

***THE IMPACT OF E-COMMERCE ON THE
PERMANENT ESTABLISHMENT DEFINITION***

A RESEARCH REPORT

BY

SUZETTE WEPENER

WPNSUZ001

MPHIL TAX LAW

UNIVERSITY OF CAPE TOWN

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1. Introduction

Taxing e-commerce has become a global challenge for governments and businesses alike over the past few years.¹ As very early as 1994 the Katz Commission was charged with the task of reviewing the tax system in South Africa to consider the impact of e-commerce on the tax system.² The Commission reported that e-commerce was a global problem and that South Africa would respond to it when the world economies began formalising policies on addressing international trade over the Internet.³

Since then e-commerce has mushroomed world-wide and South Africa is no exception. According to the managing director of research company World Wide Worx, Arthur Goldstuck, the local e-commerce sales are set to top R9bn in 2016.⁴ This is expected to be 1.03% of total retail sales in the country in that year, a milestone for South Africa's e-commerce space.⁵

More recently, the Minister of Finance announced in the 2013 Budget that a tax review committee will be set up to address among other things, the concerns about base erosion and profit shifting, especially in the of corporate income tax.⁶ Following the announcement the Davis Tax Committee was tasked with this dilemma and a BEPS Sub-committee was set up which prepared an interim report that sets out the Davis Tax Committee's position as at 30 September 2014.⁷

¹ Simon Woodside "E-commerce and taxation: a virtual reality" OECD Observer No 224, January 2001.

² September Taxation of e-commerce issue of International Tax Review, 2000.

³ Ibid.

⁴ Gareth van Zyl "SA e-commerce market still in baby shoes" www.fin24.com/Tech/News May 2015.

⁵ Ibid.

⁶ Addressing Base Erosion and Profit Shifting in South Africa, Davis Tax Committee Interim Report, 2014.

⁷ Ibid.

It was rightly stated that authorities need to strengthen tax laws and ensure level playing field between local and international companies dealing with digital goods and services.⁸ Revenue lost through digital economy is a growing concern of governments internationally.⁹

Income tax principles have traditionally been based on the existence of some form of physical presence (either residency, source of income or a permanent establishment) in an area of jurisdiction before tax may be levied.¹⁰ The main challenge posed by transactions conducted over the internet is that they transcend international boundaries and have no fixed location, a central pillar of any tax system.¹¹ Tax treaty rules apply to the concept of a permanent establishment to determine whether a country has taxing rights over the business profits of a non-resident taxpayer.¹²

South Africa's tax system has been residence based since years of assessment commencing on or after 1 January 2001.¹³ Under a resident basis of taxation or a world-wide basis of taxation, the connecting factor between the income and the country is the person who receives the income or to whom it accrued.¹⁴ This means that a residence based tax systems deals with world-wide transactions better, but the taxation of so-called e-commerce transaction still poses a lot of challenges because of the fact that a company can do a substantial amount of business in a country but they will have no tax presence. The absence of a tax presence is created by the fact that

⁸ Addressing Base Erosion and Profit Shifting in South Africa, Davis Tax Committee Interim Report, 2014.

⁹ Linda Ensor "SA must not miss out on e-commerce tax revenue, says Davis committee"
www.bdlive.co.za/economy/2014/12/31.

¹⁰ Meditari Accountancy Research Vol. 10 2002 : 243–258 Die effek van die internet op die inwonerbeginsel, soos gedefinieer in Inkomstebelastingwet Nr. 58 van 1962

¹¹ Linda Ensor "SA must not miss out on e-commerce tax revenue, says Davis committee"
www.bdlive.co.za/economy/2014/12/31.

¹² Ibid.

¹³ The definition of "resident", as defined in section 1(1) of the Income Tax Act No. 58 of 1962.

¹⁴ L Olivier & M Honiball International Tax A South African Perspective Fifth Edition (2011) at 19.

there is no physical presence and as mentioned above the concept of a permanent establishment requires a physical presence of an entity.

Parties that enter into cross-border transactions must be aware of the possibility that a 'permanent establishment' can be created in another country, which can give rise to a taxable presence in that country.¹⁵ A resident in one country that carries on a business in another country will be subject to tax in the other country if they created a 'permanent establishment' and if there is any income attributable to the permanent establishment.¹⁶ This concept will be expanded on in Chapter 3 of this dissertation.

Double Tax Agreements, or tax treaties, generally regulates that if a permanent establishment exists, the country in which it exists will have the right to tax the business profits attributable to that permanent establishment¹⁷. Tax treaties are aimed at relieving double taxation that arises when an amount is taxed in both jurisdictions.¹⁸

The objective of avoiding double taxation generally is accomplished under income tax treaties through the agreement of each country to limit, in specified situations, its right to tax income arising within its jurisdiction by residents of the other country and either to exempt from tax, or provide a credit for income taxes paid on, income arising in the other country.¹⁹ A resident of one country carrying on business in the other country generally will be subject to income tax in that country if it has a permanent

¹⁵ L Olivier & M Honiball International Tax A South African Perspective Fifth Edition (2011) at 335.

¹⁶ L Olivier & M Honiball International Tax A South African Perspective Fifth Edition (2011) at 337-338.

¹⁷ Article 7

¹⁸ L Olivier & M Honiball International Tax A South African Perspective Fifth Edition (2011) at 277.

¹⁹ L Olivier & M Honiball International Tax A South African Perspective Fifth Edition (2011) at 277-278.

establishment in that country and income attributable to the permanent establishment.²⁰

South African Double Tax Agreements are incorporated into the Income Tax Act under section 108 of the Income Tax Act.²¹ South Africa's Income Tax Act defines the permanent establishment concept with relevance to the OECD.²²

With the use of the internet and the rise of e-commerce it is worth while discussing the impact of e-commerce when determining if a permanent establishment exists in a country. This is important because at this stage it might be the only way for a country to tax a company that has no physical presence but are doing significant business in their country through e-commerce.

²⁰ Article 7 ARTICLES OF THE OECD MODEL TAX CONVENTION ON INCOME AND CAPITAL [as they read on 22 July 2010]

²¹ Income tax Act no.58 of 1962

²² Section 1 of the Income Tax Act. The court made reference to the OECD meaning of the permanent establishment concept in *SIR v Downing* (1975 (4) SA 518(A).

2. Research Question

This research report explores the following question:

What is the impact of e-commerce on the determination of a permanent establishment?

The main object of the concept of the definition of a permanent establishment in a double tax agreement is to set out the type and permanency of business activities that an entity must conduct before they can be subject to tax in another jurisdiction.²³

Furthermore, the definition of a 'permanent establishment' as defined in article 5 of the OECD model tax convention requires the existence of a fixed place of business. This indicates the existence of a facility with a certain degree of permanence.²⁴

²³ Silke on International Tax

²⁴ OECD model Article 5

The internet has changed the traditional international business model. It is no longer necessary that the entrepreneur, or his employees, agents, branches or intermediaries is in the country where the business is being conducted.²⁵

It is clear that the internet overcomes the traditional limitations of physical presence in a jurisdiction when doing business.²⁶ This poses a challenge when it comes to the determination of a 'permanent establishment', as the test is based on a physical presence of an entity in a jurisdiction.

I want to determine if the current concept of a permanent establishment is still adequate to address the challenges posed by e-commerce. Taking into account that e-commerce was not a factor when the basis of the definition of the definition of a permanent establishment was formulated. The views of the OECD on e-commerce will be analysed to determine what they envisage and if they are of the opinion that the current definition is adequate to address the concept and reality of e-commerce and the taxation thereof.

It is important to explore the views of the rest of the world on e-commerce and the taxation thereof. A multinational entity must be aware of the tax presence it can create in a foreign country, especially when it comes to creating a permanent establishment in that foreign country.

It is my aim to identify and discuss the challenges and difficulties e-commerce poses when determining the existence of a permanent establishment and also to research

²⁵ HeinOnline -- 127 S. African L.J. 328 2010 Tracy Gatuza

²⁶ Meditari Accountancy Research Vol. 10 2002 : 243–258 Die effek van die internet op die inwonerbeginsel, soos gedefinieer in Inkomstebelastingwet Nr. 58 van 1962

certain adaptations and recommendations of the current taxing system and relevant guidelines.

The following questions will be explored and researched to determine the impact of e-commerce on the current tax system with regard to the determination of the existence of a permanent establishment:

1. What is a permanent establishment?
2. What is e-commerce?
3. What is the impact or difficulties that e-commerce create when determining the existence of a permanent establishment?
4. Is the current concept of a permanent establishment still adequate and relevant when it comes to taxing e-commerce?
5. How can e-commerce be taxed more effectively?
6. What are the views of the rest of the world in respect of taxing e-commerce?

3. What is a ‘Permanent Establishment’?

Every double taxation agreement contains an article in which the term “permanent establishment” is defined and for the purposes of the Convention the term means a fixed place of business through which the business of an enterprise is wholly or partly carried on.²⁷ Where a permanent establishment is found to have been created a country may tax the income attributable to that permanent establishment.²⁸

Therefore it is quite significant to explore the concept of a permanent establishment from a South African perspective, as it means that when the concept applies South Africa will be in a position to tax the relevant income attributable to the permanent establishment.

In terms of Section 1 of the Income Tax Act²⁹ the term “permanent establishment” is defined as follows:

“a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor;”

²⁷ Permanent establishment – a South African perspective, www.taxtalk.co.za, 3 August 2015.

²⁸ Ibid.

²⁹ Income tax Act no.58 of 1962

Paragraph 1 of the Commentary to Article 5 of the OECD Model Tax Convention states that the main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State.

The question arises whether reliance can be placed upon the OECD Commentary when interpreting DTAs.

This question can be answered by considering the following two factors:

- The Vienna Convention on the Law of Treaties, which is a collation of customary international law, and as such forms part of South African law provides support for the argument that the Commentary should be taken into account when interpreting treaties in South Africa.³⁰
- Furthermore the judgment in *SIR v Downing*³¹ upheld the principle that the South African courts were bound to take cognisance of the guidelines for interpretation issued by the OECD in its Commentary as South Africa had adopted the Model Tax Convention as a basis for its own treaties.

