

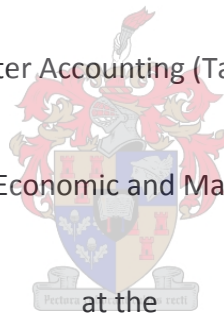
A CRITICAL ANALYSIS OF THE CONCEPTS
PERMANENT ESTABLISHMENT AND FOREIGN BUSINESS ESTABLISHMENT

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DECLARATION

I, the undersigned, declare that the contents of this assignment is my own original work and has not been submitted, in part of it or its entirety, to any other university to obtain a degree.

R C van Schaik

September 2010

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A CRITICAL ANALYSIS OF THE CONCEPTS

PERMANENT ESTABLISHMENT AND FOREIGN BUSINESS ESTABLISHMENT

The Income Tax Act, Act 58 of 1962 ('the Act') currently defines a permanent establishment in section 1. The definition of a permanent establishment in the Act refers to article 5 of the *Model Tax Convention on Income and on Capital of the Organisation for Economic Co-Operation and Development*. The existence of a permanent establishment in a tax jurisdiction determines the right of the jurisdiction to tax the profits of the permanent establishment.

The concept *foreign business establishment* was inserted into section 9D of the Act by clause 10(1)(a) of the Revenue Laws Amendment Act, Act 59 of 2000. Section 9D is an anti-avoidance provision, which determines that certain foreign-sourced income generated by South African controlled foreign companies are subject to tax in South Africa. The concept *foreign business establishment* is one of the exclusions from the anti-avoidance provisions in section 9D. The Revenue Laws Amendment Act, Act 59 of 2000, replaced all references to the concept *permanent establishment* with a reference to the newly introduced concept *foreign business establishment* in section 9D(9)(b) of the Act. The *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000* (SARS 2000:1-12) does not provide a reason for the replacement of the concept *permanent establishment*.

The objective of this study was to analyse and compare the concepts *permanent establishment* and *foreign business establishment* in order to make recommendations regarding the required additions and amendments to replace the concept *foreign business establishment* with the internationally recognised and accepted concept *permanent establishment*. The proposed replacement of the concept *foreign business establishment* with an internationally recognised and accepted tax concept will enhance the international compatibility of the Act. The use of an internationally recognised and accepted tax concept will provide clarity and certainty regarding the tax implications of section 9D(9)(b) for those affected by it.

It was found that the concepts *permanent establishment* and *foreign business establishment* are used in different contexts within the Act. The concepts also apply to different types of taxpayers in different situations. The two concepts have, however, the same objective, being the identification of criteria for the existence of legitimate and substantive business activities in the foreign tax jurisdiction.

A comparison between the definitions of the two concepts reveals that there are various components in the definitions with the same wording and meaning. After a detailed comparison between the two definitions it was found that, subject to some suggested additions and amendments, the internationally recognised and accepted concept *permanent establishment* can replace the concept *foreign business establishment* in section 9D(9)(b) of the Act without having a material impact on the objective of section 9D(9)(b). This replacement is possible due to the mutual objective of and similar components contained in the definitions of the concepts *permanent establishment* and *foreign business establishments*.

'N KRITIESE ONTLEDING VAN DIE BEGRIPPE BUITELANDSE BESIGHEIDSAAK EN PERMANENTE SAAK

Die Inkomstebelastingwet, Wet 58 van 1962 ('die Wet') definieer 'n permanente saak in artikel 1. Die definisie van 'n permanente saak verwys na artikel 5 van die '*Model Tax Convention on Income and on Capital of the Organisation for Economic Co-Operation and Development*'. Die bestaan van 'n permanente saak in 'n belastingjurisdiksie bepaal die reg van die belastingjurisdiksie om die winste van die permanente saak te belas.

Die begrip *buitelandse besigheidsaak* is deur artikel 10(1)(a) van die Wysigingswet op Inkomstewette, Wet 59 van 2000 in die Wet ingesluit. Artikel 9D is 'n teenvermydingsbepaling wat bepaal dat sekere inkomste vanaf 'n buitelandse bron gegeneer deur 'n Suid-Afrikaans beheerde buitelandse maatskappy in Suid-Afrika belas word. Die begrip *buitelandse besigheidsaak* is een van die uitsluitings van die teenvermydingsbepaling in artikel 9D. Alle verwysings in artikel 9D(9)(b) na die begrip *permanente saak* is deur die Wysigingswet op Inkomstewette, Wet 59 van 2000, vervang met 'n verwysing na die nuwe begrip *buitelandse besigheidsaak*. Die '*Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000*' (SARS 2000:1-12) verskaf nie 'n rede vir die vervanging van die begrip *permanente saak* nie.

Die doel van die studie was om die begrippe *permanente saak* en *buitelandse besigheidsaak* te vergelyk sodat voorstelle gemaak kan word rakende die nodige byvoegings en wysings om die begrip *buitelandse besigheidsaak* met die internasionaal aanvaarde en erkende begrip, *permanente saak*, te vervang. Die voorgestelde vervanging van die begrip *buitelandse besigheidsaak* met 'n internasionaal aanvaarde en erkende begrip sal die internasionale verenigbaarheid van die Suid Afrikaanse wetgewing bevorder. Die gebruik van 'n begrip wat internasionaal aanvaar en erken word, sal sekerheid en duidelikheid bewerkstellig vir diegene wat deur die artikel geaffekteer word.

Daar is bevind dat die begrippe *permanente saak* en *buitelandse besigheidsaak* in die Wet in verskillende verbande gebruik word. Die begrippe is ook van toepassing op verskillende

belastingbetalers in verskillende situasies. Die twee begrippe het egter dieselfde doelwit naamlik die identifisering van kriteria vir die bestaan van wesenlike en volwaardige besigheidsaktiwiteite in die buitelandse belastingjurisdiksie.

'n Vergelyking tussen die definisies van die twee begrippe toon dat verskeie komponente van die definisies dieselfde woorde en betekenis bevat. Na 'n detail vergelyking van die twee begrippe is daar bevind dat, onderhewig aan sommige voorgestelde byvoegings en wysigings, die internasionaal erkende en aanvaarde begrip *permanente saak* die begrip *buitelandse besigheidsaak* in artikel 9D(9)(b) van die Wet kan vervang. Die vervanging is moontlik weens die gemeenskaplike doelwit en soortgelyke komponente in die definisies van die begrippe *permanente saak* en *buitelandse besigheidsaak*.

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CHAPTER 1

Introduction

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1.1 Background and problem statement

The South African local legislation needs to accommodate South Africa's growing involvement in the global economy. The Katz Commission (Katz 1997:14) stated in the *Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa* ('the Katz Report') that the international compatibility of South Africa's tax system is a vital objective of any tax reform. International compatibility will ensure an international understanding of our tax regime, which will enhance certainty amongst taxpayers regarding their tax liability. International compatibility can provide certainty regarding the effect of a country's tax laws on foreign businesses transacting in South Africa, foreign investors investing in South Africa and local businesses investing and trading abroad. The Katz Commission (Katz 1997:15) stated that an important aspect of the afore-mentioned certainty is the use of internationally recognised and accepted tax concepts and terms in our local legislation.

The use of internationally recognised and accepted tax concepts and terms will also ensure that our tax legislation is based on tested international principles since the wealth of international expertise, research and case law will be at our disposal. In addition, the use of internationally recognised and accepted tax concepts and terms in our local legislation will ensure that the application and interpretation of our legislation can adjust to accommodate future changes in international trade practises.

The ongoing globalisation of South African companies, the establishment of South African branches by external companies and the acquisition of shares in foreign companies by South African taxpayers contribute to the importance of double tax agreements and controlled foreign company-legislation ('CFC-legislation'), which subsequently contribute to the importance of the concepts *permanent establishment* and *foreign business establishment*. The Organisation for Economic Co-Operation and Development ('OECD') (2008:80) stated that the concept *permanent establishment* is important in the interpretation and application of double tax agreements since it determines a country's right to tax a foreign enterprise's business operations within that country. The concept *foreign business establishment* is important when applying the CFC-legislation, since a foreign business establishment is an

exclusion from the CFC-legislation in section 9D of the Income Tax Act, Act 58 of 1962 ('the Act'). The concept *foreign business establishment* is currently defined in section 9D of the Act.

The concept *permanent establishment* was initially inserted into section 9C of the Act in 1997 based on the recommendations of the Katz Commission in the Katz Report (Katz 1997:20). The Katz Commission (Katz 1997:21) made their recommendations due to the certainty it would create for non-residents when familiar international terminology, supported by international law, is introduced into the domestic law. Subsequent amendments moved the definition of a permanent establishment from section 9C to section 31, and eventually to section 1 of the Act.

The residence basis of tax, which was introduced in 2000, resulted in the repeal of section 9C and several amendments to section 9D for years of assessment commencing on or after 1 January 2001. The effect was, amongst others, that a business establishment, and not a permanent establishment, was required in order to qualify for an exemption from the CFC-rules in terms of section 9D(9)(b) of the Act. Amendments in 2006 lead to the replacement of the concept *business establishment* in section 9D with the concept *foreign business establishment*.

Section 9D is an anti-avoidance provision which, subject to certain exclusions, results in the taxation of the income of controlled foreign companies ('CFCs') in the hands of resident shareholders. The Katz Commission (Katz 1997:7) stated that anti-avoidance measures should remain simple enough to be capable of effective implementation. Accordingly, the introduction of a new concept in section 9D is only justifiable if an existing concept cannot be used to achieve the desired outcome.

In his book, *The Wealth of Nations*, Smith (2003:1043) stated that one of the desired requirements of a good tax system is that it needs to provide clarity and certainty to those affected by it. The current research provides clarity and certainty to taxpayers, tax consultants, SARS officials and the courts when dealing with the concepts *permanent establishment* and *foreign business establishment*.

A comparison between the definitions of a permanent establishment and a foreign business establishment reveals various similarities and a number of differences. The concepts *permanent establishment* and *foreign business establishment* have the same objective, being the identification of criteria for the existence of legitimate and substantive business activities in the foreign tax jurisdiction. The definitions of the two concepts also have similar components. The concept *permanent establishment* applies to the interpretation and application of double tax agreements while the concept *foreign business establishment* is an exclusion from the CFC-legislation in section 9D.

The use of two separate concepts in order to achieve a similar objective could result in different interpretation by the courts, and could impede clarity and certainty for those affected by it. The question could be asked whether, due to the similarities between the objective of the two concepts and the similarities between the components of the two definitions, the concept *foreign business establishment* should not be replaced with the internationally recognised and accepted tax concept *permanent establishment*.

1.2 Objective

In this study the concepts *permanent establishment* and *foreign business establishment* are examined and the similarities of, and the differences between, the two concepts are analysed. In this analysis, reference is made to local court cases, international court cases, the *Model Tax Convention on Income and on Capital of the Organisation for Economic Co-Operation and Development* ('OECD MTC'), Explanatory Memorandums and other material on the subject matter. The objective is to make recommendations regarding the required additions and amendments in order to replace the concept *foreign business establishment* with the internationally recognised and accepted tax concept *permanent establishment*.

In order to achieve this objective, consideration is given to the following:

- the history and evolution of the concepts *permanent establishment* and *foreign business establishment*;
- an analysis of the concept *permanent establishment* as currently defined in the OECD MTC and in double tax agreements entered into by South Africa;
- an analysis of the concept *foreign business establishment* as currently defined in the Act;
- a comparison between the concepts *permanent establishment* and *foreign business establishment* in order to determine the similarities of, and the differences between, the two concepts;
- the need (if any) for the two separate concepts in the Act;
- the requirements in order to replace the concept *foreign business establishment* with the internationally recognised and accepted concept *permanent establishment*; and
- the proposed definition of a permanent establishment for purposes of section 9D.

1.3 Research design, methods and scope

A non-empirical research method will be followed as the analysis of the concepts *permanent establishment* and *foreign business establishment* can be done with reference to already published data. The data include literature, international and local statutory laws as well as international and local case law. The international cases are not binding on the South African courts, but have persuasive value.

The definition of a permanent establishment in section 1 of the Act specifically refers to article 5 of the OECD MTC. Accordingly, while analysing the concept *permanent establishment*, reference is made to and findings are based on the guidance provided by the OECD MTC.

The provisos to the foreign business establishment exclusion in section 9D(9)(b) of the Act are considered to fall beyond the scope of this study since the provisos do not refer to a foreign business establishment or a permanent establishment and subsequently have no influence on the objective of this study.

1.4 Outline of chapters

1.4.1 Chapter 2: History and evolution of the concepts *permanent establishment* and *foreign business establishment*

Chapter 2 provides an overview of the history and evolution of the concepts *permanent establishment* and *foreign business establishment*. The history and evolution are considered essential in the analysis of the concepts *permanent establishment* and *foreign business establishment* since the courts often refer to the legislative history of a provision when construing statutes (De Ville 2000:233).

1.4.2 Chapter 3: Analysis of the concept *permanent establishment*

Chapter 3 provides a detailed analysis of the concept *permanent establishment* as currently defined in Article 5 of the OECD MTC. The purpose of the analysis is to identify the objective of the concept *permanent establishment*. In addition, the components of the definition of a permanent establishment will be identified and analysed. The analysis is required in order to compare the concept *permanent establishment* with the concept *foreign business establishment*. The comparison is required to determine whether the concept *foreign business establishment* can be replaced with the internationally recognised and accepted concept *permanent establishment*.

1.4.3 Chapter 4: Analysis of the concept *foreign business establishment*

Chapter 4 provides an overview of the tax implications of section 9D of the Act in order to understand the context within which the concept *foreign business establishment* applies. This chapter also provides a detailed analysis of the concept *foreign business establishment* as currently defined in section 9D of the Act. The purpose of the analysis is to identify the objective of the concept *foreign business establishment* and to identify and analyse the components of the definition of a foreign business establishment in order to compare it with

those of a permanent establishment. The comparison is required to determine whether the concept *foreign business establishment* can be replaced with the internationally recognised and accepted concept *permanent establishment*.

1.4.4 Chapter 5: Comparison between the concepts *permanent establishment* and *foreign business establishment*

In chapter 5, the objective of the concept *permanent establishment* is compared to the objective of the concept *foreign business establishment*. In addition the components of the definition of the two concepts are compared. The purpose of the comparisons is to identify the similarities of, and the differences between the two concepts. The chapter also includes a discussion on the need for the two separate concepts in the Act. Recommendations are made regarding the required additions and amendments in order to replace the concept *foreign business establishment* with the internationally recognised and accepted concept *permanent establishment*. The chapter concludes with the proposed definition of a permanent establishment for purposes of section 9D.

1.4.5 Chapter 6: Conclusion

Chapter 6 provides a summary of the research as well as the author's findings and conclusion with regard to the stated objective.

CHAPTER 2

History and evolution of the concepts

permanent establishment and foreign business establishment

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2.1 Introduction

The history and evolution of statutory provisions are considered essential in the analysis of the concepts as stated since courts often refer to the legislative history of a provision when construing statutes (De Ville 2000:233). In this chapter, an overview is provided of the history and evolution of the concepts *permanent establishment* and *foreign business establishment*. Reference is made to the various Amendment Acts which introduced and/or amended the concepts *permanent establishments* and *foreign business establishments*, the Katz Commission, the Katz Report and the OECD MTC.

2.2 The history and evolution of the concept *permanent establishment*

2.2.1 Income Tax Amendment Act, Act 28 of 1997

The Katz Commission (Katz 1997:5) commented in the Katz Report on the feasibility of retaining a source basis of taxation. The essence of their recommendations was to retain the source basis for active income and to introduce the residence basis for passive income. The Katz Report had far-reaching implications, which resulted in various amendments to the Act. Some of the amendments were inserted into the Act by the Income Tax Amendment Act, Act 28 of 1997. These amendments were, amongst others, required due to the relaxation of exchange controls as from 1 July 1997 (SARS 1997:3).

Based on the recommendations of the Katz Commission, the concept *permanent establishment* was inserted into section 9C of the Act by clause 9(1) of the Income Tax Amendment Act, Act 28 of 1997. The Katz Commission (Katz 1997:21) recommended the use of the concept *permanent establishment* in the Act due to the certainty such insertion would create for non-residents when familiar international terminology, supported by international law, is introduced into the domestic law.

Sections 9C and 9D of the Act, which dealt with some aspects relating to the taxation of investment income, were inserted into the Act in order to protect the South African tax base

(SARS 1997:3). Initially, section 9C provided for the taxation of investment income received by or accrued to a resident from a country other than the Republic (SARS 1997:4). Section 9D was an anti-avoidance provision which, subject to certain exclusions, resulted in the taxation of the income of controlled foreign entities and investment income from certain donations, settlements and other dispositions in the hands of the resident shareholder (SARS 1997:4).

Both sections 9C and 9D of the Act contained a paragraph which, subject to the following three conditions, excluded investment income from the scope of the section (sections 9C(3)(a) and 9D(9)(b) of the Act):

- the investment income must be effectively connected to the business activities of a substantive business enterprise;
- the business activities of the substantive business enterprise must be conducted through a permanent establishment in any country other than the Republic; and
- the permanent establishment must be suitably equipped for conducting the principal business of such substantive business enterprise.

2.2.2 Taxation Laws Amendment Act, Act 30 of 1998

An amendment in the Taxation Laws Amendment Act, Act 30 of 1998, clarified that:

- The permanent establishment referred to in sections 9C(3)(a) must be owned by the particular resident (clause 27(1)(b)).
- The investment income referred to in section 9D(9)(b) must be investment income of the controlled foreign entity (clause 28(1)(e)).

2.2.3 Revenue Laws Amendment Act, Act 59 of 2000

The replacement of the source basis of taxation with the residence basis of taxation by the Revenue Laws Amendment Act, Act 59 of 2000, resulted in the repeal of section 9C since the deemed source provisions of section 9C were no longer applicable after the introduction of the residence basis of taxation. The repeal of section 9C involved, amongst others, the

deletion of the definition of a permanent establishment. Thereafter, the definition of a permanent establishment was inserted into section 31 of the Act because the definition of an international agreement in section 31 referred thereto. A definition for the newly introduced concept *business establishment* was inserted into section 9D of the Act. All references in section 9D(9)(b) to the concept *permanent establishment* were replaced with a reference to the newly introduced concept *business establishment*. The *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000* (SARS 2000:2-12) does not state the reason for this replacement of the concept *permanent establishment* in section 9D(9)(b).

2.2.4 Taxation Laws Amendment Act, Act 5 of 2001

In 2001, the definition of a permanent establishment was deleted from section 31, and inserted into section 1 of the Act by clause 5(g) of the Taxation Laws Amendment Act, Act 5 of 2001. The inclusion of the definition of a permanent establishment in section 1 was required since various sections of the Act refer to a permanent establishment.

