controlling shareholders, less weight on administrative activities, refinement of distinctions between

[22] (2010) EWCA Civ 778.
[23] (2009) UKFTT 209 (TC).
[24] Section 7.3 of the SARS Discussion Paper.
[25] Section 8.1 of the SARS Discussion Paper.
[26] Section 8.1 of the SARS Discussion Paper.
[27] Section 8 of the SARS Discussion Paper.
[28] Section 8.2 of the SARS Discussion Paper.

management levels, criteria for determining the base of operations for senior management where travel is frequent and operations are in multiple locations, etc.). [29] SARS reiterates, however, that there will be no definitive rule due to the factual nature of the POEM determination. [30]

SARS issued the much anticipated second draft Interpretation Note 6 on 14 April 2015 (second draft Interpretation Note 6). Comments were requested from the public by 20 June 2015.

The essence of the second draft Interpretation Note 6 can be summarised as followed:

- A list of definitions have been provided. Most notably, a definition for 'senior management' which refers to the level of employees responsible for developing and formulating key strategies and policies and those who oversee the execution thereof including, the CEO (or managing director), CFO (or finance director), COO and the heads of departments. A definition for 'head office' has also been inserted referring to the place where the senior management of a company and their direct support staff are predominantly located.[31]
- SARS states that the revised interpretations contained in Interpretation Note 6 will serve as a guideline to the determination of a company's residency which is consistent with the determination of POEM when used in the context of the tie-breaker rule in a treaty which adopts the OECD principles. The general principle is that a company's POEM is the place where the key management and commercial decisions that are necessary to conduct the business as a whole are made. This is aligned with international standards.[32]
- A POEM determination remains a factual enquiry. As a result, the onus of proof lies with the company who should retain evidence which supports the position taken.[33]
- SARS refers to *inter alia,* the South African case of *Oceanic Trust Co Ltd vs C:SARS*[34] and the overseas cases of *HMRC v Smallwood*[35] and *Wensleydales Settlement Trustees v Inland Revenue Commissioners*[36]. In the *Oceanic Trust* case (*supra*), the court made it clear that South African courts are applying international jurisprudence (and are thus not supporting

[29] Section 8.3 of the SARS Discussion Paper.
[30] Section 8.1 of the SARS Discussion Paper.
[31] Preamble to the second draft Interpretation Note 6.
[32] Section 2 of the second draft Interpretation Note 6.
[33] Section 2 of the second draft Interpretation Note 6.
[34] 2012 JOL 28880 (WCC), 74 SATC 127.
[35] (2010) EWCA Civ 778.

[36] (1996) STC (SCD) 241.

SARS' interpretation of the POEM concept in Interpretation Note 6), which further necessitated SARS to revise its view.[37] SARS notes that the High Court in the *Oceanic Trust* case (supra) could not make the required findings of fact. SARS acknowledged that the overseas cases have provided useful guidance in the interpretation of POEM specifically emphasising the determination of effective, realistic and positive management where the shots relating to the carrying on of the business are really called.[38]

- SARS states that the application of these principles should be relatively easy in most cases. The complexity arises in the context of large multinational groups where senior management teams responsible for the operating of the business are based in different locations and where travel is frequent. SARS states that, notwithstanding the complexity, an enquiry based on the core principles is still required in this instance.[39]
- Definitive rules cannot be laid out as all facts and circumstances must be considered in each instance.[40] In SARS' opinion, some of the factors which serve as a guideline include:
    - *Substance over form* i.e. those people who actually call the shots and exercise realistic positive management.[41]
    - The impact of the *head office* is seen as a major factor in the determination of POEM since it is the place where the key decisions of the company are made. These decisions are made more regularly than the occurrence of board of directors meetings which take place once a year. Even where board of directors meetings are scheduled more frequently, the importance of decisions made outside of these meetings cannot be overlooked in determining the POEM. Sometimes a head office is easy to determine if there is a single location from where the senior management operate as the principle place of business, however, where senior management is located in multiple locations, a 'predominant test' should be applied failing which, the location would normally be where the highest level of management are based i.e. the location of the CEO, CFO and their support staff.[42]
    - *Delegation of authority* by the board of directors to senior management and executives will infer the POEM to be where such senior management and

[37] Article by Daleen Malan on 'SARS' new draft interpretation note reflects 180 degree change on the place of effective management concept'
[38] Section 4.1 of the second draft Interpretation Note 6.
[39] Section 4.1 of the second draft Interpretation Note 6.
[40] Section 4.2 of the second draft Interpretation Note 6.
[41] Section 4.2 of the second draft Interpretation Note 6.
[42] Section 4.2.1 of the second draft Interpretation Note 6.

executives are located. This authority can be bestowed by way of a formal resolution or agreement or merely through conduct.[43]

- The *location of board meetings* where such board meetings are held regularly and where decisions are made, will still be a key factor in determining the POEM of an entity. On the other hand, however, where the board of directors meet in a country which is different to where the head office is located, the position becomes complicated. SARS states that there can be no assumption that the board of directors meetings will determine the POEM especially in the instance where authority has been delegated and the board of directors merely ratify the decisions which have in substance, already been made by the senior management teams.[44]

- *Modernisation and global travel* can impact a POEM analysis since it has changed the way in which businesses are carried on and in many instances, the need for physically board meetings is no longer required Alternatively, even where physical board meetings are held the overarching decisions are made by a director who is not physically present. SARS cautions that taxpayers should not place undue focus on the location of these meetings without considering the surrounding circumstances.[45]

- *Shareholders* typically get involved in the business where 'fundamental decisions' surrounding the existence of the company are required. For example, a sale of a major asset, dissolution or deregistration of the company, a varying of rights, new classes of shares etc. Since these decisions do not affect the ordinary conduct of the business from a management perspective, they are generally not relevant in a POEM determination. Shareholders can, however, cross the line into that of effective management when it assumes the powers of a director. This is more common in companies with a single shareholder. Guidance by a shareholder should not be confused with shareholders stepping into the shoes of the directors. Shareholders often impose limitations on the authority granted to the board of

[43] Section 4.2.3 of the second draft Interpretation Note 6.
[44] Section 4.2.3 of the second draft Interpretation Note 6.
[45] Section 4.2.4 of the second draft Interpretation Note 6.

directors and senior management. These limitations should be carefully considered in a POEM analysis.[46]

- *Operational management versus broader top level management* is normally of limited relevance in the context of a POEM determination since it concerns itself with the day-to-day operations of a company.[47]

- *Legal factors* (the incorporation, registered office, public officer etc)[48] and *the economic nexus* of the company to a certain country[49], along with the *support functions*[50] are generally not relevant in determining the POEM of a company and therefore carry with it less weight.

In SARS view the impact of the above changes to the interpretation of POEM should not result in a different POEM for a company being inside or outside of South Africa[51]. I, along with other tax advisors beg to differ since the first issue of Interpretation Note 6 placed significant emphasis on the execution and implementation of decisions and followed a three tiered approach which could, in some instances, result in the POEM being determined by the day-to-day running of operations. The focus now is on the place where the actual decisions affecting the business of the company are in substance made, which is primarily inferred by senior management and the board of directors, regardless of the place where these decisions are ultimately implemented.

In Daleen Malan's article on the topic she states '*SARS' new draft interpretation note reflects 180 degree change on the place of effective management concept*'. She goes on to say that '*SARS formerly and incorrectly, stated that an entity's POEM is at the place where the entity is managed on a day-to-day basis by the directors or senior management, irrespective of where the overriding control is exercised, or where the board of directors meet*'. '*The outcome, in the form of the new draft IN 6, seeks to locate the POEM of an entity to the place where key management and commercial decisions that are necessary for its business as a whole, are in substance made. This revised view is much welcomed by taxpayers and practitioners because it is, for the first time, consistent with international jurisprudence and the approach adopted by the Organisation for Economic Co-operation and Development. To illustrate the revised view; if the decision-making*

[46] Section 4.2.5 of the second draft Interpretation Note 6.
[47] Section 4.2.6 of the second draft Interpretation Note 6.
[48] Section 4.2.7 of the second draft Interpretation Note 6.
[49] Section 4.2.8 of the second draft Interpretation Note 6.
[50] Section 4.2.9 of the second draft Interpretation Note 6.
[51] Section 5 of the second draft Interpretation Note 6.

takes place at a location that is different to where those decisions are implemented on a day-to-day basis, SARS will now attach more weight to the location of decision-making, as opposed to the location of implementation.'