Despite the fact that South Africa is not an OECD member state, the South African courts have accepted that the OECD Model Tax Convention and Commentary have been accepted in South African case law and used to interpret treaties.³²

³⁰ Article 31 of the Vienna Convention on the law of treaties, concluded at Vienna on 23 May 1969

³¹ *SIR v Downing*, 1975 (4) SA 518 (A), 37 SATC 249

³² L Olivier & M Honiball *International Tax A South African Perspective Fifth Edition* (2011)

From the above statements it can be assumed that OECD Commentary may be relied upon when interpreting an OECD based DTA in South Africa.

Article 5 of the Model Tax Convention on Income and on Capital of the OECD defines the concept of a permanent establishment. The first paragraph of article 5 of the OECD model tax convention contains the general definition of a permanent establishment.

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

In terms of the definition, the following conditions must be applicable before a Permanent Establishment can exist:

1. an enterprise must carry on business (have a place of business);
2. the existence of a ‘fixed place of business’, which indicates the existence of a facility in the source state with a certain degree of permanence;
3. the carrying on of the business through such fixed place.

Each of the above conditions will be discussed here under with reference to the OECD commentary.

1. Place of business

In terms of paragraph 4 of the *OECD Commentary on Article 5* the term “place of business” covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are exclusively used for that purpose.³³ A place of business may also exist where no premises are available or required for carrying on of the business of the enterprise and it simply has a certain amount of space at its disposal.³⁴ It is immaterial whether the premises, facilities or installations are owned or rented by the enterprise. The place of business may be situated in the business facilities of another enterprise. For instance where a foreign enterprise has at its constant disposal certain premises or part thereof owned by the other enterprise.³⁵

In terms of Article 5(2) the following are examples of a place of business: a) a place of management; b) a branch; c) an office; d) a factory; e) a workshop, and f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.³⁶

The above conditions in respect of ‘place of business’ illustrates that a permanent establishment will only exist if the enterprise has a physical presence in the source state.³⁷

³³ Commentaries on the Articles of the Model Tax Convention 2010 at 93

³⁴ Ibid.

³⁵ Commentaries on the Articles of the Model Tax Convention 2010 at 93

³⁶ ARTICLES OF THE OECD MODEL TAX CONVENTION ON INCOME AND CAPITAL [as they read on 22 July 2010]

³⁷ E-commerce: A critique on the determination of a permanent establishment for Income Tax purposes from a South African perspective Heinonline – 20 Stellenbosch L. Rev 74 2009

2. Fixed place of business

The second condition determines that the place of business should be fixed. The *OECD Commentary* states that there has to be a link between the place of business and a specific geographical point.³⁸

It is further stated in the commentary that a permanent establishment can only exist if the place of business has a certain degree of permanency and if it is not of a purely temporary nature.³⁹ Even if the place of business only exists for a short period of time (because of the nature of the business) it can still constitute a permanent establishment.⁴⁰ An example will be when a company enters a country specifically to set up a computer system and that set-up takes about 5 months.

Furthermore, when activities are of a recurrent nature, each period of time during which the place of business is used needs to be considered to determine if there is a degree of permanency.⁴¹

From the above discussion it is again apparent that a physical test is applicable in determining a permanent establishment, whereas e-commerce can be conducted in a country by a company without having any physical presence in that country.

³⁸ Commentaries on the Articles of the Model Tax Convention 2010 at 94, Paragraph 5.

³⁹ Commentaries on the Articles of the Model Tax Convention 2010 at 95, Paragraph 6.

⁴⁰ Commentaries on the Articles of the Model Tax Convention 2010 at 95, Paragraph 6.

⁴¹ Commentaries on the Articles of the Model Tax Convention 2010 at 96, Paragraph 6.

3. The carrying on of the business through such fixed place

For a place of business to constitute a permanent establishment the enterprise must carry on its business partly or wholly through it.⁴² The activity does not have to be of a productive nature.⁴³ A productive character means that it contributes to the profits of the enterprise.⁴⁴ Within the framework of a well-run business not each part contributes to the productivity of the whole, but in the wider context of the whole business it is consequently a permanent establishment to which profits can be attributed to be taxed in a particular territory.⁴⁵

Furthermore, there can be interruption of operations as long as the operations are carried out on a regular basis and a permanent establishment will exist.⁴⁶

A distinction must be made between a permanent establishment that merely serves an enterprise and one that actually carries on the business of the enterprise. When an enterprise merely serves an enterprise, the activities may be auxiliary, for example the use of facilities for the storing of goods.⁴⁷ Depending on the nature of the business they can also be the main activities of the business, depending if they

⁴² Commentaries on the Articles of the Model Tax Convention 2010 at 96, Paragraph 7.

⁴³ Commentaries on the Articles of the Model Tax Convention 2010 at 92, Paragraph 3.

⁴⁴ Commentaries on the Articles of the Model Tax Convention 2010 at 92, Paragraph 3.

⁴⁵ Commentaries on the Articles of the Model Tax Convention 2010 at 93, Paragraph 3.

⁴⁶ Commentaries on the Articles of the Model Tax Convention 2010 at 93, Paragraph 3.

⁴⁷ Commentaries on the Articles of the Model Tax Convention 2010 at 101, Paragraph 21.

are substantial or insignificant to the business, for instance a company with the main business of storing goods.⁴⁸

A permanent establishment may exist even if no personnel are required at the location to operate the equipment, for example where a business is carried on mainly through automatic equipment.⁴⁹ The presence of personnel is not necessary to determine if an enterprise wholly or partly carries on its business at a place where no personnel is required to carry on the business activities.⁵⁰

The concept of 'carrying on a business' has been considered by our South African courts in various connotations. In *Estate G v COT*⁵¹ the Court made the following remarks:

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

⁴⁸ E-commerce: A critique on the determination of a permanent establishment for Income Tax purposes from a South African perspective 20 Stellenbosch L. Rev 74 2009

⁴⁹ Commentaries on the Articles of the Model Tax Convention 2010 at 97-98, Paragraph 10.

⁵⁰ INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION
12 October 2011 to 10 February 2012

⁵¹ *Estate G v COT*, 1964, SR, 26 SATC 168.

From the above it is important to recognize that each case should be measured against its own set of facts and circumstances, to determine if a business is carried on.

The OECD Commentary observes that the business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise, including employees and other persons receiving instructions from the enterprise.⁵²

It should be noted that specific rules apply in cases where the business is carried on via an agent or broker (see analysis of paragraphs 5 and 6 below).⁵³ In the case of a dependent agent, no fixed place of business is required if the agent has contractual capacity and regularly exercises such authority, whilst carrying on business via an independent broker or agent is specifically excluded from the concept of a PE under paragraph 6 of the OECD Model DTA.⁵⁴

Specific exclusions to a permanent establishment

Paragraph 4 of Article 5 of the Model Tax Convention specifically excludes the following from the definition of a permanent establishment:

“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

⁵² Commentaries on the Articles of the Model Tax Convention 2010 at 97, Paragraph 10.

⁵³ Commentaries on the Articles of the Model Tax Convention 2010 at 105, Paragraph 31.

⁵⁴ Commentaries on the Articles of the Model Tax Convention 2010 at 105, Paragraph 32.

- 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.”*

The common factor of these activities is the fact that they are preparatory or auxiliary functions.⁵⁵ It must be established whether these activities are essential to the activities of the enterprise or if they are just of an auxiliary or preparatory nature. Each case must be examined by its own merit in order to come to a decision if the paragraph will apply or not.

In paragraph 24 of the *OECD commentary on Article 5* it is stated that it is often difficult to distinguish between activities that have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business forms an essential and significant part of the activity of the enterprise as a whole.⁵⁶ A fixed place of business whose general purpose is identical to the

⁵⁵ Commentaries on the Articles of the Model Tax Convention 2010 at 101, Paragraph 21.

⁵⁶ Commentaries on the Articles of the Model Tax Convention 2010 at 102, Paragraph 24.

general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. For example, if the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of an enterprise exercising such an activity cannot be exempted under subparagraph (e).⁵⁷

A fixed place of business which has the function of managing an enterprise or a part thereof cannot be regarded as doing a preparatory or auxiliary activity. Such a managerial activity exceeds the level of an auxiliary activity. The function of managing an enterprise, even if it only covers a certain part of the operations constitutes an essential part of the business operations and can never be regarded as an activity which has a preparatory or auxiliary character.⁵⁸

Where an enterprise sells goods worldwide establishes an office in a State and the employees working at that office take active part in the negotiation of import parts for the sale of goods and even if they do not exercise an authority to conclude contracts, such activities will usually constitute an essential part of the business operations. Such activities should not be regarded as having a preparatory or auxiliary character.⁵⁹

When is a permanent establishment deemed to exist?

Paragraph 5 of Article 5 of the Model Tax Convention states the following:

“5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an

⁵⁷ OECD Commentary on Article 5 paragraph 24

⁵⁸ OECD Commentary on Article 5 paragraph 24.1

⁵⁹ OECD Commentary on Article 5 paragraph 24.2

*enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment*⁶⁰

Even if an entity does not have a fixed place of business, but a dependent agent has the authority to conclude contracts in the name of the enterprise, the enterprise shall be deemed to have a permanent establishment.⁶¹ Paragraph 5 of the Model Tax Convention stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of the activity of a person acting on their behalf.

Persons whose activities may create a permanent establishment for an enterprise are dependent agents.⁶² Such persons can be individuals or companies and does not have to be residents or have a place of business in the State in which they act on behalf of the enterprise. Paragraph 5 proceeds on the basis that only persons that have the authority to conclude contracts can constitute a permanent establishment.⁶³ The person must have sufficient authority to bind the enterprise's participation in the State concerned.⁶⁴ The person must also make use of this authority repeatedly and not just in isolated cases in order for a permanent establishment to exist.⁶⁵

⁶⁰ ARTICLES OF THE OECD MODEL TAX CONVENTION ON INCOME AND CAPITAL [as they read on 22 July 2010]

⁶¹ Commentaries on the Articles of the Model Tax Convention 2010 at 105, Paragraph 31.