The Act defines a permanent establishment as follows:

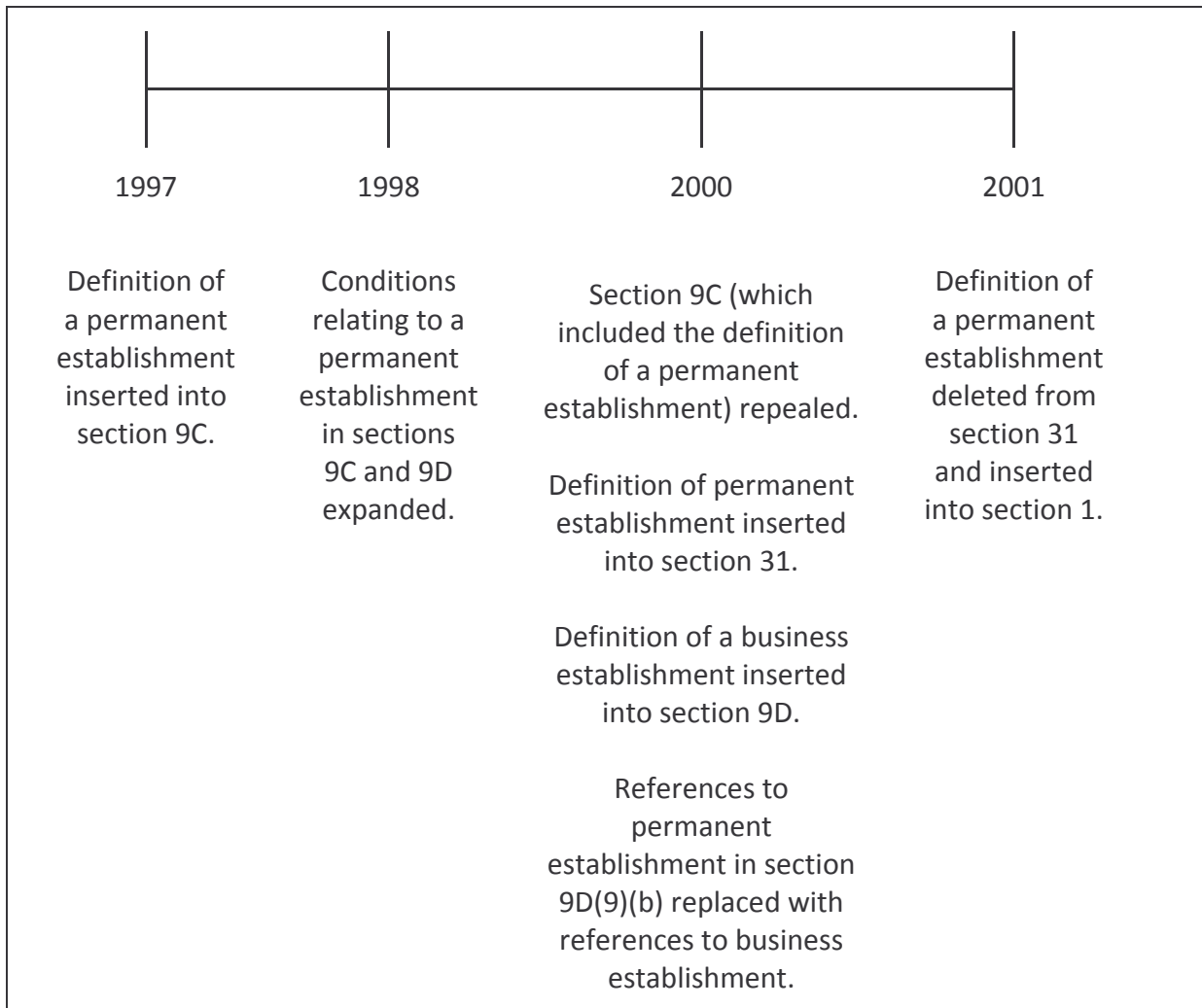
a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development.

The wording of the above-mentioned definition remained unchanged from the initial introduction into the Act in 1997. Since reference is made to the definition as per Article 5 of the OECD MTC, the history and evolution of the concept *permanent establishment* in the OECD MTC also needs to be analysed. This analysis is done in 2.3 below.

2.2.5 Summary

The history and evolution of the concept *permanent establishment* in the Act can be summarised as follows:

Figure 2.1: History and evolution of the concept *permanent establishment* in the Act



2.3 The history and evolution of the concept *permanent establishment* in the different model tax treaties with emphasis on the OECD MTC

Skaar (2005:par 1.1) states that the concept *permanent establishment* was originally developed under German domestic law. The original broad meaning was narrowed as the necessity of preventing double tax increased.

The first model tax treaty was developed by the League of Nations in the 1920s. According to Skaar (2005:par 1.1), the League of Nations presented several draft tax treaties with variations of the concept *permanent establishment* from 1927 until 1946. However, no commonly accepted definition for a permanent establishment was established by the League of Nations (Skaar 2005:par 1.1). Mexico submitted a draft tax treaty in 1943 (Skaar 2005:par 1.1). The definition of a permanent establishment in Mexico's draft modified the concept *permanent establishment* in the direction of source-state tax (Skaar 2005:par 1.1). Mexico's definition of a permanent establishment is believed to have substantially influenced the United Nations' efforts to establish a model treaty for use between developing and developed countries (Skaar 2005:par 1.1). The Mexico draft was modified by the release of the London draft at the end of World War II (Skaar 2005:par 1.1).

The Fiscal Committee of the OECD presented its first report with a definition of a permanent establishment in 1958 (Skaar 2005:par 1.1). This definition was included in article 5 of the OECD's draft report in 1963, entitled *Draft Double Tax Convention on Income and Capital* (Skaar 2005:par 1.1). The commentary to the *Draft Double Tax Convention on Income and Capital* provided guidance for the interpretation of the draft convention (Sandler 1998:17). A country could enter its reservations into the OECD MTC if it did not wish to follow a particular recommendation (Sandler 1998:17). Alternatively, a country could enter its observation if such observation was not in disagreement with the OECD MTC, but rather wanted to provide an indication of the way in which the country would apply the provision (Sandler 1998:18).

The 1963 Draft Convention and commentaries were revised, which resulted in the publication of a Model Convention on Commentaries in 1977 (Sandler 1998:18). Since 1992, the OECD MTC is printed in loose-leaf format in order for it to be subject to periodic and timely updates and amendments without waiting for a complete revision (Sandler 1998:18). The OECD's definition of a permanent establishment has not substantially changed since 1958, but the OECD's commentary on Article 5 is currently significantly more detailed (Skaar 2005:par 1.1).

Concerns that the existing tax concepts in the OECD MTC would be undermined by e-commerce lead to an extensive review by the OECD's Technical Advisory Groups. The conclusion of the reviews was that the existing tax concepts and the OECD MTC are sufficient

to deal with e-commerce and that no radical realignment of tax principles is required (Barnes 2008:1).

2.4 The concept *permanent establishment* and the Companies Act

The Companies Act does not make use of the term *permanent establishment*. Section 322 of the Companies Act, Act 61 of 1973 requires that an external company register as such within 21 days after the establishment of a place of business in the Republic. The Companies Act, Act 71 of 2008 will replace the Companies Act, Act 61 of 1973 on a date which is yet to be determined. Section 23 of the Companies Act, Act 71 of 2008 requires that an external company register as such within 20 business days after it begins to conduct business or non-profit activities within South Africa.

An external company is defined as a foreign company that is carrying on business activities of a profit or non-profit nature in South Africa (Geach 2009:28). An external company is required to continuously maintain at least one office in South Africa (Geach 2009:28).

Geach (2009:28) states that a foreign company is considered to conduct activities in South Africa if it is engaged in any of the following:

- maintaining, defending or settling any legal proceedings;
- holding shareholders' meetings or board meetings;
- conducting the internal affairs of the company;
- establishing or maintaining any bank or other financial accounts;
- establishing or maintaining offices or agencies for the transfer, exchange or registration of the foreign company's own securities;
- creating or acquiring any debts, mortgages, or security interest in any property;
- securing or collecting any debt;
- enforcing any mortgage or security interest; or
- acquiring any interest in any property.

Based on the afore-mentioned definition, requirement and criteria relating to external companies, most external companies will meet the requirements of a permanent establishment and will be subject to the related tax consequences.

2.5 The history and evolution of the concept *foreign business establishment*

2.5.1 Revenue Laws Amendment Act, Act 59 of 2000

Originally a foreign business establishment was referred to as a business establishment in the Act. Clause 10(1)(a) of the Revenue Laws Amendment Act, Act 59 of 2000 inserted the following definition of a business establishment into section 9D of the Act:

‘business establishment’, in relation to a controlled foreign entity, means a place of business with–

- (a) an office, shop, factory, warehouse, farm or other structure which is used or will continue to be used by the controlled foreign entity for a period of not less than one year;
- (b) a mine, oil or gas well, a quarry or any other place of extraction of natural resources; or
- (c) a site for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of comparable magnitude which lasts for a period of not less than six months,

whereby the business of such entity is carried on, and where–

- (i) such place of business is suitably equipped with on-site operational management, employees, equipment and other facilities for the purpose of conducting the primary operations of such business; and
- (ii) such place of business is utilised outside the Republic for a *bona fide* business purpose (other than the avoidance, postponement or reduction of any liability for payment of any tax, duty or levy imposed by this Act or by any other law administered by the Commissioner).

Clause 10(1)(k) of the Revenue Laws Amendment Act, Act 59 of 2000, amongst others, replaced all references to the concept *permanent establishment* in section 9D(9)(b) of the Act with the newly introduced concept *business establishment*. *The Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000* (SARS 2000:2-12) does not provide any reasons for this replacement.

2.5.2 Revenue Laws Amendment Act, Act 74 of 2002

The definition of a business establishment was amended by clause 14(1) of the Revenue Laws Amendment Act, Act 74 of 2002 when, amongst others, the phrase ‘controlled foreign entity’ in section 9D was changed to ‘controlled foreign company’. The two definitions are compared in Table 2.1. The differences between the two definitions are underlined for comparison purposes.

Table 2.1: Comparison between the initial and amended business establishment definition

Business establishment original definition	Business establishment amended definition
<p>‘business establishment’, in relation to a controlled foreign <u>entity</u>, means a place of business with–</p> <p>a) an office, shop, factory, warehouse, <u>farm</u> or other structure which is used or will continue to be used by the controlled foreign <u>entity</u> for a period of not less than one year;</p> <p>[see comparative paragraphs below]</p>	<p>‘business establishment’, in relation to a controlled foreign <u>company</u>, means–</p> <p>a) a place of business with an office, shop, factory, warehouse or other structure which is used or will continue to be used by the controlled foreign <u>company</u> for a period of not less than one year, whereby the business of such company is carried on, and where–</p> <p>i) <u>that</u> place of business is suitably equipped with on-site operational management, employees, equipment and other facilities for the purposes of conducting the</p>

	<p>primary operations of <u>that</u> business; and</p> <p>ii) <u>that</u> place of business is utilised outside the Republic for a <i>bona fide</i> business purpose (other than the avoidance, postponement or reduction of any liability for payment of any tax, duty or levy imposed by this Act or by any other <u>Act</u> administered by the Commissioner);</p>
<p>b) a mine, oil or gas well, a quarry or any other place of extraction of natural resources; or</p>	<p>b) a mine, oil or gas well, a quarry or any other place of extraction of natural resources, <u>where that controlled foreign company has a right to directly explore or extract those natural resources, or any area where that controlled foreign company has the right to carry on prospecting operations preliminary to the establishment of a mine, oil or gas well, quarry or other place of extraction, and where that controlled foreign company carries on those exploration, extraction or prospecting operations;</u></p>
<p>c) a site for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of comparable magnitude which lasts for a period of not less than six months,</p>	<p>c) a site for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of comparable magnitude which lasts for a period of not less than six months, <u>where that controlled foreign company carries on those construction or installation activities;</u></p>

	<p>d) <u>agricultural land used for <i>bona fide</i> farming activities directly carried on by that controlled foreign company; or</u></p>
	<p>e) <u>a vessel or an aircraft solely engaged in transportation within a single country, or a fishing vessel or a vessel used for prospecting, exploration or extraction, where that vessel or aircraft is operated directly by that controlled foreign company.</u></p>
<p>whereby the business of such entity is carried on, and where–</p> <p>i) <u>such</u> place of business is suitably equipped with on-site operational management, employees, equipment and other facilities for the purpose of conducting the primary operations of <u>such</u> business; and</p> <p>ii) <u>such</u> place of business is utilised outside the Republic for a <i>bona fide</i> business purpose (other than the avoidance, postponement or reduction of any liability for payment of any tax, duty or levy imposed by this Act or by any other <u>law</u> administered by the Commissioner).</p>	<p>[see comparative paragraphs above]</p>

The comparison in Table 2.1 reveals the following additions and amendments to the business establishment definition:

- In the amended definition the word 'entity' is replaced with the word 'company', the word 'such' is replaced with the word 'that' and the word 'law' is replaced with the word 'Act'.
- The proviso's stating that the business establishment must be suitably equipped and utilised outside the Republic for a bona fide business purpose, moved from the concluding paragraphs of the original definition to paragraph (a) of the amended definition.
- Paragraph (b) of the definition of a business establishment was extended. In terms of the amended definition, the mine, oil or gas well, quarry or any other place of extraction of natural resources needs to have the rights to carry on the exploration, extraction or prospecting operations. In addition, the controlled foreign company ('CFC') needs to carry on the exploration, extraction or prospecting activities.
- The requirement in paragraph (c) relating to certain construction and installation activities was extended to include a requirement that the CFC must carry on the construction or installation activities.
- The word 'farm' was removed from the list in paragraph (a) and included in the newly introduced paragraph (d) of the definition. Paragraph (d) applies to 'agricultural land used for bona fide farming activities' and requires the CFC to carry on the farming activities.
- Paragraph (e), which applies to a vessel or an aircraft engaged in transportation within one country, a fishing vessel and a vessel used for prospecting, exploration or extraction, was added to the definition of business establishment. Paragraph (e) requires the CFC to directly operate the vessel or aircraft.

2.5.3 Revenue Laws Amendment Act, Act 20 of 2006

The definition of a business establishment in section 9D was deleted by clause 9 of the Revenue Laws Amendment Act, Act 20 of 2006 and a definition for a foreign business establishment was inserted in section 9D. The *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006* (SARS 2006:53) provides the following reasons for the replacement:

- The definition of a business establishment was too rigid, which created difficulties for South African companies conducting genuine business activities.
- The definition of a business establishment failed to account sufficiently for the country within which active business should be conducted.
- Confusion existed regarding the locations of active international transport businesses.

The definitions of a business establishment and a foreign business establishment are compared in Table 2.2. The differences between the two definitions are underlined for comparison purposes.

Table 2.2: Comparison between the definitions of a business establishment and a foreign business establishment

Business establishment	Foreign business establishment
<p>'business establishment', in relation to a controlled foreign company, means–</p> <p>a) a place of business with an office, shop, factory, warehouse or other structure which is used or will continue to be used by <u>the</u> controlled foreign company for a period of not less than one year, whereby the business of such company is carried on, and where–</p> <p>i) that place of business <u>is suitably equipped with on-site operational management, employees, equipment and other facilities for the purposes of conducting the primary operations of that business;</u> and</p> <p>ii) <u>that place of business is utilised outside the Republic for a bona fide</u> business purpose (other than the</p>	<p>'<u>foreign</u> business establishment', in relation to a controlled foreign company, means–</p> <p>a) a place of business with an office, shop, factory, warehouse, or other structure which is used or will continue to be used by <u>that</u> controlled foreign company for a period of not less than one year, whereby the business of such company is carried on, and where that place of business–</p> <p>i) <u>is suitably staffed with on-site managerial and operational employees of that controlled foreign company and which management and employees are required to render services on a full-time basis for the purposes of conducting the primary operations of that business;</u></p>

<p>avoidance, postponement or reduction of any liability for payment of any tax, duty or levy imposed by this Act or by any other Act administered by the Commissioner);</p>	<p>ii) <u>is suitably equipped and has proper facilities for such purposes</u>; and iii) <u>is located in any country other than the Republic and is used for bona fide business purposes</u> (other than the avoidance, postponement or reduction of any liability for payment of any tax, duty or levy imposed by this Act or by any other Act administered by the Commissioner);</p>
<p>b) <u>a mine, oil or gas well, a quarry or any other place of extraction of natural resources, where that controlled foreign company has a right to directly explore or extract those natural resources, or any area where that controlled foreign company has the right to carry on prospecting operations preliminary to the establishment of a mine, oil or gas well, quarry or other place of extraction, and</u> where that controlled foreign company carries on those exploration, <u>extraction</u> or prospecting operations;</p>	<p>b) <u>any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on</u>, where that controlled foreign company carries on those prospecting, exploration, <u>mining or production</u> operations;</p>
<p>c) a site for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities;</p>	<p>c) a site <u>outside the Republic</u> for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities;</p>

<p>d) agricultural land used for <i>bona fide</i> farming activities directly carried on by that controlled foreign company; or</p>	<p>d) agricultural land <u>in any country other than the Republic</u> used for <i>bona fide</i> farming activities directly carried on by that controlled foreign company; or</p>
<p>e) a vessel or an aircraft <u>solely engaged in transportation within a single country</u>, or a fishing vessel or a vessel used for prospecting, exploration <u>or extraction</u>, where that vessel or aircraft is operated directly by that controlled foreign company.</p>	<p>e) a vessel, <u>vehicle</u>, aircraft or <u>rolling stock</u> used for <u>the purposes</u> of transportation or fishing, or prospecting or exploration <u>for natural resources, or mining or production of natural resources</u>, where that vessel, <u>vehicle, rolling stock</u> or aircraft is <u>used solely outside the Republic for such purposes and is operated directly by that controlled foreign company or by any other company that has the same country of residence as that controlled foreign company and that forms part of the same group of companies as that controlled foreign company.</u></p>

The comparison between the definition of a business establishment and foreign business establishment reveals the following additions and amendments to the foreign business establishment definition:

- The requirement that the place of business must be ‘suitably equipped’ is extended in the definition of a foreign business establishment. The definition of a foreign business establishment requires in paragraph (a)(i) and (ii) that the place of business be both ‘suitably staffed’ and ‘suitably equipped’ in order to conduct the primary operations of the business. For purposes of a foreign business establishment, the requirement to be ‘suitably staffed’ refers to the managerial staff and those at operational level, while the requirement to be ‘suitably equipped’ refers to the equipment and other facilities available. For the purposes of a business establishment both these requirements were combined in one paragraph.

