

Taxability of non-resident online retailers in South Africa and the OECD's
BEPS action plan

by

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SUMMARY

Section 9(2)(k)(ii) of the Income Tax Act requires the existence of a South African permanent establishment (PE) to impose a tax liability on non-resident online retailers. As part of the BEPS action plan, the OECD released an illustration of a multinational tax planning structure that is typically used in the industry of online retail (the OECD's online retail structure). The OECD found that this structure generally avoids the liability to tax by not creating a PE in the consumer country.

The objectives of the study were three-fold. The first objective was to create a case study of the OECD's online retail structure in a South African context, while the second objective was to analyse and apply the meanings of the key terms in section 9(2)(k)(ii) to the aforementioned case study. The third objective was to determine whether the proposed amendments to the PE definition in action point seven of the BEPS action plan may impact the applicability of section 9(2)(k)(ii) in the context of the OECD's online retail structure.

It was established that all physical goods sold by non-resident online retailers in South Africa will meet the definition of an "asset". Where a non-resident online retailer has created a South African PE, it was established that the revenue "attributable to" that PE in terms of section 9(2)(k)(ii) should be determined with reference to the Authorised OECD Approach for attributing profits to PEs.

It was concluded that the OECD's online retail structure, as applied in a South African context, does not create a South African PE, as defined. In this regard, the study established that an online retailer's South African warehouses fall within the scope of activities specifically excluded from PE status. It was also established that the use of South African delivery couriers and internet service providers will not create a PE if they operate independently from an enterprise. It follows that section 9(2)(k)(ii) of the Income Tax Act does not apply to the OECD's online retail structure in a South African context.

However, it was found that the proposed amendments to the OECD's definition of a PE in action point seven of the BEPS action plan may, depending on the circumstances, impact the interpretation of a PE in a South African context. Where the amendments apply, the activities performed by a South African warehouse are now required to have a "preparatory or auxiliary" character to qualify for the exemption from PE status. Previously, South African warehouses would generally be exempt from PE status without being subject to the "preparatory or auxiliary" requirement. The outcome in respect of the independent agents in the structure remains unaffected.

The question of whether the warehousing activities of a particular non-resident online retailer have a “preparatory or auxiliary” character is case specific and should be determined with reference to an online retailer’s own business model. If it is concluded that a non-resident online retailer’s warehousing activities do not have a “preparatory or auxiliary” character, South Africa may acquire a taxing right on revenue that was previously not subject to tax.

OPSOMMING

Artikel 9(2)(k)(ii) van die Inkomstebelastingwet vereis die bestaan van 'n "permanente saak" geleë in Suid-Afrika ten einde 'n internet-kleinhandelaar, wat 'n nie-inwoner is, te belas. As deel van die OECD se BEPS aksieplan is 'n illustrasie van 'n multinasionale belastingbeplanningstruktuur vrygestel wat kenmerkend is tot die industrie van internet-kleinhandel (die OECD se internet-kleinhandel struktuur). Daar is bevind dat die bogenoemde struktuur tipies belasting in die gebruikersland vermy weens die afwesigheid van 'n permanente saak daarin.

Die doelwitte van die studie was drieledig. Die eerste doelwit was om 'n gevallestudie van die OECD se internet-kleinhandel struktuur in 'n Suid-Afrikaanse konteks te skep. Die tweede doelwit was om die betekenis van die sleutelwoorde en frases in artikel 9(2)(k)(ii) van die Inkomstebelastingwet te analiseer en dit op die voorgenoemde gevallestudie toe te pas. Laastens het die studie dit ten doel gehad om vas te stel of die voorgestelde wysigings in aksiepunt sewe van die BEPS aksieplan die toepassing van artikel 9(2)(k)(ii) op die OECD se internet-kleinhandel struktuur kan beïnvloed.

Daar is vasgestel dat alle fisiese goedere wat deur nie-inwoner internet-kleinhandelaars in Suid-Afrika verkoop word aan die definisie van 'n "bate" sal voldoen. Verder, indien 'n nie-inwoner internet-kleinhandelaar 'n permanente saak in Suid-Afrika skep, moet die inkomste "toeskryfbaar aan" daardie permanente saak bepaal word met verwysing na die OECD se Goedgekeurde Benadering vir die toedeling van winste aan permanente sake.

Daar is vasgestel dat die OECD se internet-kleinhandel struktuur, soos in 'n Suid-Afrikaanse konteks toegepas, nie 'n permanente saak in Suid-Afrika skep nie. In hierdie verband het die studie bevind dat die Suid-Afrikaanse pakhuis van 'n internet-kleinhandelaar binne die aktiwiteite wat spesifiek van die omskrywing van 'n "permanente saak" uitgesluit is, val. Die studie het ook bevind dat die gebruik van Suid-Afrikaanse afleweringsskoeriers en internet diensteverskaffers nie 'n permanente saak skep indien hierdie partye onafhanklik van 'n onderneming funksioneer nie. Gevolglik is artikel 9(2)(k)(ii) nie van toepassing op die OECD se internet-kleinhandel struktuur in 'n Suid-Afrikaanse konteks nie.

Desnieteenstaande is vasgestel dat die voorgestelde wysigings aan die definisie van 'n permanente saak in aksiepunt sewe van die BEPS aksieplan, afhangend van die omstandighede, die interpretasie van 'n permanente saak in 'n Suid-Afrikaanse konteks kan beïnvloed. In gevalle waar die wysigings van toepassing is, sal 'n Suid-Afrikaanse

pakhuis nou slegs vir uitsluiting van die definisie van 'n permanente saak kwalifiseer indien die aktiwiteite daaruit verrig “voorbereidend of ondersteunend” van aard is. Voorheen sou 'n Suid-Afrikaanse pakhuis normaalweg vir die uitsluiting kwalifiseer sonder om onderhewig te wees aan die “voorbereidend of ondersteunend” vereiste. Die impak ten opsigte van die onafhanklike agente in die struktuur het onveranderd gebly.

Die vraag of die aktiwiteite verrig deur 'n spesifieke internet-kleinhandelaar se Suid-Afrikaanse pakhuis “voorbereidend of ondersteunend” van aard is, verskil van geval tot geval. Dit moet in die konteks van 'n internet-kleinhandelaar se spesifieke besigheidsmodel vasgestel word. Indien daar bevind word dat die aktiwiteite van 'n spesifieke Suid-Afrikaanse pakhuis nie “voorbereidend of ondersteunend” van aard is nie, kan Suid-Afrika moontlik 'n belastingreg op inkomste bekom wat voorheen nie aan belasting onderhewig was nie.

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ABBREVIATIONS AND TERMINOLOGY

BEPS –	Base Erosion and Profit Shifting
DTA –	Double Tax Agreement
OECD –	Organisation for Economic Cooperation and Development
PE –	“permanent establishment”, as defined in section 1 of the Income Tax Act
OECD MTC –	the OECD’s Model Tax Convention on Income and on Capital
Constitution –	the Constitution of the Republic of South Africa, 1996
Income Tax Act –	the Income Tax Act No. 58 of 1962 (as amended)
Tax Administration Act –	the Tax Administration Act No. 28 of 2011 (as amended)
Taxation Laws Amendment Act –	the Taxation Laws Amendment Act No. 24 of 2011

All references to “section” are to the sections in the Income Tax Act, unless stated otherwise.

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CHAPTER 1: INTRODUCTION

1.1 Background

In the past decade, the world has witnessed globalisation and improvement in information technology on an unprecedented scale. These improvements have had a significant impact on traditional business models and have brought unique challenges to policy makers across the world (OECD, 2015a:98).

The Organisation for Economic Cooperation and Development (OECD) represents an international organisation that seeks to promote global economic development through collaborative research on various topics including that of international taxation (Oguttu, 2010:174). In response to growing concerns on the tax planning structures used by multinational enterprises to shift taxable profits to low or zero-tax locations, the OECD published an action plan against Base Erosion and Profit Shifting (BEPS) in July 2013 (OECD, 2015a:16). The OECD defines the concept of BEPS as “tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations” (OECD, 2016).

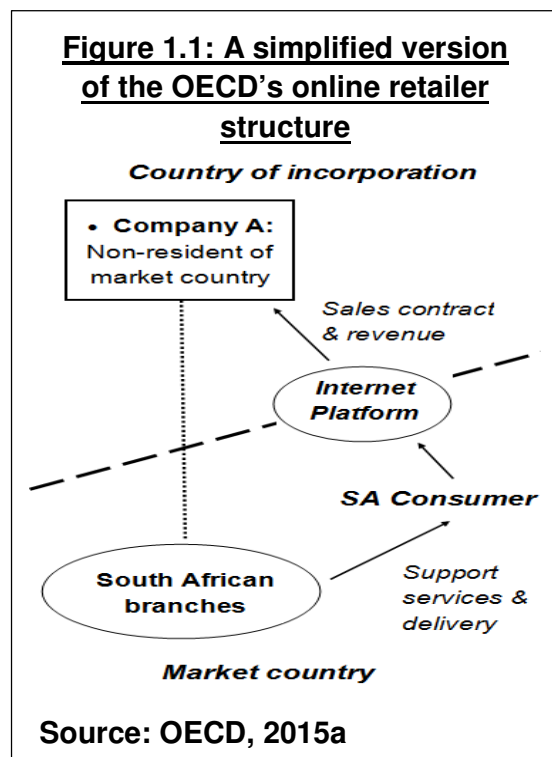
The findings of the BEPS action plan are documented in fifteen individual action points (OECD, 2015b:3). Action point one specifically focuses on the digital economy and investigates the potential consequences of tax planning structures used in the industries of online advertising, online retail, cloud computing and internet app stores (OECD, 2015a:169-180). Action point eleven estimates that the use of BEPS strategies, which include the tax structures used in the aforementioned industries, lead to corporate income tax losses of between \$100 billion and \$240 billion annually (OECD, 2015c:15).

Wepener (2016:1) notes that online retail sales in South Africa are expected to exceed R9 billion in 2016. Given the global trend towards purchases made via the internet, it is expected that the South African online retail sales figure will grow considerably in future years (PriceWaterhouseCoopers, 2016a:3-7). It follows that the taxation of revenue earned by multinational online retailers from the sale of movable goods to South African consumers, or lack thereof, can have a significant impact on the South African tax base.

Action point one to the BEPS action plan investigates a typical multinational tax planning structure (the OECD’s online retail structure) used by companies in the online retail industry (OECD, 2015a:168-171). The OECD notes that the implementation of the aforementioned structure typically results in, *inter alia*, a minimisation of taxable income in

the market country (OECD, 2015a:80). The market country represents the country in which the consumer is situated. The OECD's online retail structure was not intended to be country specific, and aims to illustrate a number of key opportunities to achieve BEPS in the online retail industry (OECD, 2015a:78,167). On the basis of the structure not being country specific, it may also be relevant in a South African context. Figure 1.1 illustrates a simplified version of the OECD's online retailer structure.

The revenue received by Company A in Figure 1.1 is generally not subject to corporate tax in the market country (OECD, 2015a:170-174). This occurs if either the domestic laws of the market country do not impose a corporate tax on the revenue, or if the relevant tax treaty, where applicable, does not allow the market country a right to tax the revenue (OECD, 2015a:170-174). An "online retailer" in the context of this study means a retailer that sells physical goods to consumers through a website operated by that retailer. Any reference to the term "non-resident" means a non-resident for South African tax purposes, unless stated otherwise.



South Africa taxes non-residents on a source-based system of tax (definition of "gross income" in section 1 of the Income Tax Act No. 58 of 1962, as amended). The Income Tax Act No. 58 of 1962, as amended (Income Tax Act) does not contain a definition of the term "source". However, section 9 of the Income Tax Act contains various uniform source rules which loosely reflect implicit tax treaty principles (with a few added built-in protections) so that the South African system is globally aligned (Stiglingh, Koekemoer, Van Zyl, Wilcocks & De Swardt, 2017:72). Case law will remain as a residual method for categories of income falling outside the categories specifically addressed in section 9 (Stiglingh et al., 2017:72).

Section 9(2) of the Income Tax Act states -

"An amount is received by or accrues to a person from a source within the Republic if that amount -

(k) constitutes an amount received or accrued in respect of the disposal of an asset other than an asset contemplated in paragraph (j) if ...

(ii) that person is not a resident and that asset is attributable to a permanent establishment of that person which is situated in the Republic ...”

The assets contemplated in subparagraph (j) are immovable property and are thus not applicable to the sale of movable goods by online retailers. The wording of section 9(2)(k)(ii) suggests that the following requirements must be met to establish a South African source on revenue earned by a non-resident online retailer:

- 1) The goods sold by the non-resident online retailer must constitute “assets” as contemplated in section 9(2)(k)(ii); and
- 2) The “assets” must be “attributable to a permanent establishment” situated in South Africa.

If the aforementioned requirements are met, the revenue earned by a non-resident online retailer is from a South African source. Such income is therefore liable to South African corporate tax. Should the sale of an “asset” not be attributable to a permanent establishment in South Africa, section 9(4)(d) becomes relevant.

In terms of section 9(4)(d), an amount derived from the sale of an “asset” is regarded to be from a source outside South Africa to the extent that section 9(2)(k)(ii) does not apply. It follows that South Africa’s right to tax the revenue earned by a non-resident online retailer depends on the applicability of section 9(2)(k)(ii) to its revenue. On this basis, the application of section 9(2)(k)(ii) of the Income Tax Act to non-resident online retailers should be investigated further.

Taking into consideration the wording of the section, it is submitted that the applicability of section 9(2)(k)(ii) depends on the interpretation of the word “asset” and the phrases “attributable to” and “permanent establishment” (PE). An investigation into the meaning of these terms could provide insight into the ambit of the section and therefore into the scope of non-resident online retailers that are subject to South African corporate tax in terms of section 9(2)(k)(ii).

The word “asset” and the phrase “attributable to” are not specifically defined in the Income Tax Act. The meanings should therefore be determined with reference to the South African principles of statutory interpretation (Haupt, 2016:11-13). On the other hand, a specific definition is provided for a PE. Section 1 of the Income Tax Act states that a PE 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 ...”.

In the context of this study, the fact that the South African definition of PE is linked to the OECD’s Model Tax Convention on Income and on Capital (OECD MTC) is significant due to the following:

- The OECD MTC serves as basis for modern tax treaties entered into by South Africa (Papadopoulos & Snail, 2012:104). Article 7 of the OECD MTC uses the PE concept as threshold for allocating taxing rights on “business profits”, including online retail revenue, to the non-resident country. In addition to creating a domestic taxing right in terms of section 9(2)(k)(ii) of the Income Tax Act, a PE in South Africa would also lead to a South African right to tax a non-resident online retailer’s revenue in terms of the relevant Double Tax Agreement (DTA), where applicable.
- The OECD’s online retail structure presented in Figure 1.1 typically avoids corporate tax in the market country by avoiding the creation of a PE therein (OECD, 2015a:170).
- As the definitions of the Income Tax Act and OECD MTC are linked, a non-resident online retailer may also be able to avoid a PE in South Africa by implementing the OECD’s online retail structure, depending on the interpretation of the definition from a South African tax perspective.
- In the absence of a South African PE, neither section 9(2)(k)(ii) nor article 7 of the OECD MTC would apply and the revenue of a non-resident online retailer would not be subject to corporate tax in South Africa.

On the basis that a possibility exists that the OECD’s online retail structure may lead to the avoidance of South African corporate tax, the applicability of section 9(2)(k)(ii) to this structure should be investigated. The OECD’s online retail structure involves a tax avoidance strategy implemented by multinational enterprises globally, known as the “Artificial avoidance of PE status through the specific activity exemptions” (OECD, 2015d:10-11).

Paragraph 4 to Article 5 of the OECD MTC, hereafter referred to as the “exception paragraph of the OECD MTC”, contains a list of activities that do not create a PE for an enterprise, provided that its presence in a particular country is limited to the listed activities. If a non-resident online retailer could successfully implement the aforementioned

strategy in South Africa, it would not create a South African PE and therefore not be liable to South African corporate tax in terms of section 9(2)(k)(ii) of the Income Tax Act.

In action point seven of the BEPS action plan, the OECD proposed certain amendments to the exception paragraph of the OECD MTC (OECD, 2015d:28-29). The proposed amendments may impact the PE status of non-resident online retailers and therefore the applicability of section 9(2)(k)(ii) to these companies. The meaning and potential impact of the aforementioned amendments should therefore be considered from a South African tax perspective. A study was undertaken to investigate the applicability of section 9(2)(k)(ii) to non-resident online retailers in the context of the OECD's online retail structure.

1.2 Problem statement

Non-resident online retailers may be able to reduce or eliminate their South African corporate tax burden through the implementation of multinational tax planning structures. This outcome could possibly be achieved by implementing the OECD's online retail structure in South Africa. The main problem identified is whether section 9(2)(k)(ii) would apply to revenue earned by a non-resident online retailer in the context of the OECD's online retail structure. If section 9(2)(k)(ii) does not apply, non-resident online retailers whose operating models follow the OECD's online retail structure would not be subject to South African corporate tax. From the main problem, the following secondary problems were posed:

1. How could a non-resident online retailer implement the OECD's online retail structure in South Africa and how could this impact the applicability of section 9(2)(k)(ii) of the Income Tax Act to a non-resident online retailer's revenue?
2. What are the meanings of "asset", "attributable to" and "permanent establishment" in section 9(2)(k)(ii) and how do these meanings apply to a South African case study of the OECD's online retail structure?
3. What is the meaning of the proposed amendments to the exception paragraph of the OECD MTC in action point seven of the BEPS action plan, and how could the proposed amendments impact the applicability of section 9(2)(k)(ii) to non-resident online retailers in the context of the OECD's online retail structure?

1.3 Literature review

The available literature dealing with each of the three research problems identified in section 1.2 is briefly discussed below.

1.3.1 The OECD's online retail structure - a South African perspective

In the post-digital age, several internet-powered business models may enable multinational online retailers to effect tax planning in South Africa (OECD, 2015a:54-64). Of these, the OECD's online retail structure may be particularly relevant in a South African context due to the following reasons:

- In 2013, the Ministry of Finance (2013) announced the formation of the Davis Tax Committee to inquire and, where necessary, propose recommendations on matters concerning the South African tax system. In particular, the committee was required to address the findings of the OECD's BEPS action plan, which includes the OECD's online retail structure in action point one (Davis Tax Committee, 2014a:1).
- The development of the OECD's online retail structure involved submissions from an extensive framework of businesses, academics and government bodies from developed and developing countries alike (OECD, 2015a:11). The extent of global participation suggests that the OECD's online retail structure may be an appropriate proxy for a number of multinational tax planning structures currently in use or available to non-resident online retailers in South Africa.
- The OECD's online retail structure involves, *inter alia*, a strategy that aims to avoid PE status in the market country (OECD, 2015a:170). This is relevant from a South African perspective as the applicability of section 9(2)(k)(ii) of the Income Tax Act depends on the existence of a South African PE.

An investigation of the OECD's online retail structure could therefore shed light on the opportunities, if any, available to non-resident online retailers to avoid South African corporate tax. In a case where South Africa is the market country, it should be determined how the implementation of the OECD's online retail structure may impact the applicability of section 9(2)(k)(ii) to a non-resident online retailer's revenue. The aforementioned investigation is performed in Chapter 2 and is used to develop a case study of the OECD's online retail structure in a South African context.

1.3.2 The meaning of “asset”, “attributable to” and PE in section 9(2)(k)(ii) of the Income Tax Act

Where words and phrases are assigned definitions in section 1(1) of the Income Tax Act, their meanings are attributed to those definitions, “unless the context otherwise indicates” (Clegg & Stretch, 2017:par 2.6). Furthermore, if words and phrases are defined in the Tax Administration Act No.12 of 2011, as amended (Tax Administration Act), those words and phrases bear the same meanings for purposes of the Income Tax Act, provided that the context does not indicate otherwise (section 1(2) of the Income Tax Act).

Section 1 of the Income Tax Act defines neither the word “asset” nor the phrase “attributable to”. A meaning has however been assigned to the word “asset” in section 1 of the Tax Administration Act. This meaning would therefore also apply to the word “asset” in section 9(2)(k)(ii), provided that no contrary context is indicated. Since the phrase “attributable to” has not been defined in either the Income Tax Act or the Tax Administration Act, its meaning should be determined with reference to the South African principles of statutory interpretation (Haupt, 2016:11-13).

Where a statute does not explicitly define a term it is generally given its ordinary dictionary meaning, provided that the legislature’s “intention” does not contradict the ordinary meaning (Clegg & Stretch, 2017:par 2.12). Haupt (2016:11) states that the legislature’s “intention” should be determined with regard to the context of a section. Goldswain (2012:52), furthermore, is of the view that the South African Constitution requires a “purposive approach” to be followed when interpreting all South African statutes, which includes fiscal legislation. The “purposive approach” transcends the legislature’s intention and requires consideration of the broader objective, history and “purpose” of a section (Goldswain, 2012:51-52). In addition to its ordinary meaning, the interpretation of “attributable to” should therefore be cognisant of the “purpose”, history and objective of section 9(2)(k)(ii).