⁶² Commentaries on the Articles of the Model Tax Convention 2010 at 105, Paragraph 32.

⁶³ Ibid.

⁶⁴ Ibid.

⁶⁵ Ibid.

Also, the phrase —authority to conclude contracts in the name of the enterprise does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.⁶⁶

Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.⁶⁷

The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only.⁶⁸

Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority —in that State, even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. The

⁶⁶ Commentaries on the Articles of the Model Tax Convention 2010 at 105, Paragraph 32.1.

⁶⁷ Ibid

⁶⁸ Commentaries on the Articles of the Model Tax Convention 2010 at 106, Paragraph 32.2.

mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.⁶⁹

The requirement that an agent must —habituallyll exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is —habitually exercisingll contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination.⁷⁰

Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the

⁶⁹ Commentaries on the Articles of the Model Tax Convention 2010 at 105, Paragraph 32.1.

⁷⁰ Commentaries on the Articles of the Model Tax Convention 2010 at 106, Paragraph 32.2.

extent that such a person exercises the authority to conclude contracts in the name of the enterprise.⁷¹

Under paragraph 5 of the Model Tax Convention, only those persons who meet the specific conditions may create a permanent establishment; all other persons are excluded. It should be borne in mind, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.⁷²

⁷¹ Commentaries on the Articles of the Model Tax Convention 2010 at 106, Paragraph 34

⁷² Commentaries on the Articles of the Model Tax Convention 2010 at 106, Paragraph 35

4. The OECD model on e-commerce and the concept of a permanent establishment

The OECD model tax convention: Commentary on Article 5 specifically for e-commerce:

The OECD Committee on Fiscal Affairs set up a Technical Advisory Group ('TAG') in January 1999 to examine how the current DTA rules for the taxation of business profits apply in the context of electronic commerce ('e-commerce') and to examine proposals for alternative rules. The TAG produced an extensive report ('the TAG Report') in November 2003 which contains a critical evaluation of the current DTA rules with respect to e-commerce. The OECD Commentary now contains a summary of the OECD views on the potential application of the permanent establishment provisions of a DTA to the conduct of business operations via e-commerce.⁷³

In Paragraph 42.1 to 42.10 of the Commentary on Article 5, guidelines are set out in respect of e-commerce and the determination of a permanent establishment:

1. The physical location where automated equipment is operated may constitute a permanent establishment in the country where it is situated. A distinction must be

⁷³ Silke on International Tax

made between the computer equipment and the data and the software which is used by or stored on that equipment.⁷⁴

Initially it seems quite logical that a server could constitute a PE. Servers are physical, tangible objects that, when placed in a country, constitute a physical presence. Furthermore, servers are capable of storing and transmitting large amounts of data that companies use to conduct business.⁷⁵ In the case of web-based companies, servers store and transmit every piece of information for an entire business. For web-based companies, the server is the business. It seems clear that under the fixed-place-of-business principles, a server may constitute a PE.⁷⁶

2. The distinction between a website and the server on which the website is stored and used is important because the enterprise that operates the server may be different from the enterprise that carries on the business through the website. For example, it happens that the website through which an enterprise carries on its business is hosted on the server of an Internet Service Provider.⁷⁷ In such a case the enterprise does not even have a physical presence at the location, because the website is not tangible. The enterprise cannot be considered to have acquired a place of business by virtue of the hosting arrangement. But if the enterprise has the server to its own disposal, for example it owns or leases and operates the

⁷⁴ INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION
12 October 2011 to 10 February 2012

⁷⁵ Commentaries on the Articles of the Model Tax Convention 2010 at 110, Paragraph 42

⁷⁶ Commentaries on the Articles of the Model Tax Convention 2010 at 110, Paragraph 42.2

⁷⁷ Commentaries on the Articles of the Model Tax Convention 2010 at 110, Paragraph 42.3

server, the location of the server could constitute a permanent establishment if the other requirements of Article 5 are also met.⁷⁸

3. For computer equipment to constitute a fixed place of business it must meet the requirement of being fixed. For example, in the case of a server it is not relevant whether it is possible to move the server, but whether it is indeed moved.⁷⁹ A server must be located at a certain location for a sufficient period of time in order to become fixed within the meaning of paragraph 1 of Article 5 of the OECD model tax convention.⁸⁰
4. It also needs to be considered whether the business of the enterprise was wholly or partly carried on at the location where the enterprise has computer equipment (like a server) at its disposal.⁸¹ Each case must be analysed on its own merits to determine whether the business is carried on wholly or partly through such equipment, having regard to whether it can be said that, because of the equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.⁸²
5. A permanent establishment may exist even if no personnel are required at the location to operate the equipment. The presence of personnel is not necessary to

⁷⁸ INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION
12 October 2011 to 10 February 2012

⁷⁹ Commentaries on the Articles of the Model Tax Convention 2010 at 111, Paragraph 42.4

⁸⁰ INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION
12 October 2011 to 10 February 2012

⁸¹ Commentaries on the Articles of the Model Tax Convention 2010 at 111, Paragraph 42.5

⁸² INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION
12 October 2011 to 10 February 2012

determine if an enterprise wholly or partly carries on its business at a place where no personnel is required to carry on the business activities. This also applies to other activities where equipment operates automatically, for instance automatic pumping equipment used in the exploration of natural resources.⁸³

6. No permanent establishment may be considered to exist where the e-commerce carried on through the computer equipment at a location are limited to activities covered by paragraph 4 of Article 5.⁸⁴ To establish whether specific activities will fall within paragraph 4, each case needs to be examined on its own merits.⁸⁵ The functions performed by the enterprise through the equipment must be examined and examples of activities excluded from the definition of a permanent establishment include:⁸⁶

- providing a communications link (like a telephone line) between suppliers and customers

- advertising of goods or services

- relaying information through a mirror server for security and efficiency purposes

- gathering market data for enterprise

⁸³ INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION
12 October 2011 to 10 February 2012

⁸⁴ Commentaries on the Articles of the Model Tax Convention 2010 at 111, Paragraph 42.7

⁸⁵ Ibid

⁸⁶ Commentaries on the Articles of the Model Tax Convention 2010 at 112, Paragraph 42.7

- supplying information.⁸⁷

7. If such functions form in themselves an essential and significant part of the business activities of the enterprise as a whole, or if other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities in paragraph 4 and if the equipment constitute a fixed place of business, there would still be a permanent establishment.⁸⁸
8. The core functions for a particular enterprise depends on the nature of the business carried on by that enterprise.⁸⁹ If you take the example of an Independent Service Provider, some of them are in the business of operating their own servers for the purpose of hosting websites for other enterprises.⁹⁰ These Independent Service Providers are in the business of providing services to their customers and it is an essential part of their commercial activity. It cannot be seen as preparatory or auxiliary within the meaning of subparagraph 4(e) and (f) or otherwise covered by paragraph 4.⁹¹

An enterprise that carries on the business of selling products through the internet is not in the business of operating servers. The fact that it carries on the business through computer equipment at a given location does not conclude that the activities performed are more than preparatory or auxiliary or not otherwise covered

⁸⁷ Commentaries on the Articles of the Model Tax Convention 2010 at 112, Paragraph 42.7

⁸⁸ INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION
12 October 2011 to 10 February 2012

⁸⁹ Commentaries on the Articles of the Model Tax Convention 2010 at 112, Paragraph 42.9

⁹⁰ Ibid.

⁹¹ Ibid.

by paragraph 4. You have to examine the nature of the business activities in light of the business carried on by the enterprise. If these activities are merely auxiliary or preparatory to the selling of the products on the internet, paragraph 4 will apply and the location will not constitute a permanent establishment. For example, the location is used exclusively for advertising, displaying a catalogue of products or providing information for potential customers.

If the typical functions relating to a sale are performed at that location (like the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed through the equipment) these activities are not covered by paragraph 4 and the location will constitute a permanent establishment.⁹²

9. It is common for Independent Service Providers to provide the service of hosting websites of other enterprises on their servers. The issue may arise whether paragraph 5 may apply to deem Independent Service Providers to constitute permanent establishments of the enterprises that carry on e-commerce through websites operated through the servers owned and operated by the Independent Service Providers.

While it could be the case in very unusual circumstances, paragraph 5 will generally not apply because the Independent Service Provider will not constitute an agent of the enterprise to which the website belong. The independent Service Provider will not have the authority to conclude contracts in the name of the

⁹² INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION
12 October 2011 to 10 February 2012

enterprise to which the website belong and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business. This is evidenced by the fact that they host the websites of many different enterprises.⁹³

Since it is clear that the website through which an enterprise carries on its business is not itself a “person” as defined in Article 3, paragraph 5 cannot apply to deem the existence of a permanent establishment by virtue of the website being an agent of the enterprise.⁹⁴

The discussion on the tax treatment of servers as computer equipment has to be distinguished from the automatic equipment discussed in paragraph 10 of the *OECD Commentary on Article 5*. Paragraph 10 refers to automatic equipment such as gaming and vending machines, which are fixed in location and enter into completed transactions with customers.⁹⁵

(The OECD Model DTA was amended in 2000 to delete art 14, which applied to independent service providers. Therefore, the income from such services is now dealt with under the provisions of article 7, read with article 5 of the OECD Model DTA).

⁹³ Commentaries on the Articles of the Model Tax Convention 2010 at 113, Paragraph 42.10

⁹⁴ INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION
12 October 2011 to 10 February 2012

⁹⁵ Commentaries on the Articles of the Model Tax Convention 2010 at 97, Paragraph 10

When it comes to e-commerce it is not always easy to apply the permanent establishment concept. This is because in the case of e-commerce a physical place of business is not always needed to do significant business transactions.

The most common questions asked when dealing with e-commerce and the determination of a permanent establishment are:

- Can my website constitute a permanent establishment?

From the above discussion of the OECD guidelines it can be seen that the view of the OECD is that a website does not in itself constitute tangible property. There is no link between the place of business and a specific physical geographical point. Therefore there cannot be a permanent establishment according to the definition as it reads currently.⁹⁶

- Can my server constitute a permanent establishment?