- In terms of paragraph (a)(ii) of the definition of a business establishment, the place of business must be 'utilised' outside the Republic for a bona fide business purpose. The definition of a foreign business establishment requires in paragraph (a)(iii) that the place of business must be 'located' in a country other than the Republic and 'used' for bona fide business purposes.
- The scope of paragraph (b) was amended to refer to prospecting, exploration, mining or production operations instead of a mine, oil or gas well, a quarry or any other place of extraction of natural resources. The definition of a business establishment required the CFC to have a 'right to directly explore or extract' or to have 'the right to carry on prospecting operations'. The definition of a business establishment also requires the CFC to carry on the exploration, extraction or prospecting operations. In comparison, the definition of a foreign business establishment only requires the CFC to carry on prospecting, exploration, mining or production operations outside the Republic.
- Paragraph (c) of the foreign business establishment definition specifically determines that the construction or installation site must be located outside the Republic.
- Paragraph (d) of the foreign business establishment definition specifically determines that the agricultural land must be located in any country other than the Republic.
- Paragraph (e) was broadened to include a vessel and rolling stock. In addition, the purposes for which the vessel, vehicle, aircraft or rolling stock can be used were also broadened to include the use in mining or production of natural resources.
- Paragraph (e) of the definition of a foreign business establishment includes a requirement that the vessel, vehicle, rolling stock or aircraft be solely used outside the Republic.
- The scope of paragraph (e) is broader in the foreign business establishment definition. In terms of the foreign business establishment definition, the vessel, vehicle, aircraft or rolling stock can also be operated by any other company in the same group of companies as the CFC if the other company has the same country of residence as the CFC.

2.5.4 Taxation Laws Amendment Act, Act 17 of 2009

The entire paragraph (a) of the foreign business establishment definition was replaced with clause 12 of the Taxation Laws Amendment Act, Act 17 of 2009. The *Explanatory*

Memorandum on the Taxation Laws Amendment Bill, 2009 (SARS 2009:74) states that the defects in the definition which provided opportunities for tax avoidance and the requirement for refinement with regard to group-company sharing of structure, employees, equipment and facilities were the reasons for the replacement. The analysis of this revised definition is the topic of chapter 4. Paragraph (a) of the previous definition of a foreign business establishment and the revised definition of a foreign business establishment are compared in Table 2.3. Paragraphs (b) to (e) are not included in Table 2.3 as it remained unchanged. The differences between the two definitions are underlined for comparison purposes.

Table 2.3: Comparison between paragraph (a) of the previous and the revised definitions of a foreign business establishment

Previous definition of a foreign business establishment	Revised definition of a foreign business establishment
<p>‘foreign business establishment’, in relation to a controlled foreign company, means–</p> <p>a) a place of business <u>with an</u> office, shop, factory, warehouse, or other structure which is used or will continue to be used <u>by</u> that controlled foreign company for a period of not less than one year, <u>whereby the business of such company is carried on, and</u> where that place of business–</p> <p>i) is suitably staffed with on-site managerial and operational employees of that controlled foreign company <u>and which management and employees are required to render services on a full-time basis for the purposes of</u> conducting the primary operations of that business;</p> <p>ii) is suitably equipped and has <u>proper</u> facilities for such purposes; and</p>	<p>‘foreign business establishment’, in relation to a controlled foreign company, means–</p> <p>a) a <u>fixed</u> place of business <u>located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of</u> that controlled foreign company for a period of not less than one year where–</p> <p>i) that <u>business is conducted through one or more</u> offices, shops, factories, warehouses, or other structures;</p> <p>ii) that <u>fixed</u> place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company <u>who conduct</u> the primary operations of that business;</p> <p>iii) that <u>fixed</u> place of business is suitably equipped for conducting the primary</p>

<p>iii) is located <u>in any country other than the Republic and is used for bona fide business purposes</u> (other than the avoidance, postponement or reduction of any liability for payment of any tax, <u>duty or levy imposed by this Act or by any other Act administered by the Commissioner</u>);</p>	<p>operations of that business;</p> <p>iv) that <u>fixed</u> place of business has <u>suitable</u> facilities for conducting the primary operations of that business; and</p> <p>v) <u>that fixed</u> place of business is located <u>outside</u> the Republic <u>solely or mainly</u> for a purpose other than the postponement or reduction of any tax <u>imposed by any sphere of government in the Republic</u>:</p>
	<p><u>Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company–</u></p> <p><u>aa) if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of a similar nature;</u></p> <p><u>bb) if that other company forms part of the same group of companies as the controlled foreign company; and</u></p> <p><u>cc) to the extent that the structures,</u></p>

	<p><u>employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company.</u></p>
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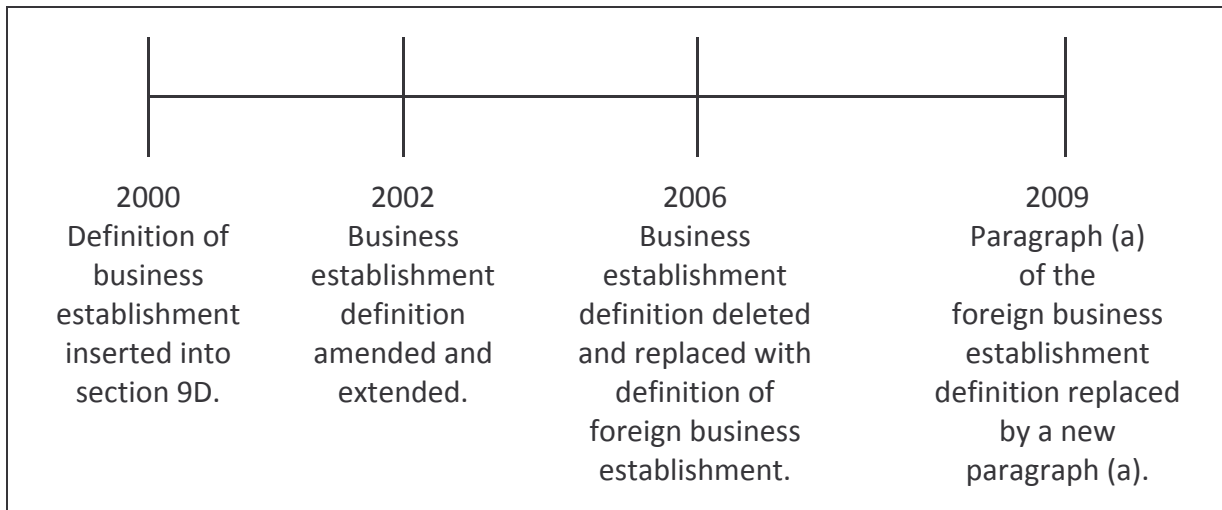
The comparison of paragraph (a) of the previous definition of a business establishment with paragraph (a) of the revised definition reveals the following changes to paragraph (a) of the previous definition:

- The requirement of having a ‘fixed’ place of business is introduced in the revised definition.
- Paragraph (a) of the revised definition determines that the fixed place of business must be ‘located in a country other than the Republic’. This requirement was previously only contained in paragraphs (b) to (e).
- The revised definition contains different words and phrases for similar concepts in the previous definition, for example ‘for the carrying on of the business’ and ‘business is conducted through’ in stead of ‘whereby the business of such company is carried on’ and ‘suitable facilities’ in stead of ‘proper facilities’.
- The requirement for the fixed place of business to be suitably staffed is retained in the revised foreign business establishment definition, but the management and employees are no longer required to render services on a full-time basis.
- The bona fide test in paragraph (a)(iii) of the previous definition required the place of business to be located in any country other than the Republic and to be used for a bona fide business purpose. These requirements are replaced in paragraph (a)(v) of the revised definition with a requirement that the fixed place of business be located outside the Republic solely or mainly for a purpose other than the postponement or reduction of tax.
- The revised definition introduces new specific requirements relating to different legal entities in the same group of companies which are located and taxed in the same foreign country as the CFC in the proviso to paragraph (a). See 4.6 for an analysis of the single country requirements for a group of companies.

2.5.5 Summary

The history and evolution of the concepts *business establishment* and *foreign business establishment* can be summarised as follows:

Figure 2.2: History and evolution of the concept *foreign business establishment* in the Act



2.6 Conclusion

The stability in the wording of the definition of a permanent establishment as opposed to the regular amendments to the wording of the definition of a foreign business establishment clearly differentiates the two concepts.

The wording of the definition of a permanent establishment remained unchanged from the initial introduction into the Act in 1997, but the place of the definition in the Act moved from section 9C, to section 31 and finally, in 2001, to section 1 of the Act. Before section 9C was repealed, it contained the definition of a permanent establishment. The references to a permanent establishment in section 9D(9)(b) were replaced in 2000 with references to the newly introduced concept *business establishment*.

The definition of a business establishment was amended and extended in 2002 before being deleted and replaced with the definition of a foreign business establishment in 2006.

Paragraph (a) of the definition of a foreign business establishment was subsequently replaced in 2009 with a new paragraph (a).

A detailed analysis of the two concepts is required in order to compare the two concepts to determine its similarities and differences. The comparison is required to determine whether the concept *foreign business establishment* can be replaced with the internationally recognised and accepted concept *permanent establishment*. The analysis of the concept *permanent establishment* is the topic of chapter 3. The analysis of the concept *foreign business establishment* is the topic of chapter 4.

CHAPTER 3

Analysis of the concept *permanent establishment*

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3.1 Introduction

Chapter 2 dealt with, amongst others, the history and evolution of the concept *permanent establishment*. It was found that the Katz Commission recommended the use of the concept *permanent establishment* in the Act since it is an internationally recognised and accepted concept used concept which is supported by international law (see 2.2.1).

A *permanent establishment* is defined as follows in section 1 of the Act:

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

The status of the OECD MTC was acknowledged by Corbett JA in *Secretary for Inland Revenue v Downing* [1975] 37 SATC 249 as an important model for interpreting concepts used in South African double taxation agreements since the South African double taxation agreements are based on the OECD MTC. Accordingly, reference is made to article 5 of the OECD MTC in order to identify the existence of a permanent establishment in a tax jurisdiction for purposes of both the Act and the double tax agreements entered into by South Africa.

In this chapter, the concept *permanent establishment* is analysed. The purpose of the analysis is to identify the objective of the concept and the components of the definition of a permanent establishment in order to compare it in chapter 5 with those of a foreign business establishment. The comparison will be used to determine whether the concept *foreign business establishment* can be replaced with the internationally recognised and accepted concept *permanent establishment*. Reference is made to the OECD MTC, international case law and other tax commentaries which deal with the concept *permanent establishment*.

3.2 The objective of the concept *permanent establishment*

The concept permanent establishment is used, amongst others, in double tax agreements and applies to an entity of one contracting state which has a permanent establishment in another contracting state. In accordance with article 7(1) of the OECD MTC (OECD 2008:26), the existence of a permanent establishment in a tax jurisdiction determines the right of the jurisdiction to tax the profits of the permanent establishment. The taxing rights of the tax jurisdiction are limited to the extent that business profits are attributable to that permanent establishment (Passos 1986:136).

Article 5 of the OECD MTC contains a definition of a permanent establishment. The definition is analysed in the remainder of this chapter (see 3.3 to 3.9). The analysis reveals the criteria for the existence of a permanent establishment. Once the criteria for the existence of a permanent establishment are met, it implies that legitimate and substantive business activities take place at the fixed place of business.

Based on the criteria for the existence of a permanent establishment, it is submitted that the objective of the concept *permanent establishment* is the identification of criteria for the existence of legitimate and substantive business activities within the foreign tax jurisdiction.

3.3 Overview of article 5 of the OECD MTC

Article 5 of the OECD MTC consists of seven paragraphs. Each paragraph deals with a different aspect of the concept *permanent establishment*. Article 5 can be summarised as follows:

Table 3.1: Overview of article 5 of the OECD MTC

PARAGRAPH IN ARTICLE 5	PURPOSE OF THE PARAGRAPH	DISCUSSED IN
1	The general definition.	3.4
2	Examples of permanent establishments.	3.5
3	The construction clause.	3.6
4	Exclusions from the concept <i>permanent establishment</i> .	3.7
5	The agency clause: independent agent.	3.8
6	The agency clause: dependent agent.	3.8
7	The relationship of control.	3.9

3.4 Article 5(1): The general definition

3.4.1 Overview of the general definition

Article 5(1) of the OECD MTC (OECD 2008:24) is considered to be the general definition of a permanent establishment and determines the following:

For the purposes of this Convention, the term ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Following article 5(1), the OECD MTC (OECD 2008:80) identifies three conditions for the existence of a permanent establishment in terms of the general definition, namely:

1. the existence of a place of business;
2. the requirement that the place of business must be fixed; and
3. the requirement that the business of an enterprise must be carried on through this fixed place of business.

The third condition mentioned above makes reference to the business of an enterprise and requires the business to be carried on through the fixed place of business. The existence of an enterprise is therefore considered to be of importance when analysing the concept *permanent establishment*. It is submitted that the existence of an enterprise and the requirement for the business to be carried on through the fixed place of business are separate conditions. Accordingly, it is submitted that article 5(1) contains four components (see table 3.2) which will be analysed in order to fully understand the concept *permanent establishment*.

Table 3.2: Overview of article 5(1) of the OECD MTC

COMPONENTS OF THE GENERAL DEFINITION	DISCUSSED IN
1. A fixed place of business.	3.4.2
2. A place of business.	3.4.3
3. Business carried on through the fixed place of business.	3.4.4.
4. The business of an enterprise.	3.4.5

3.4.2 A fixed place of business

3.4.2.1 The meaning of *fixed*

It is submitted that *fixed* is derived from the word *fix*. Accordingly, the dictionary meaning of the word *fix* can be used to understand the meaning of *fixed*. The following is an extract from the definition of *fix* from the *Oxford Reference Dictionary* (1992:304): ‘... to place definitely or permanently ... to settle ...’. This implies that a place of business must have a definite or permanent place in order to be a fixed place of business.

The requirement that the place of business must be fixed implies a connection between the place of business and a specific geographical point (OECD 2008:82). The OECD MTC (OECD 2008:82) also uses the terms *a distinct place*, *a single place of business* and *a particular*

location as alternatives for *a specific geographical point*. In addition, *fixed* is also said to involve a degree of permanency (OECD 2008:83).

Considering the dictionary definition of *fixed* and the comments in the OECD MTC referred to above, it is submitted that *fixed* can be said to refer to both the location and the permanency nature of the business. In order to be a fixed place of business, the requirements relating to location and permanency need to be met. These requirements are now analysed in order to determine their relevance in the identification of the existence of a fixed place of business.

3.4.2.2 Location as a requirement for a fixed place of business

The word *location* is defined, amongst others, as ‘a particular place’ (Oxford Reference Dictionary 1992:486). The OECD MTC (OECD 2008:82) refers to the word *coherency* as part of its commentary on the location of the fixed place of business. The word *cohere* is defined, amongst others, as ‘to remain united’ (Oxford Reference Dictionary 1992:170). Accordingly, coherency implies unity. The implications of these definitions on location as a requirement for a fixed place of business are considered below.

In terms of the definition of *location* and the OECD MTC (OECD 2008:82), the location of a business implies the operation of the business activities at a distinct place, single place of business, particular place or geographical point with no regard for a time requirement or any period. The operation of business activities at a distinct place, single place of business, particular location or specific geographical point with no regard for a time requirement or any period is submitted to be the requirement for geographic coherency since it refers to the specific geographic location of the fixed place of business. The OECD MTC (OECD 2008:82) requires ‘a link between the place of business and a specific geographical point’ in order for the location to meet the requirement for a fixed place of business. Accordingly, the location of a business will meet the requirement for a fixed place of business if geographic coherency exists.

The OECD MTC (OECD 2008:82) determines that if geographic coherency does not exist due to the nature of the business requiring the business activities to move between neighbouring locations, the requirements relating to the location of a fixed place of business will still be met if the neighbouring locations constitute 'a coherent whole commercially and geographically with respect to that business'. Accordingly, for purposes of activities taking place between neighbouring locations, the existence of commercial and geographical coherency with respect to that business will result in the requirements relating to the location of the fixed place of business being met.

The OECD MTC (OECD 2008:82) provides the following examples where activities requiring relocation meet the requirements of commercial and geographical coherency:

- Mining activities taking place in different locations within a large mine.
- A trader who often sets up his/her stand in different locations in a pedestrian street, outdoor market or fair.

The OECD MTC (OECD 2008:82) illustrates the principle of commercial and geographical coherency for activities requiring relocation by using an example of a painter working under a single contract on a large office building as opposed to a painter who works under a series of unrelated contracts for a number of clients in a large office building. In the first instance, both commercial and geographical coherence exist and subsequently the building as a whole meets the requirements relating to the location of the fixed place of business (OECD 2008:82). In the second instance, the building does not meet the requirements relating to the location of the fixed place of business since commercial coherency does not exist between the neighbouring locations (OECD 2008:82).

Similarly, work performed by a consultant in terms of a single contract at different branches in separate locations of a client meets the requirement of having commercial coherence, but lacks geographic coherence since the work is not performed in neighbouring locations (OECD 2008:83). However, geographic coherence can be achieved if the work is performed in different offices within a single branch (OECD 2008:83).

It can be derived from the above-mentioned definitions and examples that commercial coherency requires unity between the business activities. Commercial unity will be achieved if the activities are directly related to one another or if the activities are performed under a single contract.

3.4.2.3 Permanency as a requirement for a fixed place of business

Permanency is defined as 'a permanent thing or arrangement' (Oxford Reference Dictionary 1992:623) while *permanent* is defined as 'lasting or intended to last or function indefinitely' (Oxford Reference Dictionary 1992:623). Accordingly, permanency cannot be quantified as it can only be said that permanency involves a lasting or an indefinite period of time.

A certain degree of permanency is required in order for a place of business to be fixed. A place of business which only existed for a short period of time can be a fixed place of business if the nature of the business is such that it will only be carried on for that short period of time (OECD 2008:83). A place of business can be a fixed place of business from inception even if it only lasted a short period due to premature termination of activities on account of special circumstances such as the death of the taxpayer or investment failure (OECD 2008:84). Similarly, temporarily interruptions of the operations do not affect the permanency of the activities (OECD 2008:85). Accordingly, the requirement of having a degree of permanency refers to the duration of the business carried on at the fixed place of business.

The general rules are as follow (OECD 2008:83):

1. A permanent establishment is unlikely to exist if the business is conducted for a period less than six months.
2. If a business is conducted for a period longer than six months, but less than 12 months, a permanent establishment possibly exists.
3. Where a business is conducted for a period longer than 12 months, a permanent establishment is likely to exist.

Two exceptions to these general rules are activities of a recurrent nature and businesses carried on exclusively in the source country. The degree of permanency of activities of a recurrent nature should be considered in combination with the number of times during which the place is used (OECD 2008:83). Due to its nature, a business exclusively carried on in the source-country has a stronger connection with that country, which gives the source-country the right to tax if all other conditions are met, regardless of the short duration (OECD 2008:83). Accordingly, both activities of a recurrent nature and a business carried on exclusively in the source-country can be considered to be a permanent establishment regardless of the degree of permanency of the place of business (OECD 2008:83).

It was held by Maisels JA in *Transvaal Associated Hide and Skin Merchants v Collector of Income Tax Botswana* [1967] 29 SATC 97 that the regular occupation of a shed at an annual rental was an indication that the taxpayer's occupation of the premises was permanent and not temporary or occasional and that it could subsequently be regarded as continuing indefinitely. This judgement supports the comment that the use of the premises needs to be permanent and not temporary in order to have the required degree of permanency to constitute a fixed place of business.