A PE is defined with reference to its definition in the OECD MTC (section 1 of the Income tax Act). The OECD publishes extensive commentaries on each of the articles in the OECD MTC to assist with the interpretation thereof (OECD, 2015e:C(5)1-C(5)84). It should be considered to what extent, if any, the OECD commentaries and other international sources may be used when interpreting section 9(2)(k)(ii). Several South African authors have also investigated the PE concept with specific reference to its interpretation in the digital economy, notably Andreou (2014:14-35), Chaffey (2014:20-29),

Harnekar (2016:36-40) and Nkerebuka (2015:19-41). The findings of these studies could provide insight into the meaning of the PE concept in the context of online retailers in South Africa.

Chapter 3 investigates the meaning of the word “asset” and the phrases “attributable to” and “PE” in the context of section 9(2)(k)(ii) and applies the meanings to the South African case study of the OECD’s online retail structure developed in Chapter 2.

1.3.3 The impact of the proposed amendments to the exception paragraph of the OECD MTC on section 9(2)(k)(ii) of the Income Tax Act

The exception paragraph of the OECD MTC lists certain activities that may be performed in the market country without creating a PE in it. The activities that may have bearing on online retailers include “storage”, “delivery”, “purchasing goods or merchandise” and “collecting of information” (OECD, 2015e:M-16). Multinational tax planning structures, including the OECD’s online retail structure, have typically exploited the exception paragraph of the OECD MTC by limiting their presence in a particular country to the activities that are specifically excluded from PE status (OECD, 2015d:10-11).

In response to the aforementioned strategy, action point seven of the BEPS action plan proposed the following inclusion to the exception paragraph of the OECD MTC: “... provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character” (OECD, 2015d:29). In terms of the unrevised paragraph, a multinational enterprise would automatically be excluded from PE status if its presence in the market country was limited to the activities listed therein (OECD, 2015d:28). Should the amendment be implemented, an activity in the exception paragraph of the OECD MTC would only exclude a company from PE status if it is also concluded that the activity has a “preparatory or auxiliary” character (OECD, 2015d:29).

There are no fixed rules that define activities that are “preparatory or auxiliary” in character (OECD, 2015d:30). The revised OECD commentaries on the amended paragraph provide examples of activities that are generally regarded as “preparatory or auxiliary”, but states that each case must ultimately be evaluated according to its own facts (OECD, 2015d:30).

It is apparent that the amendment makes the requirements to qualify for the exclusion from PE status more onerous, as businesses are now required to determine whether the activities performed in the market country are “preparatory or auxiliary” in the context of

their own business models. If activities that previously fell within the scope of the exception paragraph of the OECD MTC do not have a “preparatory or auxiliary” character, section 9(2)(k)(ii) of the Income Tax Act may become applicable to cases where PE status, and consequently corporate tax, in South Africa was previously avoided.

The proposed amendments to the exception paragraph of the OECD MTC in action point seven of the BEPS action plan are incorporated in the text of the OECD’s multilateral instrument (OECD, 2016b:2-3). Broadly speaking, the multilateral instrument represents a document which combines the recommendations made in the various action points of the BEPS action plan (OECD, 2015d:11). South Africa confirmed its intention to participate in the implementation of the multilateral instrument by signing the instrument on 7 June 2017, which confirms the relevance of the proposed amendments to the exception paragraph of the OECD MTC from a South African perspective (OECD, 2017c:3).

Chapter 4 investigates the meaning of the proposed amendments to the exception paragraph of the OECD MTC to determine how they may impact the PE status and, as a result, the applicability of section 9(2)(k)(ii) to non-resident online retailers in South Africa.

1.4 Research rationale and objectives

From the aforementioned, it appears that opportunities may be available to non-resident online retailers to avoid corporate tax on revenue earned in South Africa. This outcome could be achieved if section 9(2)(k)(ii) does not apply to the revenue earned by a non-resident online retailer in the context of the OECD’s online retail structure. Should opportunities exist for non-resident online retailers to avoid corporate tax in South Africa, it could lead to significant losses for the South African tax base and create a competitive disadvantage for South African companies operating in the retail industry.

The study has the following objectives:

1. To develop a case study of the OECD’s online retail structure in a South African context and to determine how the implementation of the case study may impact the applicability of section 9(2)(k)(ii) to the revenue earned by non-resident online retailers. The case study would allow the study to assess whether the OECD’s online retail structure falls within the scope of section 9(2)(k)(ii), and to determine how the proposed amendments to the exception paragraph of the OECD MTC could impact this outcome;

2. To investigate the meaning of the word “asset” and the phrases “attributable to” and “PE” in section 9(2)(k)(ii) and to apply the meaning of these terms to the South African case study developed in accordance with the first objective. This is done to determine whether a non-resident online retail could avoid corporate tax in South Africa through the implementation of the OECD’s online retail structure; and
3. To investigate the meaning of the proposed amendments to the exception paragraph of the OECD MTC in action point seven of the BEPS action plan, and to apply the revised paragraph to the South African case study developed in accordance with the first objective. The outcome of this investigation would determine whether the proposed amendments to the PE definition could result in a corporate taxing right for South Africa on online retail revenue in terms of action point seven of the BEPS action plan.

1.5 Research methodology

The research methodology to be followed is the historical method. A literature review of the OECD’s online retail structure is performed and used to develop a South African case study of the structure. A detailed literature review is also performed of the interpretation of the words and phrases in section 9(2)(k)(ii), as well as the proposed amendments to the exception paragraph of the OECD MTC. The interpretation of section 9(2)(k)(ii) and the proposed amendments to the exception paragraph of the OECD MTC are applied to the case study mentioned above and used to draw conclusions on the applicability of section 9(2)(k)(ii) in the context of the OECD’s online retail structure. Master’s theses, books, legislation, publications by international organisations, academic articles and industry reports are reviewed.

1.6 Chapter outline

Chapter 1: Introduction

This chapter includes the background, literature review, research problems, research objectives, rationale of the study, research methodology and an outline of the chapters of the study.

Chapter 2: The OECD's online retail structure – a South African perspective

This chapter presents the investigation into how the OECD's online retail structure could be implemented in a situation where South Africa is the market country. The findings of the investigation are used to develop a case study of the OECD's online retail structure in a South African context. Chapter 2 further provides a broad view of the possible impact that the implementation of the South African case study may have on the applicability of section 9(2)(k)(ii) to the revenue earned by non-resident online retailers.

Chapter 3: Interpretation of the word “asset” and the phrases “attributable to” and “permanent establishment”

This chapter includes a detailed literature review regarding the interpretation of specific words and phrases in section 9(2)(k)(ii) of the Income Tax Act. These interpretations are then applied to the case study developed in Chapter 2 to determine whether opportunities currently exist for non-resident online retailers to avoid South African corporate tax through multinational tax planning (with specific reference to the OECD's online retail structure).

Chapter 4: Amendments to the exception paragraph of the OECD MTC

This chapter includes an extensive literature review of the proposed amendments to the exception paragraph of the OECD MTC in action point seven of the BEPS action plan. The chapter also supplies guidance on the effect of the amendments on the case study developed in Chapter 2. The aim of the chapter is to come to a conclusion about the possible impact of the proposed amendments to the PE status of non-resident online retailers in South Africa and, subsequently, to determine whether the proposed amendments could lead to a South African taxing right in terms of section 9(2)(k)(ii) of the Income Tax Act.

Chapter 5: Conclusion

This final chapter states the concluding arguments related to the research problems addressed in the study and provides suggestions for further research where applicable.

CHAPTER 2: THE OECD’S ONLINE RETAIL STRUCTURE – A SOUTH AFRICAN PERSPECTIVE

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CHAPTER 2: THE OECD'S ONLINE RETAIL STRUCTURE – A SOUTH AFRICAN PERSPECTIVE

2.1 Introduction

The OECD's online retail structure is one of only four multinational tax planning structures included in action point one of the BEPS action plan. The OECD (2015a:167) states that the aim of these structures is to provide governments with examples of the key opportunities available to multinational enterprises in the digital economy to achieve BEPS. Given that the structures are not country specific, they may also be relevant in South Africa. In this regard, it was established in subsection 1.1 that the characteristics of the OECD's online retail structures make this structure specifically relevant from a South African tax perspective.

A general consequence of the OECD's online retail structure is the avoidance of PE status in the market country (OECD, 2015a:170). This is significant from a South African perspective as section 9(2)(k)(ii) of the Income Tax Act, which establishes South Africa's right to tax non-resident online retailers, requires the existence of a South African PE. Depending on the interpretation of a PE and the other key words and phrases in section 9(2)(k)(ii) of the Income Tax Act, the implementation of the OECD's online retail structure may possibly avoid corporate tax in South Africa.

Chapter 2 investigates the key aspects of the OECD's online retail structure and develops a case study of the structure in a South African context. The chapter also provides a broad view of the potential impact that the implementation of the case study may have on the applicability of section 9(2)(k)(ii) of the Income Tax Act to the revenue earned by non-resident online retailers.

2.2 Case study: The OECD's online retail structure in a South African context

Oguttu (2015:58) expresses the view that effective responses to multinational tax planning structures require an understanding thereof. Such an approach is also suggested for the investigation of the OECD's online retail structure in South Africa. A basic understanding of the OECD's online retail structure is provided in Figure 1.1. This section provides further details to Figure 1.1, which are necessary to allow the study to assess whether section 9(2)(k)(ii) of the Income Tax Act applies to the OECD's online retail structure if implemented in South Africa. To this end, Figure 2.1 illustrates the OECD's online retail structure in a South African context. The key aspects of Figure 2.1 are discussed below.

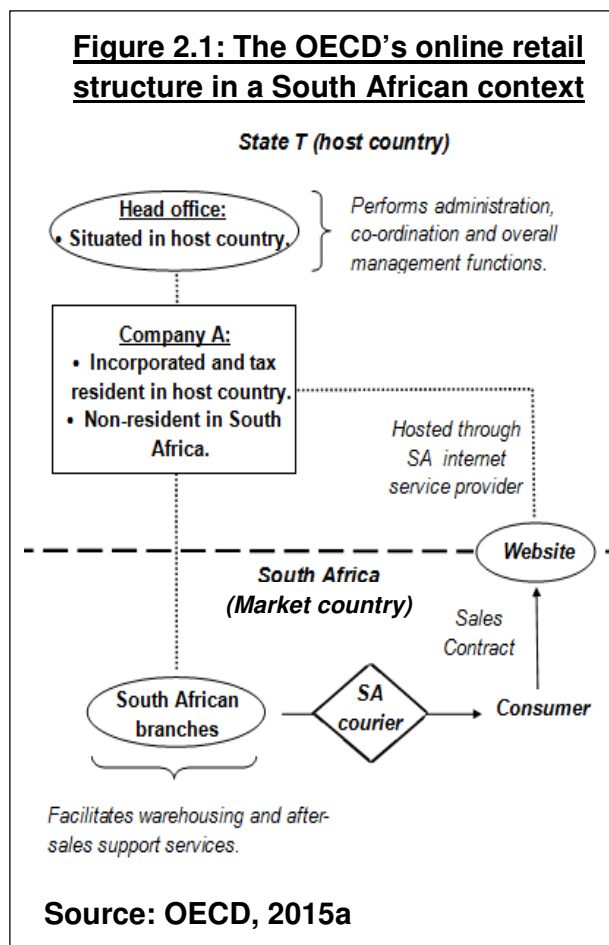
A multinational online retailer incorporates a company, Company A, in foreign State T (OECD, 2015a:168-169) Company A is structured as a non-resident for South African tax purposes (OECD, 2015a:168-169). This is achieved by ensuring that Company A does not have its “place of effective management” in South Africa in terms of the definition of a “resident” in section 1 of the Income Tax Act.

The OECD does not specify the country in which Company A in Figure 2.1 is incorporated. This is most likely an attempt to broaden the scope of multinational tax planning structures to which the OECD’s online retail structure may apply. From here on, a company’s country of incorporation and tax residence

is referred to as its “host country”. In general, Company A would select a host country that imposes low or no corporate tax to minimise any potential corporate tax consequences that may arise from its revenue (OECD, 2015a:78). The possible host countries that may be used to achieve the aforementioned result are investigated in 2.3 below.

Company A displays its product offering to South African consumers through a business website accessible via the internet (OECD, 2015a:168). The data and internet-powered software which jointly comprise the business website are stored on servers that are owned and operated by third-party contractors in South Africa known as internet service providers (OECD, 2015a:169). According to the Oxford English Dictionary (2017) an “internet service provider” is “a company or other organization which provides access to the Internet and related services”.

The servers used by the internet service providers are generally situated in South Africa, but may also be located in neighbouring countries (OECD, 2015a:169). The location of the servers hosting Company A’s business website may be relevant for the purposes of section 9(2)(k)(ii), given that a server could possibly create a PE under certain conditions



(OECD, 2015e:C5-25). As a result, the impact that the servers may have on Company A's PE status is discussed further in Chapter 3.

Company A transacts electronically with South African consumers through standardised contracts that the client accepts when concluding his/her purchase on the business website (OECD 2015a;169). From an operational perspective, Company A establishes a head office in State T and various branches throughout South Africa (OECD, 2015a:168-169). The functional division between the head office in State T and the South African branches are as follows:

- The head office staff perform administration and central management functions which include, *inter alia*, co-ordinating the functions of the South African branches; payment processing; and overall responsibility for maintaining the website and content displayed thereon (OECD, 2015a:168). Furthermore, staff at the head office determine and update the terms and conditions of the standardised internet contracts as and when necessary (OECD, 2015a:168).
- The South African branches are responsible for operating the company's warehouses situated in South Africa and for providing after-sales support to South African consumers (OECD, 2015a:168). Third-party delivery couriers are contracted to deliver purchased goods from the warehouses to South African consumers (OECD, 2015a:169).

A broad view of the potential impact that the implementation of Figure 2.1 may have on the applicability of section 9(2)(k)(ii) to the revenue of non-resident online retailers is provided in subsection 2.4.

2.3 Possible host countries for Company A in Figure 2.1

A common goal of multinational tax planning structures, including the OECD's online retail structure, is to shift taxable profits from high tax jurisdictions to low or no-tax locations (Oguttu, 2015:56). As discussed in subsection 1.1, this process is known as BEPS. In the context of Figure 2.1, this could be achieved if the host country of Company A taxes online retail revenue at a lower corporate tax rate than that which is applicable in South Africa (currently 28%).

Several authors have sought to identify or characterise host countries that may be used in multinational tax planning structures, notably the OECD (1998:21-26). In this regard, the OECD (1998:21-25) differentiates between "preferential tax regimes" and "tax haven

countries". The starting point for identifying the countries in such categories is that both impose low or no taxation on the relevant income which, in this case, is online retail revenue (OECD, 1998:23,26). The differentiating factor between "preferential tax regimes" and "tax haven countries", however, is that tax haven countries actively promote themselves as low or no-tax locations to attract foreign business (Oguttu, 2010:174).

There is no exhaustive list of "preferential tax regimes" or "tax haven countries" that may be used as a host country for Company A. Notwithstanding, the OECD (2006:5) published a list of member countries that were identified as preferential tax regimes in respect of certain revenue types, while the European Commission released a list of 30 identified tax haven jurisdictions in June 2015 (EUbusiness, 2015). The OECD's list of preferential tax regimes includes countries such as Ireland, the Netherlands, Switzerland and Luxembourg (OECD, 2006:5), while some of the popular tax havens included in the European Commission's list are Panama, the British Virgin Islands, the Bahamas, Bermuda and the Cayman Islands (EUbusiness, 2015).

There appears to be multiple low and no-tax countries that may be used as host countries for Company A in Figure 2.1. Cotrut and Ambagtsheer-Pakarinen (2015:188) are of the view that the selection of an appropriate host country in tax structuring is not solely dependent on the level of taxation imposed by a country and that there are several other factors to be considered in this regard. These could include the cost of hosting a business from the country, the protection of intangible rights in the country and the availability of adequately skilled personnel in it (OECD, 2015a:68). A non-resident online retailer implementing the OECD's online retail structure may select any one of the possible host countries noted above, depending on the country that best suits its needs.

2.4 The potential impact of the situation illustrated in Figure 2.1 on the applicability of section 9(2)(k)(ii) to a non-resident online retailer's revenue

The taxability of non-resident online retailers in South Africa depends on the applicability of section 9(2)(k)(ii) of the Income Tax Act to their revenue. Section 9(2)(k)(ii) in turn depends on the existence of a PE of the non-resident situated in South Africa. It follows that section 9(2)(k)(ii) cannot apply to a non-resident online retailer if a South African PE is not created.

As stated previously, South Africa defines the concept of a PE with reference to article 5 of the OECD MTC (section 1 of the Income Tax Act). In terms of article 5 of the OECD MTC there are two possible scenarios which can result in the creation of a PE, namely:

- Where a non-resident conducts all or part of its business in South Africa through a “fixed place of business” (OECD, 2015e:M-16). Essentially, this requires the non-resident to have physical premises through which it carries on business, provided that a sufficient degree of permanence in the use of such premises exists (OECD, 2015e:C5-1).
- Where a person “is acting on behalf of” and “habitually exercises ... an authority to conclude contracts” in the name of a non-resident in South Africa (OECD, 2015e:M-16). No PE is created, however, if the person acting on behalf of the non-resident is “an agent of independent status” (OECD, 2015e:M-16). Where a PE is created in accordance with the principles above, the person acting on behalf of the non-resident is referred to as a “dependent agent” (OECD, 2015e:C5-8).

Furthermore, paragraph 2 of article 5 of the OECD MTC includes a list of non-exhaustive examples that can be regarded, *prima facie*, to constitute a PE in the market country (being South Africa, in Figure 2.1) (OECD, 2015e:C5-9). Notwithstanding any of the provisions above, no PE is created if the activities performed by a non-resident or a dependent agent acting on behalf of the non-resident are limited to those functions stipulated in the exception paragraph of the OECD MTC (OECD, 2015e:M-16). In the case of Figure 2.1, due regard should therefore be given to whether the activities performed by Company A or any of its dependent agents in South Africa, where applicable, fall within the scope of the exception paragraph of the OECD MTC.

Taking into consideration the above guidelines for the creation of a PE, the following aspects of Figure 2.1 may be seen as indicators of a South African PE:

- The South African branches that facilitate warehousing and after-sales support services to South African consumers.
- The internet service provider that hosts Company A’s business website and the delivery couriers responsible for effecting physical delivery of goods to South African consumers.

Should any of the indicators above lead to the creation of a South Africa PE, Company A in Figure 2.1 would be subject to South African corporate tax to the extent that its revenue is “attributable to” that PE (section 9(2)(k)(ii) of the Income Tax Act).

2.5 Conclusion

Figure 2.1 illustrates a case study of the OECD's online retail structure in a South African context. Essentially, the structure consists of a non-resident company incorporated in a low or no-tax country that transacts with South African consumers via the internet. It was established that the South African corporate tax liability of the non-resident company illustrated in Figure 2.1 depends on whether the company creates a PE in South Africa. A South African PE may be the result of either a "fixed place of business" or a "dependent agent" through which the non-resident company conducts its business in South Africa. A PE may also be the result of the specific inclusions to the PE definition stipulated in paragraph 2 of article 5 of the OECD MTC.

Taking into consideration the specific details of Figure 2.1, it was noted that a South African PE may result from either the functions performed by the South African branches or the non-resident company's relations with the South African delivery couriers and internet service providers. The aforementioned outcomes are subject to further evaluation of the specific requirements for the creation of a PE. Should any of the indicators mentioned above lead to the creation of a PE, the non-resident online retailer in Figure 2.1 would be subject to South African corporate tax to the extent that its revenue is "attributable to" the identified PE.

Chapter 3 investigates the meanings of the word "asset" and the phrases "attributable to" and "PE" and applies the interpretation of these terms to Figure 2.1. The outcome of the aforementioned investigation will determine whether it is possible that the implementation of the OECD's online retail structure may avoid corporate tax in South Africa in terms of section 9(2)(k)(ii) of the Income Tax Act.

CHAPTER 3: INTERPRETATION OF THE WORD “ASSET” AND THE PHRASES “ATTRIBUTABLE TO” and “PERMANENT ESTABLISHMENT”

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CHAPTER 3: INTERPRETATION OF THE WORD “ASSET” AND THE PHRASES “ATTRIBUTABLE TO” AND “PERMANENT ESTABLISHMENT”

3.1 Introduction

Where a non-resident online retailer earns revenue from the sale of an “asset”, its revenue is subject to South African corporate tax to the extent that it is “attributable to” a South African PE (section 9(2)(k)(ii) of the Income Tax Act). In the absence of a South African PE, a non-resident online retailer is not subject to corporate tax in South Africa (section 9(4)(d) of the Income Tax Act). It follows that the meanings of the terms “asset”, “attributable to” and “PE” in section 9(2)(k)(ii) of the Income Tax Act can have a material impact on the South African tax liability of a non-resident online retailer.