5.5 Conclusion on the meaning of effective management

In conclusion to the above analysis, it appears that the international and South African interpretation of the POEM of an entity is now more aligned and in sync. More certainty is therefore available to South African taxpayers with offshore operations.

It is important to again reiterate that the POEM is not always evidenced by where the board of directors reside or where the board of directors meetings are held. A board centric approach to POEM is no longer the norm nor a favoured approach. Rather, an enquiry into the fundamental and strategic decision making of the company will infer the POEM and this is where the focus lies. Where such decision making is in substance made by the board of directors, the POEM will be where the board of directors reside. However, where such decision making is in substance made by the senior management of the company, the POEM will be where the senior management resides.

6. CHAPTER 3: HOW TO DETERMINE WHETHER A PE HAS BEEN CREATED WITH A SOUTH AFRICAN FOCUS

5.6 Relevance in South African tax

The concept of a PE is not only relevant in the context of a DTA, as it is also a concept which has been included in the domestic law of many countries. South Africa specifically refers to the concept of a PE 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 to the Act. (Olivier & Honiball, 2011: 335).

Treaty rules provide that business profits derived by an enterprise are taxable exclusively by the state of residence, unless the enterprise carries on business in the other state through a PE situated therein. The PE concept is therefore used to determine whether or not a Contracting State is entitled to exercise its rights to tax the business profits of a non-resident taxpayer. (OECD, 2015: 28).

Generally in the context of a foreign company, such company may be subject to tax in South Africa if it has South African sourced income and, in terms of the relevant provisions of the DTA, such income is attributable to a PE in South Africa.

We consider the concepts of source and PE's below.

5.6.1 Source of income

As mentioned above, South Africa has adopted a dual source/residence basis of taxation, in terms of which residents are taxed on their worldwide income. Non-residents, on the other hand, are only taxed on South African sourced or deemed sourced income.[52]

The term 'source' is not defined in the Act, and guidance must therefore be sought in relevant tax case law. In terms of the principal test that was formulated by our South African courts, the following two factors must be established:

- the originating cause of the income (i.e. what gives rise to the income); and
- the *location* of that originating cause.[53]

The question of source is not always a simple one, as there may be more than one originating cause and therefore it is important to establish the location of the dominant or main source of the income.[54]

As a consequence of the difficulties experienced when determining the dominant cause, there are many references in our case law to the concept of apportionment. In *Transvaal Associated Hide & Skin Merchants v COT Botswana*[55], the court held that a strong argument existed for the apportionment of income between Botswana and South Africa. Other case law references (apart from cases dealing with the proceeds arising from the sale of goods or rendering of services) exist to support the concept of apportionment. In the case of *Tuck v CIR*[56], it was held, in the context of deciding whether a receipt was of a capital or revenue nature, that: *'apportionment represents a sensible and practical solution to the problem which arises when a taxpayer receives a single*

[52] Definition of 'gross income' in section 1 of the Act.
[53] *CIR v Lever Brothers and Unilever Ltd* (14 SATC 441).
[54] *CIR v Black* (21 SATC 226).
[55] 29 SATC 97.
[56] 50 SATC 98.

receipt and the quid pro quo contains two or more separate elements'. In establishing the existence of two legal causae, the court in the *Tuck v CIR* (supra) used the 'originating cause' test which, as stated above, is used to determine the source of income.

Therefore, it could be argued that the approach followed in *Tuck v CIR* (supra) could be extended to the source of income. It is further the understood practice of SARS to tax foreign branches operating in South Africa on the income generated by the activities of the branch. This practice seems to indicate that SARS accepts the principle of apportionment between the activities giving rise to such income and the distinction between the head office and the branch. Each case would, however, have to be decided on its own merits and based on its particular facts.

It should be noted that the Act deems certain income to be South African sourced[57], regardless of where the originating cause of the income is located. For example, in the case of interest, any interest[58] shall be deemed to have been received or accrued from a source within South Africa, where such interest was derived from the utilisation or application in South Africa by any person of any funds or credit obtained in terms of any form of interest-bearing arrangement.[59] The place of 'utilisation or application' shall, until the contrary is proved, be deemed to be, in the case where such funds are or credit is utilised or applied by a person other than a natural person, its POEM (i.e. where the company is tax resident).[60] The Act contains deemed source rules in respect of most passive related income such as dividends[61], royalties[62] and interest[63].

Assuming the income (other than any passive related income) earned by a foreign company is sourced from South Africa, the next step is to determine whether South Africa and the foreign company's country of residence have concluded a DTA which will allocate the taxing right of the income. Assuming a DTA is in place which is based on the OECD MTC, regard should be given to Article 7 (i.e. the business profits article), Article 21 (i.e. the other income article) and Article 5 (i.e. the PE article which provides a definition of the concept in respect of the said DTA).

In essence, the basic rule is that Article 7 and Article 21 will allocate the taxing right of the 'profits of the enterprise from carrying on a business' or 'the other income not dealt elsewhere in the

[57] Section 9 of the Act.
[58] As defined in section 24J of the Act.
[59] Section 9(6) of the Act.
[60] Section 9(7) of the Act.
[61] Section 9(2)(a) of the Act.
[62] Section 9(2)(c) of the Act.
[63] Section 9(2)(b) of the Act.

articles of the DTA' to the Contracting State wherein a PE has been created and such profits or income is attributable to that PE. This is where Article 5 becomes relevant.

5.6.2 PE definition

The Act contains a definition of PE in section 1 which provides as follows:

> '"*permanent establishment" means a permanent establishment as defined from time to time in <u>Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development</u>: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor.*' (emphasis added)

5.7 International guidelines and precedents on PE's

The PE concept acts as a threshold which measures the level of economic presence of a foreign entity in a given state. A PE is determined through objective criteria and seeks to establish the situations in which the economic presence is substantial enough to justify taxation in that other state. (OECD, 2015:28).

The term PE is defined in Article 5(1) of the OECD MTC as:

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

From this definition, it can be deduced that the following conditions must be met before a foreign company has created a PE in, for example, South Africa:

- The foreign company must have a place of business in South Africa;
- Which is fixed (in other words a place of business which has a degree of permanence); and
- The place of business must be used to carry on, wholly or partly, the business of the foreign company.

The meaning of the different components of the definition is analysed below.

5.7.1 Place of business

The first requirement in order to create a PE is that a foreign company must have a place of business in South Africa.

The determination of the 'place of business' is imperative to the investigation of whether a PE exists because where no distinct place of business exists it can be said that no PE exists, irrespective of the length of time in which the business operations continue (Olivier & Honiball, 2011: 338).

The term 'place of business' covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. (OECD, 2008:4) [64]

The mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for example, where an employee of a company is allowed to use an office in another company in order to ensure that the latter company complies with its obligations under contracts concluded with the former company, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the other company will constitute a PE of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a 'fixed place of business'. (OECD, 2008: 4.1 and 4.3).[65]

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).

5.7.2 Fixed

The second requirement is that the place of business must be fixed.

The term 'fixed' implies that the business must be established at a distinct place (i.e. that the place of business must be linked to a specific location). The OECD Commentary advises that the 'place

[64] Page 81 of the OECD Commentary.
[65] Page 86 of the OECD Commentary.

of business' of an enterprise may even be situated in the business facilities of another enterprise. It acknowledges that, where the nature of the activities is such that the activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a 'single place of business'. However, the OECD Commentary concludes that a 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 as constituting a coherent whole commercially and geographically with respect to that business. (OECD, 2008:5.1).[66]

Thus, whether the business of a foreign company is carried from its own offices, the offices of its subsidiary or the offices of third party, the place of business would be regarded as being 'fixed'.

The facility does not need to be an integral portion of the plot of land on which it stands in order to constitute a fixed place of business. (Vogel, 1997: 286).