A server on the other hand is tangible equipment that has a physical location and business can be carried on through that place of business. All the other elements of paragraph 1 of Article 5 of the OECD model must however still be met before a permanent establishment will exist.⁹⁷

⁹⁶ Commentaries on the Articles of the Model Tax Convention 2010 at 110, Paragraph 42.3

⁹⁷ Commentaries on the Articles of the Model Tax Convention 2010 at 111, Paragraph 42.4

From the above it seems that a permanent establishment based on a fixed place of business will only be deemed to exist if an entity carries on business through a website that has a server at its own disposal, at a fixed location, and the business of the entity is not of a preparatory or auxiliary nature.⁹⁸

On February 17, 2012, Tax Executives Institute filed comments with the Organisation for Economic Co-operation and Development regarding the OECD's discussion draft on the Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention, released on October 12, 2011. The OECD discussion draft proposes significant changes to the official commentary to Article 5 of the model convention.

One of the issues discussed was very specific to e-commerce:

#15: Do "goods or merchandise" cover digital products or data? (paragraph 22 of the Commentary)

Another question is whether the reference to "goods or merchandise" in subparagraphs 4(a), (b), and (c) apply to digital products or, more generally, data (Issue #15)?

To address these issues, the Discussion Draft proposes clarifying that the words "goods" and "merchandise" for purposes of the exemptions to the definition of a PE

⁹⁸ 20 Stellenbosch L.Rev. 74 2009 Annet Wanyana Oguttu and Sedo Tladi

in subparagraphs 4(a) through (c) "refer to tangible property that can be stored, displayed and delivered and would not cover, for example, immovable property and data (although the subparagraphs would cover tangible products that include data such as CDs and DVDs)."

The Discussion Draft also notes that whether activities carried on through servers would qualify for the exemptions in paragraph 4 of Article 5 was addressed in paragraphs 42.7 through 42.9 of the Commentary, which are not part of the Discussion Draft. Those paragraphs generally provide that this determination depends on the nature of the business enterprise, such that "core functions" carried out on servers owned by an enterprise would not always be considered "preparatory or auxiliary" and thus could constitute a PE of the enterprise (depending on the facts and circumstances).

Paragraphs 42.7 through 42.9 of the Commentary consistently refer to the activities in paragraph 4 as being of a "preparatory or auxiliary" nature even though the clarifications in the Discussion Draft make clear that this extra requirement does not apply to subparagraphs (a) through (d). Therefore, TEI believes paragraphs 42.7 through 42.9 are outdated and need revision to make them consistent with the proposed changes to the Commentary in the Discussion Draft, especially as e-commerce and "cloud computing" trends accelerate.

Finally, whether or not the OECD agrees with the foregoing recommendations, the OECD should at a minimum clarify that when one enterprise provides data storage services to a second enterprise, the data of the second enterprise stored on the

server of the first enterprise does not create a PE of the second enterprise in the state of the first enterprise.

The latest developments on the OECD front in respect of base erosion and profit shifting (which includes the concept of a permanent establishment and the taxing of e-commerce):

After the release of the report “Addressing Base Erosion and Profit Shifting” (BEPS) in February 2013, OECD and G20 countries adopted a 15-point action plan to address BEPS in September 2013.⁹⁹ After two years of work the 15 actions were completed. All the different outputs have been consolidated into a comprehensive report.¹⁰⁰ The BEPS report is the first substantial renovation of international tax rules in almost 100 years.¹⁰¹ When the new measures are implemented it is expected that profits will be taxed where the economic activities that generate them are carried out and where value is created.¹⁰²

Implementation of the above issues becomes very important to realize this vision of the OECD. The BEPS package is designed to be implemented via changes in domestic law and tax treaty provisions, and expected to be finalized in 2016. OECD and G20 countries have agreed to continue to work together to ensure the implementation of the BEPS recommendations.¹⁰³

⁹⁹ OECD/G20 Base Erosion and Profit Shifting Project, 2015 Final Report.

¹⁰⁰ Ibid.

¹⁰¹ Ibid.

¹⁰² Ibid.

¹⁰³ Ibid.

5. What is e-commerce?

When e-commerce rose in the mid-1990s it was viewed by many as the beginning of an entirely new and radical way of buying goods and services¹⁰⁴ and on-line shopping in South Africa was birthed in 1996.¹⁰⁵

Companies were of the opinion that they can now do business in other jurisdictions without even giving a thought to the tax implications.¹⁰⁶ At the same time, owners of traditional businesses felt that their livelihood was at a tremendous economic disadvantage since they were required to charge a tax on all purchases.¹⁰⁷

“A Green Paper on Electronic Commerce for South Africa” compiled by the Department of Communications Republic of South Africa, in November 2000, defines e-commerce as:¹⁰⁸

“The use of electronic networks to exchange information, products, services and payments for commercial and communication purposes between individuals (consumers) and businesses,

¹⁰⁴ The IUP Journal of Accounting Research & Audit Practices, Vol. XI, No. 4, 2012 e-Commerce and Taxation: Past, Present and Future Priyanka Meharia

¹⁰⁵ Gareth van Zyl “SA e-commerce market still in baby shoes” www.fin24.com/Tech/News May 2015.

¹⁰⁶ The IUP Journal of Accounting Research & Audit Practices, Vol. XI, No. 4, 2012 e-Commerce and Taxation: Past, Present and Future Priyanka Meharia

¹⁰⁷ Ibid.

¹⁰⁸ A GREEN PAPER ON ELLECTTRONIC COMMERCE FOR SOUTH AFRICA Co-ordinated and compiled by the Department of Communications Republic of South Africa November 2000

between businesses themselves, between individuals themselves, within government or between the public and government and, last, between business and government ”

This definition encompasses the many kinds of business activities that are being conducted electronically, and conveys the notion that electronic commerce is much more comprehensive than simply the purchasing goods and services electronically.¹⁰⁹

E-commerce is transforming the global marketplace and its impact is being felt across the full range of business and government.¹¹⁰ E-commerce requires an open, predictable and transparent trading environment, which operates across territorial borders and jurisdictions.¹¹¹ To foster such an environment and to realise its full economic potential necessitates international co-operation, which will be instrumental in developing the enabling conditions for its growth.¹¹²

The Electronic Communications and Transactions Act No. 25 of 2002 came into effect in August 2002 and the aim of Government is to be instrumental in developing and growing e-commerce by preventing and removing barriers.¹¹³ They also aim to provide a stable environment for e-commerce and to address the need for adequate protection.¹¹⁴

¹⁰⁹ A GREEN PAPER ON ELLECTTRONIC COMMERCE FOR SOUTH AFRICA Co-ordinated and compiled by the Department of Communications Republic of South Africa November 2000

¹¹⁰ Ibid.

¹¹¹ Ibid.

¹¹² Ibid.

¹¹³ Ibid.

¹¹⁴ A GREEN PAPER ON ELLECTTRONIC COMMERCE FOR SOUTH AFRICA Co-ordinated and compiled by the Department of Communications Republic of South Africa November 2000

In a US article by Priyanka Meharia, e-Commerce and Taxation: Past, Present and Future,¹¹⁵ it is stated that nearly two decades after the initial internet-boom, taxation on e-commerce has still not become a reality. It is still in its infancy. The debate on whether to tax or not to tax continues to rage, and the extent of any future taxation on e-commerce is still unclear.¹¹⁶ According to Pastukhov (2009), the total annual uncollected sales and use taxes on e-commerce in the US, for example, are expected to reach \$11.4 billion by 2012.

The Internet can be described as a global network of linked computers. This allows people to communicate with people from all over the world. Transactions can be made all over the world without really being detected.¹¹⁷ There are no more territorial borders because the internet cuts across international boundaries undetected. The location of a person becomes irrelevant when doing business over the internet.¹¹⁸ This means that a person can have no physical tax presence in a country but they can still be doing significant business and earning income in that specific jurisdiction.

¹¹⁵ IUP Journal of Accounting Research & Audit Practices; Oct2012, Vol. 11 Issue 4, p25-33, 9p

¹¹⁶ Ibid.

¹¹⁷ Ibid

¹¹⁸ Ibid

6. The impact of e-commerce on the determination of a permanent establishment

Physical presence versus doing business on the Internet

From the above discussion on a “permanent establishment” it became apparent that a fixed place of business is required before a permanent establishment exists. This fixed place of business further requires a physical presence in a foreign country. Traditionally multinational entities had a physical presence in another country, by having an office or sale point of some sort. It was easy to identify the physical presence of an entity in a foreign country by means of the specific geographical point of the entity. With the use of the internet it is now possible for these entities to sell their goods and services via websites without having that physical presence in a foreign country. A consumer can just log onto a website from anywhere in the world and purchase products and pay for them electronically. The seller might not even be aware that someone in a specific country is doing business with him. The seller is however aware that by having a website to do business globally he is opening himself up for possible taxation in other countries.

E-commerce creates difficulties when it comes to the identification and location of taxpayers and it is also difficult to establish a link between the taxpayer and the transactions.

In traditional commerce, the reliance on a physical presence is sensible, and the permanent establishment threshold can therefore be applied with relative certainty so that business profits are attributed only to the more substantial and long-term presence of a corporation in a jurisdiction, not to a more fleeting or temporary presence that does not satisfy the required threshold.¹¹⁹

Because of the current way the concept of a permanent establishment is defined (that there should be a physical presence), e-commerce transactions will most probably not be taxed in countries where there are no servers and consumers are transacting via websites.

It is stated by Pinto, in his article *The Need to Reconceptualize the Permanent Establishment Threshold*, that before examining how the concept of a permanent establishment can be redefined, it is important to question whether source-based taxation remains theoretically valid in today's globalized business world.¹²⁰ The current definition of permanent establishment in the OECD Model relies on the existence of either a physical presence (e.g. a factory) or a representative presence (e.g. an agent) before source-based taxation applies.¹²¹ Globalization, epitomized by the advent of electronic commerce, allows substantial business activities to take place in a source state without either physical or human intermediaries, such as brokers, distributors or

¹¹⁹ *The Need to Reconceptualize the Permanent Establishment Threshold* Prof. Dr Dale Pinto

¹²⁰ *Ibid.*

¹²¹ *Commentaries on the Articles of the Model Tax Convention 2010* at 92, paragraph 2.

representatives, making it more difficult to find a permanent establishment based on its traditional formulation under the OECD Model.