Chapter 2 presented the components of the OECD’s online retail structure on the basis that the use of the structure may potentially avoid South African corporate tax by falling outside the scope of section 9(2)(k)(ii). This outcome is achieved if the structure does not create a PE, as defined for South African tax purposes. The findings in Chapter 2 were used to create a South African case study of the OECD’s online retail structure which is illustrated in Figure 2.1. It was established that Figure 2.1 illustrates three components which, pending further investigation, may lead to a South African PE. These components are the South African branches of the online retailer’s enterprise and the third-party delivery couriers and internet service providers involved in the structure. If either of the aforementioned components leads to a South African PE, the structure will be subject to South African corporate tax to the extent that revenue is “attributable to” the identified PE.

Chapter 3 focuses on the meanings of the terms “asset”, “attributable to” and “PE” in the context of section 9(2)(k)(ii) of the Income Tax Act and applies the meanings to the structure illustrated in Figure 2.1. The findings of the investigation are used to draw conclusions regarding the possibility, if any, that a non-resident online retailer implementing the OECD’s online retail structure may avoid corporate tax in South Africa in terms of section 9(2)(k)(ii) of the Income Tax Act.

3.2 The meaning and relevance of the word “asset” in section 9(2)(k)(ii) of the Income Tax Act

The application of section 9(2)(k)(ii) is triggered in situations where an amount is received by or accrues to a non-resident from the sale of an “asset”. The word “asset” therefore

provides a general scope for the application of the section to non-resident online retailers that are subject to the provisions of section 9(2)(k)(ii).

The word “asset” is not defined in the Income Tax Act. A definition has however been ascribed to the word in section 1 of the Tax Administration Act. Unless the context otherwise indicates, words defined in the Tax Administration Act bear the same meaning for purposes of the Income Tax Act (section 1(2) of the Income Tax Act). It follows that the word “asset” in section 9(2)(k)(ii) should be interpreted in accordance with the definition thereof in the Tax Administration Act. Section 1 of the Tax Administration Act defines an “asset” as follows:

“ ‘asset’ includes -

- (a) Property of whatever nature, whether movable or immovable, corporeal or incorporeal; and
- (b) A right or interest of whatever nature to or in the property.”

The definition suggests that the word “asset” includes a wide, non-exhaustive range of property or rights to such property. The Oxford English Dictionary (2017) defines “property” as “... that which one owns; possessions collectively; a person's goods ...”. On the basis that the non-resident online retailer presented in Figure 2.1 is also the legal owner of the physical goods sold to South African consumers, any goods owned and subsequently sold to consumers should collectively meet the definition of “property”.

Furthermore, the use of the phrase “of whatever nature” indicates that the nature of the property sold is irrelevant for determining whether the definition of an “asset” is met, provided that such property is “owned” by the seller. Broadly speaking, the revenue earned by non-resident online retailers from the sale of any physical goods owned by them in South Africa should therefore fall within the scope of section 9(2)(k)(ii) of the Income Tax Act.

3.3 The meaning of “attributable to” in section 9(2)(k)(ii) of the Income Tax Act

Where a non-resident creates a PE in South Africa, its revenue is subject to South African corporate tax to the extent that it is “attributable to” that PE (section 9(2)(k)(ii) of the Income Tax Act). The attribution of profits to a PE is an inherently complex subject that has been subject to widespread international debate (Oguttu, 2009:784-786). This section does not presume to address the complexities associated with the attribution of profits to a PE, but aims to provide a basic understanding of the rules that should govern the

application of the phrase “attributable to” in the context of section 9(2)(k)(ii) of the Income Tax Act.

3.3.1 The interpretation of words that are not defined

The phrase “attributable to” is not defined in the Income Tax Act, nor is it ascribed a definition in the Tax Administration Act. Where a phrase is not specifically defined, its meaning must be sought with reference to the South African principles of statutory interpretation (Haupt, 2016:11-13).

The interpretation of statutes is a hard matter of fact that has been characterised by uncertainty and inconsistency in former judgements of the South African courts (Mdumbe, 2004:472). A question that typically arises is whether the context of a statute may be taken into account in the interpretation process and, if deemed permissible, at what stage of the process the context becomes relevant (Mdumbe, 2012:472). The question mentioned above lies at the core of the two main approaches to interpretation that have historically been adopted by the South African courts, namely the literal approach and the purposive approach to interpretation (De Koker & Williams, 2017:par 25.1A-25.1D).

The literal approach is regarded as the primary approach of interpretation (Goldswain, 2008:112). In terms of the literal approach, the words of a statute are given their plain and ordinary meaning, unless the statute provides a specific definition thereof (De Koker & Williams, 2017:par 25.1A). In this regard, a court must adhere to the ordinary meaning even if it results in harsh treatment of the taxpayer (De Koker & Williams, 2017:par 25.1B). In the past, South African courts have shown a willingness to depart from the strict literal rule in cases where the ordinary meaning led to uncertainty, ambiguity or absurdity (Clegg & Stretch, 2017:par 2.1). Generally, deviation from the strict literal meaning was only allowed if the legislature’s intention could be determined beyond doubt (Clegg & Stretch, 2017:par 2.1). In such cases the courts either applied restrictive or modified interpretations to the plain meaning of a word to give effect to the legislature’s intention, depending on the particular circumstances (Goldswain, 2008:112).

Goldswain (2008:113) is of the view that the South African constitution has been a catalyst for a shift from the strict literal rule to a “purposive approach” to interpretation. Currently, it is settled law that the interpretation of all statutes, being subject to the Constitution, require cognisance of the purpose underlying a statute’s provisions (De Koker & Williams, 2017:par 25.1D). Goldswain (2008:116) states that the judgements of tax cases subsequent to the enactment of the Constitution supports the view that the purpose of a

provision should be taken into account regardless of whether clear and unambiguous language is used.

It should be noted, however, that this does not imply neglect of the wording of a statute (De Koker & Williams, 2017:par 25.1D). The specific language used will remain of paramount importance on the basis that the legislature's intention is primarily sought in the specific wording of a statute (De Koker & Williams, 2017:par 25.1D). If the ordinary meaning of a word therefore accords with the intention of the provision, further consideration is generally not required (Goldswain, 2012:37).

Regarding the application of the purposive approach, Goldswain (2012:37) states that the following aspects should be considered:

- The precise wording of a provision;
- the history of the provision; and
- the context of the provision.

In accordance with the purposive approach to interpretation, the aforementioned aspects are applied to the phrase "attributable to" in section 9(2)(k)(ii) of the Income Tax Act below.

3.3.2 The ordinary meaning of "attributable to"

The Oxford English Dictionary (2017) defines "attributable" as:

Attributable (adjective)

"Capable of being attributed or ascribed, especially as owing to, produced by."

The definition in its ordinary sense suggests that the term should be interpreted broadly. If applied to section 9(2)(k)(ii) of the Income Tax Act, the application of the ordinary definition would mean that all amounts received or accrued to a non-resident that are "capable of being attributed" to, "produced by" or "owing to" a South African PE is subject to tax in South Africa. It is submitted that the ordinary meaning of "attributable to" in section 9(2)(k)(ii) does not address the inherent complexities of attributing revenue to a PE, which, *inter alia*, should include guidance on the following:

- The appropriate apportionment method for separating the income of the PE from that of the total enterprise (Oguttu, 2009:776); and
- the expenditure which may be deducted from the attributable income allocated to the PE per the apportionment method above (Oguttu, 2009:781).

From the aforementioned it appears that the plain meaning of “attributable to” is not sufficiently appreciative of the context of section 9(2)(k)(ii) of the Income Tax Act, nor does it provide the necessary guidance for the process to be followed when allocating revenue to a PE. The meaning of the phrase is therefore investigated further below.

3.3.3 History and purpose of section 9(2)(k)(ii)

Section 9 of the Income Tax Act contains specific source rules which regard an amount to be received from a source within or outside South Africa. Where categories of income fall outside the scope of section 9, the source thereof is determined with reference to case law (Stiglingh *et al.*, 2017:72). Section 9(2)(k)(ii) of the Income Tax Act is the result of a complete substitution of its predecessor in terms of section 22 of the Taxation Laws Amendment Act No. 24 of 2011 (the Taxation Laws Amendment Act). The amendment came into effect on 1 January 2012 and applies to all amounts received or accrued to non-residents from the aforementioned date (section 22(2) of the Taxation Laws Amendment Act).

The Explanatory Memorandum on the Taxation Laws Amendment Bill of 2011 states that the amended section 9 loosely reflects implicit tax treaty principles with the purpose of aligning the South African tax system with international tax principles. As stated previously, most modern South African tax treaties are based on the OECD MTC (Papadopoulos & Snail, 2012:104). In addition to South Africa’s use of the OECD MTC as basis for negotiating tax treaties, references to the OECD MTC have also been incorporated in domestic legislation, notably the definition of a PE in section 1 of the Income Tax Act.

Given the widespread adoption of the OECD MTC in South African tax law (see 3.4.2), it could be suggested that the revision to section 9 seeks, among other objectives, to align South Africa’s source rules with the principles of source stipulated in the OECD MTC. In the context of section 9(2)(k)(ii) of the Income Tax Act this view is supported by the close resemblance that the section shares with the wording of article 7 of the OECD MTC. Article 7 of the OECD MTC stipulates the rules for allocating taxing rights on “business profits”, which includes online retail revenue, to source states. Broadly speaking, the purpose of article 7 is therefore akin to that of section 9(2)(k)(ii), as these sections both stipulate the threshold necessary for a non-resident state to tax, *inter alia*, online retail revenue. The resemblance in the wording of section 9(2)(k)(ii) and article 7 of the OECD MTC is clearly seen from the comparison presented in Table 3.1 below.

Table 3.1: A comparison of the wording of section 9(2)(k)(ii) of the Income Tax Act and article 7 of the OECD MTC	
Section 9(2)(k)(ii) of the Income Tax Act	Extract from article 7 of the OECD MTC
“An amount is received by or accrues to a person from a source within the Republic if that amount constitutes an amount received or accrued in respect of the disposal of an asset other than an asset contemplated in paragraph (j) if that person is not a resident and that asset is attributable to a permanent establishment of that person which is situated in the Republic.” <i>(own emphasis)</i>	“If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State. ” <i>(own emphasis)</i>
Source: Section 9 of the Income Tax Act, OECD (2015e:M-22)	

In South Africa, no specific guidance is provided for either the meaning or the application of the phrase “attributable to” in section 9(2)(k)(ii) of the Income Tax Act. The OECD, on the other hand, has published extensive guidance on the attribution of profits to a PE in aiming to assist governments worldwide with the attribution process. It is submitted that the similarities between article 7 of the OECD MTC and section 9(2)(k)(ii) of the Income Tax Act support the view that the phrase “attributable to” in section 9(2)(k)(ii) should be interpreted consistently with the guidance of the OECD. This view is also supported by the following statement in Olivier and Honiball (2011:336): “... it is submitted that because an international tax treaty term (i.e. ‘permanent establishment’) is being used in domestic law, the international tax treaty meaning of the words preceding it (i.e. ‘attributable to’) must also be used ...”. It follows that the meaning of “attributable to” in section 9(2)(k)(ii) should be interpreted in accordance with the OECD’s guidelines on the attribution of profits to a PE. The available OECD guidance is investigated in 3.3.4 below.

3.3.4 The meaning of “attributable to” in article 7 of the OECD MTC

The OECD provides guidance on the attribution process in paragraph 2 of article 7 of the OECD MTC and, more extensively, in the official OECD commentaries on article 7. Due to the complexities of the attribution process, Fourie (2008:68) however states that other

sources are also crucial to identifying the appropriate method to follow when attributing profits to a PE. The OECD released the “2010 Report on the Attribution of Profits to Permanent Establishment” (the Attribution Report) on 22 July 2010 to provide member and non-member countries with a consensus view on the accepted attribution method to follow when allocating profits to PEs (OECD, 2010:1). The “Authorised OECD Approach” includes the guidance expressed in article 7 of the OECD MTC and the commentary thereon, as well as the principles stipulated in the Attribution Report (OECD, 2010:11). The key principles to the Authorised OECD Approach are briefly summarised below.

In terms article 7 of the OECD MTC, profits should be allocated to a PE based on-

*... the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, **if it were a separate and independent enterprise** engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise. (OECD, 2015e:M-22) (own emphasis)*

The OECD (2015e:C7-7) clearly states that the attribution process does not merely involve dividing the overall profits of an enterprise between those attributable to the PE and those that are not. The intention is that the profits attributable to the PE be calculated on the basis of the fiction that the PE was a separate legal entity dealing at arm’s length (OECD, 2015e:C7-7). Based on this notion the profits attributable to the PE will not only include dealings of the combined enterprise with third parties, but also those profits that the PE would have made if it were dealing at arm’s length with other divisions within the enterprise by providing, for example, intrafirm administration services (OECD, 2015e:C7-8).

The basic approach above requires that an enterprise follows a two-step analysis when attributing profits to a PE (OECD, 2015e:C7-8). Under the first step, the enterprise performs a functional analysis of its business (OECD, 2015e:C7-8). The purpose of the functional analysis is to appropriately separate the assets, functions and risks of the combined enterprise into those performed and attributable to the PE and those pertaining to the rest of the enterprise (OECD, 2015e:C(7)8-C(7)9). The assets, risks and business activities that are allocated to the PE will serve as basis from which to allocate profits to the PE under step two of the analysis (Fourie, 2008:71-72). Table 3.2 provides an example of a functional analysis that relates to a multinational manufacturer. The scope of the table is limited to the process of acquiring raw materials.

Table 3.2: An example of a functional analysis of a multinational manufacturer			
Part of value chain	Functions performed	Assets to be utilised	Risks to be assumed
The acquisition of raw materials	<ul style="list-style-type: none"> ▪ Procurement activities (for example communications with suppliers, transportation of materials to warehouse, etc.) 	<ul style="list-style-type: none"> ▪ Financial resources (to fund the acquisition) ▪ Human Resources (for example personnel working in procurement department) ▪ Vehicles (to facilitate transport) 	<ul style="list-style-type: none"> ▪ Risk of financial loss due to theft/damage to assets (including raw materials acquired and vehicles) ▪ Risks associated with employment, disputes, etc.
Source: Fourie (2008:72-73)			

As stated previously, an enterprise should consider both dealings with external parties and functions performed by the PE on behalf of other divisions within the enterprise when performing the functional analysis (OECD, 2015e:C7-8). This could include administrative or other centralised functions performed by the PE on behalf of other divisions within the enterprise. Based on the notion that the PE is a distinct and separable legal entity, it is assumed that the aforementioned services would not be provided free of charge and, subsequently, that the market value of these services should be included in the PE's attributable income.

The second step of the attribution process requires that an arm's length price be allocated to the functions performed by the PE in terms of the functional analysis in step one (OECD, 2015e:C7-7). The determination of the arm's length price coincides with the approach followed when adjusting the profits of associated enterprises, also known as the transfer pricing provisions (OECD, 2015e:C7-8). The OECD (2017d) released the 2017 edition of the official OECD transfer pricing guidelines on 10 July 2017. The updated guidelines incorporate the work performed in action points eight to ten of the BEPS action plan (OECD, 2017d:20). The report provides the following generally accepted guidance for applying the arm's length price principle:

Where conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. (OECD, 2017d:35)

Essentially, the principle requires profits of associated enterprises to be calculated on the notion that the parties to the transaction were independent and dealing at arm's length (OECD, 2017d:35). This, in turn, requires that an enterprise compares its dealings with associated enterprises with a similar transaction entered into between unrelated entities (OECD, 2017d:35). There is a number of acceptable methods that may be used when determining a price that is comparable to independent transactions (OECD, 2017d:97-100). The selection of an appropriate method will ultimately depend on the particular facts of each case and should take into account the different strengths and weaknesses associated with each of the available methods (OECD, 2017:97). Table 3.3 provides a brief summary of the five accepted transfer pricing methods discussed in the 2017 OECD Transfer Pricing Guidelines.

Table 3.3: A summary of the five accepted transfer pricing methods discussed in the 2017 OECD Transfer Pricing Guidelines	
Method	General principle
Comparable uncontrolled method	This method determines the transfer price by identifying a transaction between independent parties under similar conditions, for instance the sale of a similar product, and then uses the price charged in this independent transaction as basis for the transfer price (OECD, 2017d:101-105).
Resale price method	This method uses the price at which a product is eventually sold by the associated entities to an independent party as basis for the calculation (OECD, 2017:105). For purposes of this section, the aforementioned price is referred to as the "resale" price, while a "reseller" means the associated enterprise that sells the product to an independent party. The resale price is reduced by the expenditure incurred by the reseller as well as an appropriate profit margin allocated to the reseller based on the functions it performs

	and the risks it assumes (OECD, 2017:105). The product of the calculation above represents the transfer price.
Cost-plus method	This method uses the costs incurred by the enterprise that supplies the goods or services to an associated enterprise as basis for the transfer price (OECD, 2017d:111). The costs are adjusted with an appropriate profit margin for the supplier, taking into consideration the functions performed and risks assumed by it in rendering the goods or services (OECD, 2017d:111). The OECD Transfer Pricing Guidelines specifically provide for a cost-plus mark-up of 5% to be levied on certain costs incurred in rendering “low value-adding services” (OECD, 2017d:341). Examples of low value-adding services include services of a supportive nature and may therefore be specifically relevant to the warehousing and after-sales support services performed by the South African branches in Figure 2.1 (OECD, 2017d:333).
Transactional net profit method	This method calculates a transfer price by identifying the net profit margin of a comparable transaction between independent parties, and applying that margin to the transaction with an associated entity (OECD, 2017d:117-118). The principles of this method largely follow that of the resale and cost-plus method (OECD, 2017d:117-118).
Transactional profit split method	This method splits the combined group profit from rendering services or supplying goods between the associated entities based on the division of profits that unrelated enterprises would have expected to earn on a comparable transaction (OECD, 2017:133).
Source: OECD, 2017d	

As stated previously, it is not possible to identify a method that is appropriate in all circumstances (OECD, 2017d:97). One of the key challenges facing enterprises in selecting an appropriate transfer pricing method is the availability of information necessary to apply the possible methods (OECD, 2017d:97-100). Due to the administrative burden imposed on multinational enterprises by the transfer pricing provisions, it is suggested that

an enterprise would generally prefer a method for which information is readily available or may be readily obtained (OECD, 2017d:97-100).

3.3.5 Application of the phrase “attributable to” to Figure 2.1

Should the implementation of Figure 2.1 lead to a South African PE, Company A will have to follow the OECD’s two-step analysis for attributing profits to a PE. Firstly, Company A would be required to perform a functional analysis of its combined business model. Following this, Company A would have to allocate an arm’s length price to each of the functions performed by the PE by applying one of the methods presented in Table 3.3. Taking consideration of the type of functions performed by Company A in South Africa (meaning the warehousing and after-sales support activities), it is suggested, for the reasons that follow, that the cost-plus method may be the most appropriate method for attributing profits to Company A’s South African PE, where applicable.

In terms of the cost-plus method, Company A will attribute profits to its PE by adding a profit margin to the costs incurred in performing warehousing and after-sales services in South Africa. The costs incurred should be readily available via Company A’s financial system. However, further consideration is required for an appropriate margin to be applied to the costs. As stated in Table 3.3, the transfer pricing guidelines provide for a mark-up of 5% to be levied on certain “support services”. Distribution activities, including warehousing activities, are however specifically excluded from the definition of low value-adding services, which means that the 5% cannot be applied *prima facie* (OECD, 2017d:334).

Even though distribution activities are specifically excluded from the simplified approach of applying the 5% margin, it would appear that the OECD guidelines generally support the cost-plus method for auxiliary services, which include warehousing and after-sales support (OECD, 2017:334). On this basis, it is submitted that the cost-plus method may be the preferred approach for attributing profits to Company A’s South African PE, where applicable.

3.4 The meaning of a PE in South Africa

3.4.1 The definition of a PE in section 1 of the Income Tax Act

Section 1 of the Income Tax Act defines a PE as “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 OECD MTC is subject to constant review, which results in periodic updates to the model itself; the positions of

participating countries on specific principles therein; and detailed commentaries on each of the articles (OECD, 2017a). Generally, a new version of the OECD MTC is released every two to three years (OECD, 2017a). The most recent version of the OECD MTC was released on 15 July 2014, with the following version tentatively scheduled for release late in 2017 (OECD, 2017a).