An arrangement intended to abuse the permanency requirement in order to avoid that the place be considered to have been used for more than purely temporary purposes can either fall within the scope of the anti-avoidance rules, or it can be resolved in terms of the bilateral negotiation provisions in the double tax agreements (OECD 2008:84). Accordingly, a place designed to be used for a short period so that it would not be considered a permanent establishment can still be a permanent establishment if it is in fact maintained for a longer period, which cannot be considered temporary (OECD 2008:84).

3.4.2.4 A fixed place of business versus modern trade practices

The requirement to have a fixed place of business was criticised as being no longer applicable to modern trade practices (Olivier & Honiball 2008:98). The criticism was based on the fact that modern trade practices, such as e-commerce, makes it possible to have substantial

business operations within a country without having a fixed place of business in that country. The OECD MTC remained unchanged after an OECD study of the suitability in the modern trade environment for a requirement to have a fixed place of business. The OECD only amended the commentary to the OECD MTC by adding comments on how the requirement for a fixed place of business applies to modern trade practices. Accordingly, since no change to the OECD MTC was required subsequent to the OECD study of the matter, the requirement that a permanent establishment must have a fixed place of business is considered to remain applicable to modern trade practices.

As part of its study on the effect of e-commerce on the *permanent establishment* definition, the OECD (2008:97) found that a website is a combination of software and electronic data, which is not tangible property. Accordingly, the OECD (2008:97) determined that a website cannot be a permanent establishment. A server is automated equipment on which an Internet website is stored and through which the website is accessible. When determining whether a server meets the requirement of being fixed, it is not the possibility of the server being moved, but whether it is in fact moved that is relevant (OECD 2008:98). Accordingly, due to its physical presence, the location of the server can constitute a fixed place of business (OECD 2008:97).

3.4.2.5 Conclusion on a fixed place of business

In order to constitute a fixed place of business, the requirements relating to the location and permanency nature of the business must be met. The requirements relating to the location of the fixed place of business are met if geographic coherency exists. Alternatively, if activities take place between neighbouring locations, geographic and commercial coherencies need to exist in order for the requirements relating to the location of the fixed place of business to be met.

Geographic coherency requires the operation of the business activities at a distinct place, single place of business, particular location or specific geographical point with no regard for a

time requirement or any period. Commercial coherency will be achieved if the activities are directly related to one another or if the activities are performed under a single contract.

The requirement of permanency refers to the duration of the business activities carried on at the fixed place of business. The implications of this component of the general definition of a *permanent establishment* are to limit the scope of a permanent establishment and to prevent the unintended taxation of temporary business activities within a tax jurisdiction.

3.4.3 A place of business

3.4.3.1 The definition of *place of business*

The term *place of business* is not defined in the OECD MTC. The OECD MTC determines that the term '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' (OECD 2008:81). The *Oxford Reference Dictionary* (1992:636) defines *place* as 'a particular part of space or of an area on a surface'. Accordingly, a *place of business* involves a physical presence at a particular place.

The OECD MTC (OECD 2008:81) determines that a place of business can be owned, rented or otherwise be at the disposal of the enterprise. In addition, the OECD MTC (OECD 2008:81) determines that no premises are required since the enterprise should only have an amount of space at its disposal. *Disposal* is defined as 'available for one's use' (Oxford Reference Dictionary 1992:235). Since no formal right to use a place is required, the illegal occupation of a location can constitute a place of business (OECD 2008:81).

The requirement to have a place of business implies having a physical presence at a particular place in the host country. Accordingly a permanent establishment will exist if a tangible office, shop, factory or workshop exists in the host country (Olivier 2002:871). The place of business is not required to be attached to the surface of the earth or to be visible above ground (Olivier 2002:871). The equipment constituting a place of business does not have to

be fixed to the soil, since it is sufficient if the equipment remains on a particular site (OECD 2008:82).

In order to illustrate the wide scope of the phrase a *place of business*, the OECD MTC (OECD 2008:81) provides the following examples:

1. a pitch in a market place;
2. a permanently used area in a customs depot, e.g. for the storage of dutiable goods; and
3. a place of business situated in the business facilities of another enterprise, e.g. when a foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

3.4.3.2 Conclusion on a place of business

In order to have a place of business the enterprise should have a particular space at its disposal. The place of business includes any premises, facilities or installations used for the carrying on of the business of the enterprise. A place of business in the host country implies the physical presence of the enterprise at a particular place in the host country. Accordingly, the requirement to have a place of business in the host country is very wide. In contrast to the requirement for the existence of a fixed place of business, it is submitted that this component of the general definition does not limit the scope of a permanent establishment.

3.4.4 Business carried on through the fixed place of business

3.4.4.1 The meaning of *through*

The OECD MTC (OECD 2008:82) determines that the phrase *through which* must be given a wide meaning in order for it to apply to any situation where the business is carried on at a location which is at the disposal of the enterprise. According to Russo (2007:41), 'the fixed place of business must be functional to the carrying on of the business of the non-resident taxpayer'. *Functional* is defined, amongst others, as 'serving a function' (Oxford Reference

Dictionary 1992:326). *Function* is defined, amongst others, as 'the activity proper to a person or institution or by which a thing fulfils its purpose' (Oxford Reference Dictionary 1992:326). Accordingly, the phrase *through which* requires the location to be available for use by the enterprise in order to fulfil the purpose of the enterprise.

The presence of an enterprise does not necessarily imply that the location is at the disposal of the enterprise or available for use by the enterprise. The OECD MTC (OECD 2008:81-82) illustrates this with four examples:

1. A salesman regularly visits a major customer and meets the purchasing director in his office in order to take orders. In this example, the customer's premises and the purchasing director's office are not at the disposal of the enterprise for which the salesman is working and, accordingly, not a place of business through which the business of an enterprise is wholly or partly carried on.
2. An employee uses an office in the headquarters of another company (e.g. a newly acquired subsidiary) for an extended period of time to ensure that the latter company complies with its obligations in terms of a contract with the former company. The employee is carrying on activities related to the business of the former company. The office used by the employee is at the disposal of the former company and, accordingly, meets the requirement of the business being carried on through the fixed place of business.
3. A road transportation enterprise makes daily deliveries of goods purchased by the customer at a customer's warehouse. The delivery dock is not at the disposal of the transportation enterprise since the presence of the transportation enterprise at the delivery dock will be too limited. The business of the enterprise is therefore not carried on through the delivery dock.
4. A painter spends three days a week for two years in the large office building of its main client. The presence of the painter is sufficiently significant in order for the office building to be at the disposal of the painter. Accordingly, it can be said that the painter is carrying on his business through the office building.

Gzell J held in *Unisys Corporation v Federal Commissioner of Taxation* [2002] 51 ATR 386 that rooms used for the filing and retrieval of partnership records were at the disposal of the

partnership, but did not constitute a place through which the partnership carried on its business.

3.4.4.2 Conclusion on a business carried on through the fixed place of business

The wide meaning of the word *through* entails that the requirement for the business to be carried on through a fixed place of business does not limit the scope of the concept of permanent establishment significantly. The main requirement is that the location should be at the disposal of the enterprise and used in order to fulfil the purpose of the enterprise.

3.4.5 The business of an enterprise

3.4.5.1 The meaning of *business of an enterprise*

In terms of the general definition in article 5(1) of the OECD MTC (OECD 2008:24), the business of an enterprise must wholly or partly be carried on through a fixed place of business. The OECD MTC does not provide definitive guidance on the scope of this requirement. Accordingly, the phrase *business of an enterprise* is analysed in order to understand this requirement.

It is submitted that the phrase *business of an enterprise* consists of two parts, namely *business* and *enterprise*. The definition of an enterprise in article 3(1)(c) of the OECD MTC contains the phrase *carrying on of any business*. The phrase *carrying on of any business* is a familiar phrase in South African case law. Accordingly, the meaning of the phrase *business of an enterprise* can be determined by considering the following:

1. The meaning of *business* (see 3.4.5.2).
2. The meaning of *enterprise* (see 3.4.5.3).
3. The meaning of *carrying on of any business* (see 3.4.5.4).
4. The meaning of *carrying on a business* in a South African context (see 3.4.5.5).

3.4.5.2 The meaning of *business*

Article 3(1)(h) of the OECD MTC (OECD 2008:23) determines that ‘the term “business” includes the performance of professional services and of other activities of an independent character’.

The OECD MTC (OECD 2008:70) determines that the OECD MTC does not include an exhaustive definition of *business* since the word should be interpreted according to the provisions of the domestic laws of the contracting states. However the word *business* is not defined in the Act. Accordingly, the meaning must be determined with reference to its ordinary meaning. The word *business* is defined, amongst others, as ‘buying and selling, trade; a commercial house or firm’ (Oxford Reference Dictionary 1992:117). It was held in the Canadian case, *Smith v Anderson* [1880] 15 ChD 247, by Jessel MR that *business* means ‘anything which occupies the time and attention and labours of a man for profit’.

3.4.5.3 The meaning of *enterprise*

The OECD MTC does not include an exhaustive definition of an enterprise, since the word should be interpreted according to the provisions of the domestic laws of the contracting states (OECD 2008:67). Article 3 paragraph 1(c) of the OECD MTC determines that ‘the term “enterprise” applies to the carrying on of any business’ (OECD 2008:23).

The word *enterprise* is not defined in the Act. Accordingly, the meaning for South African tax treaty purposes must be determined with reference to the ordinary meaning. The word *enterprise* is defined, amongst others, as ‘an undertaking, especially a bold or difficult one; readiness to be involved in such undertakings’ (Oxford Reference Dictionary 1992:275). Accordingly, due to the broad definitions of the word *enterprise*, a wide meaning should be ascribed to the word upon interpretation.

The OECD MTC determines that, while it is assumed that each part of the enterprise contributes to the productivity of the enterprise as a whole, each part does not need to be

productive on its own (OECD 2008:80). The business of an enterprise is carried out by the entrepreneur, employees and dependent agents of the enterprise (OECD 2008:85).

In the Australian court case, *Thiel v Federal Commissioner of Taxation* [1990] 171 CLR 338, McHugh J held that, in terms of the treaty between Australia and Switzerland, an isolated transaction may constitute an enterprise. The relevant provision in the treaty between Australia and Switzerland is similar to the corresponding provision in the OECD MTC.

3.4.5.4 The meaning of *carrying on of any business*

The OECD MTC determines that the word *enterprise* 'applies to the carrying on of any business'. The word *apply* is, amongst others, defined as 'to be relevant' (Oxford Reference Dictionary 1992:35). It can therefore be concluded that the carrying on of any business is relevant when determining the existence of an enterprise. Activities which qualify as the carrying on of any business will accordingly collectively constitute an enterprise. In the Australian court case, *Thiel v Federal Commissioner of Taxation* [1990] 171 CLR 338, McHugh J held that 'the carrying on of a business requires the habitual pursuit of business activities'.

It is submitted that the term *carrying on any business* as per the OECD MTC definition of an enterprise above, is similar to the familiar phrase, *carrying on of a business*, in the South African case law. The meaning of *carrying on of a business* in a South African context is discussed in 3.4.5.5 below.

3.4.5.5 The meaning of *carrying on of a business* in a South African context

In the absence of a profit motive, Wessel J held the following in *Modderfontein Deep Levels Ltd v Feinstein* [1920] TPD 288:

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.

Juta JA held in *Platt v Commissioner for Inland Revenue* [1922] 32 SATC 142 that, while the making of a profit is a test when determining whether the carrying on of a business is taking place, in certain circumstances, the carrying on of a business may take place without the making of a profit.

A *trade* is defined in section 1 of the Act to include 'every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act, Act 57 of 1978, or any design as defined in the Designs Act, Act 195 of 1993, or any trade mark as defined in the Trade Marks Act, Act 194 of 1993, or any copyright as defined in the Copyright Act, Act 98 of 1978, or any other property which is of a similar nature'.

There are three different interpretations regarding the relationship between *trade* as defined in section 1 of the Act, and *business* or *carrying on of a business*. The first interpretation, as per *Income Tax Case No 615* [1946] 14 SATC 399(U), is that *carrying on of a business* has a narrower meaning than *trade* since the definition of *trade* includes, amongst others, a business. The second interpretation, as per *Income Tax Case No 290* [1933] 7 SATC 333(U), is that *carrying on of a business* should have the same meaning as *trade* since *trade* as defined includes a business. Finally, it was held in *Income Tax Case No 883* [1959] 23 SATC 328(T) that *carrying on of a business* should be given its ordinary meaning in the commercial sense unless the context otherwise indicates.

In support of the third interpretation, namely that the phrase *carrying on of a business* should be given its ordinary meaning in the commercial sense unless the context otherwise indicates, all of the surrounding circumstances and activities concerned were considered in *Platt v Commissioner for Inland Revenue* [1922] 32 SATC 142, *Stephan v Commissioner for Inland Revenue* [1919] 32 SATC 54 and *Estate G v Commissioner of Taxes* [1964] 26 SATC 168 when

determining whether a business is being carried on. In these judgements, the nature and scope of the activities, the presence or absence of the profit motive and the continuity of activities were considered. In light of the above, the third interpretation is submitted to be the correct interpretation of the meaning of *carrying on of a business*.

Depending on the intention of undertaking the transaction, it was held in *Platt v Commissioner for Inland Revenue* [1922] 32 SATC 142 that a single transaction may be carried out in a manner that constitutes the *carrying on of a business*. Wessels JA held in *Commissioner for Inland Revenue v Stott* [1928] 3 SATC 253 that a single undertaking may be of such a nature that it can be correctly described as a business. Similarly, Mason J held in *Stephan v Commissioner for Inland Revenue* [1919] 32 SATC 54 that the salvaging of a single ship's cargo was considered a business because it required several business acts and the employment of a large capital and it extended over a long period.

Wessels JA held in *Commissioner for Inland Revenue v Stott* [1928] 3 SATC 253 that different tests apply to companies and individuals since continuity is inferred for a company which carries out the particular purpose for which it is formed. Juta JA confirmed this in *Platt v Commissioner for Inland Revenue* [1922] 32 SATC 142 when he held as follows:

In the case of a company formed for a certain purpose, the question of the continuity of the acts, which is another factor to be considered in deciding whether a business is carried on, is not of the same importance as in the case of an individual.

Stratford JA held in *Commissioner for Inland Revenue v Lydenburg Platinum Ltd* [1929] 4 SATC 8 that continuity is 'a necessary element in the carrying on of a business in the case of an individual but not of a company'.

Melamet J held in *Income Tax Case No 1529* [1991] 54 SATC 252 that since the words *carrying on business* are not defined in the Act and since it is not possible to devise a precise universal test for when it exists, the meaning has to be determined depending on the circumstances of the particular case.

3.4.5.6 Conclusion on business of an enterprise

An analysis of the phrase *business of an enterprise* reveals that the word *business* has a very wide definition and that activities which qualify as the carrying on of any business collectively constitute an enterprise. The carrying on of any business is defined as the habitual pursuit of business activities. In a South African context the carrying on of a business is given its ordinary meaning in the commercial sense unless the context otherwise indicates. Since no restrictive guidelines or definitions exist, the phrase business of an enterprise should be given a wide, unrestricted meaning.

3.5 Article 5(2): Examples of permanent establishments

3.5.1 The examples of permanent establishments in the OECD MTC

Article 5(2) of the OECD MTC determines the following:

The term 'permanent establishment' includes especially:

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

The list in Article 5(2) merely provides examples of places of business and is not exhaustive. In order to be a *permanent establishment*, the examples still need to satisfy the requirements in Article 5(1) (OECD 2008:86). In order to constitute a *permanent establishment*, the activity performed at the branch, office, factory or workshop must also not be specifically excluded in Article 5(4). None of the terms used in the examples are defined in the OECD MTC. Consequently, the ordinary meaning is ascribed to the terms for interpretation purposes.

The examples of permanent establishments in the 1963 OECD Model also included building sites and construction or installation projects. The burden of proof for the existence of a permanent establishment has since reversed and currently needs to be demonstrated by the person claiming the existence of the permanent establishment (Russo 2007:41).

According to the OECD MTC, a place of management is not necessarily an office (OECD 2008:86). If the concept of a *place of management* is not distinct from an *office*, according to the laws of the contracting state, no reference needs to be made to a *place of management* in the double tax agreement (OECD 2008:86). Each one of the sixty-eight double tax agreements in force between South Africa and other countries includes a place of management (or just management in the case of the double tax agreement between South Africa and Zambia) as an example of a permanent establishment.

A branch is defined as 'a part of a business carried on by a corporation, usually through an office or other fixed place of business (Olivier & Honiball 2008:571). An office is defined in the *Oxford Reference Dictionary* (1992:582) as 'a room or building used as a place of business, especially for clerical or administrative work'. A factory is defined in the *Oxford Reference Dictionary* (1992:290) as 'a building or buildings in which goods are manufactured'. The *Oxford Reference Dictionary* (1992:945) defines a workshop as 'a room or building in which manual work or manufacture is done'. A branch, an office, a factory and a workshop appear as illustrative examples of a permanent establishment in all but one of the sixty-eight double tax agreements entered into by South Africa.

In terms of article 5(2), mines, oil or gas wells, quarries or any other place of extraction of natural resources are further examples of permanent establishments. The phrase 'any other place of extraction of natural resource' should be interpreted broadly in order to, for example, include places of extraction of hydrocarbons (OECD 2008:86).

The inclusion of a provision dealing with the extraction of natural resources was, due to the difficulty of arriving at a common view, left to the contracting states (Russo 2007:41). Accordingly, it was found that the different double tax agreements entered into by South Africa may or may not refer to the exploration of natural resources.

South Africa's double tax agreements generally include the examples of article 5(2). However, the following additional examples of fixed places of business appear in some of the double tax agreements entered into by South Africa:

1. 'A sales store or any premises used as a sales outlet' or similar wording.
2. 'A warehouse, in relation to a person providing storage facilities for others', or just 'a warehouse' or similar wording.
3. 'A farm, a plantation or any other place where agricultural, forestry, plantation or related activities are carried on.'
4. 'An installation or structure used for the exploration of natural resources' or similar wording such as 'exploitation of natural resources'.
5. 'A guest farm or other operation of a similar nature.'
6. 'A drilling rig or a working ship' or similar wording.
7. 'A farm' or 'a farm or plantation' or similar wording.
8. 'A depot.'
9. 'An agricultural, pastoral or forestry property.'

3.5.2 Conclusion on the examples of permanent establishments

The list contained in article 5(2) as well as further examples of fixed places of business found in the individual double tax agreements entered into by South Africa aid to further clarify the concept of *permanent establishment*. The list does not limit the scope of the concept of *permanent establishment* since the requirements of the general definition in article 5(1) still needs to be met before the examples can constitute a permanent establishment.