Moreover, the term 'fixed' also implies that the business must be established with a certain degree of permanency (i.e. it must not be of a purely temporary nature). Nevertheless, a 'place of business' may constitute a PE, even though it existed only for a very short period of time, because the nature of the business was such that it was only carried on for that short period of time. The OECD Commentary further advises that although the practices followed by member countries are not consistent, experience has shown that PE's are normally not considered to exist in situations where the place of business was maintained for less than six months. However, one exception is where the activities are of a recurrent nature, in which case each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used. Further, temporary interruptions of activities do not cause a PE to cease to exist. (OECD, 2008:6).[67]

5.7.3 Carry on a business

Thirdly, in order for a PE to exist, the place of business must be used to carry on, wholly or partly, the business of the foreign company.

In considering the meaning of the term 'business', the OECD Commentary states, with reference to Article 3(1) (General Definitions) that:

[66] Page 82 of the OECD Commentary.
[67] Page 83 of the OECD Commentary.

'the term "business", ..., should generally have the meaning which it has under the domestic law of the State that applies the Convention." (OECD 2008:10.2)[68]

Thus, consideration should be given to its meaning under domestic law.

In terms of South African domestic tax law, although the term 'trade' is defined in the Act, the Act does not define the expressions 'business' or 'carrying on business'. The definition of 'trade' in section 1 of the Act does, however, include, *inter alia, 'every [business]'*. Although the carrying on of a trade is not the same thing as carrying a business (De Koker, A. & Williams, R.C, 2012: 14.47), it is submitted that, provided the 'active step' requirement for a trade has been complied with, the carrying on of a 'business' has the same meaning as the carrying on of a 'trade' for income tax purposes.

In terms of judicial definitions, the broadest expression of the term 'business' merely describes it as being a duty, as opposed to pleasure. To this end, the term 'business' was held in *Rolls v Miller* [69] to mean:

'....almost anything which is an occupation, as distinguished from a pleasure – anything which is an occupation or duty which requires attention is a business.'

In terms of *CIR v Stott*[70] and *CIR v Lydenburg Platinum Ltd*[71] the test to be applied to an individual differs to a company. In the context of a company continuity is not a necessary element in the carrying on of a business whereas in the context of an individual it is. In *Modderfontein Deep Levels Ltd v Feinstein*[72], the court held:

'To constitute a business there must either be a definite intention at the first act to carry on similar acts from time to time if opportunity offers, or the acts must be done not once or twice but successively, with the intention of carrying it on, so long as it is thought desirable.'

The objective of making a profit is also not an essential feature in determining the carrying on of a business.[73]

The court, in *Estate G v COT*[74], held:

[68] Page 70 of the OECD Commentary..
[69] (1884) 27 ChD 71.
[70] 1928 AD 252, 3 SATC 253.
[71] 1929 AD 137, 4 SATC 8.
[72] 1920 TPD 288.
[73] *Platt v CIR* 1922 AD 42, 32 SATC 142.
[74] 1964, 3 ALL SA 182 (SR).

'The sensible approach, I think, is to look at the activities concerned as a whole, and to ask the question: Are these the sort of activities which, in commercial life, would be regarded as 'carrying on business'? The principle features of the activities which might be examined in order to determine this are their nature, their scope and magnitude, their object (whether to make a profit or not), the continuity of the activities concerned, if the acquisition of property is involved, the intention with which the property was acquired. This list of features does not purport to be exhaustive, nor are any one of these features necessarily decisive, nor is it possible to generalize and state which feature should carry most weight in determining the problem. Each case must depend on its own particular circumstances.' (emphasis added)

A PE will come into existence when the enterprise commences carry on its business through a fixed place of business. The period of time during which the fixed place of business itself is being set-up (i.e. the start-up phase) will not count towards the duration and existence of the PE provided that, the start-up activities differ substantially to the activity which the place of business intends conducting on a permanent basis. The PE will therefore come into existence once the enterprise has prepared, at the place of business, the activity that will be conducted on a permanent basis. A PE will no longer exist when the fixed place of business is sold or when the essential activities of the business have ceased. (OECD, 2008: 6 and 6.1).[75]

5.7.4 Inclusions in the PE definition

Under Article 5(2) of the OECD MTC, the following activities are specifically regarded as sufficient to constitute a PE:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop; and
- a mine, an oil or gas well, a quarry or any other place relating to the exploration for or the exploitation of natural resources.

Most South African DTA's follow the above list of examples. This list is not, however, exhaustive and varies from treaty to treaty where some treaties add or substitute further examples. (Olivier & Honiball, 2011: 337).

[75] Page 83 of the OECD Commentary.

Although regarded as *prima facie* constituting a PE, the abovementioned activities are not conclusive evidence of a PE. (Olivier & Honiball, 2011: 337). The OECD Commentary makes it clear that this list should be considered against the background of the general rule in Article 5(1) (i.e. a fixed place of business through which the business of the enterprise is carried on must still be met before a PE can exist). (OECD, 2008:12).[76]

5.7.5 Exclusions from the PE definition

Even where the above mentioned general requirements of a PE are met (and sometimes the specific inclusions as well), there are certain activities that are specifically excluded from constituting a PE even if, they are carried on through a fixed place of business as referred to above.

In particular, Article 5(4) of the OECD MTC lays out the activities which are specifically excluded from creating a PE. The most relevant of the activities is Article 5(4)(e) of the OECD MTC where a fixed place of business is maintained solely for purposes of carrying on any activity of a preparatory or auxiliary character.

The OECD Commentary acknowledges that it is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criteria, it is said, is whether or not the activity of the fixed place of business in itself forms a vital and significant part of the activity of the enterprise as a whole. (OECD, 2008:24).[77]

A common feature of 'preparatory or auxiliary' activities is that through them only an incomplete portion of the enterprise's overall business is exercised. Such activities only make economic sense because they are supplemented by the work performed somewhere else. In other words, the question is whether the activity being undertaken is of no or very little significance in view of the other work performed by the enterprise. If the answer is yes, then the activity may be of a preparatory or auxiliary nature. It is akin to a secondary, not primary function of a business.

A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity. This kind of managerial activity is significant in the context of any business and exceeds a so-called auxiliary involvement. (OECD, 2008:24).[78] Thus, for example, where an enterprise establishes a so-called management office in a country in which it maintains subsidiaries or

[76] Page 86 of the OECD Commentary.
[77] Page 89 of the OECD Commentary.
[78] Page 89 of the OECD Commentary.

exercises managerial functions, the office, having supervisory and coordinating functions for all departments of the enterprise located within the region concerned, will constitute a PE as it may be regarded as either an 'office' or 'place of management' within the meaning of Article 5(2) of the OECD MTC. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of an enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of article 5(4)(e). (Olivier & Honiball, 2011: 342).

5.7.6 Agency relationships

Article 5(6) of the OECD MTC considers the impact of agency relationships in the context of a PE determination.

The essence of the article provides that, even if an enterprise does not have a fixed place of business in South Africa for example, a PE will be deemed to be created when persons in a Contracting State (for example South Africa) act or function on behalf of another Contracting State (for example a foreign company) in terms of an agency relationship. The activities of all agents will not, however, automatically result in the creation of a PE. To create a PE, the agent must:

- be a dependent agent; and
- have and habitually exercise the authority to contract on behalf of the foreign company in South Africa.

The only exception provided to the above is where the activities of the dependant agent fall within the 'exclusions list' dealt with in section 5.7.5 of this document (i.e. when the nature of the activities are 'auxiliary or preparatory' in nature).

There is a two-stage enquiry to determine the agency relationship in the context of a PE. The first enquiry is whether the agent is independent. If this is confirmed, no PE would exist. If the agent is, however, regarded as a dependent agent, the second enquiry becomes relevant which is a function of whether or not such agent habitually exercises an authority to conclude contracts on behalf of the Contracting State in another State.

5.7.6.1 Dependent versus independent

Article 5(6) of the OECD MTC provides that an enterprise shall not be deemed to have a PE in a Contracting State merely because it carries on a business in that Contracting 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.

A distinction therefore needs to be made between a dependent agent and an independent agent. (Olivier & Honiball, 2011: 345).

Generally a person will be regarded as a dependent agent if he/she has authority in respect of the core business of the enterprise.

An independent agent is a person that is both legally and economically independent of the enterprise for which it acts, and who acts in the ordinary course of his business when acting on behalf of an enterprise. (Olivier & Honiball, 2011: 346).