The use of the phrase “from time to time” in the definition suggests that South Africa’s interpretation of a PE follows the most recent version of the OECD MTC. On this basis, the meaning of a PE in section 9(2)(k)(ii) of the Income Tax Act is currently linked to the 2014 version of the OECD MTC, being the latest version in issue. The investigation of the meaning of a PE in this section therefore follows the 2014 version of the OECD and the accompanying information thereto, where applicable.

Article 5 of the OECD MTC consists of seven paragraphs, each stipulating the rules for a separate component of the PE definition. Table 3.4 provides a summary of the matters discussed in each paragraph.

Table 3.4: A summary of matters discussed in each paragraph of article 5 of the OECD MTC	
Paragraph 1	Primary rule for determining when a PE exists.
Paragraph 2	Illustrative examples of a PE.
Paragraph 3	Construction/Installation projects that may be PEs.
Paragraph 4	Exceptions to the primary rule for a PE
Paragraph 5	Dependent agents may create a PE.
Paragraph 6	Independent agents do not create a PE.
Paragraph 7	Control of a subsidiary does not give rise to a PE for its parent.
Source: Olivier & Honiball, 2011:334	

The paragraphs relevant to this study are paragraphs 1, 2, 4, 5 and 6 respectively. In the context of Figure 2.1, it was established that a PE may be the result of either the South African branches, or delivery couriers, or internet service providers that are involved in the structure. Taking these findings into consideration, paragraphs 1 and 2 are relevant for determining whether a PE is created on account of the South African branches. Paragraphs 5 and 6 are relevant for determining whether the delivery couriers or internet service providers could create a PE in terms of the provisions for dependent agents. The

general principles of the relevant paragraphs are investigated in 3.4.5 below, while 3.5 applies the principles to the potential PEs identified in Figure 2.1.

3.4.2 The interaction between a PE in tax treaties and domestic legislation

The PE concept may be found in two capacities in South African tax law. Firstly, it is generally used as a threshold to allocate taxing rights to non-resident states in DTAs entered into by South Africa (Oguttu, 2009:773). In addition to its use in tax treaties, South Africa has also incorporated the PE concept in various sections of the Income Tax Act, notably section 1, section 9(2)(k)(ii), section 9D, section 10(1)(h), section 24I, section 31 and paragraph 2 of the Eighth Schedule of the Income Tax Act (Andreou, 2014:9). Of relevance to this study is the meaning of a PE in the context of section 9(2)(k)(ii) of the Income Tax Act.

The vast majority of South African literature, especially case law, on the interpretation of a PE relates to its use in DTAs. It should be considered whether the principles that apply to the interpretation of a PE in a DTA are also relevant for the purposes of the Income Tax Act, specifically section 9(2)(k)(ii). A number of arguments support a consistent approach between the interpretation of a PE in its treaty and domestic context, including the following:

- Oguttu and Tladi (2009:76-77) state that, even though the PE concept is incorporated in domestic legislation, it is primarily a tax treaty term. In cases where common tax treaty principles, such as the PE, are incorporated in domestic legislation, Olivier and Honiball (2011:311) takes the view that the relevant section of domestic legislation should be interpreted in accordance with the international tax treaty meaning of the term.
- In the United Kingdom case of HMRC v Martin Frederick Fowler UKUT 0219 (TCC), the Upper Tribunal, akin to the Supreme Court of Appeal, quoted the following with approval:

The language of an international convention has not been chosen by an English parliamentary draftsmen. It is neither couched in the conventional English idiom nor designed to be construed exclusively by English judges. It is addressed to a much wider and more varied judicial audience than is an Act of Parliament which deals with purely domestic law. It should be interpreted ... 'unstrained by technical rules

of English law, or by English legal precedent, but on broad principles of general acceptance' ... (2017:par.21)

Taking into consideration the court's view cited above, it is submitted that the meaning of a PE representing the "language of an international convention" in domestic legislation should be interpreted in accordance with the "broad principles of general acceptance" that relate to it. This suggests that the interpretation of a PE in section 9(2)(k)(ii) should be cognisant of, *inter alia*, the interpretation of the concept as used in the bilateral tax treaties entered into by South Africa.

On the basis above, it is submitted that the principles of interpretation that apply to a PE in its treaty context should be equally relevant for the purposes of interpreting a PE in section 9(2)(k)(ii) of the Income Tax Act. The literature investigated in this section therefore includes sources relevant to the interpretation of a PE in its treaty context.

3.4.3 The use of the OECD commentaries in South Africa

Each version of the OECD MTC is accompanied by commentaries which provide guidance on the interpretation of the articles therein (OECD, 2015e:l-9). The commentaries include, *inter alia*, extensive guidance on the interpretation of article 5 of the OECD MTC (OECD, 2015e:C(5)1-C(5)41). The guidance expressed in the commentaries represent a consensus view reached among the tax officials delegated by the OECD member countries to serve on the OECD's Committee of Fiscal Affairs (OECD, 2015e:l-9). Although the guidance in the commentaries is not legally binding on countries, they provide governments with important insights into the internationally accepted interpretation of the provisions stipulated in the OECD MTC (OECD, 2015e:l-9).

South Africa is not a member of the OECD, but is an observer to OECD matters and actively participates in OECD-related activities, which includes the BEPS action plan (OECD, 2017b). It should be considered whether the views expressed in the OECD commentaries may be used as persuasive evidence for South African arguments, and to what extent, if any, South African courts are bound to apply the OECD commentaries when interpreting a PE in South Africa. If the OECD commentaries are regarded as a source of persuasive evidence in South Africa, it would provide detailed guidance on the meaning of a PE in the context of section 9(2)(k)(ii) of the Income Tax Act.

This section entails an investigation of the persuasive value of the OECD commentaries in South Africa with specific reference to case law and the Constitution of the Republic of

South Africa, 1996 (the Constitution). The findings of this section are also relevant to Chapter 4, as the proposed amendments to article 5 of the OECD MTC include updated commentaries on this article. Pending the outcome of this section, the updated OECD commentaries could provide guidance on the expected impact that the amendments to the exception paragraph of the OECD MTC may have on the tax consequences of non-resident online retailers in South Africa.

3.4.3.1 South African case law and the OECD commentaries

The OECD commentaries have been considered in a number of South African cases. This section focuses on recent case law as well as cases in which the interpretation of a PE was considered. Detailed discussions of the case facts are not provided as the investigation is aimed at the approach followed by the court with regard to the principles stipulated in the OECD commentaries.

In *SIR v Downing* 37 SATC 249 (*the Downing case*), the Appellate Division considered the South African tax liability of a Swiss resident taxpayer who held a share portfolio in South Africa. The share portfolio was held by a broker firm situated in Durban and managed by a broking member of the Johannesburg Stock Exchange. The relevance of the case pertains to the approach adopted by the court in interpreting the provisions of the DTA between South Africa and Switzerland.

The question before the court was whether the functions performed by the broker firm and broking agent created a South African PE for the Swiss taxpayer in terms of article 5 of the DTA. Although the court did not explicitly refer to the OECD commentaries in its judgement, South African authors agree that the court gave implicit approval for the use of the commentaries by interpreting the facts in a manner consistent therewith (Papadopoulus & Snail, 2012:104; Du Plessis, 2012:45; Olivier & Honiball, 2011:312). According to Oguttu and Tladi (2009:77), the judgement in *the Downing case* supports the view that South African courts should take cognisance of the guidance in the OECD commentaries when interpreting tax treaty principles.

The Johannesburg tax court and Supreme Court of Appeal recently deliberated on two cases relevant to the interpretation of tax treaties, namely *AB LLC and BD Holdings LLC v CSARS* 13276 ZATC 2 (*the AB LCC case*) and *Krok and Another v CSARS* 78 SATC 1 (*the Krok case*). In *the AB LLC case*, the court considered whether a non-resident taxpayer, being a consulting company incorporated in the United States, had created a PE in South Africa in terms of the relevant DTA. During the period under consideration, the

United States Company sent employees to South Africa to perform consulting services for clients who were resident in South Africa. The taxpayer contended that the services rendered by its employees did not create a South African PE in terms of the DTA and provided evidence from the official OECD commentaries to that effect.

The court however rejected the interpretation of the OECD commentaries on the basis that the wording of the relevant section of the DTA differed from the wording of the OECD MTC. In this regard, Valley J stated that the accepted interpretation expressed in the commentaries “cannot be replicated without thought or input” (2015:par.31). It was subsequently held that the OECD commentaries were “of no assistance” in the particular case (2015:par.31). Notwithstanding the above, Valley J stated that “if any treaty contains the same article as that of the OECD Model then it would not be uncommon to rely on the commentary of the OECD Model to interpret that article” (2015:par.14). Valley J further affirmed the relevance of the OECD commentaries in South Africa by stating that “the explanations provided in the Commentary are of immense value in understanding or interpreting any article contained in the treaty” (2015:par.22).

In a different matter regarding the interpretation of a PE that was considered in *the AB LCC case*, the court adopted a seemingly contradictory approach to the one above by ruling in favour of an interpretation in the OECD commentaries (2015:par.47). In the view of Du Plessis (2016:487) the court’s approach to accept and reject the use of the OECD commentaries in two matters of *the AB LLC case* raises the question of whether the court was bound to apply the commentaries and whether the commentaries were applied because the court considered it appropriate to do so.

In *the Krok case*, the court considered the interpretation of an article in the DTA between South Africa and Australia. The taxpayer, one Mr Krok, relied on a specific section of the official OECD commentaries to support his appeal. In his judgement, Maya JA notes the taxpayer’s use of the OECD commentaries, but provides no indication as to the basis on which the OECD commentaries may be used as evidence from a South African perspective (Du Plessis, 2016:487). Although the use of the OECD commentaries was not rejected, the court disagreed with the taxpayers’ application of the relevant principles therein, which contributed to the ultimate dismissal of the taxpayer’s appeal.

The cases referred to above represent those in which the court implicitly or explicitly referred to the OECD commentaries in their judgement and proceeded to either apply or reject the interpretation therein. Du Plessis (2012:50), however, states that there is a

number of South African cases regarding the interpretation of DTAs where the court did not even refer to the OECD commentaries in their judgement. It appears that different approaches to the use of the OECD commentaries have been adopted in the past. In the view of Du Plessis (2016:487) the inconsistent treatment of the OECD commentaries by the South African courts leads to uncertainty about whether the courts are obliged to apply the principles in the OECD commentaries or whether they may do so at their discretion.

Notwithstanding the uncertainties raised above, the recent judgement in *the AB LLC* case confirms the OECD commentaries as a source of “immense value” when interpreting the PE concept in South Africa. This view is supported by the court’s implicit approval of the interpretation of the PE concept stipulated in the OECD commentaries in *the Downing* case. On this basis it is submitted that future South African judgements on the interpretation of a PE should, at a minimum, be cognisant of the views expressed in the OECD commentaries.

3.4.3.2 The OECD commentaries and the South African Constitution

The Constitution is the supreme law of South Africa (section 2 of the Constitution). In terms of section 2 of the Constitution, any law or conduct that is inconsistent with the provisions thereof will be considered invalid. Section 232 of the Constitution states that “Customary international law is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament”. It is further stated in section 233 of the Constitution that “When interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.” If the OECD commentaries constitute either “customary international law” or “international law” in South Africa, the South African courts will be constitutionally bound to either apply or prefer the interpretation stipulated therein. In considering the above, the following questions are relevant to evaluating the evidentiary value of the OECD commentaries in South Africa:

- 1) Do the OECD commentaries constitute customary international law or international law in South Africa?
- 2) How does the Vienna Convention on the Law of Treaties, 1969 (the Vienna Convention) impact the use of the OECD commentaries when interpreting the PE concept in South Africa?

The aforementioned questions are considered below.

1) The OECD commentaries as customary international law or international law in South Africa

Black's Law Dictionary (2017) defines "international law", also termed "public international law", as "the legal system governing the relationships between nations; more modernly, the law of international relations, embracing not only nations but also such participants as international organizations and individuals...". This "law of international relations" includes, *inter alia*, the rules of "customary international law" that exist between two states (Garner, 2004). Black's Law Dictionary (2017) defines "customary international law" as "International law that derives from the practice of states and is accepted by them as legally binding". From the definitions provided above it appears that "international law" has the broader scope as it includes, *inter alia*, the rules of "customary international law".

Differing views exist on whether the OECD commentaries constitute customary international law or international law in South Africa. In the view of Olivier and Honiball (2011:312), albeit not conclusive, the OECD commentaries probably form part of customary international law, and by implication international law, in South Africa. Du Plessis (2016:488), on the other hand, states that compelling evidence exists that the OECD commentaries do not fall within the scope of either customary international law or international law. In support of his view, Du Plessis (2016:488) notes that the OECD commentaries themselves state that the guidance expressed therein represents a non-binding view between states. The OECD (2015e:l-9) states:

Although the Commentaries are not designed to be annexed in any manner to the conventions signed by member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions.

On the basis that the OECD commentaries constitute neither customary international law nor international law in South Africa, Du Plessis (2016:488) concludes that no constitutional obligation is imposed on the South African courts to apply or even refer to the OECD commentaries in their judgements. Nevertheless, following the statement of the OECD (2015e:l-9) cited above, the commentaries should be regarded as a source of "great assistance" where the interpretation of treaty terms are concerned.

2) The Vienna Convention on the Law of Treaties

The Vienna Convention is a multilateral agreement that regulates the international law on treaties entered into between states (United Nations, 1969:2-3). Although South Africa is not a signatory to this agreement, academic authors agree that South Africa is generally bound by the provisions of the Vienna Convention as it represents a codification of customary international law principles (Du Plessis, 2012:42; Oguttu & Tladi, 2009:77; Olivier & Honiball, 2011:312).

The Vienna Convention contains specific rules regarding the interpretation of treaties (United Nations, 1969:12). Of particular interest to this study are the provisions of article 32 of the Vienna Convention, as this article provides for the use of supplementary means of interpretation, such as the OECD commentaries, when interpreting treaties. Article 32 of the Vienna Convention states that-

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

(a) leaves the meaning ambiguous or obscure; or

(b) leads to a result which is manifestly absurd or unreasonable. (United Nations, 1969:13)

It appears that article 32 only allows the use of supplementary means of interpretation where the ordinary meaning attributed to a term results in an ambiguous, absurd or unreasonable result (Olivier & Honiball, 2011:312). Article 32 of the Vienna Convention therefore imposes no constitutional obligation on the South African courts to apply the OECD commentaries (Du Plessis, 2016:498-499). Notwithstanding, it may provide a basis from which the South African courts can apply the OECD commentaries in their judgements (Du Plessis, 2016:498-499).

3.4.4 Conclusion on the use of the OECD commentaries in South Africa

Currently it would appear that there is no definitive answer as to the legal status of the OECD commentaries in South Africa. In previous judgements where the South African courts have applied the OECD commentaries it is unclear whether it was done as a result of a constitutional obligation or whether the court considered it appropriate to use the commentaries under the particular circumstances. It is further submitted that neither

section 232 nor section 233 of the Constitution imposes a constitutional obligation on South African courts to apply or even refer to the OECD commentaries in judgements regarding the interpretation of tax treaty terms (Du Plessis, 2016:488).

Notwithstanding, *the AB LLC case* confirms the commentaries as a source of “immense value” when interpreting the provisions of tax treaties, particularly the concept of a PE, in South Africa. In support of this view, Olivier and Honiball (2011:314) state that the commentaries “[have] become widely accepted and is generally followed by countries which use the MTC (which includes South Africa) as basis for their treaties” (own brackets). Moreover, numerous South African studies that have considered the meaning of a PE have made extensive use of the OECD commentaries as authority. These include Andreou (2014:14-35); Chaffey (2014:20-29); Harnekar (2016:36-40); Nkerebuka (2015:19-41); and Wepener (2016:8-40). Based on these findings, it is concluded that the views expressed in the OECD commentaries should be regarded as strong persuasive evidence when interpreting the concept of a PE in section 9(2)(k)(ii) of the Income Tax Act.

3.4.5 General principles

References to a “paragraph” in this section means a paragraph in article 5 of the OECD MTC, unless stated otherwise. The interpretation of the paragraphs is primarily investigated at the hand of the OECD commentaries. Due to the comprehensive nature of the commentary on article 5, the section focuses on the guidance relevant to the online retail industry.

3.4.5.1 Primary rule for determining when a PE exists

Paragraph 1 provides the primary rule for the existence of a PE and states that “the term ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on” (OECD, 2015e:M-16).

The primary rule contains three distinct requirements, namely:

- 1) A “place of business” (OECD, 2015e:C5-1);
- 2) the “place of business” must be “fixed”, meaning that there must be a sufficient degree of permanence in the use thereof (OECD, 2015e:C5-1); and
- 3) the “fixed place of business” must be used for the purpose of carrying on the business activities of the enterprise (OECD, 2015e:C5-1).

There are arguments that the primary rule should require the “fixed place of business” to also have a productive character which would require that the place contributes to the overall profits of an enterprise (OECD, 2015e:C5-2). If this were the case, it would have been doubtful whether a cost centre such as a warehouse could be seen as a PE. The requirement has however not been included in the 2014 version of the OECD MTC and will therefore not impact the current definition of a PE in South Africa (OECD, 2015e:C5-2). The guidance on each of the requirements listed above is investigated below.

1) A “place of business”

The creation of a PE is conditional on the existence of physical premises; a facility or other “place” from which the enterprise can conduct its business (OECD, 2015e:C5-2). The term “place” is generally interpreted broadly and may include any physical presence of an enterprise in the market country (Sudding, 2011:24). The requirement is not exclusive to immovable property and may also include, *inter alia*, movable machinery and equipment (OECD, 2015e:C5-2).

It is further not required that the “place” be owned by the enterprise, nor is it required that the “place” be used exclusively for the purpose of carrying on its business (OECD, 2015e:C5-3). It is merely required that the “place” be at the disposal of the enterprise (OECD, 2015e:C5-3). Subsequently, rented premises may also fall within the scope of a “place of business”.

2) The “place of business” must be “fixed”

A “place of business” will only create a PE if there is a sufficient degree of permanence to the use thereof (OECD, 2015e:C5-1). The requirement depends on the outcome of two tests, namely the “location test” and the “duration test” (Sudding, 2011:25-26). The key elements of the tests are briefly examined below.

- **The “location test”**

The “location test” requires a “place of business” to be fixed to a particular geographic location. In Reimer’s (2015:344) view this criterion stems from the general principle that so-called “moving-targets” should not create a taxing right for the source state. The rationale of the aforementioned rule is that movable “targets” are generally considered to be insufficiently tied to the source state to create a taxable presence therein (Reimer, 2015:344).

Despite the general rule above, there is a number of instances in which items of a movable nature may meet the “location test”. These include the following:

- 1) Equipment may meet the test if it is usually and regularly used at a specific geographic location (Reimer, 2015:344). Should there be any change to this “primary location”, the change is further required to be the result of either a change in use of the particular equipment or a change in ownership thereof (Reimer, 2015:344).
- 2) A further example involves “moving targets” that can be regarded as a single project (Reimer, 2015:345). In this regard, the different places of business used in a project may be regarded as a single place for the purpose of applying the “location test”. There are no specific rules for determining whether activities carried on at different locations represent a single project. Indicators of a single project may include cases where an enterprise requires periodic relocation of activities due to the nature of its operations or where a long-distance relocation of business activities requires extensive capital expenditure (Reimer, 2015:345). A typical example of the above is a drilling rig moved between different locations in the same region of the sea (Reimer, 2015:345).

In the context of the online retail industry, the criteria listed above are especially relevant for determining whether a server, which is a movable asset, may meet the requirements of the “location test”. The considerations relating to the “location test” are less relevant, however, in the context of an office or branch which is structurally fixed to the ground (Reimer, 2015:343). An office or branch in the market country will accordingly meet the “location test” *prima facie* (Reimer, 2015:343).

- **The “duration test”**

In terms of the “duration test”, there must be a sufficient degree of permanence in an enterprise’s use of the “place of business” (OECD, 2015e:C5-5). It is generally accepted that this requirement is met where an enterprise has carried on business from a particular location for a period of six months or more (OECD, 2015e:C5-6). The six month threshold should not be regarded as conclusive, though, and should be evaluated in the context of the specific business of an enterprise (OECD, 2015e:C5-6).

3) The enterprise must carry on its business wholly or partly through the “fixed place of business”

The mere existence of a physical presence in the market country is not sufficient to create a PE (Chaffey, 2014:24). A further requirement is that an enterprise conducts its business activities “through” the identified “place of business” (OECD, 2015e:C5-3). The OECD (OECD, 2015e:C5-3) states that the word “through” should be given a broad meaning so as to include any situation in which business activities are carried on from a specific location. As stated previously, it is not required that the business activities performed from the specified location are productive in character.