3.6 Article 5(3): The construction clause

3.6.1 Overview of the construction clause

Article 5(3) of the OECD MTC, which is also referred to as ‘the construction clause’, states the following:

A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

While the above-mentioned is not conclusive for the existence of a permanent establishment, a building site or construction or installation project which does not meet the twelve-month requirement will not be a permanent establishment even if there is an office or a workshop within the meaning of article 5(2) associated with the activity (OECD 2008:86).

If an office or workshop is used for a number of buildings, construction or installation projects and the activities go beyond the exclusions mentioned in article 5(4) (refer to 3.7 below), the activities performed through the office or workshop will constitute a permanent establishment if the other conditions of a permanent establishment, as per article 5(1) of the OECD MTC, are met. Only the profits attributable to the functions performed and risk assumed through that office or workshop must be attributed to the permanent establishment (OECD 2008:86).

In terms of the MTC of the OECD MTC, the phrase ‘building site or construction or installation project’ refers to the construction and the renovation of buildings, roads, bridges or canals. It also refers to the laying of pipe-lines, excavating and dredging. The phrase ‘installation project’ refers to an installation related to construction and the installation of equipment (OECD 2008:87).

Continuous relocation due to the nature of the construction or installation project is considered to be a single project which must be regarded as a permanent establishment if the entire project lasts more than twelve months (OECD 2008:88). Examples of projects which

require continuous relocation are the construction of roads and canals or the laying of pipelines (OECD 2008:88).

3.6.2 The twelve-month test

The twelve-month period mentioned in article 5(3) is referred to as 'the twelve-month test'. This test applies to each individual site or project (OECD 2008:87). The time spent by the contractor on other unconnected sites or projects must not be taken into account when determining the twelve-month period. If the building site forms a coherent whole commercially and geographically, it should be regarded as a single unit even if it is based on several contracts. A building site forms a single unit even when sold to many different customers (OECD 2008:87).

The twelve-month test in article 5(3) replaces the permanency test of article 5(1) with a duration test (Rohatgi 2002:76). Accordingly, the requirements relating to permanency do not apply to a building site, construction or installation project. A building site, construction or installation project needs to meet the twelve-month period requirements.

The OECD MTC provides the following guidelines regarding the measurement of the twelve-month period (OECD 2008:87-88):

1. The twelve-month period starts when the contractor begins his work or preparatory work in the country where the construction is to be established. The twelve-month period ends when the work is completed or permanently abandoned. Seasonal or temporary interruptions should be included when determining the duration of the construction period. The time spent on on-site planning and supervision of the erection of a building is included in the twelve-month period unless specifically modified in the double tax agreements between the contracting states.
2. The time spent by a subcontractor on site must be considered to be time spent on the site by the general contractor of the project. If the subcontractor spends more than twelve months on the site, he/she will have a permanent establishment at the site in terms of article 5(3).

3. If the partners and employees of a partnership spend the required twelve months on a site, each partner will have a permanent establishment regardless of the time spent on the site by the individual partner.
4. Abuses of the twelve-month period, such as the division of contracts into periods of less than twelve months between different companies in the same group may fall under the anti-avoidance rules or can be dealt with in the double tax agreements entered into by the different states.

3.6.3 The model tax convention of the United Nations

In contrast to the OECD MTC, the Model Tax Convention of the United Nations (UN MTC) determines that a permanent establishment exists if the projects lasts longer than six months (Olivier & Honiball 2008:102). The UN MTC also provides that the furnishing of services, including consulting services, constitutes a permanent establishment if it lasts for a period aggregating more than six months in a twelve-month period (Olivier & Honiball 2008:102).

The requirement of the UN MTC with regard to building sites, construction or installation projects is considered to be of relevance since many double tax agreements deviate from the OECD MTC in favour of the UN MTC in this regard. In line with before-mentioned, Australia, Greece, Korea and New Zealand noted their reservation on article 5(3) and treat any building site or construction or installation project which lasts more than six months as a permanent establishment (OECD 2008:112).

3.6.4 The construction clauses in South Africa's double tax agreements

When comparing the construction clauses of the double tax agreements entered into by South Africa with the construction clauses in the OECD MTC, it is found that articles 5(2) and 5(3) of the OECD MTC are often combined into one paragraph in the double tax agreements entered into by South Africa.

The construction clause in the OECD MTC determines that a building site, construction or installation project constitutes a permanent establishment only if such project lasts more than twelve months. The double tax agreements entered into by South Africa often deviates from the twelve-month period by providing for a period of either six or nine months.

Table 3.3: Deviations from the twelve-month test in South Africa’s double tax agreements

Period used in construction clause	Examples of double tax agreements which deviate from the twelve-month period in the OECD MTC
Six-month period	Double tax agreements between South Africa and Algeria/ Botswana/Egypt/Ethiopia/Ghana/Lesotho/Mozambique/Namibia/ Nigeria/Seychelles/Swaziland/Tanzania/Tunisia/Uganda/Brazil/ Bulgaria/Greece/India/ Indonesia/Israel/Kuwait/Malta/New Zealand/Oman/ Pakistan/Saudi Arabia/Thailand.
Nine-month period	Double tax agreements between South Africa and Mauritius/ Romania.

In addition, it was found that article 5(3) in the double tax agreements entered into by South Africa often contains additional wording which broadens the scope of this section and subsequently also the scope of the concept *permanent establishment*.

Table 3.4: Examples of additional wording in South Africa’s double tax agreements

Provision is made for the inclusion of assembly projects and supervisory activities in connection with the site or projects	Double tax agreements between South Africa and Algeria/ Botswana/Egypt/Ethiopia/Ghana/Lesotho/Mauritius/Mozambique/ Namibia/Nigeria/Seychelles/Swaziland/Tanzania/ Tunisia/ Uganda/ Belarus/Belgium/Brazil/Bulgaria/Canada/ China/Croatia/Cyprus/ Czech/Denmark/Finland/Greece/India/Indonesia/Iran/Ireland/Israel/ Italy/Japan/Kuwait/Luxembourg/ Malaysia/Malta/Netherlands/New Zealand/Norway/Oman/ Pakistan/Portugal/Saudi Arabia/Singapore/ Slovak Republic/ Spain/Sweden/Switzerland/Thailand/Turkey/ Ukraine/United Kingdom/United States of America.
The inclusion of assembly projects	Double tax agreements between South Africa and Australia/Hungary/Poland/Romania/Russian Federation/Taiwan.

3.6.5 Conclusion on the construction clause

The construction clause in the OECD MTC narrows the scope of the term *permanent establishment* for building sites, construction and installation projects by adding a time requirement of twelve months to the general definition found in article 5(1). It is submitted that the intention appears to be to prevent certain short-term or once-off projects to result in a permanent establishment being present within the tax jurisdiction.

3.7 Article 5(4): Exclusions from the concept *permanent establishment*

3.7.1 Overview of the exclusions from the concept *permanent establishment*

Article 5(4) of the OECD MTC contains the following list of exclusions from the concept *permanent establishment*:

Notwithstanding the preceding provisions of this article, the term 'permanent establishment' shall be deemed not to include:

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise;
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall

activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

Activities mentioned in the list contained in article 5(4) of the OECD MTC do not constitute a permanent establishment even if the activity is performed through a place of business mentioned in article 5(2) of the OECD MTC (OECD 2008:88). Russo (2007:42) determined that 'as explicitly stated in Art. 5(4)(e), the essential feature of these activities is their preparatory or auxiliary character'. Accordingly, it is submitted that all of the examples in article 5(4) are activities of a preparatory or auxiliary character which are subsequently excluded from the scope of a permanent establishment.

The exclusion mentioned in article 5(4)(a) refers to the acquisition of space while article 5(4)(b) refers to the stock and merchandise itself (Olivier & Honiball 2008:100). The use of the phrase *the delivery of goods* in article 5(4)(a) implies that a warehouse used for storage does not qualify as a permanent establishment (Olivier & Honiball 2008:100).

Article 5(4)(e) of the OECD MTC specifically determines that a country does not have a right to tax the activities of an enterprise with a fixed place of business or dependent agent within the country if the enterprise only performs preparatory or auxiliary activities within the country. The decisive factor when determining whether an activity is of a preparatory or auxiliary nature is to assess whether or not the activity forms an essential and significant part of the activity of the enterprise as a whole (OECD 2008:89). If so, the activity is not of a preparatory or auxiliary character. However, each case needs to be examined on its own merits. Examples of these preparatory or auxiliary activities are fixed places of business used for advertising, the supply of information, scientific research and servicing of a patent or a know-how contract (OECD 2008:89).

Since the preparatory or auxiliary services are remote from the actual realisation of profits, it is difficult to allocate profits to the fixed place of business providing preparatory or auxiliary services (OECD 2008:89). If no profit can be allocated to preparatory or auxiliary services, the existence of a permanent establishment in a tax jurisdiction does not lead to the taxation of the permanent establishment by the foreign jurisdiction since the permanent establishment

will have no taxable income. It is submitted that this explains why preparatory or auxiliary services are specifically excluded from the concept *permanent establishment*.

The scope of auxiliary activities was, amongst others, disputed in *Income Tax Case No 1503* [1990] 53 SATC 342. The taxpayer was an overseas company with branches in South Africa. Inland Revenue wanted to include the interest earned on the local bank accounts in the taxpayer's taxable income. The taxpayer objected on the grounds that the interest was incidental to its air transport business. Melamet J held in *Income Tax Case No 1503* [1990] 53 SATC 342 that it is a matter of degree whether an item of revenue is auxiliary and incidental to the business and that where interest is earned on surplus funds and not from a separate investment, the interest is earned from an auxiliary activity.

3.7.2 Conclusion on the exclusions from the concept *permanent establishment*

It is submitted that the common characteristic of all the exclusions listed in article 5(4) is that these exclusions are all activities of a preparatory or auxiliary character. Activities of a preparatory or auxiliary character are excluded from the concept *permanent establishment*. A preparatory or auxiliary activity is one which is not an essential and significant part of the activities of the enterprise as a whole.

3.8 Article 5(5) and 5(6): The agency clauses

3.8.1 Overview of the agency clauses

Articles 5(5) and 5(6) of the OECD MTC contain the provisions relating to dependent and independent agents and are referred to as the Agency clauses. Article 5(5) only applies to dependent agents and is an additional rule for the existence of a permanent establishment in a state. Article 5(5) determines as follows:

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

Article 5(6) of the OECD MTC determines as follows regarding independent agents:

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

Vogel (1997:332) stated that the mere authority to conclude contracts does not mean that the dependent agent is actually engaged in business in such a way that it would constitute the existence of a permanent establishment. Huston and Williams (1993:90) stated that a general power of attorney to conclude contracts is not sufficient for the existence of a permanent establishment unless the general power of attorney is regularly exercised since it is the relevant authority which is exercised, not that which is given, that attracts taxation. Skaar (1991:525) stated that the dependent agent provision does not require the connection between the business activity and the place of business, however authority to perform a business activity on behalf of a principal does not constitute a permanent establishment since the business of the principal has to be performed and the authority has to be habitually exercised.

The OECD MTC (2008:92-93) determines the following with regard to a dependent agent:

- A dependent agent may be, or may not be, an employee of the enterprise.
- The person may be either an individual or a company and need not be a resident or have a place of business in the state in which he/she acts for the enterprise.
- The person should have sufficient authority to bind the enterprise in the business activity in the foreign jurisdiction.
- The person should repeatedly, and not only in isolated cases, make use of this authority.
- A dependent agent who is authorised to negotiate all elements of a contract and to bind the enterprise contractually can be said to exercise his/her authority.
- The participation of the agent in negotiations in isolation does not create a permanent establishment, but is a relevant factor in determining the exact functions performed by the person on behalf of the enterprise.
- Once the requirements of article 5(5) are met, a permanent establishment of the enterprise exists to the extent that the person acts for the enterprise.

In contrast to a dependent agent, article 5(6) of the OECD MTC determines that the activities of an independent agent (such as a broker, general commission agent or other agent) of independent status will not result in the establishment of a permanent establishment in the source country if the agent is acting in the ordinary course of his or her business. It was held by Corbett JA in *Secretary for Inland Revenue v Downing* [1975] 37 SATC 249 for purposes of the double tax agreement between South Africa and the Swiss Federal Council, that the management of a portfolio of shares by an independent stockbroker in South Africa on behalf of a non-resident does not result in a permanent establishment in South Africa.

Article 5(6) applies to a person who is both legally and economically independent of the enterprise and who acts in the ordinary course of his/her business when acting on behalf of the enterprise (OECD 2008:94). Article 5(6) has been inserted into the OECD MTC for the sake of clarity and emphasis since an agent representing a separate enterprise cannot constitute a permanent establishment of the foreign enterprise (OECD 2008:94).

Table 3.5: Comparison of the requirements relating to a dependent agent with those of an independent agent

Dependent agent	Independent agent
<ul style="list-style-type: none"> • Acting on behalf of an enterprise. • Habitually exercises an authority to conclude contracts in the name of the enterprise. • Authority to conclude contracts in the name of the enterprise. <p>[Afore-mentioned requirements do not apply if the activities are excluded in terms of article 5(4) of the OECD MTC.]</p>	<ul style="list-style-type: none"> • Independent of the enterprise. • Acting in ordinary course of his/her business.

Many agencies of foreign business companies do not meet the requirements of article 5(1) or 5(5). In order to avoid large-scale businesses in a state which do not get taxed, many double tax agreements concluded by OECD member countries include a provision which stipulates that insurance companies are deemed to have a permanent establishment in a state if they collect premiums or insure risks through an agent situated in that state.

Gzell J held in *Unisys Corporation v Federal Commissioner of Taxation* [2002] 51 ATR 386, that the dependent agent who concluded one contract in the course of two years did not habitually exercise his authority even if the business in question did not require more than one contract for this period of time.

It was held in the Tax Court of Canada by Miller CJ in both *American Life Insurance Co v R* [2008] D.T.C. 3631 and *Knights of Columbus v R* [2008] D.T. C. 3648 that the taxpayer did not have permanent establishments in Canada in spite of the significant businesses they carried out in Canada. The taxpayers were listed in the telephone directories, provided promotional material and had office space in Canada. It was held that the taxpayers did not have a fixed place of business at their disposal since the office space in Canada was under the control of independent agents who were carrying on their own businesses and not the business of the taxpayer. The court held that the agents were independent contractors and that all contracts

were subject to final approval in the United States. Accordingly, the taxpayers did not have permanent establishments in Canada since they had no dependent agents who habitually exercised their ability to conclude contracts in Canada.

3.8.2 The agency clauses in South Africa's double tax agreements

The OECD MTC determines that, in order for the activities of a dependent agent to result in the existence of a permanent establishment of the enterprise, the dependent agent must habitually exercise his/her authority to conclude contracts in the name of the enterprise. This does not apply if the activities of the dependent agent are limited to those mentioned in the list of exclusions from the scope of a permanent establishment in article 5(4).

A comparison of article 5 of the double tax agreements entered into by South Africa with the OECD MTC reveals the following additional provisions relating to dependent and independent agents in some of the double tax agreements entered into by South Africa:

Table 3.6: Comparison of the provisions relating to dependent agents in South Africa's double tax agreements with the similar provisions in the OECD MTC

Additional provisions relating to dependent agents in the double tax agreements entered into by South Africa	Examples of double tax agreements with the said additional provision
A person without the authority to conclude contracts in the name of an enterprise of the other contracting state who habitually maintains a stock of goods or merchandise from which goods or merchandise are regularly delivered on behalf of the enterprise, unless the activities of such a person are limited to those mentioned in the exclusions listed in paragraph 4 of article 5.	Double tax agreement between South Africa and Botswana/Egypt/Ethiopia/Lesotho/Mauritius/Namibia/Swaziland/Tunisia/Malaysia/Oman/Romania/Russian Federation/Saudi Arabia/Taiwan /Thailand.

<p>A person who regularly secures orders in a state for an enterprise of the other contracting state.</p>	<p>Double tax agreement between South Africa and Lesotho/Namibia/Nigeria/Tunisia/Romania/Russian Federation/Taiwan/Thailand.</p>
<p>An insurance enterprise of a contracting state shall, except in regard to reinsurance, be deemed to have a permanent establishment in other contracting state if it collects premiums in the territory of that other state or insures risks situated therein through a person other than an agent of an independent status to whom the paragraph relating to independent agents applies.</p>	<p>Double tax agreement between South Africa and Egypt/Ethiopia/Tanzania/ Tunisia/ Thailand.</p>

Table 3.7: Comparison of the provisions relating to independent agents in South Africa’s double tax agreements with the similar provisions in the OECD MTC

<p>Additional provisions relating to independent agents in the double tax agreements entered into by South Africa</p>	<p>Examples of double tax agreements with the said additional provision</p>
<p>A broker, general commission agent or any other agent with independent status acting in the ordinary course of his/her business will not be considered to be independent if his/her activities are devoted wholly or almost wholly to the enterprise in the other contracting state.</p>	<p>Double tax agreement between South Africa and Namibia/Uganda.</p>
<p>An agent will only be independent if his/her activities, which are devoted wholly or mainly on behalf of the enterprise in the other contracting state, were made under arm’s length conditions.</p>	<p>Double tax agreement between South Africa and Iran/Malta.</p>

<p>The presence of an agent who habitually exercises an authority to conclude contracts in the name of the enterprise from the other contracting state, will not be deemed to be a permanent establishment in the state if his/her activities are limited to the purchase of goods or merchandise for the enterprise.</p>	<p>Double tax agreement between South Africa and Israel/Italy/Poland/Switzerland.</p>
<p>If the activities of an independent agent are wholly or mainly on behalf of the enterprise or wholly or mainly on behalf of an enterprise which is controlled by or in which the agent has a controlling interest, this will not result in the agent being an independent agent for purposes of the agency clauses.</p>	<p>Double tax agreement between South Africa and Thailand.</p>

3.8.3 Conclusion on the agency clauses

In terms of the agency clauses contained in article 5(5) and 5(6), the activities of an agent, other than those of an independent agent, with the authority to conclude contracts in the contracting state in the name of the enterprise, are deemed to be a permanent establishment of an enterprise in the contracting state unless the activities are specifically excluded in terms of article 5(4) of the OECD MTC. An independent agent is a broker, general commission agent or any other agent, with an independent status, acting in the ordinary course of his/her business.

The deviations from article 5 of the OECD MTC found in some of South Africa's double tax agreements extend the scope of the dependent and independent agent clauses for purposes of the particular double tax agreement. The consequence of any deviation from the agency clauses in the OECD MTC should be considered on a case-by-case basis in order to determine whether independent an agent in terms of the OECD MTC is considered to be a dependent agent in terms of the relevant double tax agreement.

3.9 Article 5(7): Relationship of control

3.9.1 The relationship of control

Article 5(7) contains the following provisions regarding the relationship of control:

The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

A subsidiary company is an independent legal entity and is subsequently not a permanent establishment of its parent company (OECD 2008:96). This applies regardless of the level of control exercised by the parent or other company in the group (OECD 2008:96).