Is the location of a server relevant to the business activity when it comes to e-commerce?

The location of computer equipment, like a server often bears little relationship to the location of the essential economic activity that electronic commerce comprises.¹²² The possibilities afforded by electronic commerce for functions to be spread or disaggregated between servers, combined with server arrays, make it difficult as practical matter to determine whether activities are core or preparatory. This may also allow electronic commerce transactions to be disaggregated into different functions which, by themselves, may be considered only preparatory in nature, but when linked via the Internet may constitute a viable business that may not be subject to tax in any jurisdiction. These possibilities provide further reasons why a server may not be a stable physical presence on which the right to tax is based, and they further expose the vulnerabilities of trying to apply the existing way source is defined under the treaty formulation of a permanent establishment to transactions conducted in an electronic commerce environment.¹²³

If the location of a server were relevant to determining taxing jurisdiction, the server could be readily moved (without affecting the underlying transaction) at regular intervals between different servers in different countries and mirror sites could be established to direct customers to different servers depending on the level of traffic at any time. Actions such as these could frustrate the attempts of tax authorities to find a stable

¹²² The Need to Reconceptualize the Permanent Establishment Threshold Prof. Dr Dale Pinto

¹²³ The Need to Reconceptualize the Permanent Establishment Threshold Prof. Dr Dale Pinto

physical presence on which to base taxation under the permanent establishment threshold. It have therefore been observed that the finding that a permanent establishment exists may easily be avoided by moving operations to a server in another country before the conditions of being "fixed" under the permanent establishment test are satisfied.¹²⁴

The way source is defined for business profits under the permanent establishment threshold may need to be re-evaluated in light of electronic commerce transactions. Theoretically the taxation of business profits is justifiable in the absence of a physical presence, yet trying to deal with electronic commerce transactions in the context of the conventional formulation of the permanent establishment threshold seems to be inadequate as these rules depend on a finding of some kind of physical presence at a specific geographical location for a certain period of time.

Therefore, the permanent establishment principle, which emerged as a tax concept very long ago, may no longer represent an appropriate instrument for the taxation of business profits.¹²⁵

As noted by Prof. Hinnekens there is nothing sacred about the legacy of the permanent establishment principle as a fixed place of business. Similarly, Prof. Doernberg observed that there is nothing sacred about the permanent establishment concept, which, according to them, simply denotes "a threshold that business activities in the source country must have reached in order to entitle that country to tax the pertinent

¹²⁴ Skaar, Arvid A., Permanent Establishment: Erosion of a Tax Treaty Principle

¹²⁵ Skaar, Arvid A., Permanent Establishment: Erosion of a Tax Treaty Principle

income. It is not unreasonable for this threshold to be adjusted for changes in the nature of business and in the way business is carried on".¹²⁶

¹²⁶ Doernberg, Richard and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999)

7. Three approaches to re-evaluating the permanent establishment threshold

7.1 The base-erosion approach:

This is a withholding approach that has been advocated by Prof. Doernberg. The base-erosion approach seeks to address two main concerns created by electronic commerce, described by Prof. Doernberg as follows:¹²⁷

First, countries that import e-commerce transactions are concerned that they may lose some of their existing tax base and will not be able to share in any new tax base generated by e-commerce transactions.¹²⁸

Second, taxpayers and governments are concerned about the likelihood of double taxation because of inconsistencies in the application of existing tax principles to income generated by e-commerce.¹²⁹

The base-erosion approach has features which are designed to overcome the concerns mentioned above:

¹²⁷ Doernberg, Richard and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999)

¹²⁸ Ibid.

¹²⁹ Ibid.

- the base-erosion approach is intended to operate within the existing international tax regime, including maintaining the permanent establishment principle. Preserving the permanent establishment principle in its current form and seeking to apply it to e-commerce transactions may allow tax revenue to be shifted from source countries to residence countries if non-resident businesses operate in source countries without a physical presence. In this way, the approach seeks to preserve the long-standing permanent establishment principle while, at the same time, making some adjustments to recognise the claims of countries that are concerned that existing OECD principles are too heavily weighted toward residence-based taxation.¹³⁰
- it is intended that a source country be permitted to withhold tax at a single rate on any payment that has the effect of "eroding" the country's tax base. A payment would be considered as eroding the source country's tax base if it was either deductible by a source-country purchaser or formed part of his cost of goods sold (as this would decrease the gain on the sale of goods). If either of these conditions applies, withholding would occur under the base-erosion approach irrespective of the category of the income.¹³¹
- This feature is an important element of Prof. Doernberg's approach, and it is intended to respond to the concern regarding the characterization problems that are likely to intensify in electronic commerce transactions, as the test for

¹³⁰ Doernberg, Richard and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999)

¹³¹ *Ibid.*

withholding would be independent of the characterization of the income in the transaction.¹³²

- Another feature of the base-erosion approach is that the withholding tax is intended to be creditable in the residence country, as the approach is premised on allocating the tax base from electronic commerce between source and residence countries, rather than increasing the overall level of taxation. This feature is designed not only to achieve an allocation of the tax base between residence and source countries, but also to operate as a mechanism to avoid double taxation.¹³³
- The last feature of the base-erosion approach is the inclusion of a mechanism to allow vendors from residence countries to file on a net basis in source countries. This feature is necessary to overcome the potential excessive tax burden that may be associated with a gross-based tax under the proposal, along with concerns of double taxation, such as those expressed in the previous paragraph.¹³⁴

The base-erosion approach seeks to preserve the permanent establishment threshold, while supplementing it with a new test for tax links in source countries which is based on a withholding tax that would apply to any base-eroding payment made by source-country businesses to residence-country businesses.¹³⁵

¹³² Doernberg, Richard and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999)

¹³³ *Ibid.*

¹³⁴ *Ibid.*

¹³⁵ *Ibid.*

Source countries benefit as they can withhold tax on any base-eroding payment made by businesses to persons in residence countries. Relief from double taxation could be accommodated by allowing a credit.¹³⁶

Problems with this approach are also evident, including the risk of excessive credits that may arise from applying the credit mechanism. These difficulties would have to be effectively overcome to ensure that the approach can operate in a way that is acceptable to most countries.¹³⁷

7.2 The virtual permanent establishment approach:

The virtual permanent establishment approach is a policy approach that has been advocated by Prof. Hinnekens.

This approach seeks to relax the permanent establishment principle by adopting a threshold for source-based taxation that is lower than that of a traditional permanent establishment. This will be achieved by creating a tax presence in source countries even in the absence of a fixed place of business in them.¹³⁸

This effectively means that the tax link will be a permanent establishment by allowing tax jurisdiction on the basis of a virtual permanent establishment in the source country.¹³⁹

¹³⁶ Doernberg, Richard and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999)

¹³⁷ *Ibid.*

¹³⁸ *The Need to Reconceptualize the Permanent Establishment Threshold* Prof. Dr Dale Pinto

¹³⁹ *Ibid.*

While the virtual permanent establishment approach may seem to be radical, Prof. Skaar has suggested that perhaps the most radical suggestion in re-inventing the permanent establishment concept is to completely abandon it as the leading condition for tax jurisdiction and to introduce a system of source-state taxation of business profits.¹⁴⁰ At the same time, he acknowledged that it is not likely that developed countries as a group will agree to changes of this nature and that history suggests that the most practical solution to re-invent the permanent establishment concept is to leave its development to case law and bilateral treaty practice.¹⁴¹ To support this process, Prof. Skaar suggested that source countries "may seek to include permanent establishment fictions in their treaties for industries where the lack of physical location are predominant". Prof. Skaar's writings therefore provide support for Prof. Hinnekens' proposed virtual permanent establishment approach, which seeks to create such a fiction in determining the source-country tax nexus.¹⁴²

The proposal has two elements:

- a lower threshold for a permanent establishment is intended to apply in the case of electronic commerce transactions, and this is achieved by deleting the requirement for the existence of a "fixed place of business" in the source country from the current formulation of source under the permanent establishment threshold.

¹⁴⁰ Skaar, Arvid A., *Permanent Establishment: Erosion of a Tax Treaty Principle* (1991)

¹⁴¹ Skaar, Arvid A., *Permanent Establishment: Erosion of a Tax Treaty Principle* (1991)

¹⁴² *Ibid.*

- core or mainstream business activities are subject to source-country taxation under the approach, while ancillary activities are not. This is similar to the present exclusion for preparatory or auxiliary activities in Art. 5(4) of the OECD Model, though the proposed exclusion requires the development of suitable guidance and appropriate criteria in order to distinguish core activities from ancillary activities in an electronic commerce context. Prof. Hinnekens argued that the traditional permanent establishment concept can be redesigned to accommodate electronic commerce transactions in a way that taxes these transactions consistent with the principles of economic allegiance and equivalence. Such an approach could also represent a compromise between the interests of electronic commerce exporting and importing countries, thereby achieving the sharing of revenue between these countries.

The theoretical basis for the possible reconceptualization of source under the virtual permanent establishment approach may be justified by reference to Prof. Skaar's writings, which provide support for adopting an approach that seeks to tax businesses in source countries even in the absence of a fixed place of business in those countries.¹⁴³

It can be a problem to establish an internationally acceptable standard for determining when this virtual permanent establishment should exist and this can mean that successful implementation could be difficult.¹⁴⁴ These problems are made worse by the likely difficulties that will be met in attributing profits to a virtual permanent establishment.¹⁴⁵

¹⁴³ The Need to Reconceptualize the Permanent Establishment Threshold Prof. Dr Dale Pinto

¹⁴⁴ Ibid.

¹⁴⁵ Ibid.