The requirement is generally satisfied by the presence of the entrepreneur, the employees of the enterprise or other persons acting on its behalf (OECD, 2015e:C5-7). Human involvement is not a prerequisite to meeting the requirement (OECD, 2015e:C5-7). If, for example, an enterprise uses automated equipment, a PE may exist even if the employees or dependent agents of an enterprise are merely involved in setting up or performing periodic maintenance on the equipment (OECD, 2015e:C5-8). This is particularly relevant in the industry of digital commerce where it is possible to perform an increasing number of business activities with little or no human intervention.

3.4.5.2 Illustrative examples of a PE

Paragraph 2 includes a non-exhaustive list of illustrative examples of a PE (OECD, 2015e:C5-9). These examples are also known as the “positive list” (Sudding, 2011:32). Among the examples specifically listed is a branch from which an enterprise carries on business activities (OECD, 2015e:M-16). It should be noted that the positive list is merely illustrative and that the existence of a PE is still conditional on the requirements of the primary rule as discussed above (OECD, 2015e:C5-9). It follows that the mere existence of an item on the positive list, for instance a branch, is not conclusive of PE status and should still meet the primary rule of a PE.

3.4.5.3 Exceptions to the primary rule of a PE

Paragraph 4 includes a list of exceptions to the primary rule, according to which a PE will not be created, regardless of whether the enterprise conducts its business activities through a “fixed place of business” or via a dependent agent (OECD, 2015e:C5-13). The list of exceptions is commonly referred to as the “negative list” (Sudding, 2011:34). The business activities in the negative list are generally regarded as “auxiliary or preparatory”

to the main business of an enterprise and are therefore deemed insufficient to create a PE in the market country (OECD, 2015e:C5-13).

The negative list specifically includes premises used solely for the following business activities:

- The storage, display and/or delivery of goods (OECD, 2015e:C5-13). On this basis, warehouses and depots should generally not create a PE in the market country, provided that the functions performed at these locations are limited to the activities listed above.
- The procurement and purchasing of goods (OECD, 2015e:M-16).

On the basis of the negative list, the business activities generally associated with that of a typical warehouse would not create a PE for an enterprise. Where an enterprise performs a combination of business activities listed in the negative list from a single location, the location will still be exempt from PE status if the following requirements are met:

- Each activity must individually meet the requirements for the exception from PE status (OECD, 2015e:M-16); and
- the overall activity performed from the specified location must be of a “preparatory or auxiliary” character (OECD, 2015e:M-16).

The negative list does not provide a specific exception to the primary rule relating to services, but subparagraph (e) contains a general exception for “any other activity of a preparatory or auxiliary character” (OECD, 2015e:M-16). Should a service be regarded as a business activity with a “preparatory or auxiliary” character, the place from which such service is performed would not create a PE for an enterprise.

Distinguishing between business activities that have a “preparatory and auxiliary” character and those which do not is inherently difficult (OECD, 2015e:C5-14). The OECD (OECD, 2015e:C5-14) states that “the decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole”. This requires an assessment of whether a business activity is qualitatively important in the context of an enterprise as whole (OECD, 2015e:C5-14). A business activity would be considered qualitatively important if, *inter alia*, its “general purpose is one which is identical to the general purpose of the whole enterprise” (OECD, 2015e:C5-14). Although the so-called “general purpose test” is commonly used to identify

business activities that have a “preparatory or auxiliary” character, each case will ultimately have to be considered on its own merits (OECD, 2015e:C5-14).

3.4.5.4 Dependent agents may create a PE

Paragraph 5 stipulates the circumstances under which an agent will create a PE for an enterprise (OECD, 2015e:C5-17). A person who meets the requirements of paragraph 5 is referred to as a “dependent agent” (OECD, 2015e:C5-18). The requirements of such an agent are as follows:

- 1) The person must have the authority to conclude contracts on behalf of the enterprise (OECD, 2015e:M-17), and
- 2) the authority must be habitually exercised (OECD, 2015e:M-17).

The guidance on the aforementioned conditions are considered below.

1) The authority to conclude contracts on behalf of an enterprise

A dependent agent requires sufficient authority to bind an enterprise’s participation in the business activities carried on in a particular state (OECD, 2015e:C5-18). This authority could exist even if an agent does not contract in the name of an enterprise, but has the authority to bind the enterprise to certain performance obligations (OECD, 2015e:C-18). It is not required that the authority is given explicitly (OECD, 2015e:C5-18). In cases where the principal does not actively or continuously participate in the business activities in a particular state, it may indicate that implicit authority has been provided to an agent acting on its behalf (OECD, 2015e:C5-18).

A further requirement entails that the nature of contracts entered into by the agent is closely linked to the core business of an enterprise (OECD, 2015e:C5-18). Where, for example, an agent is merely authorised to conclude contracts pertaining to administrative matters or the internal affairs of an enterprise, such as employee contracts, no PE is created (OECD, 2015e:C5-18). Moreover, when an agent is authorised to substantially negotiate the details of contracts pertaining to the enterprise’s core business, a PE may be created regardless of whether the formal signing is done by another person or in a different state (OECD, 2015e:5-18). Ultimately, the question of whether authority exists should be considered on a case-by-case basis (OECD, 2015e:C5-19).

2) The authority must be habitually exercised

There is no single definition for the word “habitually” (OECD, 2015e:C5-19). In this regard, the OECD (2015e:C5-19) states that “it is not possible to lay down a precise frequency test”. The assessment of whether an agent exercises the granted authority with a sufficient degree of frequency will depend, *inter alia*, on the nature of the principal’s business and the type of contracts it enters into (OECD, 2015e:C5-19). As a general rule, it should be noted that the requirement will not be satisfied where an agent is merely granted authority to conclude contracts in emergencies or on an ad-hoc basis (OECD, 2015e:C5-19).

From the aforementioned, it is clear that the existence of a dependent agent depends on the specific facts of a case. It should also be noted that even if both requirements are met, no PE will be created if the functions performed by the agent are limited to those stipulated in the exception paragraph to the OECD MTC (OECD, 2015:M-17). The principles for determining whether a business activity falls within the scope of the exceptions to the primary rule of a PE (see 3.4.5.3) are therefore equally relevant for determining whether a dependent agent exists.

3.4.5.5 Independent agents do not create a PE

Paragraph 5 specifically excludes an agent of independent status from the definition of a dependent agent (OECD, 2015e:C5-20). The requirements of an independent agent are stipulated in paragraph 6 (OECD, 2015e:M-17). Essentially, a person acting on behalf of an enterprise is “independent” if such a person meets the following conditions:

- a) The person is legally and economically independent of the enterprise (OECD, 2015e:C5-20); and
- b) the person acts in the ordinary course of its own business (OECD, 2015e:C5-20).

Broadly speaking, the activities of an independent agent are subject to neither detailed instruction nor comprehensive control by the principal (OECD, 2015e:C5-20). Furthermore, agents of independent status assume the entrepreneurial risk related to their commercial activities, including the risk of financial loss, etc. (OECD, 2015e:C5-20). However, the guidance supplied above should be applied with due consideration of the specific facts of a case (OECD, 2015e:C5-20). Should a person acting on behalf of an enterprise be regarded as an independent agent, no PE is created for the principal (OECD, 2015e:M-17).

3.4.5.6 The impact of electronic commerce on the creation of a PE

There has been widespread discussion on the impact that the emergence of electronic commerce has had on the interpretation of the PE definition in article 5 of the OECD MTC (OECD, 2015e:C5-24). A question that has received particular attention is whether a business website or server may lead to the creation of a PE in the source country (OECD, 2015e:C5-24). Because of the relevance of the aforementioned question in the context of online retailers, it is investigated further below.

The OECD (OECD, 2015e:C5-24) explicitly states that a website cannot constitute a “place of business” as it has no physical nature. Consequently, a business website cannot create a PE for an enterprise. A server, on the other hand, represents a physical piece of equipment which, under specified conditions, may lead to the creation of a PE (OECD, 2015e:C5-25).

It is not uncommon for enterprises to use internet service providers to host their websites (OECD, 2015e:C5-25). As established in 3.4.5.1, a “place of business” does not require ownership, but merely that specific premises or a specific piece of equipment is at the disposal of the enterprise (OECD, 2015e:C5-25). In typical hosting agreements an enterprise has neither access to nor control over the servers themselves or the location at which they are held (OECD, 2015e:C5-25). If a hosting agreement meets the aforementioned criterion, the server hosting a company’s website is not “at the disposal” of the enterprise and, subsequently, cannot create a PE for the enterprise (OECD, 2015e:C5-25).

However, if an enterprise were to rent and operate a server from its own premises, the server will be at the disposal of that enterprise and subsequently the “place of business” requirement will be met (OECD, 2015e:C5-25). Assuming that a server meets the “place of business” requirement, the following additional factors should be considered to determine whether a PE is created:

- 1) In order to meet the “duration test”, the server must remain at a specified location for a sufficient period of time (OECD, 2015e:C5-25). As previously stated, the generally accepted period is six months or more. If an enterprise either physically moves a server, or transfers its website from one server to another, the required level of permanence to create a PE may not be met (OECD, 2015e:C5-25).
- 2) Where a business website is capable of performing automatic functions, including automatic contracting with consumers via a website, a PE may be created even in

the absence of personnel (OECD, 2015e:C5-26). The general requirement that the carrying on of a business requires the presence of personnel is therefore waived where activities are performed automatically and should not be seen as excluding a server from creating a PE (OECD, 2015e:C5-26).

- 3) However, if the automatic functions performed on the website are of a “preparatory or auxiliary” character, no PE is created (OECD, 2015e:C5-26). It should be noted that the OECD explicitly states that the conclusion of contracts by a website is not “preparatory or auxiliary” in character (OECD, 2015e:C5-27). In the event that a server meets the general requirements of a PE, it would not be exempt from PE status if a website stored thereon automatically concludes contracts with an enterprise’s customers (C5-27).

From the investigation reported above, it is clear that a business website cannot create a PE. However, a server, being a piece of physical equipment, could potentially meet the definition of a PE under certain conditions. In the context of Figure 2.1, it should be considered whether the servers on which Company A’s website is stored may create a PE in South Africa. This assessment is presented in 3.5.5.

3.5 Application of the meaning of a PE to Figure 2.1

This section applies the general principles of a PE as established in 3.4.5 to the potential PEs identified in Figure 2.1. The purpose of this section is to identify the possibility, if any, that the use of the OECD’s online retail structure in South Africa may avoid the creation of a PE, and therefore corporate tax, in South Africa.

3.5.1 The impact of the South African branches on Company A’s PE status

A “branch” is one of the illustrative examples of a PE specifically included in article 5 of the OECD MTC (OECD, 2015e:M-16). The OECD (2015e:C5-9) states that the mere inclusion of a place of business in the illustrative list is not conclusive of PE status. The illustrative examples only lead to the creation of a PE if the general requirements of a PE, as stipulated in paragraph 1, are also met. The general requirements of a PE are applied to the South African branches below:

- 1) The branches meet the “place of business” requirement as they represent physical premises from which Company A may conduct its business. The same outcome is achieved regardless of whether the facilities are rented or owned, provided that such facilities are at the disposal of Company A.

- 2) Given the inherent costs of relocating a business, it is assumed that Company A will maintain each of its South African branches for at least six months. This meets the generally accepted period necessary to satisfy the “duration test” (see 3.4.5.1). Furthermore, given that the South African branches are fixed structures, there should be no disagreement that the “location test” is met. Each branch should therefore be regarded as a “fixed place of business” in South Africa.
- 3) The South African branches are responsible for warehousing and after-sales support services. Company A therefore carries on business activities “through” the South African branches. There is no requirement that the warehousing and after-sales support services should have a productive character.

Based on the assessment above, the South African branches should satisfy the primary rule of a PE. The primary rule is however subject to the exceptions stipulated in the exception paragraph of the OECD MTC. Should the warehousing and after-sales services fall within the scope of business activities listed in the exception paragraph of the OECD MTC (see 3.4.5.3), no PE will be created. The application of the exception paragraph of the OECD MTC to the South African branches is investigated below.

3.5.2 The application of the exception paragraph of the OECD MTC to the South African branches

The business activities of “storage, display or delivery of goods” are regarded as exceptions to the primary rule of a PE (OECD, 2015e:M-16). It follows that Company A’s warehousing activities, considered in isolation, do not create a PE. On the other hand, the after-sales support services will fall short of the primary rule of a PE if these services are regarded as “preparatory or auxiliary” to Company A’s business (OECD, 2015e:M-16). The OECD’s guidance on the interpretation of the phrase “preparatory or auxiliary” makes it clear that each case has to be considered on its own merits.

The OECD (2015e:C5-14) further states that the assessment should be performed at the hand of the following questions:

- 1) Are the after-sales support services essential or significant to Company A’s business as a whole?
- 2) Is the general purpose of the after-sales support services identical to that of Company A as a whole?

The questions are applied to the facts presented in Figure 2.1 below.

1) Are the after-sales support services essential or significant to Company A's business?

Online retailers generate revenue from sales to customers. It is therefore suggested that the essential or significant business activities of an online retailer are those that are closely linked to its sales activities, for example the conclusion of sales contracts, strategic decisions regarding sales activities, etc. The OECD (2015a:183) states that the structures typically implemented by multinational online retailers, *inter alia*, involve a "call centre" in the market country which renders after-sales support services to the consumers situated therein. Taking into consideration the general nature of a call centre, it is submitted that these services are incidental to the conclusion of a sale and comprise of ad-hoc responses to queries and complaints from customers. On this basis, the after-sales support services should not be regarded as essential or significant to Company A's sales activities.

It should be noted, however, that there are certain instances in which after-sales support services may be regarded as essential or significant to an enterprise's business (OECD, 2015e:C5-15). The OECD (2015e:C5-15) provides the example of an enterprise that repairs and maintains certain machinery while also delivering spare parts of the machinery to consumers as an additional service. In such a case, the act of delivering the spare parts will be considered as closely linked to the enterprise's business of repair and maintenance and will therefore not qualify as an exception to the primary rule of a PE. However, given the preceding discussion, it is submitted that a call centre which responds to ad-hoc queries from customers should not be regarded as essential or significant to the sales concluded by Company A, nor the activities that are essential thereto.

2) Is the general purpose of the after-sales support services identical to that of Company A as a whole?

Concurrent with the assessment in the first question, it is suggested that the general purpose of an online retailer is to generate profit from the sale of goods. Assuming that the after-sales services performed by the call centre are incidental and merely occur on an ad-hoc basis, it is submitted that the purpose of these services are not similar to the core sales activities, such as the conclusion of contracts, of Company A. These services rather support the core sales activities and are therefore "auxiliary" to the sale.

Based on the investigation above, it appears that the nature of the after-sales services are neither an essential or significant part of Company A's business, nor are its purposes similar to that of Company A's core sales activities. On this basis, it is concluded that the

services should be regarded as “preparatory or auxiliary” in nature and should therefore not lead to the creation of a PE for Company A.

3.5.3 A combination of activities performed from the same branch

Presuming that the warehousing and after-sales support services are performed within the same facility, the location as a whole would still be exempt from PE status if the following conditions are met:

- The warehousing and after-sales support activities must be individually exempt from PE status (OECD, 2015e:M-16). It was established in 3.5.2 that both the warehousing and the after-sales support activities performed by the South African branches individually qualify for the exception to the primary rule of a PE. This requirement is therefore met.
- The overall business activity of the facility, considered holistically, must be “preparatory or auxiliary” in nature. Following the assessment in 3.5.2, an activity (or in this case the overall activity) will not be “preparatory or auxiliary” if it forms an essential part of Company A’s sales business or if it is closely linked to the core sales activities of the business. In 3.5.2 it was posed that the core sales activities of an online retailer may include, *inter alia*, the conclusion of sales contracts, sales strategy management, etc. Considering the above, it is submitted that the combined business activity of storing goods and providing after-sales support to consumers via a call centre should not be regarded as closely linked to the core sales activities of Company A. The warehousing activities are preparatory to sales concluded with South African consumers, while the after-sales support services are auxiliary and incidental to the actual sale and conclusion thereof. It is therefore submitted that the overall business activity should also be regarded as “preparatory or auxiliary” in character.

On the basis of the preceding argument, the South African branches should qualify for the exception from PE status regardless of whether the warehousing and after-sales support activities are performed from within the same location.

3.5.4 Application of the PE principles to the delivery couriers

The delivery couriers shown in Figure 2.1 may create a PE for Company A if they meet the dependent agent requirements. The requirements for a dependent agent discussed in paragraph 5 specifically exclude agents of independent status. If the third-party delivery

couriers do not act on the detailed instructions of Company A and, assuming furthermore that their activities are not subject to comprehensive control by Company A, they should be regarded as independent agents. On this basis, the activities performed by the delivery couriers should not create a PE for Company A.

However, if Company A exercised a higher degree of control over the activities of the delivery couriers, they may potentially be regarded as dependent agents. Should the delivery couriers represent dependent agents, the existence of a PE for Company A is conditional on whether the activities performed by the delivery couriers fall within the scope of the exception paragraph of the OECD MTC. Business activities relating to “delivery” are included as a specific exception to the primary rule of a PE (OECD, 2015e:M-16). Consequently, the delivery couriers should not create a PE for Company A, whether they are dependent agents or not.

3.5.5 Application of the PE principles to the internet servers providers

Two aspects are relevant when considering Company A’s relationship with the internet service providers, namely:

- 1) It should be considered whether the internet service providers are dependent agents of Company A.
- 2) Given that the servers hosting Company A’s website are generally situated in South Africa, it should be considered under what circumstances, if any, the servers may create a PE for Company A in South Africa.

The aforementioned aspects are considered separately below.

1) The dependent agent provisions applied to the internet service providers

The internet service providers, as presented in Figure 2.1, may create a PE for Company A in South Africa if they meet the requirements for a dependent agent. Assuming that the internet service providers are not under detailed instruction or comprehensive control by Company A, they should fall within the scope of independent agents. On the basis that the definition of a dependent agent specifically excludes agents of an independent status, the internet service providers should not create a PE for Company A in South Africa.

2) Circumstances under which a server may constitute a PE for Company A

As illustrated in Figure 2.1, the servers hosting Company A’s website are owned and operated by the internet service providers in South Africa. It was established in 3.4.5.6 that

a server in South Africa may create a PE even in the absence of ownership. However, to meet the “place of business” requirement the server must be at the disposal of Company A. Given that the servers shown in Figure 2.1 are owned and operated by the internet service providers, it is submitted that these servers are not at the disposal of Company A. Assuming that Company A only rents a fixed or variable amount of disk space on which to store its website, no PE is created as a website, being intangible in nature, cannot be regarded as a “place of business”. It follows that the servers, as illustrated in Figure 2.1, should not create a PE for Company A, regardless of whether those servers are situated in or outside South Africa.

If, however, Company A were to rent and maintain a server at its own premises, the server would constitute a “place of business”. In the aforementioned scenario a PE may be created depending on whether the remaining requirements to the primary rule of a PE discussed in 3.4.5.1 are met.

3.5.6 Conclusion on the PE status of Company A as seen in Figure 2.1

It appears unlikely, for reasons to follow, that the use of the OECD’s online retail structure in South Africa will result in a PE:

- 1) Even though the South African branches of Company A meet the requirements for the primary rule of a PE, the warehousing and after-sales support activities fall within the scope of the exceptions to the primary rule, and will therefore not lead to a PE for Company A. This outcome should be achieved irrespective of whether the warehousing and after-sales support activities are performed from the same or different facilities. Consequently, the South African branches should not lead to the creation of a PE for Company A.
- 2) Assuming that Company A does not provide detailed instruction or have comprehensive control over the activities of the third-party delivery couriers and internet services providers, these parties should be regarded as independent agents. As the definition of a dependent agent specifically excludes agents of an independent status, neither the use of the delivery couriers nor the internet service providers should create a PE for Company A.
- 3) Even if the server on which Company A’s business website is stored is situated in South Africa, it should not lead to a PE as it is not at the disposal of Company A (the servers are maintained and operated by the internet service providers). Moreover,

the business website from which Company A contracts and facilitates transactions with customers cannot lead to the creation of a PE as it has no physical nature.

3.6 Conclusion

It was established that the word “asset” in section 9(2)(k)(ii) of the Income Tax Act should be interpreted broadly so as to include physical goods of whatever nature. It is therefore submitted that the sales revenue earned by non-resident online retailers in South Africa will generally fall within the scope of section 9(2)(k)(ii).

South Africa defines a PE with reference to the definition of the term in article 5 of the OECD MTC. The meaning of a PE in section 9(2)(k)(ii) of the Income Tax Act is therefore attributed to the OECD MTC’s definition of and guidance on the term. It was established that the official OECD commentaries on article 5 of the OECD MTC may be used as persuasive evidence when interpreting a PE for South African tax purposes, but that the courts are under no obligation to do so. This notwithstanding, the consensus reached is that the views expressed in the OECD commentaries to article 5 of the OECD MTC should be regarded as a source of “immense value” when interpreting a PE in section 9(2)(k)(ii) of the Income Tax Act.