A permanent establishment is not based on ownership, control or association between related enterprises (Rohatgi 2002:78). A subsidiary will be regarded as a permanent establishment of the parent company if it concludes contracts for joint business activities without the ability to carry it out other than in partnership with the parent (Rohatgi 2002:78). Accordingly, the activities of a foreign parent company in the jurisdiction of the subsidiary might result in the parent company having a permanent establishment in the jurisdiction of the subsidiary, but this would be subject to the requirements of a permanent establishment and is not dependent on the relationship of control between the two entities.

3.9.2 Conclusion on the relationship of control

Regardless of the level of control exercised by the parent company, a subsidiary company is not a permanent establishment of the parent company. This is due to the fact that a subsidiary is a separate legal entity.

3.10 Conclusion

The definition of a permanent establishment in section 1 of the Act refers to article 5 of the OECD MTC. The objective of the concept *permanent establishment* is the identification of criteria for the existence of a permanent establishment in a tax jurisdiction. Once the criteria for the existence of a permanent establishment are met, it implies that legitimate and substantive business activities take place at the fixed place of business. The existence of a permanent establishment in a tax jurisdiction determines the right of the jurisdiction to tax the profits of the permanent establishment. The components of the concept *permanent establishment* are summarised in figure 3.1 below.

It is submitted that the concept *permanent establishment* is thoroughly defined, explained and analysed in existing commentaries and case law. Accordingly, the existing reference material on the concept *permanent establishment* and the components thereof can be applied when analysing other concepts with corresponding components. The concept *foreign business establishment* is analysed in chapter 4. The two concepts are compared in chapter 5 in order to determine if the concept *foreign business establishment* can be replaced with the internationally recognised and accepted concept *permanent establishment*.

Figure 3.1: The concept *permanent establishment* as per article 5 of the OECD MTC

OECD MTC: Article 5: Permanent Establishment					
Article 5(1): General definition	Article 5(2): Examples	Article 5(3): Construction clause	Article 5(4): Exclusions	Articles 5(5) & 5(6): Agency clauses	Article 5(7): Relationship of control
<p>Components of the general definition:</p> <p>Fixed place of business.</p> <p>Place of business.</p> <p>Business carried on through the fixed place of business.</p> <p>The business of an enterprise.</p>	<p>Examples of permanent establishments:</p> <p>A place of management.</p> <p>A branch.</p> <p>An office.</p> <p>A factory.</p> <p>A workshop.</p> <p>A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.</p>	<p>Article 5(3): Construction clause</p> <p>A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.</p>	<p>Exclusions from the concept permanent establishment:</p> <p>Activities of a preparatory or auxiliary character are excluded from the scope of a permanent establishment.</p>	<p>The activities of an independent agent who regularly exercises his/her authority to conclude contracts in the contracting state in the name of the enterprise is deemed to be a permanent establishment of the enterprise unless the activities are excluded by article 5(4).</p> <p>The activities of an independent agent who acts in the ordinary course of his/her business will not constitute a permanent establishment in the contracting state.</p>	<p>Regardless of the level of control exercised by the parent company, a subsidiary company is not a permanent establishment of the parent company. Before-mentioned is due to the fact that a subsidiary is a separate legal entity.</p>

CHAPTER 4

Analysis of the concept *foreign business establishment*

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4.1 Introduction

The concept *foreign business establishment* forms part of section 9D of the Act. Section 9D subjects certain foreign-sourced income generated by South African-CFCs to tax in South Africa. One of the exclusions from the provisions in section 9D is the existence of a foreign business establishment in the foreign jurisdiction.

The history and evolution of the concept *foreign business establishment* were analysed in chapter 2 in order to fully understand the background of the concept. Initially the concept *business establishment* was inserted into the Act in 2000. The *business establishment* definition was amended in 2002 and then replaced with the definition of a *foreign business establishment* in 2006. Paragraph (a) of the foreign business establishment definition was replaced in 2009.

In this chapter, an overview is provided on the tax implications of section 9D. This overview is required in order to understand the context within which the concept *foreign business establishment* applies. The overview of section 9D is followed by an analysis of the concept *foreign business establishment*. The purpose of the analysis is to identify both the objective of the concept *foreign business establishment* and the components of the definition of a foreign business establishment in order to compare it with that of a permanent establishment in chapter 5. The purpose of the comparison is to determine if the concept *fixed business establishment* can be replaced with the internationally recognised and accepted concept *permanent establishment*. Reference is made to the National Treasury's detailed Explanation to Section 9D of the Income Tax Act, the Katz Report, Revenue Law Amendment Acts, Taxation Law Amendment Acts, Explanatory Memorandums and other tax commentaries which deal with the concept *foreign business establishment*.

4.2 Overview of section 9D

Section 9D was introduced into the Act as a result of the change in the South African tax base during 2000. The tax base changed from a source base to a residence base. The change in tax

base required the introduction of a number of anti-avoidance provisions. Section 9D, which provides for the taxation in South Africa of certain foreign-sourced income generated by South African-CFCs, is one of these anti-avoidance provisions.

Section 9D is an anti-avoidance provision which applies to residents who invest off-shore through a CFC. Section 9D prevents the resident from converting the taxable income from the investment into non-taxable income and/or from deferring or avoiding domestic taxation by accumulating the income in the CFC (Meyerowitz 2008:9-79).

The application of section 9D involves a two-part test. The first part of the test determines the existence of a foreign company, and the second part determines whether the foreign company is controlled by South African shareholders (National Treasury 2002:3). A foreign company is defined in section 9D as 'any association, corporation, company, arrangement or scheme ... which is not a resident'. A CFC is defined in section 9D as 'any foreign company where more than 50% of the total participation rights in that foreign company are held, or more than 50% of the voting rights in that foreign company are directly or indirectly exercisable, by one or more residents'. This definition is followed by a number of provisos relating to voting rights and participation rights.

Section 9D applies when the participation rights or voting rights of South African residents in a CFC exceeds 50%. When section 9D applies, the net income of a CFC is attributed to and included in the taxable income of South African shareholders (SARS 2009:73). The foreign business establishment exclusion in section 9D is the main exclusion resulting in the net income from the foreign business establishment being excluded from the taxable income of South African shareholders (SARS 2009:73).

Initially the opening lines of section 9D(9) determined that 'the provisions of subsection (2) shall not apply to the extent that'. Due to the choice of words in the opening lines of section 9D(9) it is not clear whether the subsection provides for the exemption of or for the exclusion from the provisions of section 9D(2) (Olivier & Honiball 2008:446). The opening lines of section 9D(9) were amended by clause 14(1)(i) of the Revenue Laws Amendment Act, Act 31 of 2005. In terms of the amendment the words 'shall not apply' were replaced with the

words 'there must not be taken into account'. The *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2005* (SARS 2005:13) determines that 'the amendment clarifies that the amounts contemplated in section 9D(9) must be excluded in the determination of the net income of the CFC'. Afore-mentioned explanation in the Explanatory Memorandum is followed by the statement that 'subsection (9) therefore operates as an exemption provision'. Since the Explanatory Memorandum uses both the terms 'excluded' and 'exemption' it does not clarify the intention of the amendment. Even though the intention is still not clear, it appears from the above-mentioned amendment that section 9D(9) provides for exclusions from the net income of a CFC. It is submitted that the exclusions in section 9D(9) require the amounts to be omitted from net income. The provisos to the foreign business establishment exclusion in section 9D(9)(b) are extensive and complicated and are considered to fall beyond the scope of this chapter.

4.3 The objective of the concept *foreign business establishment*

The concept *foreign business establishment* is defined in section 9D(1), while the exclusion paragraph in terms of which the net income of a foreign business establishment is excluded from the taxable income of South African shareholders, is included in section 9D(9)(b). Section 9D(9)(b) states that, subject to certain provisos, when determining net income in terms of section 9D(2A) 'there must not be taken into account' any amount which is attributable to a foreign business establishment of that CFC. The disposal or deemed disposal of any asset forming part of that foreign business establishment is included in the section 9D(9)(b)-exclusion.

The objective of the foreign business establishment exclusion in section 9D is to grant exclusion to income derived from legitimate and substantive business activities while non-substantive business undertakings remain subjective to the CFC-legislation (Olivier & Honiball 2008:447). This objective is in agreement with the international use of CFC-legislation since countries with CFC-legislation generally do not intend for the CFC rules to interfere with legitimate and substantive business activities (Sandler 1998:9).

In June 2002, the National Treasury (2002:8) identified the following three categories of foreign business establishment income which does not qualify for the foreign business establishment exclusion:

1. mobile foreign business income;
2. diversionary foreign business income; and
3. mobile foreign passive income.

Mobile foreign business income refers to all taxable income from businesses without economic substance which have no adequate business reason for being established offshore versus being established in South Africa (National Treasury 2002:8).

Diversionary foreign business income refers to income generated by a CFC from sales and service transactions with related South African residents, which were conducted in a manner that will most likely lead to transfer pricing tax avoidance (National Treasury 2002:8).

Mobile foreign passive income is income from passive assets which does not involve any direct international competitiveness concerns due to a lack of business activities (National Treasury 2002:8).

Anti-deferral provisions, such as section 9D, are diametrically opposed to international competitiveness since anti-deferral leads to the inclusion of foreign net income in taxable income while international competitiveness requires the exclusion of foreign net income from taxable income (National Treasury 2002:2). Section 9D achieves a balance between anti-deferral and international competitiveness by providing exclusions for income from active operations (National Treasury 2002:2). The result is that section 9D applies to income from passive investments or income from transactions that meet objective criteria with a high tax-avoidance risk (National Treasury 2002:2).

In terms of the principle of international competitiveness, foreign company income should be ignored in order to enable South African multinational companies to compete on an equal basis with their foreign local rivals (National Treasury 2002:1). Section 9D achieves this since

the section does not apply to active income but only to passive investments or to transactions that meet objective criteria with a high risk for tax avoidance (National Treasury 2002:2).

Since the objective of the foreign business establishment exclusion in section 9D is to exclude income derived from legitimate and substantive business activities from the CFC-legislation (see above), it can be derived that if a CFC meets the criteria of the foreign business establishment exclusion, it has legitimate and substantive business activities in the foreign tax jurisdiction.

4.4 Overview of the concept *foreign business establishment*

Clause 12 of the Taxation Law Amendment Act, Act 17 of 2009 provides for the replacement of paragraph (a) of the *foreign business establishment* definition. After this replacement, a foreign business establishment is defined as follows in section 9D(1) of the Act:

- (a) a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that CFC for a period of not less than one year, where –
 - (i) that business is conducted through one or more offices, shops, factories, warehouses or other structures;
 - (ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that CFC who conduct the primary operations of that business;
 - (iii) that fixed place of business is suitably equipped for conducting the primary operations of that business;
 - (iv) that fixed place of business has suitable facilities for conducting the primary operations of that business; and
 - (v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic:

Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a CFC may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company –

- (aa) if that other company is subject to tax in the country in which the fixed place of business of the CFC is located by virtue of residence, place of effective management or other criteria of a similar nature;
 - (bb) if that other company forms part of the same group of companies as the CFC; and
 - (cc) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the CFC;
- (b) any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on, where that CFC carries on those prospecting, exploration, mining or production operations;
 - (c) a site outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that CFC carries on those construction or installation activities;
 - (d) agricultural land in any country other than the Republic used for *bona fide* farming activities directly carried on by that controlled foreign company; or
 - (e) a vessel, vehicle, rolling stock or aircraft used for the purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the

Republic for such purposes and is operated directly by that CFC or by any other company that has the same country of residence as that CFC and that forms part of the same group of companies as that CFC.

If the same method applied in chapter 3 is used to analyse the definition of a foreign business establishment, it is submitted that the definition of a foreign business establishment can be divided into three main components which are summarised in table 4.1. These components are analysed in 4.5 and 4.6 below in order to determine its meaning and scope in the South African context.

Table 4.1: Overview of the foreign business establishment definition

Components of the foreign business establishment definition	Discussed in
1. The basic rule for the existence of a foreign business establishment.	4.5
2. The single country requirement relating to a group of companies.	4.6
3. The industry specific requirements.	4.7

4.5 The basic rule for the existence of a foreign business establishment

4.5.1 Overview of the basic rule

It is submitted that the basic rule consists of a general definition and five conditions (see table 4.2). The general definition is contained in the opening paragraph of the foreign business establishment definition. The first condition requires the business to be conducted through one or more offices, shops, factories, warehouses or other structures. Three of the remaining four conditions relate to the nature of the business while the final condition relates to the purpose of the business.

Table 4.2: Overview of the basic rule

The basic rule for the existence of a foreign business establishment	Discussed in
1. The general definition.	4.5.2
2. Condition 1: The business is conducted through one or more offices, shops, factories, warehouses or other structures.	4.5.3
3. Condition 2: The fixed place of business is suitably staffed.	4.5.4
4. Condition 3: The fixed place of business is suitably equipped.	4.5.4
5. Condition 4: The fixed place of business has suitable facilities.	4.5.4
6. Condition 5: The fixed place is located outside the Republic solely or mainly for a purpose other than a tax-related purpose.	4.5.5

4.5.2 The general definition

4.5.2.1 Overview of the general definition

The general definition is contained in the opening paragraph of the definition of a foreign business establishment. In terms of the general definition, a foreign business establishment is

a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that CFC for a period of not less than one year.

It is submitted that the general definition of a foreign business establishment consists of the following six components:

Table 4.3: The six components of the general definition of a foreign business establishment

The six components of the general definition	Discussed in
1. A fixed place of business.	4.5.2.2
2. A place of business.	4.5.2.3
3. The location of the fixed place of business in a country other than the Republic.	4.5.2.4
4. The fixed place of business is used or will continue to be used.	4.5.2.5
5. The carrying on of the business of the CFC.	4.5.2.6
6. The time requirement of not less than one year.	4.5.2.7

4.5.2.2 A fixed place of business

In accordance with the explanation of the National Treasury in section 9D, a business establishment must operate through ‘a fixed location that suggests some permanence’ in order to ensure that the business is more than a mere mailing address, website or momentary single business project (National Treasury 2002:9). The requirement for a fixed place of business is also a requirement for the existence of a permanent establishment. This requirement is thoroughly discussed in 3.4.2 above. It is submitted that the existence of a fixed place of business has the same requirements in the concepts *permanent establishment* and *foreign business establishment*, namely the requirements relating to the location and permanency nature of the business.

4.5.2.3 A place of business

The place of business does not have to be owned by the CFC since rented premises are sufficient (Clegg & Stretch 2009:8-56). The place of business must be the place in which the business is carried on (Clegg & Stretch 2009:8-56(1)). Accordingly, an ambulatory business operation which is managed out of an office which carries on only management and support functions will not meet the requirements of a place of business (Clegg & Stretch

2009:8-56(1)). The term *place of business* is also part of the concept *permanent establishment*. The term *place of business* is thoroughly discussed in 3.4.3 above. It is submitted that the phrase *a place of business* has the same meaning in the concepts *permanent establishment* and *foreign business establishment*, namely to require an enterprise to have a particular space at its disposal.

4.5.2.4 The location of the fixed place of business in a country other than the Republic

The requirement that the fixed place of business must be located in a country other than the Republic was added to the definition of a *foreign business establishment* by clause 9 of the Revenue Laws Amendment Act, Act 20 of 2006. In accordance with the *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006* (SARS 2006:53), the amendment was required to account for the country within which the active business should be conducted. A foreign company is defined in section 9D as ‘any association, corporation, company, arrangement or scheme contemplated in paragraph (a), (b), (c), (e) or (f) of the definition of “company” in section 1, which is not a resident’. Accordingly, it is submitted that the requirement for the location to be in a country other than the Republic is unnecessary. The reason being that section 9D applies to South African-controlled foreign companies which implies that the foreign business establishment will be a foreign company and therefore located in a country other than the Republic.

4.5.2.5 The fixed place of business is used or will continue to be used

The word *use* is defined in the *Oxford Reference Dictionary* (1992:902) as ‘to cause to act or serve for a purpose; to bring into service’ and also as ‘the right or power of using; ability to be used’. It is submitted that the requirement that the fixed place of business is used or will continue to be used requires that the location of the fixed place of business in a country other than the Republic is used for the carrying on of the business. The implications of temporary interruptions on the requirement that the fixed place of business be ‘used’ or ‘continued to be used’ are not clear. The National Treasury (2002:9) determined that the requirement to

use the property implies some level of activity with regard to the structure and that the mere ownership or leasing right is insufficient. Due to the similar meaning, it is submitted that this requirement is similar to the permanent establishment requirement that a business be carried on 'through' the fixed place of business. Accordingly, the location should be at the disposal of the enterprise and used in order to fulfil the purpose of the enterprise.

4.5.2.6 The carrying on of the business of the CFC

The meaning of the phrase *carrying on of the business* was discussed in 3.4.5.4 above. It is submitted that the phrase *carrying on of the business* has the same meaning in the definitions of both *permanent establishment* and *foreign business establishment*, being the habitual pursuit of business activities.

4.5.2.7 The time requirement of not less than one year

The minimum time requirement of 'not less than one year' presupposes some activity, which extends beyond mere holding rights as owner or lessee (Olivier & Honiball 2008:449). The *Explanatory Memorandum on the Taxation Laws Amendment Act, 2009* (SARS 2009:75) determines that the one-year time requirement allows for a one-year back or forward determination. The previous foreign business establishment definition had no minimum time requirement for prospecting or exploration operations, farming activities and the operation of certain vessels, vehicles, aircraft or rolling stock since, due to its nature, it is unlikely that the requirements regarding permanency, economic substance and business purpose will not be met (Olivier & Honiball 2008:449).

It is submitted that the time requirement of not less than one year in the concept *foreign business establishment* is similar to the requirement for a degree of permanency since permanency also refers to a period of time. The requirement of not less than one year is further discussed in 5.3.2 below.

4.5.2.8 Conclusion on the general definition

The general definition of a foreign business establishment consists of six components. Four of these components are similar to the components of the general definition of a permanent establishment. The other two, the location of the fixed place of business in a country other than the Republic and the time requirement of not less than one year, are unique to the general definition of a foreign business establishment.

The location of the fixed place of business in a country other than the Republic is submitted to be unnecessary since the concept *foreign business establishment* and the CFC-rules in section 9D applies to foreign companies which, by implication, are located in a country other than the Republic. The time requirement of not less than one year in the general definition of a foreign business establishment is similar to the requirement for a degree of permanency. The requirement for a degree of permanency forms part of the requirement for a fixed place of business which is already included in the general definitions of a foreign business establishment and a permanent establishment.

4.5.3 The first condition

4.5.3.1 Overview of the first condition

The first condition is contained in subparagraph (a)(i) of the definition of a foreign business establishment and requires the business to be conducted through one or more offices, shops, factories, warehouses or other structures.

It is submitted that the first condition consists of two requirements:

- physical presence in the foreign jurisdiction (see 4.5.3.2); and
- business conducted ‘through’ the premises (see 4.5.3.3).