In essence, an agent is legally independent if he can conduct the business of the principal according to his own view, expertise and methods without intervention from the principal.[79] With regards to economic independence, an agent will be regarded as being economically independent from his principal if the agent's business is able to stand on its own and not look to the principal for its very economic viability. (Vogel, 1997: 345).

Factors to be taken into account when applying these criteria include:

- the extent of the obligations that the person has towards the instructing enterprise;
- whether the commercial activities for the enterprise is subject to detailed instructions or to comprehensive control by the enterprise, and
- the entrepreneurial risk borne by the agent or the enterprise on whose behalf it acts.

(Olivier & Honiball, 2011: 347 and OECD, 2008: 37-38)[80]

5.7.6.2 Authority to conclude contracts

The OECD Commentary states that persons whose activities may create a PE for the enterprise are so-called dependent agents (i.e. persons, whether or not they are employees of the enterprise, who are not independent agents falling under paragraph 6). This presupposes that in the context of employees, an analysis of the dependent vs independent agents should still be considered. (OECD, 2008: 32)[81].

[79] See *Taisei Fire and Marine Insurance Co. Ltd* 104 TC No. 27 (May 2, 1992) and *Donroy Ltd v United States* 301 F.2d 200, 206 (9th Circuit.1982).
[80] Page 94 of the OECD Commentary.
[81] Page 93 of the OECD Commentary.

It should be noted that Article 5 of the OECD MTC proceeds on the basis that only persons who have the authority to conclude contracts can lead to the establishment of a PE for the enterprise maintaining them. In such a case, the person must have sufficient authority to bind the enterprise's participation in the business activity in the state concerned.

In terms of the OECD Commentary the authority to conclude contracts must cover contracts relating to the business proper of the enterprise (i.e. the actual underlying business). Therefore the authority to conclude contracts relating to internal operations or contracts of an auxiliary nature will not result in the creation of a PE. Furthermore it is provided that a dependent agent who has the authority to negotiate all elements and details of a contract which binds the enterprise, would also create a PE even if that agent does not actually sign the contract. (OECD, 2008: 33).[82]

Whilst the South African courts have not considered the meaning of the dependent agency provisions in any DTA concluded by South Africa and, in particular, what is meant by the phrase '*is acting on behalf of an enterprise and has, and habitually exercises, in a contracting state, an authority to conclude contracts on behalf of the enterprise*', this aspect has been considered in a number of international cases, which may provide persuasive authority.

From the Indian case of *DDIT v B4U International Holdings Limited*[83], it was evident that when determining whether an agent may constitute a PE for its principal on the basis of the agency provisions of the DTA, one must firstly consider the agreement entered into between principal and agent.

To the extent that the agreement clearly stipulates the functions of the agent and it is evident that the agent has no authority to negotiate, conclude, vary any term or represent the principal in dealings with the principal's customers, *prima facie*, the agent will not create a PE for its principal. However, it must also be considered whether such agent, outside the scope of any legal existence of such authority, habitually exercises the authority to conclude contracts on behalf of its principal. Therefore, it must be ensured that the parties' conduct corresponds with the wording of the agreement and that all agreements are implemented in accordance with its form.

In an earlier decision in *Knights of Columbus v Her Majesty the Queen*[84], which was based on the DTA entered into between the America and Canada, support was provided that even where an agent in a Contracting State performs a significant role in its principal's business, solicits all applications and engages with prospective customers, on the basis that the contract is only entered into at such

[82] Page 93 of the OECD Commentary.
[83] (ITA 880/MUM/2005) (AY2001/02).
[84] 2008 TC3648.

time that the principal has finalised all its procedures and the agent merely acts as messenger, the agent will not create a PE for the principal.

An important consideration in the case was that the agent had no authority to vary any contractual terms and that the agreement was based on a standard agreement of which all terms and conditions are subject to the principal's authority.

5.8 Conclusion on the meaning of PE

In conclusion to the above analysis it appears that the international and South African interpretation of the creation of a PE is largely aligned. The focus of the general rule is broadly interpreted on a consistent basis and requires that a business, which could be seen as stand-alone but with a degree of permanence, be conducted and carried on through an office or premises in a foreign country. Only in that instance will a PE exist (i.e. an extension of the existing business in another country). The specific rules around the so-called inclusions, exclusions and the agency relationships of persons could create a PE for a company in another jurisdiction. These principles must be considered in light of the factual circumstances in each case.

7. CHAPTER 4: UNDERSTANDING THE DIGITAL ECONOMY

The evolution of the digital economy as we know it consists of various interrelated components. In the Final Action Plan issued by the OECD titled '*Addressing the Tax Challenges of the Digital Economy*' they measure the impact of information and communication technology on the economy. In so doing they consider several of the components making up the digital economy, an explanation of which is set out below:

- *Personal computing devices* – this includes manufacturers of hardware and more recently, integrated packages of hardware and software (i.e. smart phones and tablets).
- *Telecommunications networks* – this was driven primarily by the internet and the major business which has derived therefrom. As a result, the internet service providers (ISPs), network component providers and infrastructure intermediaries became central to the digital economy. Nowadays ISPs are competing with 'over-the-top' service providers (OTTs) who

do not only provide network access (such as an ISP), but also provide valuable content and data to the end user.

- *Software* – the world wide web (www) marked the emergence of internet-powered software and is made up of millions of webpages and websites. The most common software includes Hypertext Transfer Protocol (HTML); Hypertext Markup Language (HTML); Extensible Markup Language (XML); Post Office Protocal (POP) etc.
- *Content* – as an indexation, content has been regarded as the biggest driver of growth and success in the digital economy's value chain. In today's times many major players in the digital economy are content providers (i.e. search engines). Examples of successful sites of content providers are Wikipedia and YouTube. Social media and networking has also created a business phenomenon much larger than expected.
- *Use of data* – collected data can be volunteered (i.e. registering for an application and providing your personal details), observed (i.e. tracking website browsing and history) or inferred (i.e. based on analysis of online activities) from the end user. The capacity to store and collect data is increasing due to the growing number of internet users. This data is very important for businesses so they can quickly react to and capitalise on the needs of their customers and provide tailor made solutions.
- *Cloud based processes* – due to the standardisation of the separate components such as hardware, software and infrastructure, some businesses have combined these components and made these resources available over the internet. By using a network of remote servers hosted on the internet, one is able to store, manage, and process data anywhere in the world as opposed to through a local server or a personal computer.

(OECD, 2015: 66 to 82)[85].

Due to rapid technology changes and advances, the development of information and communication technology has resulted in various new trends. These include:

- *Internet of Things* – this refers to the internet as a network connecting individuals and content and the ability to access this information from any smart device. It consists of various components, such as machine-to-machine communication, cloud computing, substantial data analysis, sensor, machine learning and the advancement in remote control devices.

[85] Page 35 to 41 of the Final Action Plan issued by the OECD.

- *Virtual currencies* – this refers to units of exchange which are entirely digital and are not issued by government legal tender. Some virtual currencies are specific to a single virtual economy (i.e. online gaming) whilst others are designed to allow for the purchase of real goods and services (i.e. bitcoins). Virtual currencies are creating policy issues as they are gaining real economic value and in the context of bitcoin for example, can be concluded on an entirely anonymous basis.
- *Advanced robotics* – automated factories and smart robots are changing the manufacturing industry. By using advanced robotics, manufacturing can be redirected to countries with higher labour costs and closer to the end customer since they are primarily automated. This changes the traditional business model where low labour costs were key since they represented one of the highest cost components in the manufacturing business. In time, this technology may extend beyond the manufacturing industry into other segments of the economy.
- *3D printing* – similar to advanced robotics, where manufacturing is redirected to a place closer to the customer, the design of a product can be completely personalised and customised to the needs of the customer. This is particular relevant in the healthcare industry (i.e. ear pieces).
- *The sharing economy and collaborative production* – this refers to peer-to-peer sharing of goods and services. Although this is not new, due to the advancements in technology, the transaction costs have reduced substantially, whilst the availability for information and security have increased. In recent years there have been various sharing applications using different models and focusing on one service offering or product such as cars, spare rooms, food, clothes etc (i.e. gumtree). From the sharing economy the 'crowdsourcing' and 'crowdfunding' (i.e. collaborative production and consumption) has evolved wherein a platform is created to enable lending, borrowing, donations, equity based financing etc.
- *Access to government data* – governments are progressively making government resources available to the public in an electronic form in order to promote an 'open data policy'. The objectives are to increase accountability by government, increase transparency, improve service delivery and promote co-operation with government agencies etc.
- *Reinforced protection of personal data* – In most countries, the legal system provides 'data protection and privacy laws' wherein the personal data collected about a person remains the property of such person and it is only such person (and not the organisation who may have access to such information) that can disseminate and use this data. There is a growing concern that the privacy and security of this information is not being upheld. Therefore, a

number of countries are considering ways in which to strengthen, improve and regulate compliance with the data protection and privacy laws.