The application of the South African meaning of a PE to the components of Figure 2.1 suggest that the implementation of the OECD’s online retail structure in South Africa should not create a PE for Company A. Even though the South African branches in Figure 2.1 meet the requirements to the primary rule of a PE, the functions performed by the branches fall within the scope of the exception paragraph of the OECD MTC. Furthermore, the internet service providers and delivery couriers shown in Figure 2.1 should not create a PE for Company A on the basis that they represent agents of independent status.

Should a PE be created, however, Company A will be subject to South African corporate tax to the extent that its revenue is “attributable to” the PE. It was established that the attribution of revenue to a non-resident in terms of section 9(2)(k)(ii) of the Income Tax Act should follow the Authorised OECD Approach. This approach includes the collective guidance expressed in article 7 of the OECD MTC, the OECD commentaries on article 7 of the OECD, as well as the Attribution Report. Broadly speaking, this approach entails that the revenue attributable to a South African PE, where applicable, be calculated according to the notion that the PE is a distinct and separate legal entity dealing at arm’s length. On the assumption that a PE is created, it is suggested that, on the basis of the type of

functions performed by Company A in South Africa, the cost-plus approach may be the most practical method of attributing revenue to that PE.

The findings in Chapter 3 suggest that the implementation of the OECD's online retail structure may facilitate corporate tax avoidance in South Africa. This outcome is achieved by avoiding the creation of a South African PE. The aforementioned outcome may be impacted by the amendments proposed to article 5 of the OECD MTC in action point seven of the BEPS action plan. If South Africa adopts these amendments, a non-resident online retailer may create a PE under the revised definition of the term where such a PE previously did not exist. On this basis, the meaning and impact of the amendments proposed to article 5 of the OECD MTC are investigated in Chapter 4.

CHAPTER 4: PROPOSED AMENDMENTS TO THE EXCEPTION PARAGRAPH OF THE OECD MTC

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CHAPTER 4: PROPOSED AMENDMENTS TO THE EXCEPTION PARAGRAPH OF THE OECD MTC

4.1 Introduction

Governments across the world experience challenges in addressing complex tax planning structures used by multinational enterprises to reduce their global tax burdens (OECD, 2015a:11). An example of such a structure is the OECD's online retail structure (OECD, 2015a:182). The OECD's online retail structure typically avoids tax in the market country by ensuring that a company's presence in the market country falls short of the requirements of a PE. This is especially relevant in the context of this study as non-resident online retailers will only be subject to South African corporate tax if such an online retailer's revenue is attributable to a South African PE (section 9(2)(k)(ii) of the Income Tax Act). In Chapter 3 it was established that the implementation of the OECD's online retail structure in South Africa should not give rise to a PE. Consequently, non-resident online retailers implementing this structure should not be subject to South African corporate tax in terms of section 9(2)(k)(ii) of the Income Tax Act.

In response to structures such as the OECD's online retail structure, action point seven of the BEPS action plan proposed certain amendments to the definition of a PE in article 5 of the OECD MTC. These amendments include a revision of the exception paragraph of the OECD MTC. If the amendments in action point seven of the BEPS action plan impact the interpretation of a PE in a South African context, it could affect the PE status of non-resident online retailers and subsequently the liability of these entities to South African tax.

Chapter 4 provides a brief overview of the recommendations in action point seven of the BEPS action plan, which include the amendments to the exception paragraph of the OECD MTC, as well as the potential legislative impact of the recommendations from a South African tax perspective. A detailed literature review is then performed to establish the meaning of the amendments that relate to the exception paragraph of the OECD MTC. Taking into consideration the meaning of the aforementioned amendments, the revised exception paragraph of the OECD MTC is applied to the potential indicators of a PE as identified in Figure 2.1 (see 2.4). The findings of Chapter 4 are used to draw conclusions concerning the possible impact that action point seven of the BEPS action plan may have on the tax liability of non-resident online retailers in South Africa.

4.2 An overview of the recommendations in action point seven of the BEPS action plan

Action point seven of the BEPS action plan investigates the definition of a PE as stipulated in article 5 of the OECD MTC. The revision of the PE concept is the result, among other contributory factors, of an increased use of tax planning strategies that circumvent the current definition of a PE while generating substantial revenue in the market country (Davis Tax Committee, 2014b:1-2). In February 2013 the OECD (2013a:33-36) released a report titled “Addressing Base Erosion and Profit Shifting”, which identifies a number of key opportunities for BEPS in the global market place. The report questions the relevance of the PE concept in a post-digital era and states the following:

... developments brought about by the digital economy are putting increasing pressure on these well-established principles and in particular on the concept of permanent establishment ... In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits. (OECD, 2013a:33-36)

Following these findings, the OECD and the G20 jointly adopted a fifteen point action plan, referred to as the BEPS action plan, to address the challenges raised in the initial report (OECD, 2013b:14-24). Action point seven of the BEPS action plan specifically targets multinational business structures that “artificially” avoid PE status in market countries (OECD, 2015d:9-11). In response to these “artificial” avoidance structures, action point seven proposed certain amendments to article 5 of the OECD MTC as well as the official commentaries thereon (OECD, 2015d:9-11). The proposed amendments have bearing on the exception paragraph of the OECD MTC and the requirements for a dependent agent presented in article 5 of the OECD MTC respectively. Broadly speaking, the amendments lower the requirements necessary for a non-resident to create a PE in the market country, therefore possibly increasing the likelihood that a PE is created. The proposed amendments in action point seven of the BEPS action plan are briefly summarised below.

4.2.1 Proposed amendments to the “dependent agent” provisions

The dependent agent provisions are stipulated in paragraph 5 of article 5 of the OECD MTC. This paragraph stipulates the conditions under which an agent known as a “dependent agent” may create a PE for its principal. The proposed amendments to the dependent agent provisions specifically, though not exclusively, target business structures

in which an agent sells products on behalf of a non-resident, but concludes the contracts in its own name (OECD, 2015d:9-10). This is known as a *commissionaire* arrangement (OECD, 2015d:9). Prior to the amendments, the existence of a dependent agent generally depended on whether such an agent transacted in the name of its principal and therefore bound the principal to the terms of a contract (OECD, 2015d:10). Previously, an agent acting in terms of a *commissionaire* agreement would therefore fall outside the scope of a dependent agent as it concluded contracts in its own name (OECD, 2015d:10).

In response to the use of *commissionaire* and similarly structured agreements, action point seven of the BEPS action plan proposed that the definition of a dependent agent be expanded to include an agent that “plays the principal role leading to the conclusions of contracts” (OECD, 2015d:16). The existence of a dependent agent on the basis of the aforementioned criteria is subject thereto, however, that the agent “routinely” concludes these contracts “without material modification” by its principal (OECD, 2015d:16). In terms of the amended provisions, PE status could no longer be avoided, *prima facie*, by either concluding contracts in the name of the agent or by performing mere formalities, such as the signing of contracts, outside the market country.

It would appear that the amendments to the dependent agent provisions entail a substance over form approach, which requires the principal to consider where the “substantive activities” leading up to the conclusion of contracts are performed (OECD, 2015d:19). Should these “substantive activities” be performed in the market country, a PE may be created under the amended provisions where one previously did not exist (OECD, 2015d:19).

4.2.2 Proposed amendments to the exception paragraph of the OECD MTC

As stated in 1.3.1, the proposed amendments to the exception paragraph of the OECD MTC aim to impose more onerous requirements for qualifying for the exception to the primary rule of a PE. Essentially, action point seven proposed that all activities should have a “preparatory or auxiliary character to qualify for the exception from PE status, regardless of whether those activities are explicitly listed in the exception paragraph of the OECD MTC or not (OECD, 2015d:29).

Prior to the amendment, an entity would automatically fall short of PE status should its presence in the market country be limited to the activities explicitly listed in the exception paragraph of the OECD MTC. Examples of such activities include storage, delivery and procurement of goods, which represent activities typically associated with that of a retail

business (OECD, 2015e:M-16). In terms of the amended paragraph, an enterprise is required to consider, taking into account both qualitative and quantitative factors, whether each of the activities performed from a particular place of business is of a “preparatory or auxiliary” character (OECD, 2015d:29-30). The assessment is case specific and should be performed in the context of an enterprise’s own business model (OECD, 2015d:29-30).

It is submitted that the proposed amendments above are especially relevant in the context of Figure 2.1, for the following reasons:

1. Figure 2.1 involves two agent relationships, namely third-party delivery couriers and internet service providers. The proposed amendments to the dependent agent provisions may impact whether these parties are regarded as “dependent” agents, and may subsequently impact the PE status of Company A in Figure 2.1.
2. The OECD’s online retail structure, which forms the basis of Figure 2.1, typically avoids PE status by limiting its presence in the market country to activities that fall within the scope of the exception paragraph of the OECD MTC (OECD, 2015a:170). Any amendments to the exception paragraph could potentially impact the PE status, and therefore the liability to tax, of Company A in Figure 2.1.

Given the significance of the proposed amendments in the context of this study, the extent, if any, to which South Africa is bound to adopt these amendments when interpreting the PE concept should be considered. This investigation is conducted and discussed under 4.3 below.

4.3 The potential legislative impact of the proposed amendments on the interpretation of a PE in South Africa

As stated in 3.4.2, South African tax law has incorporated the PE concept in two capacities. The concept is primarily found in South African DTAs, but has also been incorporated in a number of sections in domestic legislation. In this regard the PE concept has also been incorporated in section 9(2)(k)(ii) of the Income Tax Act, which is the focus of this study. Although the study is focused on the use of a PE in its domestic context, it is submitted that the concept of a PE in South African DTAs and domestic legislation are inextricably linked. This view is supported below.

DTAs are incorporated into South African tax law through section 108(2) of the Income Tax Act. In terms of section 108(2) of the Income Tax Act read with section 231(2) of the Constitution, a DTA entered into by South Africa will obtain the full force of domestic law

as soon as the DTA is approved by Parliament and notification of such approval is published in the Government Gazette. Once domesticated into law, a DTA has the same legal status and creates the same statutory obligations as any other provision of the Income Tax Act (De Koker & Brinckler, 2010:par 12.7).

A question that typically arises when interpreting DTAs in South Africa concerns how the provisions of a DTA will interact with the relevant provisions of domestic legislation. In this regard, De Koker and Brinckler (2010:par 12.7) provide the following guidance:

- The provisions of a DTA cannot create or increase a person's liability to tax (De Koker & Brinckler, 2010:par 12.7).
- The wording of section 108(1) of the Income Tax Act indicates that the purpose of a DTA is the "prevention, mitigation or discontinuance of the levying ... of tax in respect of the same income, profits or gains." A DTA should therefore be interpreted in a manner that limits an existing South African tax liability, where applicable (De Koker & Brinckler, 2010:par 12.7).

The aforementioned findings may be applied to this study as follows:

- If section 9(2)(k)(ii) of the Income Tax Act does not apply to a non-resident online retailer, the existence of a DTA, where applicable, cannot create a South African tax liability for that online retailer.
- If section 9(2)(k)(ii) of the Income Tax Act does apply to a non-resident online retailer, the relevant DTA, where applicable, may limit the South African tax liability imposed on that online retailer so as to prevent double taxation, potentially reducing the tax liability to zero.

It was established in 3.3.3 that the concept of a PE in the OECD MTC and in section 9(2)(k)(ii) of the Income Tax Act fulfils a similar purpose. Both article 7 of the OECD MTC and section 9(2)(k)(ii) of the Income Tax Act use the PE as a threshold for non-resident online retailers to create a taxable presence in South Africa. Taking into consideration the principles that apply when interpreting DTAs in a South African context (refer above), it is submitted that the meaning of a PE in a particular DTA may modify the applicability of section 9(2)(k)(ii) of the Income Tax Act to a non-resident online retailer's revenue. If, for example, a non-resident online retailer meets the requirements of a PE in section 9(2)(k)(ii), but does not meet the threshold as defined in the relevant DTA, the DTA will limit that online retailer's South African tax liability to zero. Should, however, the PE definition be met in a DTA context, but not for the purposes of section 9(2)(k)(ii) of the

Income Tax Act, no South African tax liability arises as a DTA cannot create a tax liability for a person.

Following the investigation discussed above, it is submitted that the tax liability imposed on non-resident online retailers in terms of section 9(2)(k)(ii) also depends on the existence of a DTA, which could potentially eliminate the tax liability imposed in terms of section 9(2)(k)(ii). On this basis, the proposed amendments in action point seven of the BEPS action plan should be considered in the context of both section 1 of the Income Tax Act and the DTA's entered into by South Africa in terms of section 108(2) of the Income Tax Act. This assessment is performed below.

4.3.1 The definition of a PE in section 1 of the Income Tax Act

It was established in 3.4.1 that the use of the phrase “from time to time” in the definition of a PE in section 1 of the Income Tax Act indicates that South Africa follows the definition of a PE as stipulated in the most recent version of the OECD MTC. Any amendments to the OECD MTC's definition of a PE are therefore equally relevant to the definition of a PE in section 1 of the Income Tax Act. The impact of the proposed amendments in the context of the definition of a PE in section 1 of the Income Tax Act therefore depends on the OECD's intention to incorporate these amendments in a subsequent version of the OECD MTC.

The definition of a PE in section 1 of the Income Tax Act is currently linked to the 2014 version of the OECD MTC, which is the latest version in issue. The following version of the OECD MTC is scheduled for release late in 2017 (OECD, 2017e). The OECD released the “Draft Contents of the 2017 update to the OECD MTC” (2017 Draft Update) on 11 July 2017 (OECD, 2017e). The 2017 Draft Update specifically includes the recommendations set forth in the BEPS action plan, including the proposed amendments to the PE definition in action point seven (OECD, 2017f:12-13).

Although the 2017 Draft Update has not been approved by the OECD's Committee on Fiscal Affairs, significant sections of the document have already been approved by the OECD member and G20 countries as part of the BEPS action plan (OECD, 2017d). On the basis that formal approval has already been obtained for the recommendations of the BEPS action plan, the OECD (2017d) has not requested public commentary on these sections. It is therefore submitted that the amendments proposed to the PE definition in action point seven of the BEPS action plan will be included in the following version of the OECD MTC. On the basis that South Africa adopts the definition of a PE in the most recent version of the OECD MTC, the amendments proposed to the PE definition in action

point seven of the BEPS action plan will apply to the interpretation of a PE in section 1 of the Income Tax Act upon release of the next version of OECD MTC.

4.3.2 The interpretation of a PE in South African DTAs

Taking into consideration the requirements of section 108(2) of the Income Tax Act, any amendment to a South African DTA will only become binding if the following requirements are met:

- Firstly, South Africa must renegotiate the provisions of the DTA with the other contracting state. This renegotiation must lead to both parties formally signing the amended DTA.
- Secondly, the signed DTA, as amended, must be approved by Parliament and notice of such approval published in the Government Gazette (section 108(2) of the Income Tax Act).

The proposed amendments to the PE definition in action point seven of the BEPS action plan will only apply to the interpretation of the PE concept in South African DTAs if the aforementioned requirements are met. Assuming that the proper procedure is followed, it should also be noted that the amended DTA will only apply to cross-border transactions with residents of the other contracting state to the DTA. As a result of the burdensome legislative process that will be required by local governments, such as South Africa, to renegotiate and enact bilateral tax treaties to reflect the recommendations of the BEPS action plan, the OECD developed the “multilateral instrument” (OECD, 2016b:2). The multilateral instrument is the product of the recommendations included in the action points of the BEPS action plan and aims to provide countries with a swift means by which to implement these recommendations (OECD, 2016b:2-3).

The multilateral instrument is especially relevant to this study given that the proposed amendments to the PE definition in action point seven of the BEPS action plan are incorporated in the text thereof (OECD, 2016b:2-3). Depending on South Africa’s intention to implement the multilateral instrument, the proposed amendments to the PE definition may become binding from a South African DTA perspective. A basic understanding of the multilateral instrument and South Africa’s participation in the implementation thereof are investigated in 4.3.3 below.

4.3.3 An overview of the multilateral instrument – a South African perspective

As stated in 4.3.2, the aim of the OECD's multilateral instrument is to serve as a swift means by which countries can amend their bilateral tax treaties to reflect the recommendations in the BEPS action plan (OECD, 2016b:2-3). The multilateral instrument will not replace existing tax treaties, but rather modify the application of an existing DTA, where applicable (OECD, 2016b:2-3). The text of the multilateral instrument was accepted on 24 November 2016 by an ad-hoc group that was assigned to its development by the OECD member and G20 countries (OECD, 2016b:3). South Africa confirmed its intention to participate in the implementation of the multilateral instrument by signing the instrument, subject to certain reservations, among 75 other countries on 7 June 2017 (OECD, 2017c:3).

The OECD MTC currently forms the basis of more than 3000 bilateral tax treaties entered into worldwide (OECD, 2016b:1). Included in this figure is the network of South African DTAs that are based on the OECD MTC. Due to the enormous scope of tax treaties that the multilateral instrument seeks to modify, the text of the instrument provides a number of options, reservations and compatibility clauses that provide governments with the necessary flexibility to renegotiate existing DTAs on a case-by-case basis (OECD, 2016b:3-5). In this regard governments may specify their positions on, *inter alia*, the following matters:

- 1) The bilateral tax treaties that they wish to be included in the scope of the multilateral instrument (OECD, 2016d:3). Participating governments may elect that certain DTAs do not fall within the scope of the multilateral instrument.
- 2) The options that they wish to apply under the respective articles of the multilateral instrument, where available (OECD, 2016d:3-5). In this regard, it should be noted that a participating government may select different options for the individual DTAs it has placed within the scope of the multilateral instrument in accordance with point 1 above (OECD, 2016d:3-5). This provides the necessary flexibility to amend DTAs on a country-by-country basis, therefore taking into consideration the specific economic relationships with each state.

Notwithstanding the ability of participating governments to specify their positions on specific matters, it should be noted that the multilateral instrument includes a number of so-called "minimum standards" that cannot be modified (PriceWaterhouseCoopers, 2016b:2). This means that a participating government may not take an alternative position

or make a reservation in respect of these standards (PriceWaterhouseCoopers, 2016b:2). The “minimum standards” only apply, however, if a participating government has placed the relevant DTA within the scope of the multilateral instrument.

The amendments proposed to the definition of a PE in action point seven of the BEPS action plan have not been included as a “minimum standard” of the multilateral instrument (OECD, 2016d:39-46). The articles in the multilateral instrument that are relevant to the definition of a PE provide participating governments with a number of options, including the option that the amendments should not apply (OECD, 2016d:39-46). The circumstances under which the multilateral instrument may impact the interpretation of a PE in South African DTAs should be considered, given that South Africa has signed the multilateral instrument. This assessment is performed in 4.3.4 below.

4.3.4 Circumstances under which the multilateral instrument will modify the interpretation of a PE in South African DTAs

For the purposes of this section, it is first necessary to consider the options and reservations South Africa has made upon signing the multilateral instrument on 7 June 2017. It was established in 4.2 that the proposed amendments to the PE definition may be separated into two categories, namely amendments to the dependent agent provisions and amendments to the exception paragraph of the OECD MTC. South Africa’s position on the aforementioned categories is considered individually below.

1) South Africa’s position on the proposed amendments to the dependent agent provisions

The proposed amendments to the dependent agent provisions are stipulated in article 12 of the multilateral instrument (OECD, 2016c:19-20). South Africa has indicated that it will not pursue the amendments in respect of the dependent agent provisions (South Africa, 2017:33). Consequently, the multilateral instrument will not modify the application of the dependent agent provisions in existing South African DTAs.

2) South Africa’s position on the proposed amendments to the exception paragraph of the OECD MTC

The proposed amendments to the exception paragraph of the OECD MTC are stipulated in article 13 of the multilateral instrument (OECD, 2016c:20-22). In contrast to the position on the dependent agent amendments, South Africa has indicated that it intends to pursue the

modification of existing DTAs for the amendments proposed to the exception paragraph of the OECD MTC (South Africa, 2017:34-35).

It should be noted that article 13 of the multilateral instrument provides participating governments with two options, namely Option A and Option B, in pursuing the amendments to the exception paragraph of the OECD MTC (South Africa, 2017:34-35). South Africa elected to pursue Option A (South Africa, 2017:34). Option A represents the more onerous of the two options and reflects the recommendations set forth in action point seven of the BEPS action plan (OECD, 2016d:43-44). The meaning of the amendments proposed to the exception paragraph of the OECD MTC in action point seven of the BEPS action plan are considered in 4.4.