4.5.3.2 Physical presence in the foreign jurisdiction

The foreign business establishment must be physically present in the foreign jurisdiction since the offices, shops, factories, warehouses or other structures listed in this requirement are all physical objects. The requirement for a physical presence in the foreign jurisdiction appears to be similar to the permanent establishment requirement for the existence of a fixed place of business (see 3.4.2). If so, it is also a duplication of the first component of the general requirement, being a fixed place of business (see 4.5.2.2). This apparent duplication is further discussed in 5.3.2 below.

4.5.3.3 Business conducted through the premises

The second requirement is that the business must be conducted through the premises. The requirement for the business to be conducted through the premises appears to be similar to the permanent establishment requirement that the business must be carried on through the fixed place of business (see 3.4.4). It is submitted that this requirement is similar to the requirement that the fixed place of business is used or will continue to be used (see 4.5.2.5). Accordingly, this requirement is a duplication of a requirement which is already included in the general definition of a foreign business establishment. This apparent duplication is further discussed in 5.3.4 below.

4.5.3.4 Conclusion on the first condition

The first condition for the existence of a foreign business establishment requires a physical presence in the foreign jurisdiction. The business of the foreign business establishment also needs to be conducted through the premises. Both these requirements are found to be a duplication of requirements already included in the general definition of a foreign business establishment. Accordingly, the inclusion of the first condition in the definition of a foreign business establishment is submitted to be unnecessary.

4.5.4 The three conditions relating to the nature of the business

4.5.4.1 Overview of the three conditions relating to the nature of the business

The three requirements relating to the nature of the business are as follows:

1. The fixed place of business is suitably staffed with on-site managerial and operational employees of the CFC that conducts the primary operations of said business.
2. The fixed place of business is suitably equipped for conducting the primary operations of the business.
3. The fixed place of business has suitable facilities for conducting the primary operations of the business.

The three requirements relating to the nature of the business are also referred to as the *economic substance requirements* (Olivier & Honiball 2008:448). An entity will not be a foreign business establishment if such establishment has no real economic nexus with the country within which it is located (Olivier & Honiball 2008:448). The National Treasury (2002:9) stated that the economic substance requirements ensure that the business is more than a paper transaction or disguised form of passive income. The CFC lacks economic substance if the primary daily operations of the business are conducted by an independent contractor (National Treasury 2002:10). If the work performed by independent contractors are merely incidental, it will not negatively impact the economic substance requirements (National Treasury 2002:10).

The difficulty with these requirements is that neither the Act nor the Explanatory Memorandum defines what is meant with by word *suitably* or *suitable*. Accordingly, the meaning of these words needs to be determined with reference to their ordinary meanings. The *Oxford Reference Dictionary* (1992:825) defines *suitable* as 'right or appropriate for the purpose or occasion'. It is submitted that the word *suitably* is derived from the word *suitable* and accordingly has the same meaning.

The requirements for suitable staff, suitable equipment and suitable facilities must be for the primary operations of the business since the secondary operations need not necessarily require dedicated personnel, etc (Clegg & Stretch 2009:8-57).

In order to be suitably staffed, full-time employees who take management decisions and full-time employees who take operational decisions need to be present at the foreign business premises (Olivier & Honiball 2008:448). The requirement for full-time employees could be problematic when the actual requirements of the business and practice of the industry suggest that part-time staff could be sensibly employed (Clegg & Stretch 2009:8-57). The requirement to be suitably staffed means that not all activities of the foreign business establishment can be outsourced (Clegg & Stretch 2009:8-57). If outsourcing takes place, a full-time manager with the appropriate knowledge, skills and authority to hire and fire the outsourcing service provider must be employed (Clegg & Stretch 2009:8-57).

In order to be suitably equipped, the CFC needs to own the premises from which it is conducting its business activities or it needs a legal right to use the premises (Davis & Olivier & Urquhart & Ferreira & Roeleveld 2009:9D-16A).

The CFC is required to have 'suitable facilities for conducting the primary operations of the business'. No further guidance is available to determine the scope of this requirement.

4.5.4.2 Conclusion on the three conditions relating to the nature of the business

Since no clear guideline is supplied and since the dictionary meaning of the words are very wide, it is submitted that the meaning of the phrases *suitably staffed*, *suitably equipped* and *suitable facilities* will be determined objectively on a case-by-case basis while considering the specific circumstances of the specific fixed place of business.

4.5.5 The condition relating to the purpose of the business

4.5.5.1 Overview of the condition relating to the purpose of the business

The revised definition of *foreign business establishment* requires that the fixed place of business of the foreign business establishment be located outside the Republic 'solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic'. This requirement is referred to by National Treasury as the 'business purpose test' (SARS 2009:75). In terms of the business purpose test, the business purpose (as opposed to the purpose of avoiding South African tax) must be the sole or main reason for the location of the fixed place of business in the foreign jurisdiction (SARS 2009:75).

The business purpose test replaced the bona fide-test in the previous definition of a foreign business establishment. In terms of the business purpose test, the fixed place of business must be located outside South Africa for a sole or main purpose other than the avoidance of South African tax (de Koker 2010:5-53). The business purpose test does not require that the sole or main purpose must be a business purpose (de Koker 2010:5-53). The National Treasury (2002:10) stated that a bona fide business purpose exists when the business is located in any country other than the Republic for reasons other than a tax advantage. A significant saving in shipment cost is considered to be a sufficient business reason for operating abroad (National Treasury 2002:10). An employee cost saving which is insignificant when compared to the tax saving due to the operations being abroad versus in South Africa, is not considered to be a bona fide business purpose (National Treasury 2002:11).

4.5.5.2 Conclusion on the condition relating to the purpose of the business

In terms of the condition relating to the purpose of the business, the sole or main purpose for the location of the CFC in a jurisdiction other than the Republic must be a purpose other than to obtain a tax advantage.

4.6 The single country requirement for a group of companies

4.6.1 Overview of the single country requirement for a group of companies

Since the activities of a single business are often divided between different legal entities, the revised *foreign business establishment* definition allows for the structures, employees, equipment and facilities of other group companies to be taken into account when determining the existence of a foreign business establishment (SARS 2009:76).

The *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009* (SARS 2009:76) lists the following conditions for this requirement:

1. The other entities must be subject to tax in the foreign country by virtue of residence, place of effective management or other criteria of a similar nature.
2. The other entities must be part of the same group of companies as the CFC.
3. The structures, employees, equipment and facilities must be located in the same foreign country as the CFC.

The *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009* (SARS 2009:76) illustrates the single country requirement for a group of companies with the following example:

A South African resident company owns all the shares in three CFCs. One CFC owns a building which is used in the business, another has ten employees who are employed in the business and the third one owns substantial equipment and facilities which are used in the business. The three CFCs are incorporated and effectively managed within the same country. The buildings, employees, equipment and facilities are located in the country of incorporation. In terms of the single country requirement, the interest in the three CFCs can be pooled when determining whether the business qualifies as a foreign business establishment. The pooling is allowed since the buildings, employees, equipment and facilities are located in the same country which is also the country of residence and all three companies are part of the same group.

4.6.2 Conclusion on the single country requirement for a group of companies

Subject to the three conditions (see 4.6.1) being met, a group of companies can collectively meet the requirements of the foreign business exclusion. Accordingly, the foreign business establishment exclusion is extended by this provision to accommodate certain groups of companies.

4.7 The industry specific requirements

4.7.1 Overview of the industry specific requirements

Paragraph (b) to (e) of the foreign business establishment definition contains requirements which apply to certain operations, projects, activities and entities. If the operation, project, activity or entity falls within the scope of paragraph (b) to (e), it does not have to meet the requirements of the general rule contained in paragraph (a) (see 4.5 above). For ease of reference, paragraph (b) to (e) is referred to as the industry specific requirements. The industry specific requirements consist of four categories which are summarised in table 4.4 below.

Table 4.4: Overview of the industry specific requirements

<p style="text-align: center;">The industry specific requirements</p> <p style="text-align: center;">includes the following operations, projects, activities and entities</p>	<p style="text-align: center;">Discussed in</p>
1. Prospecting or exploration operations for natural resources.	4.7.2
2. Construction or installation projects.	4.7.3
3. Bona fide farming activities	4.7.4
4. Transport entities.	4.7.5

4.7.2 Prospecting or exploration operations for natural resources

Paragraph (b) of the definition of a foreign business establishment determines that a foreign business establishment includes, amongst others, the following:

Any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on, where that CFC carries on those prospecting, exploration, mining or production operations.

Accordingly, for purposes of prospecting or exploration operations for natural resources, the operations must be carried on by the CFC concerned in a place outside the Republic.

4.7.3 Construction or installation projects

Paragraph (c) of the definition of a foreign business establishment determines that a foreign business establishment includes, amongst others, the following:

A site outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that CFC carries on those construction or installation activities.

Paragraph (c) requires the physical construction or installation of substantial assets by the CFC concerned. Paragraph (c) also introduces a minimum time-requirement of not less than six months.

4.7.4 Bona fide farming activities

Paragraph (d) of the definition of a foreign business establishment determines that a foreign business establishment includes 'agricultural land in any country other than the Republic used for *bona fide* farming activities directly carried on by that CFC'. Since paragraph (d) specifically requires that the CFC must carry out the farming activities, depending on the facts, a partnership with another company might disqualify the CFC from the foreign business establishment exclusion (Clegg & Stretch 2009:8-58).

4.7.5 Transport entities

Paragraph (e) of the definition of a foreign business establishment determines that a foreign business establishment includes, amongst others, the following:

A vessel, vehicle, rolling stock or aircraft used for the purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for such purposes and is operated directly by that CFC or by any other company that has the same country of residence as that CFC and that forms part of the same group of companies as that CFC.

Paragraph (e) requires that either the CFC or a group company operates the transport entity. Accordingly, the operation of the transport entity may be indirect.

4.7.6 Conclusion on the industry specific requirements

Industry specific rules exist for prospecting or exploration operations for natural resources, construction or installation projects, bona fide farming activities and transport entities. The industry specific requirements provide an alternative to the basic rule (see 4.5). If the CFC

meets the requirements of either paragraph (b), (c), (d) or (e) of section 9D(1) of the Act, it does not have to meet the requirements of the basic rule in order to meet the requirements of a foreign business establishment.

4.8 Conclusion

The concept *foreign business establishment* is used within the context of CFC-legislation. The objective of the foreign business establishment exclusion is to provide for income from qualifying active operations to be excluded from the net income of a CFC. The qualifying active operations are those that meet the requirements as per the *foreign business establishment* definition in section 9D(9)(b). It is submitted that a CFC that meets the criteria of the foreign business establishment exclusion has legitimate and substantive business activities in the foreign jurisdiction.

The analysis of the concept *foreign business establishment* revealed that many of the components of the definition of a foreign business establishment are similar to those in the definition of a permanent establishment. In addition, some components of the foreign business establishment definition are duplicated within the definition.

The components identified in the analysis of a permanent establishment in chapter 3 and the analysis of a foreign business establishment in chapter 4 provides the basis for the comparison of the two concepts. This comparison is done in chapter 5.

CHAPTER 5

Comparison between the concepts

permanent establishment and foreign business establishment

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5.1 Introduction

In this chapter the concepts *permanent establishment* and *foreign business establishment* are compared in order to identify the similarities of, and the differences between the two concepts. This is achieved by comparing both the objective of the concepts *permanent establishment* and *foreign business establishment* (see 5.2) and the components of the definitions of the two concepts (see 5.3).

The comparisons are followed by a discussion of the need for the two concepts in the Act and the additions and amendments required in order to replace the concept *foreign business establishment* in section 9D(9)(b) of the Act with the internationally recognised and accepted concept *permanent establishment*. In order to effect the replacement, a proposed wording for the definition of a permanent establishment for purposes of section 9D is provided.

5.2 Comparison between the objectives of the concepts *permanent establishment* and *foreign business establishment*

The objective of the concepts *permanent establishment* and *foreign business establishment* were discussed in 3.2 and 4.3 respectively. Table 5.1 indicates that the concepts *permanent establishment* and *foreign business establishment* are used in different contexts within the Act and that the two concepts affect different taxpayers. However, the objective of both the concepts *permanent establishment* and *foreign business establishment* is the identification of criteria for the existence of legitimate and substantive business activities in the foreign tax jurisdiction. This similarity will be further analysed in 5.3 when the components of the definitions of the two concepts are compared.

Table 5.1: Comparison between the objectives of the concepts *permanent establishment* and *foreign business establishment*

	Permanent establishment	Foreign business establishment
Context in which the concepts are used	Provides criteria for the existence of a permanent establishment in order to determine the rights of the jurisdiction to tax the profits of a permanent establishment for purposes of the application of double tax agreements.	An exemption from the CFC provisions in section 9D of the Act which determines that income derived from legitimate and substantive business activities is subject to taxation in the hands of South African residents while non-substantive business undertakings remain subjective to the CFC-legislation.
Taxpayers affected by the concepts	Applies to an entity of one contracting state which has a permanent establishment in another contracting state.	Applies to the resident shareholders of controlled foreign companies.
Objective of the concepts	Provides the criteria for the existence of legitimate and substantive business activities within a foreign tax jurisdiction.	Provides the criteria for the existence of legitimate and substantive business activities within a foreign tax jurisdiction.

5.3 Comparison between the components of the definitions of a permanent establishment and a foreign business establishment

5.3.1 Overview of the components of the definitions of a permanent establishment and a foreign business establishment

The general definition of a permanent establishment consists of four components (see 3.4.1). In comparison, the general definition of a foreign business establishment consists of six

components (see 4.5.2). The components of the two general definitions are compared in table 5.2 below.

Table 5.2: Comparison between the components of the general definitions of a permanent establishment and a foreign business establishment

PERMANENT ESTABLISHMENT	FOREIGN BUSINESS ESTABLISHMENT
Similar components	
A fixed place of business.	A fixed place of business.
A place of business.	A place of business.
Business carried on through the fixed place of business.	The fixed place of business is used or will continue to be used.
The business of an enterprise.	The carrying on of the business of the CFC.
Unique components	
[no comparative components]	The location of the fixed place of business in a country other than the Republic. The time requirement of not less than one year.

Table 5.3 lists all the components of the concepts *permanent establishment* and *foreign business establishment* as identified in chapters 3 and 4. The components with similar meanings are grouped together in order to reveal the similarities of and differences between the two concepts.

Table 5.3: Comparison between the components of the definitions of a permanent establishment and a foreign business establishment

Permanent establishment	Foreign business establishment	Discussed in
<ul style="list-style-type: none"> A fixed place of business. 	<ul style="list-style-type: none"> A fixed place of business. The location of the fixed place of business in a country other than the Republic. 	

	<ul style="list-style-type: none"> • The time requirement of not less than one year. • The fixed place of business is suitably staffed. • The fixed place of business is suitably equipped. • The fixed place of business has suitable facilities. 	5.3.2
<ul style="list-style-type: none"> • A place of business. 	<ul style="list-style-type: none"> • A place of business. 	5.3.3
<ul style="list-style-type: none"> • Business carried on through this fixed place of business. 	<ul style="list-style-type: none"> • The fixed place of business is used or will continue to be used. 	5.3.4
<ul style="list-style-type: none"> • The carrying on of the business of an enterprise. 	<ul style="list-style-type: none"> • The carrying on of the business of the CFC. 	5.3.5
<ul style="list-style-type: none"> • Examples of permanent establishments: a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. 	<ul style="list-style-type: none"> • The business is conducted through one or more offices, shops, factories, warehouses or other structures. • Prospecting or exploration operations for natural resources. • Bona fide farming activities. • Transport entities. 	5.3.6
<ul style="list-style-type: none"> • The construction clause: a building site, construction or installation project will only constitute a permanent establishment if it lasts more than twelve months. 	<ul style="list-style-type: none"> • Construction or installation projects which lasts for a period of not less than six months. 	5.3.7
<ul style="list-style-type: none"> • Exclusions from the permanent establishment definition: activities of a preparatory or auxiliary nature are excluded from the concept permanent establishment. 		5.3.8

<ul style="list-style-type: none"> The agency clauses: provisions relating to a dependent agent and to an independent agent. 		5.3.9
<ul style="list-style-type: none"> The control relationship between group companies does not contribute to the existence of a permanent establishment. 	<ul style="list-style-type: none"> The single country requirement for a group of companies. 	5.3.10
	<ul style="list-style-type: none"> The business purpose: the fixed place of business is located outside the Republic solely or mainly for a purpose other than a tax related purpose. 	5.3.11

5.3.2 A fixed place of business

Both the definitions of a permanent establishment and a foreign business establishment require the existence of a fixed place of business (see 4.5.2.2). In terms of the analysis of the concept *permanent establishment*, the requirement for a fixed place of business refers to the location and permanency nature of the business (see 3.4.2). It is submitted that the phrase *a fixed place of business* has the same meaning for both concepts, being the existence of a fixed place of business with geographic coherency, commercial coherency and a degree of permanency.

The definition of the concept *foreign business establishment* has a separate component which deals with the location of the place of business. In terms of the definition of a foreign business establishment the fixed place of business must be located in a country other than the Republic. The definition of a permanent establishment contains no similar requirement. Due to the context in which the concepts *foreign business establishment* and *permanent establishment* are used in the Act, it is implied that the fixed place of business will be located in a country other than the Republic. Accordingly, it is submitted that this requirement in the definition of a foreign business establishment is unnecessary.

In terms of the current definition of a foreign business establishment, a time requirement of not less than one year applies to all activities which fall within paragraph (a) of the definition of a foreign business establishment (see 4.5.2.7). It is submitted that the purpose of this time requirement in the concept *foreign business establishment* is to exclude temporarily and/or once-off activities by quantifying a degree of permanency. The definition of a permanent establishment only contains a time requirement of twelve months for building sites, construction or installation projects. It is submitted that the nature of activities such as mining, farming and the operation of certain vessels and aircraft are such that permanency is implied. As discussed in 3.4.2.3 above, the OECD MTC provides for activities of a recurrent nature and businesses carried on exclusively in the source-country to potentially be permanent establishments regardless of the degree of permanency of the place of business. Accordingly, for purposes of the degree of permanency, the scope of the definition of a permanent establishment is wider than the scope of the definition of a foreign business establishment.

The concept *foreign business establishment* requires that the fixed place of business be suitably staffed, suitably equipped and that it has suitable facilities. The requirements to be suitably staffed, suitably equipped and to have suitable facilities are referred to as the *economic substance requirements* (see 4.5.4). As per the discussion in 4.5.4 above, economic substance requires a real economic nexus with the country in which it is located and a business which is more than a paper transaction or a disguised form of passive income. Similarly, a fixed place of business requires a physical presence within the foreign jurisdiction and a degree of permanency. Accordingly, it is submitted that the requirement for the existence of a fixed place of business renders the economic substance requirements to be unnecessary.

As per the discussion in 4.5.4 above, the intended meaning and scope of the requirements for the fixed place of business to be suitably staffed, suitably equipped and for it to have suitable facilities are unknown. Accordingly, the replacement of the concept *foreign business establishment* with the concept *permanent establishment* will have the benefit that these undefined and unfamiliar terms will be eliminated from section 9D(9)(b).