(OECD, 2015: 84 to 98)[86].

In summary, the information and communication technology within the digital economy comprises of various interactions between layers of hardware and software. At the base lies the internet (i.e. *infrastructure*) which consists of cables and routers and data centres which are operated by ISPs and network carriers. Content delivery networks pay the ISPs for hosting servers in their data centres. Internet domain names are also managed and organised at this level. Then comes the core *software resources* which allows organisations to create new applications based on raw data and content. The layer of tools that follow is to provide *accessibility* which combines the infrastructure and software resources to create applications which can now be used and operated by end users (i.e. an operating system and protocols such as HTTP which provides access to the WWW or simple mail transfer protocol (SMTP) which provides for email transmission). The accessibility layer provides the foundation for the *applications* layer which is required to connect end users to suppliers of goods and services. This is followed by the *machine-to-human interface* layer which represents the user's experience through a device. The device can be generic and support many applications or it can be non-generic and only support one application. The last layer is the actual *user* who could be individuals and businesses who interact via the interface. Some businesses provide only one layer in the virtual economy and pay other operators for the other levels (i.e. a software company will provide the 'software resources layer' but may rely on a separate operator to provide the 'accessibility layer' (HTTP) etc). (OECD, 2015: 99 to 108).[87]

[86] Page 42 to 46 of the Final Action Plan issued by the OECD.
[87] Page 46 to 48 of the Final Action Plan issued by the OECD.

8. CHAPTER 5: APPLICATION OF POEM GUIDLEINES TO THE DIGITAL ECONOMY AND SUGGESTED SOLUTIONS TO PRACITICAL CHALLENGES IDENTIFIED

5.9 Current application of POEM principles in the context of the digital economy

As mentioned above, in as early as 2001 the Technical Advisory Group to the OECD released a report titled '*The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule*'. This report examines whether the principles of POEM can be applied taking into account technological developments and the globalisation of businesses. Focusing specifically on the new aged digital economy, the OECD acknowledged that applying the factors as discussed in section 5 (chapter 2) above, may prove to be difficult and may result in the POEM being outside of the policy intentions of the provisions. (OECD, 2001:35).[88]

The digital economy has profoundly changed the way in which businesses operate since advanced technology makes it cheaper, faster and more effective to conduct business wirelessly and in multiple jurisdictions, without the need for expensive board meetings where directors are required to be physically present. This improved mobility may have a significant impact on dual resident companies, and with that, the application of POEM tie-breaker rules. (OECD, 2001:34 and 37).[89]

In their report, the Technical Advisory Group highlights the following limitations when applying POEM principles to the digital and borderless environment:

- Assume for example the senior, top level directors and management of a French online shopping company is scattered across the globe (i.e. the CEO is based in China, the CFO is based in Indonesia, the COO is based in Singapore, the Chief IT Officer (CIO) is based in the Philippines and the sales directors are across the region). Decisions in respect of the business are made via video or teleconferencing. Applying the existing POEM principles there may well be a risk that a POEM has been created in each of these jurisdictions and

[88] Page 8 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.
[89] Page 8 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.

may be near impossible to identify one place over the other as being more dominant. (OECD, 2001:38-40).[90]

- As an alternative to the above, the business may dictate and see value in the directors situated across the globe physically attending meetings with senior and top level management on a regular basis, but always in a different jurisdiction. Once again a strict application of the POEM principles may result in the POEM arising in each of the jurisdictions in which these meetings are held. (OECD, 2001:44).[91]
- There may also be instances where the CEO, as the main decision maker in respect of a certain business, is constantly on the move. From one week to the next he is across the globe. Just because he is travelling does not mean that the business stops to operate, rather, the key commercial decisions affecting the business are made remotely whilst he is abroad. Applying the existing POEM principles there may well be a risk that a so-called mobile POEM have been created in each of the jurisdictions in which significant decisions in respect of the business were made. (OECD, 2001:42-43).[92]

The above illustrates that in certain instances and especially in certain industries, the POEM principles do not result in an effective allocation of tax residency to a single location. In order to overcome this, the Technical Advisory Group suggested the following: (OECD, 2001:48).[93]

- Option 1: Replace the POEM concept.
- Option 2: Refine the POEM test.
- Option 3: Establish a hierarchy of tests (similar to the individual tie-breaker rule) so that if one test does not provide an outcome, the next test should apply.
- Option 4: A combination of option 2 and option 3 above.
- Option 5: Deny dual resident companies the benefits under the OECD MTC. (This last option does not necessarily solve the conflicts around dual residency, but it does prevent treaty abuse).

[90] Page 8 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.
[91] Page 9 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.
[92] Page 9 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.
[93] Page 10 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.

5.10 Alternatives to address challenges in applying POEM principles to the digital economy

5.10.1 Replacing the POEM concept

Three alternatives to the POEM concept were suggested by the Technical Advisory Group. These included (1) the place of incorporation or where the laws of the company apply; (2) the place where the directors or shareholders reside; or (3) the place where the economic nexus of the company is the strongest. (OECD, 2001:50).[94]

The first option is simple and easy to understand and administer, however, it will not always give rise to the place where the actual substance of the business arises since one can incorporate a company anywhere (and nowadays, it can be done online). Therefore, the link between the country of incorporation and the actual business may not exist (other than the legal corporation). It can also easily be manipulated and the amount of companies registered in tax havens around the world will surely increase. It is also not aligned with the policy intention (i.e. to grant the taxing rights on a substance basis). The OECD dismissed this alternative to the POEM in its 2000 OECD Commentary on Article 4 in paragraph 22 wherein it said: '*It would not be an adequate solution to attach importance to a purely formal criterion like registration...*'. Also, the place of incorporation can be changed in future (i.e. through a redomicile of the corporate seat of the company). Further, it does not reflect the underlying businesses economics, similar to that of an individual, where more emphasis is placed on his country of birth as opposed to the country in which he has lived his whole life. (OECD, 2001:51-57).[95]

The second test of placing reliance on where the board or senior management resides will not provide a conclusive answer either. The position is further complicated when the shareholders are juristic persons as opposed to individuals. (OECD, 2001:58).[96]

The third test focuses on the economic connection of the business to a particular country. The question is how to measure or determine this connection. The OECD suggests a connection to the

[94] Page 10 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.
[95] Page 10 and 11 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.
[96] Page 11 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.

land, labour, capital and enterprise (the factors of production) employed by the company in generating its revenue. In a way, this approach makes most sense since the country providing the infrastructure and facilities to operate the business is granted the tax benefits of residency. Should the economic connection be created in more than once country, the country with the strongest most dominant connection will ultimately drive the POEM. The counter argument to this approach is that it supports a source basis of taxation (as opposed to a residency basis of taxation). Even in that case, however, it could still serve as a test in a tie-breaker clause similar to the concept of 'centre of vital interests' used for individuals or natural persons. The Technical Advisory Group further suggests that the characteristics that would determine whether an economic connection exist be defined and specified to create more certainty and uniformity. (OECD, 2001:59 to 61).[97]

5.10.2 Refining the POEM test

The refinement of the POEM principles entails either making a determination based on predominant factors or attributing a weighting to factors. (OECD, 2001:62).[98]

Per Article 24 of the 2000 OECD Commentary, the dominant factors in a POEM analysis have already been established as (1) the place where the key management and commercial decisions are made in substance; (2) where the most senior management makes its decisions; and (3) where the actions to be taken by the enterprise as a whole are determined. Where these factors are indecisive additional factors could be considered in combination with the dominant factors. These other factors could include (1) the location of and functions performed at the headquarters; (2) where the central management and control of the company is situated; (3) place of incorporation; (4) relative importance of the functions performed within certain countries; and (5) where a majority of the directors reside. The more important question is whether these factors are actually useful and if so, the appropriate weighting they should have in a POEM determination. (OECD, 2001:62).[99]