7.3 Refundable withholding approach:

The refundable withholding approach is defined for active business income by proposing an alternative to the permanent establishment threshold. The refundable withholding approach draws upon elements from above proposals, but it also includes other elements to establish the source-country tax nexus.¹⁴⁶

It is a hybrid approach to re-invent the way source is currently defined for both active and passive income. The refundable withholding approach is designed to establish a jurisdictional framework for the source-based taxation of e-commerce transactions by introducing a system of withholding to be applied by source countries at a uniform rate to all international electronic commerce transactions.¹⁴⁷

While many are critical of systems based on withholding, given the characteristics of e-commerce¹⁴⁸, the use of withholding taxes by source countries may be justified. The literature on electronic commerce provides support for tax systems based on withholding, and Prof Doernberg's base-erosion withholding approach represents a leading example of such support.¹⁴⁹ In addition to Prof. Doernberg, others have proposed withholding tax approaches for the source taxation of e-commerce transactions.¹⁵⁰ Some propose applying withholding at the corporate tax rate in the source country, while Prof. Doernberg's approach proposes a low rate of withholding

¹⁴⁶ The Need to Reconceptualize the Permanent Establishment Threshold Prof. Dr Dale Pinto

¹⁴⁷ Ibid.

¹⁴⁸ Linda Essor SA must not miss out on e-commerce tax revenue, says Davis Committee, 31 December 2014, www.bdlive.co.za

¹⁴⁹ Doernberg, Richard and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999)

¹⁵⁰ The Need to Reconceptualize the Permanent Establishment Threshold Prof. Dr Dale Pinto

tax.¹⁵¹ Countries such as India are already seeking to rely to a greater extent on withholding approaches in determining how to tax e-commerce transactions.¹⁵² From a practical perspective a withholding tax can be a good option to tax e-commerce transactions.¹⁵³

Basing the source-country tax nexus on total gross sales above a de minimis threshold would, to many, seem to be a novel, if not unique, proposal. It is submitted, however, that such a threshold for nexus may be necessary to take into account the challenges that electronic commerce provides to established tax principles, such as the permanent establishment threshold, which rely on a physical presence that could become more elusive (or even absent) in an electronic commerce context.

The refundable withholding approach could operate by taxing all international transactions involving goods or services that are provided electronically or purchased via electronic means to be treated as "withholding income" which would then be subject to a uniform rate of withholding tax by source countries.¹⁵⁴

The system is also designed to avoid the difficult issues regarding the classification of income that could become more problematic in an e-commerce context.¹⁵⁵ And as the system can be unilaterally enacted by countries, it would not require a revision of the double taxation treaty network that exists between countries.¹⁵⁶

¹⁵¹ Doernberg, Richard and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999)

¹⁵² *The Need to Reconceptualize the Permanent Establishment Threshold* Prof. Dr Dale Pinto

¹⁵³ *Ibid.*

¹⁵⁴ *Ibid.*

¹⁵⁵ *Ibid.*

¹⁵⁶ *Ibid.*

A concern regarding the proposal relates to the fact that, as electronic commerce transactions would effectively be taxed based on their ultimate destination (where they are consumed), it could be argued that the system resembles a consumption tax and not an income tax.¹⁵⁷ It could therefore be argued that it is not necessarily illogical to allocate income tax revenues to countries in which consumption takes place, the same way that it is acceptable to allocate an origin-based VAT to the production country.¹⁵⁸

¹⁵⁷ The Need to Reconceptualize the Permanent Establishment Threshold Prof. Dr Dale Pinto

¹⁵⁸ Ibid.

8. Conclusion and recommendations

E-commerce creates the dilemma that an entity can do business in a country without having a physical presence in that country. The reason why this creates a dilemma is because of the way source is currently defined under the permanent establishment threshold. Profits may not be taxed by source countries in an electronic commerce context unless a server (through which core activities are conducted) exists in the source country.

Theoretically business profits can be taxed in the absence of a physical presence, yet trying to deal with electronic commerce transactions in the context of the conventional formulation of the permanent establishment threshold seems to be inadequate. The rules of a permanent establishment still depend on a finding of some kind of physical presence at a specific geographical location for a certain period of time.

E-commerce creates the possibility that entities can trade significantly in foreign countries without the existence of a permanent establishment. This means that income will be earned by the company in a foreign jurisdiction, but without a permanent establishment it will not be taxed in that jurisdiction.

Taking into account the different approaches discussed to re-evaluate the taxing of e-commerce it is my view that the withholding tax approach is feasible. This will mean that source countries can tax significant business profits gained through e-commerce without the physical presence of the foreign company in the source state.

Recent view of South Africa on taxing e-commerce and recommendations:

In the 2015 Budget Speech presented on 25 February 2015 the Minister of Finance announced that amendments will be proposed to change the rules for e-commerce in line with the latest guidance issued by the OECD¹⁵⁹ in its report on base erosion and profit shifting.¹⁶⁰ The proposed changes for South Africa is based on the interim report of the Davis Committee¹⁶¹ which stated that there is limited scope for South African residents to shift profits to offshore tax havens via e-commerce, but the opposite is true with respect to e-commerce conducted by non-residents with South African customers.

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Non-residents are subject to tax in South Africa on income derived from a source in South Africa, but the problem arises that the source rules do not deal specifically with e-commerce transactions.

¹⁵⁹ Addressing the tax challenges of the Digital Economy – Action 1 – 2015 Final Report (OECD/G20 Base erosion and profit shifting project).

¹⁶⁰ 2015 Budget Speech, www.treasury.co.za, electronic version, 25 February 2015.

¹⁶¹ Addressing base erosion and profit shifting in South Africa, Davis Tax Committee Interim Report.

¹⁶² Arnaaz Camay, New rules proposed for e-commerce transactions, taxENSight, 22 April 2015.

The interim report on base erosion and profit shifting of the Davis Committee makes the following recommendations in respect of the new direct tax legislation relating to e-commerce:¹⁶³

- new source rules that deal with e-commerce transactions to provide that digital goods or services are sourced where consumption takes place and that a portion of the profits will be taxed in South Africa¹⁶⁴
- the South African Revenue Service should focus on foreign multi-national entities and compel them to submit tax returns¹⁶⁵
- rules should be implemented that require non-residents with South African sourced income to submit income tax returns, even if they do not have a permanent establishment in South Africa¹⁶⁶
- a withholding tax system should be implemented where a resident that enters into an e-commerce transaction with a non-resident should withhold tax on payments made to the non-resident¹⁶⁷
- the legislation should allow for the provisions of the Electronic Communications and to be used to identify taxpayers, since the main challenge that e-commerce poses is in identifying where the taxpayers are and what their transactions are¹⁶⁸

¹⁶³ Ibid

¹⁶⁴ Addressing base erosion and profit shifting in South Africa, Davis Tax Committee Interim Report.

¹⁶⁵ Ibid

¹⁶⁶ Ibid

¹⁶⁷ Ibid

¹⁶⁸ Ibid

The committee also recommended that the tax authorities await the outcome of the OECD's ongoing work on the permanent establishment threshold for the digital economy rather than trying to come up with its own one-sided solutions.¹⁶⁹

¹⁶⁹ Linda Essor SA must not miss out on e-commerce tax revenue, says Davis Committee, 31 December 2014, www.bdlive.co.za

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The impact of Income Tax Case No 1859 on the buy back by a
company of its own shares from a connected person

Suzette Wepener

A minor dissertation presented in partial fulfilment of the
requirements for obtaining the M.Phil Tax Law

UNIVERSITY OF CAPE TOWN

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1. Introduction

The recent decision of the Johannesburg Tax Court in *Income Tax Case No 1859* (74 SATC 213), handed down on 13 February 2012, addresses for the first time by a South African court the unexplored aspects of key concepts in the capital gains tax regime laid down in the Eighth Schedule to the Income Tax Act No.58 of 1962 (the Act). In particular, the judgement explored the fundamental nature of a disposal and the essential nature of a redemption of redeemable shares.

In this case SARS has disallowed a capital loss claimed by the taxpayer company which had been incurred as a result of the redemption of redeemable shares held by it in a second company in the same group. The capital loss was disallowed on the basis that it was a “clogged loss”¹ as envisaged in paragraph 39(1) of the Eighth Schedule to the Act.

One of the issues dealt with is whether the redemption of the shares is a “disposal to any person”. If paragraph 39(1) of the Eighth Schedule were applicable, it was clear that the capital loss would be a clogged loss, since it was common cause that the two parties involved were “connected persons”.

For purposes of this research report I want to explore whether there is a “disposal to any person” when a company ‘repurchase’ or ‘buys back’ its own shares, with reference to the judgement laid down in *ITC 1859*.

In order to reach a conclusion on the matter, the following issues will be explored:

- the judgement laid down in *ITC 1859* will be analysed as far as it refers to whether the redemption of shares is a “disposal to any person”

¹ Silke on South African Income Tax Vol. 3.24.160

- the proper interpretation of paragraph 39(1) will be analysed as well as the legislators intention with paragraph 39(1)
- the nature and definition of a share will be analysed
- the nature of the act of redemption versus a 'repurchase' or 'buy-back' of shares will be analysed
- the buy-back of shares in terms of the Companies Act will be analysed
- the tax treatment of capital losses between connected persons in other jurisdictions will be explored

This research reports aims to analyse the consequences of *ITC 1859* in light of the case being the first to address unexplored aspects of key concepts in the Eighth Schedule. It will explore whether the case could be applied to the 'buy back' of a company of its own shares from a connected person and other scenarios where the judgement could be applied.

Furthermore, the aim of the paragraph 39(1) will be analysed to determine the true intention of the Legislator and what he envisaged with paragraph 39(1), which is in essence an anti-avoidance paragraph in the Eighth Schedule.

2. Analysis of *Income Tax Case 1859*

In the recent judgement of the Tax Court, one of the issues for determination was whether the “clogged loss” as envisaged by paragraph 39(1) of the Eighth Schedule to the Income Tax Act applies to the redemption of preference shares.