It is submitted that the requirement for a fixed place of business in the definition of a permanent establishment has a wider scope than the requirement for a fixed place of business in the definition of a foreign business establishment. This wider scope is due to the absence of a specific time requirement in the general definition of a permanent establishment. Accordingly, when the concept *foreign business establishment* in section 9D is replaced with the concept *permanent establishment*, the scope of the concept *permanent establishment* needs to be limited for purposes of section 9D by adding additional requirements to the exemption from the CFC-rules in section 9D. These additional requirements are discussed in 5.5 below.

5.3.3 A place of business

The requirement for the existence of a place of business appears in both the concepts *permanent establishment* (see 3.4.3) and *foreign business establishment* (see 4.5.2.3). It is submitted that this requirement has the same meaning for both concepts, namely that the enterprise should have a particular space at its disposal. Accordingly, there will be no effect in respect of this requirement if the concept *foreign business establishment* in section 9D is replaced with the concept *permanent establishment*.

5.3.4 Business carried on through this fixed place of business

The permanent establishment definition includes a requirement that the business be carried on through the fixed place of business. The definition of a foreign business establishment requires that the fixed place of business must be used or will continue to be used for the carrying on of the business. The requirements contained in the foreign business establishment and permanent establishment definitions both imply that the fixed place of business must be at the disposal of the business (see 3.4.4 and 4.5.2.5). Accordingly, it is submitted that the requirement for the business to be carried on through the fixed place of business in the definition of a permanent establishment has the same meaning as the requirement that the fixed place of business must be used or will continue to be used in the

definition of a foreign business establishment. No amendment regarding this requirement is therefore needed.

5.3.5 The carrying on of the business of the enterprise

The requirement for a business to be carried on appears in both the concepts *permanent establishment* and *foreign business establishment*. The definition of a permanent establishment makes reference to an enterprise while a foreign business establishment applies to a CFC. Due to the wide scope of the definition of an enterprise (see 3.4.5.3), it is submitted that a CFC will be included in the scope of an enterprise. It is therefore submitted that the substitution of the definition of a foreign business establishment by the definition of a permanent establishment will have no negative impact on this requirement. However, since the concept foreign business establishment is used in context of the CFC-legislation, the replacement of the concept foreign business establishment with the concept permanent establishment will require some amendment to section 9D in order to retain the context in which the exemption applies. This required amendment is further discussed in 5.5 below.

5.3.6 Examples of permanent establishments

The definition of a foreign business establishment only includes some of the examples of business establishments found in the definition of a permanent establishment. The examples are not considered to be an essential part of the definition of a permanent establishment since the list is not an exhaustive list and the requirements of article 5(1) of the OECD MTC still needs to be satisfied in order to constitute a permanent establishment (see 3.5).

A 'place of management' and a 'branch' are not included in the examples contained in the definition of a foreign business establishment. However, as per the discussion in 4.5.2.5 above, the basic rule of the foreign business establishment definition requires a form of economic connection between the office and the carrying on of the essential functions of the business (Clegg & Stretch 2009:8-56(1) and 8-57). Accordingly, it is submitted that a place of

management or a branch will constitute a foreign business establishment if the place of management or the branch is also used for the carrying on of the business. Similarly, for purposes of the existence of a permanent establishment in a foreign jurisdiction, the place of management or the branch still needs to satisfy the requirements of the general definition in article 5(1) of the permanent establishment definition. Accordingly, the fact that a 'place of management' and a 'branch' are not included in the examples contained in the definition of a foreign business establishment will not have any influence if the concept *foreign business establishment* is replaced with the concept *permanent establishment*.

A mine, an oil or gas well, a quarry and any other place of extraction of natural resources are included in the examples of permanent establishments. The definition of a foreign business establishment contains an industry specific requirement for prospecting or exploration operations for natural resources in paragraph (b) (see 4.7.2). For purposes of a foreign business establishment, the prospecting or exploration operations of a foreign business establishment are not required to have an economic connection between the operations and the office. The only requirements are that the operations must be carried on by the CFC concerned in a place outside the Republic. It is submitted that the prospecting or exploration operations for natural resources will meet the requirements as per the general definition contained in the definition of a permanent establishment. Accordingly, since the prospecting or exploration operations of a CFC in a place outside the Republic will meet the requirements of both a foreign business establishment and a permanent establishment, it is submitted that the replacement of the concept *foreign business establishment* with the concept *permanent establishment* will have no impact on prospecting or exploration operations for natural resources.

The definition of a foreign business establishment also includes industry specific requirements for bona fide farming activities and transport entities. The industry specific requirements relating to bona fide farming activities determine that the activities must be directly carried on by the CFC in a country other than the Republic. The industry specific requirements relating to transport entities determine that the vessel, vehicle, rolling stock or aircraft must be used solely outside the Republic and must be operated directly by the CFC or a group company that has the same country of residence as the CFC. Bona fide farming activities and

transport entities are not separately dealt with in the definition of a permanent establishment.

It is submitted that bona fide farming activities and transport activities which meet the industry specific requirements of a foreign business establishment will also have the following:

- a location and a degree or permanency to constitute a fixed place of business;
- a particular space at its disposal to constitute a place of business;
- a location at the disposal of the enterprise in order for the business to be carried on through the fixed place of business; and
- the habitual pursuit of business activities to constitute the business of an enterprise.

Based on the above, it is submitted that the general definition of a permanent establishment is sufficient to include both bona fide farming activities and transport activities. Accordingly, the replacement of the concept *foreign business establishment* with the concept *permanent establishment* will have no impact on bona fide farming activities and transport entities.

5.3.7 The construction clause

The difference between the construction clause in the definition of a permanent establishment as per the OECD MTC (see 3.6) and the industry specific requirement relating to construction or installation projects in the definition of a foreign business establishment (see 4.7.3) is the time requirement of twelve months for purposes of a permanent establishment versus the time requirement of six months for a foreign business establishment. Accordingly, when replacing the concept *foreign business establishment* with the concept *permanent establishment*, the definition of a permanent establishment for purposes of section 9D(9)(b) needs to be amended to provide for a time requirement of six months for construction or installation projects (see 5.5 below).

5.3.8 Exclusions from the permanent establishment definition

The definition of a foreign business establishment contains no list of exclusions. The definition of a permanent establishment contains a list of exclusions which is submitted to be activities of preparatory or auxiliary character (see 3.7.1). However, as per the discussion in 5.3.2 above, due to the time requirement included in the definition of a foreign business establishment, the requirement for the business of a foreign business establishment to be conducted through a fixed place of business is narrower than that of a permanent establishment. This narrower requirement implies that exclusions from the permanent establishment definition will also be excluded from the definition of a foreign business establishment if it continues for less than 12 months. Activities of a preparatory or auxiliary nature, as listed in the exclusions from the permanent establishment definition, are likely to last for less than 12 months. Since activities that last for less than 12 months are excluded from the definition of a foreign business establishment, the fact that the concept permanent establishment includes a list of exclusions from the permanent establishment definition will not affect the objective of the exclusion in section 9D(9)(b) if the concept *foreign business establishment* is replaced with the concept *permanent establishment*.

5.3.9 The agency clauses

There are no deeming provisions relating to independent and dependent agents in the foreign business establishment definition. The replacement of the concept *foreign business establishment* with the concept *permanent establishment* will result in the inclusion of the agency clauses in section 9D(9)(b). This inclusion might extend the scope of section 9D(9)(b), since, as per the discussion in 3.8 above, the agency requirements is an alternative test for the existence of a permanent establishment. In terms of the agency clauses a fixed place of business is not required for the existence of a permanent establishment due to the activities of a dependent agent in the foreign tax jurisdiction. Upon replacement of the concept foreign business establishment in section 9D(9)(b) with the concept permanent establishment, a requirement can be added that a fixed place of business also needs to exist in order for the

exemption to apply to the activities of a dependent agent. This addition is discussed in 5.5 below.

5.3.10 The control relationship

The concept *permanent establishment* contains a provision which deals with the control relationship between a holding company and a subsidiary (see 3.9). The provision determines that, since a subsidiary is a separate legal entity, a subsidiary company is not a permanent establishment of the parent company.

The concept *foreign business establishment* contains a provision which, subject to certain conditions (see 4.6), allows for the structure, employees, equipment and facilities of the other companies in the group to be taken into account when determining the existence of a foreign business establishment. This provision is required due to the fact that single businesses are often divided between different legal entities. The concept *permanent establishment* does not specifically contain such a provision. Accordingly, it is submitted that this single country requirement for a group of companies needs to be added to the requirements in section 9D(9)(b) if the concept *foreign business establishment* is to be replaced with the concept *permanent establishment*. This addition is discussed in 5.5 below.

5.3.11 The business purpose test

The business purpose test is not included in the concept *permanent establishment*. This test is included in the concept *foreign business establishment* since it forms part of an anti-avoidance provision. The business purpose test prevents the relocation of business activities to foreign jurisdictions in order to delay and/or avoid taxation in South Africa. It is submitted that, should the concept *permanent establishment* replace the concept *foreign business establishment* in section 9D(9)(b), the business purpose test should be added to the provision as an additional requirement for the exemption to apply. This addition is discussed in 5.5 below.

5.4 The need for the two concepts in the Act

One of the desired requirements of a good tax system is that it needs to provide clarity and certainty to those affected by it (Smith 2003:1043). The use of both the concepts *permanent establishment* and *foreign business establishment* in the Act, in spite of its common objective, could result in different interpretation by the courts and could impede clarity and certainty for those affected by it. The analysis of the concept *foreign business establishment* reveals that the definition consists of many components of which the meaning is not clear. This ambiguity prevents clarity and certainty regarding the scope and application of the concept *foreign business establishment*.

The concept *permanent establishment* is an internationally recognised and accepted tax concept. Accordingly, the use of the concept *permanent establishment* in the Act enhances the international compatibility of the Act. Since the concept *foreign business establishment* is not an internationally recognised and accepted concept, the concept *permanent establishment* should have preference.

5.5 Additions and amendments required to replace the concept *foreign business establishment* in section 9D(9)(b) with the concept *permanent establishment*

It is submitted that, subject to some additions and amendments, the concept *foreign business establishment* in section 9D(9)(b) can be replaced with the concept *permanent establishment*. This replacement is possible due to the mutual objective of and similar components contained in the definitions of the concepts *permanent establishment* and *foreign business establishments* (see 5.2).

The following are additions to section 9D(9)(b) which will be required upon replacement of all references to a foreign business establishment in section 9D(9)(b) with references to a permanent establishment:

- A time requirement of not less than one year should be added to the definition of a permanent establishment for purposes of section 9D(9)(b) (see 5.3.2). This addition will ensure that the net income related to temporary and once-off activities remains subject to the CFC-legislation in section 9D.
- If it is intended that the activities of a dependent agent (which does not require the existence of a fixed place of business) should not provide exemption from the CFC-legislation in the absence of a fixed place of business, it should be added to the definition of a permanent establishment for purposes of section 9D(9)(b) that a fixed place of business needs to be present in order for the exemption to apply to dependent agents (see 5.3.9).
- The single country requirement for a group of companies which is included in the current definition of a foreign business establishment (see 4.6) should be added to the definition of a permanent establishment for purposes of section 9D(9)(b) upon the replacement of the two concepts. This is required so that the structure, employees, equipment and facilities of the other companies in the group can be considered when determining if the section 9D(9)(b)-exemption applies (see 5.3.10).
- The business purpose test, which is currently included in the concept *foreign business establishment*, should be added to the definition of a permanent establishment for purposes of section 9D(9)(b) in order to ensure that the place of business is located outside South Africa solely or mainly for a purpose other than a tax related purpose (see 5.3.11).

The following amendments to section 9D(9)(b) will be required upon replacement of all references to a foreign business establishment in section 9D(9)(b) with references to a permanent establishment:

- The exemption in section 9D(9)(b) is used in context of the CFC-legislation. Accordingly, the definition of a permanent establishment for purposes of section 9D(9)(b) needs to be amended in order to retain the context in which the exemption applies. This is achieved by replacing the word 'enterprise' in the definition of a permanent establishment with the word 'CFC' (see 5.3.5).
- The time requirement for construction or installation projects needs to be changed to six months (see 5.3.7).

5.6 Proposed definition of a permanent establishment for purposes of section 9D

The definition of a permanent establishment should be included in section 9D(1). The proposed definition below is based on the definition of a permanent establishment in the OECD MTC. Additions to the OECD definition are underlined while omissions are shown in brackets:

- (1) For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of [an enterprise] a CFC is wholly or partly carried on for a period of not less than one year.
- (2) The term 'permanent establishment' includes especially:
 - a) a place of management;
 - b) a branch;
 - c) an office;
 - d) a factory;
 - e) a workshop; and
 - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
- (3) A building site or construction or installation project constitutes a permanent establishment only if it lasts more than [twelve] six months.
- (4) Notwithstanding the preceding provisions of this article, the term 'permanent establishment' shall be deemed not to include:
 - a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the [enterprise] CFC;
 - b) the maintenance of a stock of goods or merchandise belonging to the [enterprise] CFC solely for the purpose of storage, display or delivery;

- c) the maintenance of a stock of goods or merchandise belonging to the [enterprise] CFC solely for the purpose of processing by another [enterprise] CFC;
 - d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the [enterprise] CFC;
 - e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the [enterprise] CFC, any other activity of a preparatory or auxiliary character;
 - f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
- (5) Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of [an enterprise] a CFC and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the [enterprise] CFC, that enterprise shall, provided that a fixed place of business exists, be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the [enterprise] CFC, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.
- (6) [An enterprise] A CFC shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or

any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

(7) The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

(8) Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a CFC may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company –

- a) if that other company is subject to tax in the country in which the fixed place of business of the CFC is located by virtue of residence, place of effective management or other criteria of a similar nature;
- b) if that other company forms part of the same group of companies as the CFC; and
- c) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the CFC.

(9) The fixed place of business must be located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic.

5.7 Conclusion

The concepts *permanent establishment* and *foreign business establishment* are currently used in different contexts within the Act where it affects different types of taxpayers. However, both concepts have the same objective namely the identification of criteria for the existence of legitimate and substantive business activities in the foreign tax jurisdiction.

The comparison of the components of the definitions of a permanent establishment and a foreign business establishment in 5.3 above reveals that the definitions of a permanent establishment and foreign business establishment contain many similar components and/or contain components which have the same meaning.

The concept *foreign business establishment* in section 9D(9)(b) can be replaced with the concept *permanent establishment* if the following additions and amendments are made to the definition of a permanent establishment for purposes of section 9D(9)(b):

Additions to the definition of a permanent establishment for purposes of section 9D(9)(b):

- The inclusion of a time requirement of not less than one year.
- The existence of a fixed place of business in order for the activities of a dependent agent to result in the existence of a permanent establishment in the foreign tax jurisdiction.
- The single country requirements which are currently included in the definition of a foreign business establishment.
- The business purpose test which is currently included in the definition of a foreign business establishment.

Amendments to the definition of a permanent establishment for purposes of section 9D(9)(b):

- The word 'enterprise' needs to be replaced with the word 'CFC'.
- The time requirement for construction and installation projects needs to be changed to six months.

It is submitted that the concept *permanent establishment* is more suitable than the concept *foreign business establishment* as the requirement for a degree of permanency, as contained

in the definition of a permanent establishment, is more suitable in the modern business environment than the fixed time requirement of 12 months as per the definition of a foreign business establishment. The components of the definition of a permanent establishment are also better defined than those of a foreign business establishment.

CHAPTER 6

Conclusion

The Act currently includes both the concepts *permanent establishment* and *foreign business establishment*. These two concepts have a similar objective and the definitions of the concepts include many similar components. The use of both concepts in the Act could result in different interpretation by the courts, and could impede clarity and certainty for those affected by it. Accordingly, the two concepts were examined and the similarities of, and the differences between, the two concepts are analysed. This examination and analysis were done by considering the history and evolution, objective and the components of the definitions of the two concepts. The objective was to determine which additions and amendments are required in order to replace the concept *foreign business establishment* in section 9D(9)(b) of the Act with the internationally recognised and accepted concept *permanent establishment*.

The concept *permanent establishment* was introduced into the Act in 1997 based on the recommendations of the Katz Commission. The Katz Commission supported the use of familiar international terminology in the Act due to the certainty the international compatibility of the Act will create for non-residents. The definition of a permanent establishment in the Act refers to the definition of a permanent establishment in Article 5 of the OECD MTC. Clause 10(1)(a) of the Revenue Law Amendment Act, Act 59 of 2000 replaced all references to the concept *permanent establishment* in section 9D(9)(b) to the newly introduced concept *business establishment*. The definition of a business establishment was amended in 2002 before it was replaced in 2006 with a definition of a foreign business establishment. Paragraph (a) of the foreign business establishment definition was replaced with a new paragraph (a) in 2009.

The concepts *permanent establishment* and *foreign business establishment* are used in different contexts within the Act and affects different taxpayers. However, the objective of both concepts is the identification of criteria for the existence of legitimate and substantive business activities in the foreign tax jurisdiction.

The analyses of the components of the definition of a permanent establishment and a foreign business establishment reveal that both concepts contain many similar components and/or contain components which have the same meaning.

It is submitted that, subject to the following additions and amendments to the definition of a permanent establishment for purposes of section 9D(9)(b), the concept *foreign business establishment* in section 9D(9)(b) can be replaced with the concept *permanent establishment*:

The following additions are required to the definition of a permanent establishment for purposes of section 9D(9)(b):

- The addition of a time requirement of not less than one year should be added to the general definition of a permanent establishment for purposes of section 9D(9)(b). This addition will ensure that the net income related to temporary and once-off activities remains subject to the CFC-legislation in section 9D.
- In order to ensure that the activities of a dependent agent (which does not require the existence of a fixed place of business in terms of the OECD MTC) do not result in the existence of a permanent establishment in the absence of a fixed place of business, a provision should be added that a fixed place of business needs to be present in order for the exemption to apply to dependent agents.
- The single country requirement for a group of companies which is included in the current definition of a foreign business establishment should be added to the definition of a permanent establishment for purposes of section 9D(9)(b) upon the replacement of the two concepts. This is required so that the structure, employees, equipment and facilities of the other companies in the group can be considered when determining if the section 9D(9)(b)-exemption applies.
- The business purpose test, which is currently included in the concept *foreign business establishment*, should be added to the definition of a permanent establishment for purposes of section 9D(9)(b) in order to ensure that the place of business is located outside South Africa solely or mainly for a purpose other than a tax related purpose.

The following amendments to section 9D(9)(b) will be required upon replacement of all references to a foreign business establishment in section 9D(9)(b) with references to a permanent establishment:

- The exemption in section 9D(9)(b) is used in context of the CFC-legislation. Accordingly, the definition of a permanent establishment for purposes of section 9D(9)(b) needs to be amended in order to retain the context in which the exemption applies. This is achieved by replacing the word 'enterprise' in the definition of a permanent establishment with the word 'CFC'.
- The time requirement for construction or installation projects needs to be changed to six months.

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