The mechanisms in Article 4 of the OECD MTC does not provide any guidance on POEM in a mobility context. The reference to Article 8 of the OECD MTC (which deals with shipping, inland waterways transport and air transport) may be helpful since it considers an example in the event of

[97] Page 12 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.
[98] Page 12 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.
[99] Page 12 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.

mobility. More specifically, it states in Article 8(3) of the OECD MTC: '*If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.*'. In effect, the provision recognises that a POEM which is located on board a ship will be mobile since the asset itself is mobile. In that instance, POEM is linked to the place where the most important person in respect of which such business operates is a tax resident since in that case, the business link is the strongest. It is suggested that a similar test could be introduced to cater for so-called mobile places of management (i.e. place the emphasis on the tax residency of the person making the decisions regardless of where such decisions are actually made). This test will not, however, assist in the event that the management and decision making relating to the business is done via teleconferences or where there are various decisions made by various persons. (OECD, 2001:66 to 68).[100]

5.10.3 Establishing a hierarchy of tests to determine POEM

Similar to the 'waterfall' approach adopted in the case of an individual persons residency, a hierarchy approach to the POEM determination may prove to be beneficial. Careful consideration of the 'levels' will however be required. A suggested hierarchy structure could include (starting with the main priorities):

- POEM (i.e. where the key management and commercial decisions are in substance made; and where the most senior management makes their decisions); followed by
- Place of incorporation; followed by
- Economic connection; followed by
- Mutual agreement between the Revenue Authorities of the respective countries.

The risk of a hierarchy approach is that it is very rigid without room for interpretation. This could be both a good and a bad thing. (OECD, 2001:69 to 72).[101]

[100] Page 13 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.
[101] Page 13 and 14 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.

5.10.4 Refining and establishing a hierarchy of tests to determine POEM

A combined approach may result in consolidating the best elements of each option when considered in isolation. The combination of options should not be limited to that as suggested by the Technical Advisory Group. Rather, the Technical Advisory Group recognises that other combinations could exist which may be valuable and constructive in establishing the POEM guidelines for fluid businesses and industries. (OECD, 2001:73).[102]

5.10.5 Deny dual resident companies the benefits under the OECD MTC

As mentioned above, this option does not necessarily solve the interpretation issues surrounding POEM. Also, due to the differences in domestic law, companies could find themselves being subject to double tax where the Revenue Authorities are not in agreement. (OECD, 2001:74 to 75).[103]

5.11 Conclusion

To date, none of the suggested changes by the Technical Advisory Group as set out in the report titled '*The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule*' has been implemented. It is also interesting to note that the Final Action Plan by the OECD issued on 5 October 2015 and titled '*Addressing the Tax Challenges of the Digital Economy*' does not consider, nor highlight POEM as a key tax principle contributing towards BEPS. As a result, no specific recommendations or changes to the POEM determination of a company operating in the digital space is noted.

From a South African perspective, the position also remains unchanged. No formal amendments have been made to the definition or interpretation of POEM to specifically cater for the digital economy. The most recent developments are those covered by the second draft Interpretation Note 6 (issued by SARS on 14 April 2015) which seeks to align South Africa's POEM interpretation to that of the rest of the world.

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[102] Page 14 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.
[103] Page 14 of the OECD report on The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule.

9. CHAPTER 6: APPLICATION OF PE GUIDLEINES TO THE DIGITAL ECONOMY AND SUGGESTED SOLUTIONS TO PRACITICAL CHALLENGES IDENTIFIED

5.12 Current application of PE principles in the context of the digital economy

One of the most brief yet useful explanations of what e-commerce entails is provided for by Chetuti in his publication titled '*The Challenge of ECommerce to the Definition of a Permanent Establishment: The OECD's Response*'. In essence he describes e-commerce as the electronic sale by online stores of downloadable merchandise which can be referred to as 'soft merchandise'. This would include anything from music, e-books, e-newsletters, photos and video recordings, software and documents (direct e-commerce), ordering of tangible products online (indirect e-commerce), securities transactions online as well as the provision of financial or other services. E-commerce includes the subscription to and use of an ISP, 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 (throughout the entire supply chain) and the consumer. (Chetcuti, 2002). It is clear that the information and communication technology as discussed in section 7 (chapter 4) above, particularly the advances in this sector, is rapidly impacting the growth of the digital economy. (OECD, 2015: 64 and 65). [104]

As already mentioned, e-commerce and the digital economy presents significant challenges for tax administrations due to *inter alia,* the multi-jurisdictional nature of the underlying transactions. In today's times, businesses are able to sell their goods and services anywhere in the world at a much larger scale and without necessarily creating a physical presence. In addition, due to information and communication technology, it is now possible for businesses to centralise many functions of their operations. The existing thresholds for PE's requiring a so-called physical presence was partly premised on the fact that traditional businesses required a physical presence to conduct their operations. This model is becoming outdated. The PE definition also required a physical presence as

[104] Page 36 of the Final Action Plan issued by the OECD.

it was linked to the source country who then acquired the administrative ability of enforcing its taxing rights on non-resident entities. (OECD, 2015: 246). [105]

The OECD aims to address the tax issues (including those mentioned above) arising from the digital economy in a collective spirit amongst governments and fiscal organisations. Despite the challenges, the concept of a PE remains a dominant taxing principle. The question is, however, whether the current PE principles will achieve the policy intent for which the taxation of PE's was originally introduced. (PWC, 2013).

5.12.1 The OECD Commentary on E-Commerce

The aspect addressed by the OECD in this instance relates to whether the mere use of ecommerce operations of computer equipment in another country could create a PE. The OECD Commentary is therefore limited to this facet of e-commerce only and does not deal with all aspects of the digital economy in the context of PE's.

In terms of the existing OECD Commentary on Article 5, the view is taken that the general requirements of a PE must still be satisfied but provides that one must distinguish between the physical assets (i.e. the computer equipment), which may in itself create a PE, and the underlying software and data which passes through the computer equipment and may be stored there. The example of an internet site is provided which lacks tangibility and does not have a location which could meet the concept of a 'place of business' since it does not have actual premises where machinery or equipment is operated. Having said that, the actual server which stores the website r to the tre, and through which the website operates, constitutes equipment having a physical location. In that case the location of the server may meet the requirements of a 'fixed place of business' of the enterprise that operates that server. (OECD, 2001:42.2).[106]

Distinguishing between the website and server is therefore critical since the enterprise that operates the server may be different from the enterprise that carries on its business through the website. For example, where one makes use of an ISP, typically a fee is paid to operate through the ISP which is based on the actual software and data stored on the ISP. These contracts do not, however, mean that the server of the ISP is at the disposal of the business carrying on its website (i.e. the server is not legally owned by the business, nor is the business, the only user of the server provided by the ISP).

[105] Page 99 of the Final Action Plan issued by the OECD.
[106] Page 97 of the OECD Commentary.

Since the server will not have a physical location in relation to the business and the website is in itself intangible, no place of business has been created through this hosting arrangement with the ISP. On the other hand, however, where the enterprise which carries on their business through a website owns or leases the server and actually operates the server, such server will be considered to be at the enterprises' disposal. In that instance, the location of the server could create a PE for the enterprise (provided the remaining requirements of Article 5 paragraph 1 are satisfied. (OECD, 2008: 42.3)[107].

Before a 'fixed place of business' will exist the computer or server will need to be located at a certain place for a sufficient period of time. The other requirement is that the business of the enterprise should wholly or partly be carried on at such location where the enterprise holds equipment i.e. the server. (OECD, 2008: 42.4-42.5)[108]. The presence of actual personnel of the enterprise is not a determining factor as to whether the computer equipment is wholly or partly carrying on the business of the enterprise since often, the computer equipment operates autonomously. (OECD, 2008: 42.6)[109].

The existing OECD Commentary further goes on to state that the 'tangibility' requirement is not decisive in all cases either. This would result in the view that all intangible assets (which are very valuable assets in the digital economy) could not be considered as 'places of business' due to their lack of traditional physicality and local fixedness. The OECD Commentary clarifies that this should be considered on a case-by-case basis especially where software and hardware components are combined by business enterprises. The OECD Commentary states that the mere licensing of software in a different country does not, in itself, create a PE. Once again the other principles of a PE will need to be considered. (OECD, 2008: 42)[110].