2.1 The facts of the case:

- The taxpayer had concluded a sale of shares agreement whereby it had purchased redeemable preference shares from E Bank that had been allotted and issued by B Ltd in accordance with Article 34 of its Articles of Association and Articles 34.2 and 34.3 of B’s Articles of Association.
- The taxpayer, pursuant to the agreement, had paid an amount of R 274 149 831 to E Bank on 25 February 2004 and in March 2004 B Ltd redeemed the preference shares in accordance with Article 34, pursuant to a resolution dated 12 March 2004, for a total redemption price of R 234 893 886.
- At the time of the redemption the taxpayer and B Ltd were members of the same group of companies and were connected persons as defined in section 1 of the Income Tax Act.
- The redemption price was paid by B Ltd to the taxpayer on 12 March 2014 and the total redemption price included the issue price, the dividend and the redemption premium.
- The cancellation of the preference shares was registered through STRATE (the licenced central securities depository for the electronic settlement of financial instruments in South Africa)

and B was obliged to cancel the preference shares on redemption.

- SARS had dismissed an objection raised by the taxpayer to his assessment for the 2003 year in which SARS had reduced and disallowed a capital loss claimed by the taxpayer in respect of the redemption of the shares, on the basis that the loss was a “clogged loss” contemplated in paragraph 39(1) of the Eighth Schedule to the Income Tax Act.

2.2 The two main issues before the court:

- The interpretation of paragraph 39(1) of the Eighth Schedule, and more particularly, whether that paragraph applied to the redemption of the preference shares and accordingly rendered the taxpayer’s capital loss, a “clogged loss” because of the connection between the taxpayer and B Ltd.
- The *quantum* of the taxpayer’s capital loss and, more particularly, the meaning of the word ‘recover’ in paragraph 20(3) of the Eighth Schedule and whether the taxpayer actually recovered part of the cost of purchasing the preference shares from E Bank when B Ltd redeemed them.

The taxpayer contended that paragraph 39(1) was not applicable because the redemption of the shares was not a disposal by it to any other person.

The taxpayer placed emphasis on the preposition ‘to’ which was used in addition to the term ‘disposal’ in paragraph 39(1) and submitted that the kinds of disposals that were contemplated in paragraph 39(1) were those where the asset, or the rights in the asset, were **transferred from the disposer to any other person.**

It was further submitted by the taxpayer that in the case of the redemption of shares there was no transfer of the shares (or the bundle of rights represented by the shares) from the holder of the shares to the redeeming company as on redemption the shares (or rights represented by the shares) were extinguished and ceased to exist.

SARS contended that paragraph 39(1) was applicable and that the redemption of the shares was a disposal. The redemption was a kind of 'buy back' and was a disposal to B Ltd as contemplated in paragraph 39(1) and that the taxpayer's loss was a "clogged loss".

These submissions mentioned above brought into focus the meaning of paragraph 39(1) and whether the term 'disposal' in that paragraph had to be given a constrained meaning in the light of its context in that paragraph and, because it was used in that paragraph in conjunction with the preposition 'to'.

2.3 The applicability of paragraph 39(1) of the Eighth Schedule

Paragraph 39(1) provides the following:

'39. Capital losses determined in respect of disposals to certain connected persons.-

(1) A person must, when determining the aggregate capital gain or aggregate capital loss of that person, disregards any capital loss determined in respect of the disposal of an asset to any person –

(a) who was a connected person in relation to that person immediately before that disposal; or

(b) which is immediately after the disposal-

(i) a member of the same group of companies as that person ...

(ii) ...'

A 'disposal' is defined in paragraph 11(1) of the Eighth Schedule as follows:

'11. Disposals.- (1) Subject to subparagraph (2), a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes –

(a) the sale, donation, expropriation, conversion, grant, cession, exchange, or any other alienation or transfer of ownership of an asset;

(b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;

(c) the scrapping, loss or destruction of an asset;

(d) ...

(e) ...

(f) ...

(g) ...'

The following was held in the judgement:

- In interpreting fiscal or tax legislation one commences with a literal interpretation because such legislation ought to be certain and the golden rule of statutory interpretation meant that words in a statute had to be given their ordinary literal meaning within their context in the statute. In terms of this rule the ordinary grammatical meaning of the words must be adhered to if the language is unambiguous and clear. The court may

only depart from the ordinary meaning if it leads to an absurdity so glaring that it could never have been contemplated by the Legislature.

- It was also a fundamental principle that when interpreting legislation every word used must be taken into account and it had to be borne in mind that in interpreting anti-avoidance provisions (such as paragraph 39(1)), a wider interpretation is required so as to suppress the mischief at which the provision is aimed at and to advance the remedy. In this regard, interpreting 'widely' did not mean that the meaning of the provision must be stretched beyond what its language permits.
- The mischief at which paragraph 39(1) is aimed at is clearly to prevent a taxpayer from avoiding or reducing its tax liability by creating a tax loss through the disposal of an asset to a person (including a company) that it is connected to and to allow such losses. This would provide fertile ground for the creation of fictitious losses that came about as a result of disposals to connected persons to be deducted generally. Tax liability would be reduced while the asset, or the benefit thereof, would still be retained by the disposer, albeit through the connected person.
- The wording of paragraph 39(1) covers all transactions such as sales, or the transfer of assets (including shares), from the disposer to a connected person. The difficulty arises where there is no transfer of the asset (or the rights therein) from the disposer to the connected person.
- According to the canons of construction referred to above the preposition 'to' in paragraph 39(1) cannot be ignored unless its inclusion would result in an absurdity so glaring that it could never have been contemplated by

the Legislature. When adopting a literal interpretation of paragraph 39(1) the disposal of the asset must be 'in the direction of' or 'so as to reach' the connected person. This implies a disposal of a kind in which the asset (or the rights represented therein, in the case of shares) must be transferred to the connected person.

- It was important to determine what occurred upon redemption of the shares and whether the act of redemption automatically resulted in the extinction of the shares, or whether it merely resulted in a transfer to the redeemer, who had to perform a further act of extinguishing the shares. In the present case it was common cause that upon redemption the asset (the shares, or the bundle of rights the represented) were extinguished despite the provisions of the Articles of Association. No share certificates were handed over by the taxpayer upon redemption and the shares were 'dematerialised', they ceased to exist.
- SARS did not submit that the preposition 'to' was mere surplusage, nor did SARS make out a case for the deletion of the word from the paragraph. And it had not been shown that the ordinary literal meaning of the paragraph (inclusive of the preposition 'to') led to an absurdity or that it would permit the mischief which it intended to prevent by means of that paragraph.
- The redemption of shares constituted a 'disposal' as defined in paragraph 11 of the Eighth Schedule, but it was not a 'disposal to any other person' as envisaged in paragraph 39(1) as the redemption of shares resulted in the extinction and not in a transfer of the rights embodied in the shares to the company redeeming the, or to any other person.

- The loss was accordingly not a 'clogged loss' as envisaged in paragraph 39(1).

2.4 The nature of a 'disposal to another person' as distinct from a mere extinction of rights

The taxpayer argued that even though paragraph 11(1) of the Eighth schedule explicitly defines 'disposal' as including redemption, the language of the provision envisaged in paragraph 39(1) (and particularly the word 'to' in the phrase 'disposal of an asset to any person) had the effect of confining the application of paragraph 39(1) to where there was a transfer of the asset itself, or of the rights in the asset, to another person.

The taxpayer argued that where shares are redeemed, there is no transfer of the shares themselves, or any of the rights represented by the shares. The shares or the rights are simply extinguished and ceased to exist.

SARS's counter-argument was that the redemption of shares is in essence a kind of buy-back of the shares and constitutes a disposal to the taxpayer.

2.5 The court applied the principles of statutory interpretation

Challenged with these arguments stated above, the court looked to the legal principles regarding the interpretation of fiscal legislation with the emphasis on the importance of the word 'to' in the phrase and whether that word could simply be ignored.

In *Van Heerden and another v Joubert NO and others* the court explained the golden rule of statutory interpretation in terms of which words in a statute had to be given their ordinary literal meaning within their context in the statute. The ordinary grammatical meaning of the words must be adhered to if the

meaning is clear and unambiguous. The court may only depart from the ordinary meaning if it leads to an absurdity that could never have been intended by the Legislature.

In *Cape Brandy Syndicate v IRC* the rule which applied in interpreting the fiscal legislation was stated as follows:

'...look at what is clearly said. There is no room for intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look at fairly at the language used.'

Taking the above into account and referring to the *Concise Oxford Dictionary* the preposition 'to' means 'in the direction of' and 'so as to reach'. On adopting a literal interpretation of the provision, the disposal of the asset must be 'in the direction of', or 'so as to reach' the connected person. The asset must be transferred to the connected person.

It should also be taken into account that paragraph 39(1) is an anti-avoidance provision and the decision in *Commissioner for Taxes v Ferera* [1976] 38 SATC 66 stated that in interpreting anti-avoidance provisions, a wider interpretation is required to suppress the mischief at which the provision is aimed.

The court decided that there must be a transfer of the asset to the connected person.

2.6 The redemption of shares

SARS argued that there is no difference between the redemption of shares and the 'buy-back' of shares. A full analysis of the nature of a share, the redemption of shares and the 'buy-back' or 'repurchase' of shares will follow in the next chapter.

I want to mention that the court held that the redemption of shares results in extinction and not in a transfer of rights embodied in the shares to any other person.

3. The nature of the redemption of shares

A great deal of argument in ITC 1859 was directed at the nature of the redemption of shares. SARS did not submit that the preposition 'to' was mere surplage, but in essence, submitted that there was no difference between the redemption of shares and a share 'buy-back'.

SARS argued that the redemption was the same as a 'buy-back' or repurchase by a company of its own shares. In each case the asset (the corporeal right) is extinguished, in each case the issued share capital is reduced, the share premium is reduced, on redemption of the preference shares they revert to authorised shares and can be re-issued. The company pays for the shares and payment is a bilateral act. Furthermore, the sale or redemption takes place pursuant to an agreement, which means there is a contract that regulates the relationship. SARS submitted that there was an alienation or transfer of ownership of the asset which resulted in its extinction as contemplated in paragraph 11(a) of the Income Tax Act, and this resulted in a disposal to a person. It was further submitted that the disposal contemplated in paragraph 11(b) is also a disposal to a person. SARS argued that with reference to that paragraph that listed there are all concepts which connote waiver and that the right which is abandoned, or waived, or an asset which is forfeited, does not occur '*in vacuo*', there is a disposal to another person.