Given that DTAs are bilateral instruments, South Africa cannot unilaterally modify the application of an existing DTA by signing the multilateral instrument. The multilateral instrument will only modify an existing DTA if the options, reservations and compatibility clauses selected by the other contracting state to the DTA can appropriately be “matched” to those selected by South Africa (OECD, 2016b:4-6). The steps required for the proposed amendments to the exception paragraph of the OECD MTC to modify the application of an existing South African DTA are briefly summarised in Table 4.1.

Table 4.1: The steps required for the multilateral instrument to modify the application of the exception paragraph of the OECD MTC in existing South African DTAs	
Step	Requirement
1	The multilateral instrument itself must be in force (OECD, 2017g:1). In terms of article 34 of the multilateral instrument, the instrument comes into force within a period of three months after the fifth contracting state has deposited its instrument of ratification, acceptance or approval (OECD, 2017g:1). The “approval” instrument above essentially represents the necessary proof that the multilateral instrument has been incorporated in a country’s domestic legislation (OECD, 2017g:1). The procedures necessary to incorporate the multilateral instrument in a country’s domestic legislation depend on the specific country’s legal requirements (OECD, 2017g:1).
2	The multilateral instrument must be in force in terms of the domestic legislation of both contracting states to the DTA (OECD, 2017g:1). This means that both contracting states must ratify the instrument in their domestic

	legislation (OECD, 2016b:6). From a South African perspective, this requires that the multilateral instrument is approved by Parliament and notification of such approval is published in the Government Gazette (section 108(2) of the Income Tax Act). The process of ratification for the other contracting state will depend on that state's legal requirements (OECD, 2016b:6).
3	Upon signing the multilateral instrument, both contracting states should have placed the relevant DTA within the scope of the multilateral instrument (OECD, 2017g:1). If either of the states indicated that the DTA will not fall within the scope of the multilateral instrument, the provisions of the multilateral instrument will not modify the interpretation of that DTA.
4	As previously stated, article 13 of the multilateral instrument provides participating governments with two options within which to pursue the amendments to the exception paragraph of the OECD MTC, as well as the option that these amendments will not apply (OECD, 2017g:1). For article 13 to modify the interpretation of a PE in a particular DTA, both contracting states are required to select the same option and neither one is to make a reservation in respect of article 13 (OECD, 2017g:1). Taking into consideration that South Africa has selected Option A, the other contracting state must also have elected to pursue Option A under article 13 of the multilateral instrument. If the other contracting state made a reservation in respect of article 13 or elected for Option B to apply, the proposed amendments to the exception paragraph of the OECD MTC in article 13 of the multilateral instrument will not modify the interpretation of a PE in the particular DTA.

Table 4.1 specifically applies to the amendments to the exception paragraph of the OECD MTC in article 13 of the multilateral instrument. However, the principles in Table 4.1 are equally relevant for determining whether other articles in the multilateral instrument will modify existing South African DTAs. Where the impact of the multilateral instrument on a particular South African DTA is considered, an evaluation similar to that presented in Table 4.1 should be performed per article of the multilateral instrument.

4.3.5 Conclusion on the potential legislative impact of the proposed amendments on non-resident online retailers in South Africa

From the aforementioned investigation it appears that the potential legislative impact of the proposed amendments to the definition of a PE in South Africa will depend, *inter alia*, on whether a DTA exists. On this basis, the potential impact of the proposed amendments on non-resident online retailers in South Africa should be considered separately for those residing in DTA and non-DTA countries in relation to South Africa. This assessment is performed and discussed below.

1) Non-resident online retailers residing in DTA countries

Where a non-resident online retailer resides in a country with which South Africa has entered into a DTA, the online retailer's South African tax liability is subject to the existence of a PE as defined in the particular DTA. In the absence of a PE as defined in the DTA, any South African tax liability imposed on the online retailer in terms of section 9(2)(k)(ii) of the Income Tax Act is limited to zero. Following the investigation in 4.3.3, the potential impact of the proposed amendments on the interpretation of a PE in South African DTAs depends on South Africa's participation in the multilateral instrument. In this regard, it should be noted that the multilateral instrument will not modify the dependent agent provisions currently stipulated in South African DTAs as South Africa has elected not to apply these amendments in its participation of the multilateral instrument.

The proposed amendments to the exception paragraph of the OECD MTC in article 13 of the multilateral instrument may however modify the interpretation of the PE concept in South African DTAs if certain requirements are met. These requirements are stipulated in Table 4.1 and should be considered on a country-by-country basis. As a general rule, the proposed amendments to the exception paragraph of the OECD MTC will not modify a particular South African DTA if either of the following conditions is present:

- The foreign contracting state did not sign the multilateral instrument.
- Either South Africa or the foreign contracting state elected the particular DTA not to be within the scope of the multilateral instrument.
- Either South Africa or the foreign contracting state did not ratify the multilateral instrument domestically.
- The foreign contracting state has made a reservation in respect of article 13 to the multilateral instrument.

- The foreign contracting state has not selected to apply Option A under article 13 of the multilateral instrument.

2) **Non-resident online retailers residing in non-DTA countries**

In the absence of a DTA, a non-resident online retailer will be subject to the definition of a PE as stipulated in section 1 of the Income Tax Act. It was shown in 4.3.1 that the OECD intends to include both the amendments to the dependent agent provisions and the amendments to the exception paragraph of the OECD MTC in the updated version of the OECD MTC, which is scheduled for release late in 2017. On the basis that the South African definition of a PE is linked to that of the OECD MTC, the proposed amendments to the PE definition will become binding on non-resident online retailers residing in non-DTA countries upon release of the next version of the OECD MTC.

From the investigation discussed above, it appears that non-resident online retailers in non-DTA countries will be the first to be impacted by the proposed amendments in action point seven of the BEPS action plan. Furthermore, whereas non-resident online retailers residing in non-DTA countries will be impacted by both the amendments to the dependent agent provisions and the exception paragraph of the OECD MTC, non-resident online retailers residing in DTA countries could only be impacted by the amendments to the exception paragraph of the OECD MTC. As the proposed amendments to the exception paragraph of the OECD MTC are relevant to the interpretation of a PE in both domestic legislation and South African DTAs, the meaning of these amendments are considered further in the discussion in 4.4 below.

4.4 **The meaning of the proposed amendments to the exception paragraph of the OECD MTC**

A “subparagraph” in this section refers to a subparagraph to the exception paragraph of the OECD MTC, unless stated otherwise. Action point seven of the BEPS action plan proposed the following amendments to the exception paragraph of the OECD MTC:

*Replace paragraph 4 of Article 5 by the following (changes to the existing text of the paragraph appear in **bold italics** of additions and strikethrough for deletions):*

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

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

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character. (OECD, 2015d:28-29)

It appears that the operative term to the proposed amendments is “preparatory or auxiliary”. In terms of the unrevised exception paragraph of the OECD MTC the requirement for an activity to have a “preparatory or auxiliary” character was reserved to subparagraphs (e) and (f) (OECD, 2015e:M-16). Subparagraph (e) provides the general scope of activities that are not explicitly listed in subparagraphs (a) to (d), the latter merely being examples of activities that generally have a “preparatory or auxiliary” character (OECD, 2015e:C(5)-13). Subparagraph (f), on the other hand, applies to scenarios in which a combination of activities that individually qualify for the exception to the primary rule of a PE are performed from the same place of business (OECD, 2015e:C5-16).

In terms of the revised exception paragraph of the OECD MTC, an activity must have a “preparatory or auxiliary” character whether that activity is explicitly listed in subparagraphs (a) to (d) or not (OECD, 2015d:28-29). From the aforementioned, the following inferences could be made:

- Activities that previously fell within the scope of subparagraphs (e) or (f) should not be impacted by the proposed amendments as these activities were subject to the “preparatory or auxiliary” requirement already.

- The activities that should be impacted by the proposed amendments are those that qualified for the exception to the primary rule of a PE in terms of subparagraphs (a) to (d). Under the unrevised paragraph, a place of business used solely for either of the activities in subparagraphs (a) to (d) would not lead to a PE for an enterprise. Essentially, subparagraphs (a) to (d) previously acted as automatic qualification for the exception to the primary rule of a PE, provided that an enterprise's presence at a particular place of business was limited to the activities stipulated therein. Under the amended exception paragraph of the OECD MTC, the activities in subparagraphs (a) to (d) would only qualify for the exception if they are also concluded to have a "preparatory or auxiliary" character.

There are no single definitions for the words "preparatory" or "auxiliary". However, action point seven of the BEPS action plan proposed certain amendments to the existing commentaries on article 5 of the OECD MTC which, *inter alia*, provides additional guidance with regard to activities that have a "preparatory or auxiliary" character (OECD, 2015d:29-30). In this regard, the discussion in 3.4.4 already established that the OECD commentaries represent a source of strong persuasive evidence in South African arguments. Consequently, the updated OECD commentaries should provide a basis from which to establish the meaning and impact of the proposed amendments from a South African tax perspective. The meaning of the phrase "preparatory or auxiliary" is considered further in 4.4.1 below.

4.4.1 The meaning of "preparatory or auxiliary"

Neither the Income Tax Act nor the Tax Administration Act provides definitions for the words "preparatory" or "auxiliary". Where words have not been assigned specific definitions, the South African principles of statutory interpretation dictate that the words should be ascribed their ordinary meaning (Goldswain, 2012:37). The Oxford English Dictionary (2017) provides the following definitions for the words "preparatory" and "auxiliary":

Preparatory (adj.)

"An act, procedure, or circumstance that prepares the way for, or is performed in preparation for, something else; a preliminary..."

Auxiliary (adj.)

"Helpful, assistant, affording aid, rendering assistance, giving support ..."

The ordinary meaning of “preparatory” suggests an activity that precedes or prepares for an activity to come. Reimer (2015:381) provides the following examples of activities that generally prepare for future activities: “market research, ... the acquisition of operating assets, interviews with potential future employees, the collecting of capital for the start-up for an industrial or commercial enterprise...”. These examples tend to illustrate activities that are performed prior to the commencement of an enterprise’s income-generating operations.

The definition of “auxiliary”, on the other hand, denotes an activity which is performed in support of other activities. The aforementioned characteristic is evidenced by the following examples of “auxiliary” activities provided by Reimer (2015:381): “advertising or the supply of marketing information or of scientific research”. Provided that an enterprise does not generate revenue from advertising services or the sale of information, the aforementioned activities are generally not causal to the generation of an enterprise’s revenue. They rather support revenue-generating activities by, for example, attracting new customers or providing the enterprise with the necessary information to potentially increase its capacity to earn revenue.

The ordinary meanings of “preparatory” and “auxiliary” provide limited guidance on the application of these words in the context of the exception paragraph of the OECD MTC. As previously stated, the revised OECD commentaries on the exception paragraph of the OECD MTC in action point seven of the BEPS action plan includes guidance that illustrates how these words should be interpreted. On the basis that the official OECD commentaries may be used as persuasive evidence in South Africa (see 3.4.4), the sections of the revised commentaries that are relevant to this study are investigated in 4.4.2 below.

4.4.2 The revised OECD commentaries on the exception paragraph of the OECD MTC

The revision of the OECD commentaries on the exception paragraph of the OECD MTC led to the amendment, deletion or introduction of entirely new paragraphs in the existing commentaries (OECD, 2015d:29-38). To a substantial degree, the amendments clarify how the “preparatory or auxiliary” character requirement should be applied to subparagraphs (a) to (d), which likely is due to the fact that this requirement previously did not apply to these subparagraphs (OECD, 2015d:29-38).

The following principles regarding activities that have a “preparatory or auxiliary” character as established in 3.4.5.3 have remained unchanged in action point seven of the BEPS action plan:

- The decisive criteria for activities with a “preparatory or auxiliary” character is whether or not the activity forms an essential or significant part of an enterprise’s business as a whole (OECD, 2015e:C5-14). If it is concluded that a specified activity does not form an essential or significant part of a particular business, that activity will have a “preparatory or auxiliary” character. This assessment is case specific and should take into account the particular facts of an enterprise’s business model (OECD, 2015e:C5-14).
- Where the general purpose of a place of business is identical to the purpose of the enterprise as a whole, the activities performed from that place of business will not have a “preparatory or auxiliary” character (OECD, 2015e:C5-15).

Notwithstanding these principles, there are a number of instances in which action point seven of the BEPS action substantially amended or introduced new paragraphs in the commentary on the exception paragraph of the OECD MTC. In the context of this study it should be considered which of these amendments, if any, may impact the PE status of Company A presented in Figure 2.1.

In order to identify the sections of the revised OECD commentaries that are relevant to Company A’s PE status, it should first be determined which elements of Figure 2.1 are impacted by the exception paragraph of the OECD MTC. Chapter 3 concluded that the South African branches of Company A should satisfy the primary rule of a PE. However, on the basis that the warehousing and after-sales support activities performed by the branches fall within the scope of the unamended exception paragraph of the OECD MTC, it was concluded that no PE should arise on account of these activities.

In arriving at the aforementioned conclusion, it was found that the warehousing activities qualified for the exception from PE status in terms of subparagraph (a), while the after-sales activities qualified for the exception from PE status in terms of subparagraph (e). From the assumption that the warehousing and after-sales activities are performed from the same place of business, it was established that the overall activity should qualify for exception in terms of subparagraph (f).

With Company A’s exception from PE status relying on the provisions in subparagraphs (a), (e) and (f), the sections of the revised OECD commentaries that are relevant to these

subparagraphs should be considered further. To this end, Table 4.2 identifies three paragraphs to the revised OECD commentaries on the exception paragraph that may impact the PE status of Company A as in Figure 2.1. References to a “paragraph” in this section signifies a paragraph in the revised OECD commentaries on article 5, as stipulated in action point seven of the BEPS action plan.

Table 4.2: Paragraphs from the revised OECD commentaries on the exception paragraph of the OECD MTC that may impact the PE status of Company A as illustrated in Figure 2.1	
Paragraph	Key matters discussed
Paragraph 21.2	This paragraph was added in its entirety to the revised OECD commentaries (OECD, 2015d:30). The paragraph provides general guidance on activities that have a “preparatory or auxiliary” character and includes popular examples of such activities (OECD, 2015d:30).
Paragraphs 22 and 22.1	Paragraphs 22 and 22.1 provide guidance on the application of the “preparatory or auxiliary” requirement to the activities listed in subparagraph (a) of the exception paragraph of the OECD MTC (OECD, 2015d:31). Subparagraph (a) pertains to activities of “storage ... or delivery of goods”, which represent the activities generally associated with that of a warehouse (OECD, 2015d:28). Both paragraphs provide examples which illustrate how the “preparatory or auxiliary” requirement may impact the applicability of subparagraph (a) to an enterprise, with specific reference being made to online retailers in paragraph 22 (OECD, 2015d:28).

Given the general nature of the guidance provided in paragraph 21.2, this paragraph should apply to both the after-sales support and the warehousing activities performed by Company A’s South African branches as in Figure 2.1. However, as paragraphs 22 and 22.1 are specifically directed towards storage and delivery activities, the guidance in these paragraphs will only apply to Company A’s warehousing activities in South Africa. The paragraphs identified in Table 4.2 are investigated in further detail below.

Paragraph 21.2

As stated in Table 4.2, paragraph 21.2 provides general guidance on the meaning of the words “preparatory” or “auxiliary”, which may be applied to all activities considered in terms of the exception paragraph of the OECD MTC. The guidance, *inter alia*, illustrates the typical relationship between a “preparatory” or “auxiliary” activity and the essential or significant part of an enterprise’s overall business (OECD, 2015d:30). In this regard the paragraph states that a “preparatory” activity precedes and is performed “in contemplation” of the essential or significant part of an enterprise’s overall business (OECD, 2015d:30). On the other hand, an “auxiliary” activity supports the essential or significant part of an enterprise’s overall business without becoming a part thereof (OECD, 2015d:30). The guidance mentioned above bears strong resemblance to the ordinary meaning of the words “preparatory” and “auxiliary” investigated in 4.4.1 and may likely be deduced therefrom.

In addition to the above, paragraph 22.1 provides a number of general rules that may be used when identifying activities that have a “preparatory” or “auxiliary” nature (OECD, 2015d:30). These rules are stipulated below:

- 1) Activities with a “preparatory” character are generally carried on for relatively short periods of time (OECD, 2015d:30). There is no specific passage of time after which an activity will cease to be “preparatory” (OECD, 2015d:30). This assessment should be performed in the context of an enterprise’s own business (OECD, 2015d:30).
- 2) An activity that requires the allocation of significant assets and employees of an enterprise, could not be considered as “auxiliary” to the essential or significant part of the enterprise’s overall business (OECD, 2015d:30).

Point 1 above should not apply to Company A’s warehousing and after-sales support activities on the assumption that these activities will be carried on continuously in the furtherance of Company’s online sales business and therefore not be temporary in nature. Point 2, on the other hand, may, pending further investigation, apply to Company A’s South African branches and is therefore given further consideration below.

The view expressed in point 2 above is shared by Reimer (2015:380-381). Reimer (2015:380) states that activities could be characterised as “preparatory” or “auxiliary” with reference to either relative or absolute standards. Reimer (2015:380) illustrates the difference between the application of a relative and absolute standard with the following example: Two multinational enterprises, company A and company B, are involved in the

delivery of goods to consumers (Reimer, 2015:380). Where company A is involved in the manufacturing, delivery and sale of goods to consumers, company B specialises exclusively in delivery (Reimer, 2015:380).

On the basis of an absolute standard, the delivery activity, by its nature, would be considered “preparatory or auxiliary” for both companies (Reimer, 2015:380). However, should a relative standard be applied, the delivery services performed by company B should not be “preparatory or auxiliary” on the basis that company B would allocate significant assets and employees to the fulfilment of its core activity (Reimer, 2015:380). Reimer (2015:380) concludes that the application of relative standards in applying the “preparatory or auxiliary” requirement is supported by most authors.

In terms of a relevant standard, the meaning of the words “preparatory” and “auxiliary” should be determined with reference to the facts of a particular enterprise (Reimer, 2015:380). Reimer (2015:381) provides the following criteria that may be used when performing this assessment:

- An activity should be regarded as “preparatory or auxiliary” to a particular enterprise if it does not have “more than a marginal relevance” to the overall business of that enterprise (Reimer, 2015:381). This assessment is not merely based on a particular activity’s contribution to the net profit of an enterprise (Reimer, 2015:381). The assessment should take into account factors such as the type, intensity and frequency of an activity in relation to the overall business of an enterprise (Reimer, 2015:381).
- A place of business should not qualify for the exception from PE status if that place exceeds a certain size in relation to the overall business of an enterprise or if that place operates with a sufficient degree of autonomy and “professional entrepreneurship” (Reimer, 2015:381).

Following the investigation above, the following have to be considered when identifying activities with a “preparatory” or “auxiliary” character:

- 1) The assets and employees allocated to a place of business in relation to the total assets and employees of an enterprise.
- 2) The type, intensity and frequency of the activity in relation to the overall business of an enterprise.
- 3) The degree of autonomy and “professional entrepreneurship” with which the relevant place of business is operated.

Paragraph 22

Concurrent with Reimer's (2015:380) view on relative standards, paragraph 22 states that the assessment of activities with a "preparatory or auxiliary" character will depend, *inter alia*, on the specific business of an enterprise. Paragraph 22 provides the following example that is specific to the industry of online retail: An online retailer operates a large warehouse that employs a substantial number of employees (OECD, 2015d:31). The warehouse facilitates the storage and delivery of goods ordered by consumers through the internet (OECD, 2015d:31). Assuming that the warehouse constitutes a significant asset in relation to the online retailer's overall business and that the operation of the warehouse requires a substantial number of employees, the activities performed from that warehouse will not qualify for the exception from the primary rule of a PE (OECD, 2015d:31).

The example in paragraph 22 is based on a scenario in which the particular warehouse is a "significant asset" in relation to an online retailer's total business value and that the particular warehouse requires a substantial number of employees in relation to the online retailer's total workforce (OECD, 2015d:31). It should therefore not be considered conclusive that all warehouses operated by online retailers would henceforth fall outside the scope of the exception paragraph of the OECD MTC. The assessment remains case specific and would require consideration of, *inter alia*, the factors noted under the investigation discussed in paragraph 21.2 above.

Paragraph 22.1

Paragraph 22.1 provides the following two examples of warehousing activities that are regarded to have a "preparatory or auxiliary" character:

1. A fruit exporter that maintains a specialized warehouse in the importing state for purposes of storing goods during the customs clearance process (OECD, 2015d:31).
2. An enterprise that sells machinery to consumers, while maintaining a warehouse in the market country that provides spare parts to that particularly machinery as and when required by consumers (OECD, 2015d:31).

These examples do not have direct bearing on an online retailer such as Company A which sells a range of different goods to a potentially vast consumer base. Consequently, these examples were not considered further.