The OECD further confirms that a PE cannot exist where the e-commerce operations which are carried on through the computer equipment at a fixed location are restricted to 'auxiliary and preparatory activities'. This would include:

- providing a communication link i.e. a means of communicating between the supplier and the customers;
- advertising goods or services;

[107] Page 98 of the OECD Commentary.
[108] Page 98 of the OECD Commentary.
[109] Page 98 of the OECD Commentary.
[110] Page 97 to 99 of the OECD Commentary.

- conveying information through a mirror server for security and efficiency purposes;
- gathering market information for the enterprise; and
- the supply of information.

(OECD, 2008: 42.7)[111].

Where the activities are not auxiliary or preparatory but rather, forms an essential 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, combined with the equipment constituting a fixed place of business, could very well result in a PE having been created. (OECD, 2008: 42.9)[112]. With reference to the discussion in section 5.13.1 below, it appears that most BEPS abuse by companies in the context of PE determinations, arises from reliance on the exceptions to the PE article on the basis that they are 'auxiliary or preparatory' in nature.

Concepts such as 'virtual PE's' have also appeared in recent times. Spain specifically showed their support for this in 2012 when the Dell computer case was heard. In brief, the Spanish courts held that an online store owned and operated by an Irish affiliate within the Dell group could qualify as an online PE in Spain, even though (1) the server was located outside of Spain; (2) there was no human personnel employed by the Irish affiliate and situated in Spain which were required to perform the activities; and (3) no assets (including computer equipment) was physically located in Spain. In this case, the creation of a virtual PE turned on two important facts, namely (1) the Irish Dell affiliate sold products into the Spain using a website focused on the Spanish market; and (2) a Spanish affiliate of the Irish company employed persons who translated the web pages, reviewed content, and otherwise administered the site. The court, in coming to its view, relied heavily on their interpretation of the OECD Commentary relating to e-commerce as discussed above. The court also placed reliance on older versions of 'reservations' to the OECD Commentary on this Article 4 relating to e-commerce. This was found to be incorrect since those 'reservations' were later removed from the OECD Commentary. Some commentators are of the view that the court's interpretation was flawed and that no PE would have been created in Spain (since it lacked key features such as equipment being placed in Spain which would of created a 'place of business'). (Sprague, 2015).

[111] Page 98 and 99 of the OECD Commentary.
[112] Page 99 of the OECD Commentary.

It is interesting to note that the Technical Advisory Group to the OECD on '*Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits in the Context of Electronic Commerce*' issued its final report in June 2004. The Technical Advisory Group concluded that creating a nexus for a non-resident enterprise without an actual physical presence in the State based on a 'virtual PE' basis would require a fundamental modification of the existing PE standards, and should not be pursued by the OECD. The case has gone on appeal to a higher court in Spain and a judgement is still to be given. (Sprague, 2015).

Where this higher court upholds the decision and creates a precedent for virtual PE's, non-resident sellers into the Spanish market would be exposed to direct income tax if their business is supported by personnel of a Spanish affiliate who assists in managing the website. This would present a huge extension of the power to tax non-resident enterprises that in fact do not maintain actual operations within the State. This will undoubtedly have an impact on and target information technology giants such as Google, Amazon and Facebook. (PWC, 2013).[113]

Based on the OECD Commentary it is apparent that the focus has primarily been on creating a taxable presence which is hardware driven and still requires a physical presence in the form of a 'place of business'. Due to the valuable nature of intangible property, however, as well as the Dell case, there is now a trend towards creating a taxable presence which is software driven. This is becoming more prominent in light of cloud computing and high-speed broadband. (PWC, 2013).[114]

5.13 Alternatives to address challenges in applying PE principles to the digital economy

The OECD issued its Final Action Plan titled '*Addressing the Tax Challenges of the Digital Economy*' on 5 October 2015.

Specifically with regards to PE's, the OECD highlighted that in the context of BEPS companies are minimising tax in the market country (i.e. where the customer base sits) or the ultimate parent company (i.e. which is typically in a high tax jurisdiction) by avoiding a taxable presence. For example, a non-resident company may interact with customers in a country remotely through websites, cell phone applications or through independent agents without the need to maintain a physical presence in the country. Before a PE can be created in terms of the current definition and

[113] Page 14 of the publication by PWC titled 'Permanent Establishment 2.0. At the heart of the matter.'
[114] Page 13 of the publication by PWC titled 'Permanent Establishment 2.0. At the heart of the matter.'

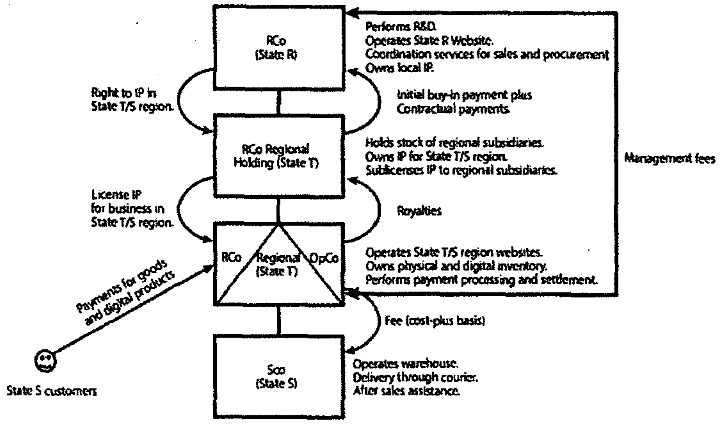
guidelines discussed above, some form of permanent physical presence is required, but in these circumstances there is no need since the communication with the customers are conducted through digital applications. The location of the customer base and the sales with such customers could, however, be seen as a significant value driver for the business but that is not the test in creating a PE. This in isolation does not create a BEPS risk. The concern arises when the income sourced from the sale of goods or services to these customers is not taxed anywhere in the world. In that case BEPS becomes relevant. (OECD, 2015:181 to 185)[115].

What is also currently prevalent in the market is the fragmentation of certain operations within multi-national group entities in order to specifically qualify for the PE exceptions. The most popular PE exception relied on is regarding the activities as 'auxiliary or preparatory' in nature. Where this is artificially done for tax purposes, understandably BEPS is raised as a concern. (OECD, 2015: 185)[116].

Below is a diagrammatical representation of the direct tax risks (not limited to PE's) prevalent in the instance of an online retailer (source: Annexure B.1., Figure B.1. of the OECD report titled '*Addressing the Tax Challenges of the Digital Economy*').[117]

[115] Page 78 and 79 of the Final Action Plan issued by the OECD.
[116] Page 79 of the Final Action Plan issued by the OECD.
[117] Page 169 of the Final Action Plan issued by the OECD.

Figure B.1. **Online retailer**



The above represents a typical legal structure in the context of online retailers. The structure carries significant worldwide tax consequences. The issue that arises is that most of the income generated from the structure is taxed in State T, since a so-called taxable presence has not been established in State S. This is because State S's risk profile is low as it conducts routine services to RCo Regional OpCo situated in State T. The income generated from sales in State S are concluded with RCo Regional OpCo and therefore are taxed in State T since RCo Regional OpCo has not created a taxable presence in State S and SCo has no relation or interaction with customers in State S. Since RCo Regional OpCo does not have a PE in State S, State S is unable to tax the transactions. (OECD, 2015: Annexure B.1)[118].

5.13.1 Preventing the artificial avoidance of a PE status

The Task Force on the Digital Economy (TFDE) (who are the key contributors to the issuance of the Final Action Plan by the OECD titled '*Addressing the Tax Challenges of the Digital Economy*')

[118] Page 168 to 170 of the Final Action Plan issued by the OECD.

has suggested changes to the definition of a PE to circumvent the abovementioned BEPS risks. (OECD, 2015:181 and 215)[119].

The TFDE specifically wishes to target arrangements where sales of goods and services are effectively concluded by one company, on 'behalf of' of a so-called other company in a multinational group. The purpose would be to ensure that in terms of the PE rules, the company effectively concluding the sale (although mechanisms are used to bypass this) has created a PE for the company on whose behalf they are acting. For example, where a local subsidiary of an online clothing retailer plays the principal role and habitually concludes contracts in the name of the parent company, it will result in a PE for the parent company in the jurisdiction in which the local subsidiary is based, regardless of the fact that the subsidiary does not formally conclude the contracts and the contracts are largely standardised. As a result, the parent company will be subject to tax in the country where the economic transaction with the customer is actually concluded. (OECD, 2015: 216)[120].