4.5 Application of the proposed amendments to the exception paragraph of the OECD MTC to Figure 2.1

For the purpose of comparison, application of the unamended PE provisions illustrated in Figure 2.1 as discussed in Chapter 3 is briefly revisited below. It was concluded in Chapter 3 that no PE should arise in the context of Figure 2.1 for the following reasons:

1. Even though the South African branches of Company A should meet the primary rule of a PE, no PE is created because both the warehousing and the after-sales activities performed by the branches qualify for the exception to the primary rule of a PE.
2. The third-party delivery couriers and internet service providers used by Company A should not lead to a PE on the basis of being agents of independent status.

The impact of the delivery couriers and internet service providers on Company A's PE status should remain unaffected on the basis that action point seven of the BEPS action plan made no recommendations in respect of the independent agent provisions. However, given that Company A's South African branches previously qualified for the exception paragraph of the OECD MTC, it should be considered whether the activities performed by the branches still qualify for the exception from PE status after the proposed amendments are implemented. The potential impact of the proposed amendments on the after-sales and warehousing activities performed by Company A's South African branches are considered separately below.

4.5.1 Application of the proposed amendments to Company A's after-sales support activities

The exception paragraph of the OECD MTC does not provide a specific exception for services such as providing after-sales support to consumers. Notwithstanding, it was established in 3.5.2 that the after-sales support activities should qualify for the exception from PE status in terms of subparagraph (e). As subparagraph (e) was subject to the "preparatory or auxiliary" requirement prior to the proposed amendments to the exception paragraph of the OECD MTC, action point seven of the BEPS action plan should not impact the aforementioned conclusion. Provided that the call centres operated by Company A are neither regarded as a significant asset of Company A's total business nor employ a significant number of Company A's total workforce, the after-sales activities should still qualify for the exception to the primary rule of a PE after the proposed amendments are implemented.

4.5.2 Application of the proposed amendments to Company A's warehousing activities

As was explained in 3.5.2, the warehousing activities performed by Company A will qualify for the exception from PE status in terms of subparagraph (a) to the exception paragraph of the OECD MTC. In terms of the revised exception paragraph of the OECD MTC, the warehousing activities will only qualify for the exception if it is also concluded that these activities are “preparatory or auxiliary” in relation to Company A's overall business.

The revised OECD commentaries on the exception paragraph of the OECD MTC make specific reference to the application of the “preparatory or auxiliary” requirement to online retailers such as Company A. In this regard, the commentaries state that activities conducted from a large warehouse which employs a significant number of personnel will not have a “preparatory or auxiliary” character. However, the revised commentaries do not provide specific thresholds at which the size or workforce of Company A's warehouses will cause the activities performed from these warehouses to fall outside the scope of the exception paragraph of the OECD MTC, resulting in a South African PE for Company A. The assessment above is case specific and should be considered in the context of Company A's overall business. The following factors should be taken into consideration when determining whether Company A's warehousing activities have a “preparatory or auxiliary” character:

- The asset value of the warehouses in relation to Company A's total asset value.
- The amount of staff members employed by the warehouses in relation to Company A's total workforce.
- The degree of autonomy and entrepreneurship with which the warehouses are allowed to operate.

Figure 2.1 does not provide the necessary facts to perform a detailed assessment of the aforementioned factors. Broadly speaking, the risk that Company A's warehousing activities will not be “preparatory or auxiliary” will increase according to increases in the following:

- The percentage of Company A's total asset value that is attributable to the warehouses.
- The percentage of Company A's total workforce that are employed by the warehouses.
- The degree of autonomy with which the warehouses operate.

The potential impact of the proposed amendments to the exception paragraph of the OECD MTC may also be illustrated by comparing the following examples of multinational online retailers:

Example 1

Company X is a multinational online retailer. Company X has a corporate head office in Ireland from where strategic and overall management, procurement and all other value-chain management functions are performed. Company X sells its products through the internet to multiple African and European countries, among these South Africa. Company X has a number of large warehouses in Germany. Purchases are originally shipped to the German warehouses, after which the products are redistributed to smaller operational warehouses in Company X's market countries, including South Africa.

Example 2

Company Y is a multinational online retailer. Company Y has a corporate head office in Ireland from where financial and management functions are performed. Company Y sells its products through the internet to South African consumers. Company Y has a number of large South African warehouses, each of which is responsible for its own general management and procurement functions. The South African warehouses acquire stock locally from approved suppliers.

In terms of the unamended exception paragraph of the OECD MTC, both Company Y and Company X would qualify for the exception to the primary rule of a PE in terms of subparagraph (a). However, subsequent to the implementation of the amendments discussed in this chapter, the aforementioned outcome will depend on whether Company X and Y's warehousing activities are "preparatory or auxiliary" in relation to their respective businesses. Taking into account the facts provided in Examples 1 and 2 above, the following inferences could be made:

- Company X's South African warehouses should contribute a lower percentage to the company's total asset value than the warehouses of Company Y.
- Company X's South African warehouses should require a lower percentage of the company's total workforce than the warehouses of Company Y
- Company X's South African warehouses operate with a lower level of autonomy than those of Company Y.

Taking into consideration the factors mentioned above, Company Y would be more likely to create a South African PE in terms of the revised exception paragraph of the OECD MTC than Company X. A similar assessment could be performed to determine whether a particular online retailer's business model creates PE exposure under the revised exception paragraph of the OECD MTC. When performing the assessment above, the following view expressed by Reimer (2015:380-381) may however also be relevant:

... the strict and exclusive application of relative standards would not do justice to cases where an enterprise .. is so large that places of business which, from an absolute perspective, are respectable entities with valuable assets, a considerable number of employees and fully-fledged bureaucratic and administrative facilities of their own, just seem to be small, preparatory or auxiliary from the perspective of the company's headquarters. If they are still the biggest employer in a given municipality, it is hardly justified from the viewpoint of fiscal equivalence to exempt such place of business under Article 5(4) of the OECD... (Reimer, 2015:380-381)

If the aforementioned view were applied to the facts of Example 1, it is submitted that Company X's South African facilities could not be considered "preparatory or auxiliary" on the sole basis that these facilities are "small, preparatory or auxiliary" in relation to Company X's multinational ventures. If, for example, Company X's South African warehouses represent one of the largest warehouses in a particular industrial district, Reimer (2015:381) takes the view that it would be "hardly justified" that the warehouse in question should be considered "preparatory or auxiliary" to Company X's business. On this basis, it would appear that the "preparatory or auxiliary" requirement should be cognisant of both an enterprise's own business operations and the relative size of those operations in relation to similar place of business in its "municipality" or business district.

4.6 Conclusion

It was established that the legislative impact of the proposed amendments to the exception paragraph of the OECD MTC on non-resident online retailers in South Africa will depend, *inter alia*, on whether an online retailer resides in a DTA or non-DTA country in relation to South Africa. Should an online retailer reside in a non-DTA country, the proposed amendments will apply to that online retailer upon release of the following version of the OECD MTC. This version is scheduled for release late in 2017.

On the other hand, the impact of the proposed amendments on online retailers residing in DTA countries will depend on whether the multilateral instrument modifies the

interpretation of a PE in a particular DTA. The requirements necessary for the multilateral instrument to modify a DTA for the proposed amendments to the exception paragraph of the OECD MTC are summarised in Table 4.2. The assessment of Table 4.2 should be performed with reference to a particular DTA and will not necessarily yield the same result for DTAs entered into with different countries. Broadly speaking, the fact that article 13 of the multilateral instrument provide governments with a number of options in respect of the exception paragraph of the OECD MTC may result in these amendments not applying in a DTA context.

It was established that the operative term to the amendments proposed to the exception paragraph of the OECD MTC is “preparatory or auxiliary”. Essentially, the amendments require that the activities listed in subparagraphs (a) to (d) of the exception paragraph of the OECD MTC must also have a “preparatory or auxiliary” character to qualify for the exception from PE status. Activities that previously qualified for the exception from PE status in terms of subparagraphs (e) and (f) to the exception paragraph of the OECD MTC should not be affected, as these activities were already subject to the “preparatory or auxiliary” requirement prior to the amendments.

The elements in Figure 2.1 that may be impacted by the proposed amendments to the exception paragraph of the OECD MTC are the after-sales support and warehousing activities performed by Company A’s South African branches. The application of the unamended PE provisions to the aforementioned activities in Chapter 3 led to the conclusion that the after-sales support activities should qualify for the exception from PE status in terms of subparagraph (e), while the warehousing activities qualify for the exception from PE status in terms of subparagraph (a). The outcome in respect of the after-sales support activities should remain unaffected by the proposed amendments on the basis that these activities were already subject to the “preparatory or auxiliary” requirement prior to amendments. On the other hand, the warehousing activities should be reassessed under the revised exception paragraph of the OECD MTC as these activities are now required to have a “preparatory or auxiliary” character.

The assessment of whether the warehousing activities performed by a particular non-resident online retailer have a “preparatory or auxiliary” character will depend on that online retailer’s own business model. The facts in Figure 2.1 are not sufficient to reach a concrete conclusion on whether Company A’s warehousing activities should be considered “preparatory or auxiliary”. Generally, the following factors, *inter alia*, should be taken into

account when determining whether the warehousing activities carried on by an online retailer such as Company A have a “preparatory or auxiliary” character:

- The percentage that the warehouse contributes to the total asset value of the online retailer’s overall business.
- The percentage that the workforce of the warehouse contributes to the online retailer’s total workforce.
- The degree of autonomy with which the warehouse is operated.

As the aforementioned indicators increase, it becomes more likely that the activities conducted from a particular warehouse will not be “preparatory or auxiliary” in character. If Company A’s warehouses no longer qualify for the exception from PE status under the amended provisions, a South African taxing right on Company A’s revenue will arise where this previously did not exist (section 9(2)(k)(ii) of the Income Tax Act). It follows that the proposed amendments to the exception paragraph of the OECD MTC may impact the liability of certain non-resident online retailers to South African tax. This assessment should be performed on a case-by-case basis, with due regard for a particular online retailer’s business model.

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CHAPTER 5: CONCLUSION

5.1 Introduction

Governments across the world experience difficulties in addressing multinational tax planning structures that facilitate BEPS. BEPS is defined as “tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations” (OECD, 2016). The OECD (2015c:15) estimates that the use of BEPS strategies globally lead to corporate tax losses for governments ranging from USD 100 million to USD 240 million annually.

In response to the use of BEPS strategies, the OECD and the G20 jointly authorised the development of a BEPS action plan consisting of fifteen individual action points (OECD, 2015b:4). Action point one of the BEPS action plan focuses on tax avoidance strategies in the digital economy and includes an illustration of a tax planning structure typically used in the online retail industry (OECD, 2015a:169-180).

It was established that the use of tax avoidance strategies in the online retail industry should be of particular concern to South Africa as estimates show that total online retail sales were expected to exceed R9 billion in 2016 (Wepener, 2016:1). Taking into consideration the increases in online retail sales noted globally, this figure is expected to increase in 2017 and onwards (PriceWaterhouseCoopers, 2016a:3-7). If online retailers in South Africa are able to avoid corporate tax by implementing the OECD’s online retail structure in a South African context, it could result in significant losses to the South African tax base and create a competitive disadvantage for South African companies in the retail industry.

The OECD’s online retail structure entails the use of a company that is a non-resident of the consumer country for tax purposes. In South Africa, the liability of non-resident online retailers to tax depends on the applicability of section 9(2)(k)(ii) of the Income Tax Act. If section 9(2)(k)(ii) does not apply, a non-resident online retailer’s revenue will not be subject to South African corporate tax. On this basis, the study set out to determine whether section 9(2)(k)(ii) is applicable to online retailers in the context of the OECD’s online retail structure.

5.2 Findings on the research problems and conclusions reached

The key findings and conclusions reached in respect of each of the research problems are discussed individually in the following subsections.

5.2.1 How could the OECD's online retail structure be implemented in a South African context and how could its use impact the applicability of section 9(2)(k)(ii) of the Income Tax Act?

The key components of the OECD's online retail structure in a South African context are illustrated in Figure 2.1. Figure 2.1 depicts the business structure of Company A. In the context of this study, Company A represents a proxy for companies implementing the OECD's online retail structure. Company A is incorporated and tax resident in a country other than South Africa, while concluding sales contracts with South African consumers via the internet. Company A will generally be incorporated in a low or no-tax country so as to minimise any potential corporate tax liability that may arise on its online sales revenue.

Company A's business structure essentially consists of a corporate head office in the country of incorporation and a number of South African branches that facilitate warehousing and after-sales support activities with regard to the goods sold to South African consumers. In addition to the above, Company A has service contracts with third-party delivery couriers and internet service providers respectively to deliver its goods to consumers and host its business website.

It was established that the applicability of section 9(2)(k)(ii) to Company A's revenue depends on whether Company A has created a South African PE, as defined. South Africa defines a PE with reference to article 5 of the OECD MTC. In terms of article 5 of the OECD MTC, a South African PE may be created as a result of two possible scenarios, namely:

- 1) Where a non-resident carries on business in South Africa through a "fixed place of business" (OECD, 2015e:M-16). This is also referred to as the primary rule of a PE; or
- 2) Where a "dependent agent" is acting on behalf of a non-resident in South Africa (OECD, 2015e:C(5)-8). This scenario excludes agents of an independent status (OECD, 2015e:M-16).

Notwithstanding the scenarios above, no PE is created if the activities conducted through the "fixed place of business", or by a "dependent agent", qualify for exception from PE status in terms of the exception paragraph of the OECD MTC (OECD, 2015e:M-16).

It was established that, pending further investigation of the exception paragraph of the OECD MTC, the components of the OECD's online retail structure that may create a South African PE for Company A are:

- 1) The South African branches that facilitate Company A's warehousing and after-sales support activities, provided that the branches meet the requirements of the primary rule of a PE; and
- 2) The internet service providers and delivery couriers, provided that these parties are regarded as "dependent agents" of Company A.

If either of these components lead to a South African PE, Company A would be subject to tax on as much of its revenue as is "attributable to" the identified PE (section 9(2)(k)(ii) of the Income Tax Act). However, in the absence of a South African PE, section 9(2)(k)(ii) will not apply and Company A's revenue will not be subject to South African corporate tax.

5.2.2 What are the meanings of the terms "asset", "attributable to" and "PE" in section 9(2)(k)(ii) and how do these terms apply to the OECD's online retail structure?

It was established that the word "asset" should be interpreted broadly and that an "asset", *inter alia*, includes physical goods of whatever nature owned by a person. In this regard, it was concluded that, regardless of their nature, all physical goods owned and sold by Company A to South African consumers should meet the definition of an "asset". Consequently, all assets sold by Company A to South African consumers should fall within the general scope of section 9(2)(k)(ii).

It was established that the interpretation of the phrase "attributable to" in section 9(2)(k)(ii) of the Income Tax Act should follow the Authorised OECD Approach for attributing profits to a PE. This approach includes the collective guidance expressed in article 7 of the OECD MTC, the OECD commentaries on article 7 of the OECD MTC and the OECD report titled the "2010 Report on the Attribution of Profits to Permanent Establishments". Broadly speaking, the Authorised OECD Approach entails that the revenue attributable to a South African PE, where applicable, should be calculated on the notion that the PE is a distinct and separate legal entity dealing at arm's length.

In the context of Figure 2.1, it was suggested that the most practical method for attributing profits to a South Africa PE of Company A, where applicable, may be the cost-plus approach. In terms of this approach, the revenue attributable to the identified PE is

determined as the costs directly attributable to that PE's operations plus an appropriate profit margin on the costs so incurred.

It was established that South Africa defines the PE concept with reference to the definition of the term in article 5 of the most recent version of the OECD MTC (section 1 of the Income Tax Act). The South African definition of a PE is currently linked to the 2014 version of the OECD MTC, which is the latest version in issue. Based on the 2014 version of the OECD MTC, it was established that Company A will not create a South African PE for the following reasons:

1. Even though Company A's South African branches meet the requirements of the primary rule of a PE, the warehousing and after-sales support activities performed by the branches fall within the scope of the exception paragraph of the OECD MTC. Consequently, no PE is created. This outcome is achieved irrespective of whether the warehousing and after-sales activities are performed from the same location.
2. The delivery couriers and internet service providers represent independent agents of Company A. As the definition of a "dependent agent" specifically excludes agents of independent status, no PE is created.

On the basis that Company A's presence in South Africa will not create a PE, it was concluded that Company A will not be subject to South African corporate tax in terms of section 9(2)(k)(ii) read with section 9(4)(d) of the Income Tax Act. It follows that the use of the OECD's online retail structure may currently facilitate corporate tax avoidance in the South African online retail industry.

5.2.3 What is the meaning of the proposed amendments to the exception paragraph of the OECD MTC and how does this impact the applicability of section 9(2)(k)(ii) to the OECD's online retail structure?

It was established that the proposed amendments essentially introduce a requirement that all activities must have a "preparatory or auxiliary" character to qualify for the exception from PE status. Prior to the amendments, the activities in subparagraphs (a) to (d), which include activities typically associated with that of a warehouse, automatically qualified for the exception from PE status if an enterprise's presence at a particular place of business was limited to the listed activities.

Under the revised exception paragraph of the OECD MTC, the activities in subparagraphs (a) to (d) will only qualify for the exception from PE status if they are "preparatory or

auxiliary” in the context of an enterprise’s own business model. Activities that previously qualified for the exception from PE status in terms of subparagraphs (e) or (f) should remain unaffected as these activities were already subject to the “preparatory or auxiliary” requirement prior to the amendments.

From a South African perspective, the impact of the proposed amendments on a particular non-resident online retailer, in this case Company A, depends, *inter alia*, on whether that online retailer is tax resident in a country with which South Africa has entered into a DTA. If the non-resident online retailer resides in a non-DTA country, the amendments will become effective on release of the next version of the OECD MTC, which is tentatively scheduled for late in 2017.

If the non-resident online retailer resides in a DTA country, the impact of the amendments will depend on whether the OECD’s multilateral instrument modifies the interpretation of the exception paragraph of the OECD MTC in a particular DTA. The requirements necessary for the OECD’s multilateral instrument to modify an existing DTA are provided in Table 4.1.

Applied to Company A, it was established that the proposed amendments to the exception paragraph of the OECD MTC should have the following impact:

1. Since the delivery couriers and internet service providers are independent agents, the impact of these entities on Company A’s PE status will remain unaffected on the basis that action point seven of the BEPS action plan made no recommendations in respect of the independent agent provisions.
2. The after-sales support activities will remain unaffected since these activities were already subject to the “preparatory or auxiliary” requirement prior to the amendments.
3. The warehousing activities of Company A may be impacted by the amendments because these activities previously qualified for the exception from PE status without being subject to the “preparatory or auxiliary” requirement.

There is no single definition for the words “preparatory” or “auxiliary”. This notwithstanding, it was established that an increase in the following factors will generally increase the likelihood that Company A’s warehousing activities are not “preparatory or auxiliary” in the context of Company A’s business structure:

- The percentage of Company A’s total asset value that is attributable to the warehouses.

- The percentage of Company A's total workforce employed by the warehouses.
- The degree of autonomy with which the warehouses operate.

The question of whether a particular non-resident online retailer's warehousing activities are "preparatory or auxiliary" in character ultimately depends on the merits of each case. If the assessment concludes that the activities performed from a particular South African warehouse do not have a "preparatory or auxiliary" character, a non-resident online retailer will create a South African PE in terms of action point seven of the BEPS action plan where one previously did not exist.

5.3 Areas for further research

The following areas were identified for further research:

1. The interaction between the multilateral instrument and existing South African DTAs and how conflicts between the relevant provisions of the aforementioned should be resolved.
2. The impact of the "minimum standards" to the multilateral instrument on the interpretation of South African DTAs that are within the scope of the multilateral instrument.
3. The constitutionality of the vague wording used in the text of the multilateral instrument, including the undefined use of phrases such as "in place of", "modifies" or "in the absence of", from a South African perspective.

5.4 Conclusion

On the basis that the OECD's online retail structure does not lead to the creation of a South African PE, the use of the structure in South Africa may currently avoid corporate tax in terms of section 9(2)(k)(ii) of the Income Tax Act. However, if a non-resident online retailer's South African warehouses create a PE in terms of action point seven of the BEPS action plan, South Africa will acquire a right to tax online retail revenue that has not been subject to tax previously. This assessment is case specific and should be performed with reference to a non-resident's particular business model.

The findings of this study suggest that the work of the OECD BEPS action plan may lead to scenarios in which a non-resident, in this case an online retailer, who previously fell outside the corporate tax net, will now be subject to South African tax. Although the scope of this study was limited to the industry of online retail, the methodology used to determine

the potential impact of the BEPS action plan on a multinational tax planning structure should be equally relevant for determining how the BEPS action plan may impact multinational business structures in other industries.

Practitioners and businesses should closely monitor South Africa's participation in the recommendations of the BEPS action plan, specifically the multilateral instrument, in order to limit the possible exposure that the recommendations may have in current and proposed international business structures.

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