Alternatively, the local subsidiary could be granted the required and legal authority to formally execute the contracts. In that case, the local subsidiary will have the taxing right to the income received from the sale of clothing to the customers. Ultimately the same purpose achieved, which is to ensure that the country that is economically affected by the transactions, also benefits from taxation (i.e. either through a PE of the parent company or through the local subsidiary itself). (OECD, 2015: 216)[121].

In addition, the TFDE recommended that where the essential business activities of an enterprise are carried out at a specific location, reliance cannot be placed on the list of exceptions in the PE definition. In order to achieve this, all the listed exceptions should only be capable of application where such exception is 'preparatory or auxiliary' in nature. For example, where a storage and distribution centre for stock of goods or merchandise solely for the purpose of storage display or delivery (i.e. the exception in Article 5(4)(b) of the OECD MTC), is an essential element of the companies business operations, then it cannot rely on the specific exceptions in Article 5(4) of the OECD MTC. Reliance can only be placed on the exceptions in the article if the storage and distribution centre in itself, is auxiliary or preparatory in the context of the business as a whole. This

[119] Page 78 and 88 of the Final Action Plan issued by the OECD.
[120] Page 88 of the Final Action Plan issued by the OECD.
[121] Page 88 of the Final Action Plan issued by the OECD.

will effectively be regarded as the 'anti-fragmentation' rule attached to each exception. (OECD, 2015: 216)[122].

The OECD highlights in the report that some jurisdictions are of the view that modifications to Article 5(4) of the OECD MTC are not necessary and should not be subject to the 'auxiliary or preparatory' condition. The OECD states that these countries can adopt different rules in line with domestic laws, provided they include some form of anti-fragmentation criteria. (OECD, 2015: 216)[123].

5.14 Conclusion

To summarise, the concept of a PE remains dominant in the international tax space. In the context of the digital economy, the biggest challenge is determining whether a 'place of business' has been created in a certain country through electronic means and transactions. In 2004 the Technical Advisory Group to the OECD recommended against changes which could create a 'virtual PE' without requiring an actual physical presence in a particular State. Eleven years on it appears that the position has somewhat evolved. In essence, the OECD now recognises a more refined and developed form of the so-called virtual PE. For example, even where a physical presence has not been created through an office or in the context of the digital economy, a server, where an offshore company relies on essential assistance in-country to conclude sales in the name of the offshore company, then a PE may exist. The purpose of the test will be to give effect to the substance of the operations and the essential nature thereof. In addition, a much stricter application of the PE exceptions in Article 5(4) of the OECD MTC will be given effect to in order to prevent the fragmentation of activities purely for tax purposes.

South Africa has not been very vocal in its application of the PE principles to the digital economy. Since South Africa has largely followed international precedence regarding PE's, it is expected that this approach will continue. Should South Africa have any reservations to the suggestions and recommendations put forward by the OECD in their report *'Addressing the Tax Challenges of the Digital Economy'*, these should appear in the drafting and negotiating of the multilateral instrument which will introduce these changes to the PE article in DTA's. (OECD, 2015: 13).

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[122] Page 90 and 91 of the Final Action Plan issued by the OECD.
[123] Page 90 and 91 of the Final Action Plan issued by the OECD.

10. CHAPTER 7: CONCLUSION OF THE STUDY

With reference to BEPS, it is noted that due to the increasing interconnectivity of the world, it has been identified that national tax laws were not keeping pace with global corporations, fluid capital and digital economies. This has resulted in potential loopholes which could be abused by companies purely relocating their activities around. In that instance, companies can avoid taxation in their country of residence and rather pay tax in a low (or in some cases no) tax jurisdiction. The effect of this would undermine the fairness and integrity of tax systems globally. (OECD, 2013b:7).

The purpose of this study was to determine whether, in the context of digital economies and BEPS, the well-recognised principles of POEM and PE's are still achieving the desired tax outcomes and are still in line with the policy intentions for which they were initially introduced.

Based on the extensive literature review conducted, the POEM test remains largely intact and unaffected by the digital economy *per se*. It is not even addressed as a key area in the BEPS report. Through the issue of the second draft Interpretation Note 6 in 2015, South Africa has aligned itself in adopting international principles and guidelines when determining the POEM for a legal entity. Even in the international context, however, there has been a steady shift in the determination of where the key management and commercial decisions of businesses are in substance made, with a greater focus on senior management as opposed to a board centric approach. This shift has definitely been influenced by elements of the digital economy, for example, mobility and telecommunication advancements. To date, no specific recommendations or changes to the POEM determination of a company operating in the digital space is noted.

The impact of the digital economy has, however, been significant in the context of PE's. Most notably, the challenges have been the lack of physical presence for a 'place of business' to exist. This has been a focus area for BEPs and the OECD has recognised the need for changes and refinement in the PE principles. More specifically, the OECD summarised and concluded in their report titled '*Addressing the Tax Challenges of the Digital Economy*' that *inter alia*:

- The exceptions to the PE definition regarding 'auxiliary or preparatory' activities must be amended. In essence, the OECD aims to ensure that fragmentation of business activities among closely related enterprises does not benefit under the 'auxiliary or preparatory' exception. The example given is a local warehouse employing a substantial amount of people. The local warehouse mainly provides storage and facilitates the distribution of physical goods to customers. This is generally the case where deliveries are required to be made on a quick turnaround basis. In that instance the rules would ensure that a PE has been created in the country where the local warehouse was set up (i.e. one could not argue that the storage or distribution of the products was a so-called auxiliary activity in the context of the enterprise as a whole). (OECD, 2015: 11).

- The PE definition is modified to ensure that artificial scenarios, where contracts are habitually concluded by local subsidiaries within a multinational group in the name of the parent company, will result in the creation of a PE for such parent company in the jurisdiction of the local subsidiary. The example given in this instance is an online advertising company where the local subsidiary arguably and negotiates the contracts with clients 'on behalf of' the parent company with little to no modification. (OECD, 2015: 11).

It is the intention of the OECD that these changes to the PE exceptions be implemented across the existing treaty network in the form of a multilateral instrument that modifies the relevant provisions of Article 5 of the OECD MTC. (OECD, 2015: 11 and 13).

In addition to the above suggested solutions, the OECD also recommended changes to transfer pricing guidelines in respect of hard-to-value intangibles and special contractual arrangements, as well as specific inclusions to the income of 'controlled foreign companies' typically derived from the digital economy. These solutions are aimed at closing the gap on so-called stateless income (i.e. income which is 'lost' for tax purposes since it is not specifically attributable to a specific jurisdiction). (OECD, 2015:12).

Other than the issues of POEM and PE in the context of the digital economy, the Final Action Plan issued by the OECD titled '*Addressing the Tax Challenges of the Digital Economy*' highlights the broader tax challenges for policy makers which relates to both direct and indirect direct taxation.

In respect of direct taxation determining the nexus, data and characterisation of the income requires refinement. In this regard the OECD is hopeful that the modification to the PE exceptions for activities which are 'auxiliary or preparatory' may solve or assist in limiting this issue.

In respect of indirect tax, the collection of value added tax specifically where goods, services and intangibles are acquired by private consumers from suppliers abroad is of particular importance. The recommendation is that countries apply the 'International VAT/GST Guidelines' and the collection mechanisms included therein.

Suggestions to introduce a new nexus in the form of an 'economic presence', a withholding tax on specific transactions in the digital space and an 'equalisation levy' were dismissed, at this stage, since it is expected that the current measures will already have a significant impact on taxation in the digital economy.

The OECD recognises that due to the fast evolution of the digital economy the above recommendations and conclusions should be further explored, developed and monitored with time. The aim is to produce a follow up report by 2020. (OECD, 2015:13). At that stage the OECD hopes to measure the success and if necessary re-assess the impact of the suggested changes to *inter alia* PE's in the context of the digital economy.

It will be interesting to monitor the developments in this area of international tax as the digital economy continues to transform itself.

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