On this point, the taxpayer argued that upon redemption the rights of the relevant shareholder simply cease to exist. No transfer of rights occurs. Viscount Simmonds stated in IRC v Universal Grinding Wheel Co Ltd that:

'Where a redemption has been affected, the shares disappear for every purpose'

In an extraction from Blackman² it was said that a company does not 'buy-back' the rights in the shares, but the rights of the shareholder cease to exist. There is no disposal of rights in the redeeming company.

A company cannot hold its own shares and upon redemption the shares cannot be disposed of 'to' the company. It was submitted that in a 'buy-back' a company does not buy back the rights in the shares, but the rights of the shareholder cease to exist. It was further submitted by the taxpayer that the relevant question to ask when dealing with the application is not whether an act is a bilateral act, but whether the asset is transferred by the disposer to a connected person.

It is very clear from the above arguments by the taxpayer that they rely almost exclusively on the preposition 'to' in paragraph 39(1). The whole argument is based thereon.

In this case the judge decided that it is not necessary to decide the difference between a redemption of shares and a 'buy-back' or repurchase of shares. He stated that it is important to determine what happens upon redemption. Does the act of redemption automatically result in the extinction of shares or whether it merely results in a transfer to the redeemer who has to perform a further act of extinguishing them? He decided that it is common cause that upon redemption the assets are extinguished and that no share certificates were handed over and that the shares were dematerialised, they ceased to exist.

SARS' view:

SARS suggests that upon redemption the assets are transferred (or pass) to the redeemer who then extinguishes them when they are in his

² Blackman, Jooste et al

possession. SARS submitted that in terms of the Articles of Association of B Ltd (the connected person) the following was stated:

‘At the time of redemption, the registered holders of the preference shares shall be bound to surrender to the company the certificate relating thereto in order that the same may be cancelled...’

The court held that even though the Articles of Association envisaged that the certificated be handed over, this did not occur and the shares were dematerialised. Furthermore, the handing over of certificates is not for the purpose of transferring the rights, but rather to cancel the share certificates.

The parties agreed that at the time of the redemption of the preference shares there was no certificate that could be surrendered. The cancellation of the preference shares was registered through STRATE (the licensed central securities depository for the economic settlement of financial instruments in South Africa).³ The parties also agreed that whether the redeemable preference shares were redeemed in terms of section 98 of the Companies Act 61 of 1973 (as amended) or cancelled in terms of section 85(8) of the Companies Act, the accounting treatment would be the same.

The judge thought it more important to concentrate on what happens when shares are redeemed. In this light I thought it important to look at the nature of shares.

3.1 The Companies Act on the nature of shares

The proprietary interest that a person holds in a company is a ‘share’.⁴
The company as a separate legal person can own assets, therefore

³ ITC 1859 [4]

⁴ Cassim et al (2011) Contemporary Company Law

ownership of the assets resides in the company and the holding of the share does not entitle the shareholder to ownership of the asset.

The Income Tax Act⁵ defines a share as follows:

“share means, in relation to any company, any unit into which the proprietary interest in that company is divided”

Because the above definition only states that a share is a unit into which the proprietary interest of the company is divided it must be looked at case law to give a better understanding of the nature of a share.

In *Standard Bank of South Africa Ltd and another v Ocean Commodities Inc and others* Corbett JA stated the following:⁶

“A share in a company consists of a bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends...Normally the person in whom the share vests is the registered shareholder in the books of the company and has issued to him a share certificate specifying the share, or shares, held by him.”

In *Bradbury v English Sewing Cotton Co Ltd*⁷ Lord Wrenbury stated that a share is a fractional part of the capital and it confers upon the holder certain rights to a proportionate part of the assets of the corporation, by way of dividend or distribution of assets in winding up. It forms a separate right of property and the capital is the property of the corporation. The share is the property of the corporator.

In *Cooper v Boyes*⁸ Van Zyl J said that there is no simple definition of a share and that the various definitions emphasise a complex of characteristics which are peculiar to it. A share represents an interest in a company, which interest consist of a complex of personal rights

⁵ Section 1 of the Income Tax Act No 58 of 1962

⁶ 1983 (1) SA 276 (A) at 288

⁷ [1923] AC 744 (HL) 746

⁸ 1994 (4) SA 521 (C) 535

which may, as an incorporeal movable entity, be negated or otherwise disposed of.

Fidelis Oditah⁹ explains the legal nature of a share as a bundle of intangible property rights shareholders receive from the company in return for their contribution of cash or non-cash assets to the company. By reason of ownership of a share, a shareholder becomes the owner of a property right in a company made up of income, capital and voting rights, all determined by the terms of the issue of the share, the company's Memorandum of Incorporation, the general law and applicable statutes of the country of incorporation of the company. Shares are the units into which the shareholder's rights of participation in the company's cash flow, management and on return of capital, are divided.

In *Liquidators, Union Share Agency v Hatton*¹⁰ the court held that 'a share is a *jus in personam*, a right of action, the extent and nature of which and the liability attaching to the ownership of which depend upon statute'.

The court held in *Randfontein Estates Ltd v The Master*¹¹ that they (shares) are simply rights of action, entitling their owner to a certain interest in the company, its assets and its dividends. As between those in whose names they are registered in the books of the company, and any other person with whom the registered holders deal, they may be freely assigned, even though the original registration remains unaltered. That is the ordinary way in which shares are dealt with, they pass from hand to hand, and form the subject of many transactions without the original registration in the books of the company being disturbed.

⁹ 'Takeovers, share Exchanges and the Meaning of Loss' (1996) 112 LQR 424 at 426 and 427

¹⁰ 1983 (1) SA 276 (A) at 288

¹¹ 1909 TS 978 at 981 and 982 followed in *De Leef Family Trust and Others v Commissioner for Inland Revenue* 1993 (3) SA 345 (A)

Furthermore, a share issued by a company is regarded as moveable property.¹²

It is possible for a company to have shares with different rights, preferences, limitations and terms, this is called 'classes' of shares.¹³ The division of shares into various classes is based on the nature of the rights they give with regards to dividends and participation in a distribution on liquidation, and voting rights. All the shares of any particular class authorised by a company have preferences, rights, limitations and other terms that are identical to the shares of the same class.¹⁴ Shares have been divided, according to rights attached to them, into three classes of shares: preference shares (which may or may not be redeemable), ordinary shares, and deferred shares.¹⁵

Where the rights of classes of shares differ on the basis of rights to priority, the classes that enjoy preference rights are referred to as 'preference' shares. The shares that enjoy no preferred rights are referred to as 'ordinary shares'.¹⁶

3.2 The Companies Act on the redemption of shares and the 'repurchase' or 'buy-back' of shares

A redemption of shares is a repurchase of the shares made in terms of a right to purchase or to sell conferred on the company or the holder of the shares as a term of the issue.¹⁷

Before an amendment in the 1973 Companies Act in 1999 a company could not acquire its own shares even if permitted to do so by its Memorandum of Incorporation or Articles of Association. This was held in *Trevor v Whitworth*¹⁸ and until 1999 was a fundamental part of law.

¹² Section 35(1) of the Companies Act

¹³ Cassim et al (2011) Contemporary Company Law

¹⁴ Section 37(1) of the Companies Act.

¹⁵ Cassim et al (2011) Contemporary Company Law I

¹⁶ *ibid*

¹⁷ *ibid*

¹⁸ (1887) 12 App Cas 409 (HL)

This was to protect creditors and to protect shareholders by preventing a company from trafficking in its own shares.

Lord Watson held that a company could not become a member of itself and it could not legally resell the shares, or cancel them, as this would be a reduction in capital.¹⁹ In order to prevent avoidance this prohibition was also placed on a subsidiary of a company through which the shares could be repurchased.²⁰ This prohibition was rejected in the UK, Australia, New Zealand, Canada, most states of the USA and also in South Africa.²¹

A distinction is drawn in the Companies Act²² and practice between 'redemptions' and "repurchases' or 'buy-backs' of shares. All of these involve the return to a company of shares that were issued to shareholders. The company will pay money or transfer assets to shareholders for the shares. In the case of a redemption the company acquires the shares in terms of a contract contained in the Memorandum of Incorporation or in terms of the issue of the shares.²³ In the case of a 'repurchase' or 'buy-back' the company enters into a transaction with one or more of its shareholders and they agree that the company will acquire the shares. The distinction turns on whether the company takes back the shares in accordance with rights attaching to the shares, or in accordance with a separate contract entered into with shareholders.²⁴

Section 48 of the Companies Act refers to the 'acquisition" by a company of its own shares. This seems to be a misnomer because it indicates that the company holds the shares. This is not possible because a company cannot acquire rights against itself.²⁵ Section 35(5) of the Companies Act states that the shares bought by the

¹⁹ 428

²⁰ Section 39 of the 1973 Companies Act

²¹ Cassim et al (2011) Contemporary Company Law

²² Section 37(5) of the Companies Act

²³ Cassim et al (2011) Contemporary Company Law

²⁴ Blackman et al (n3) at 5-43

²⁵ Blackman et al (n3) at 5-43

company no longer retain the status of issued shares, but have the same status as shares that have been authorised, but not issued. This brings me to the concept of 'treasury shares'.

3.3 The nature of treasury shares

Treasury shares are shares acquired by a company through repurchase, surrender, donation, inheritance or similar method.²⁶ Instead of being cancelled when they were repurchased, they are held by the company until reissue or resale.²⁷ The Companies Act does not permit the direct holding of a company of treasury shares, but do so through a subsidiary or subsidiaries. The acquisition of treasury shares does not reduce the number of issued shares of the company, nor does the sale of treasury shares increase the number of issued shares. They carry no voting rights or rights to dividends, nor the rights to participate in a distribution of assets on a winding-up. Treasury shares are treated as the property of the company, to be disposed of by the company on such terms it chooses.²⁸

Treasury shares appear to be assets of the company, but they are similar to authorised but unissued shares of the company and cannot be properly taken into account when calculating the net assets of the company.²⁹ Therefore treasury shares really only represents an opportunity to acquire new assets for the corporate treasury by creating new obligations. They really are authorised shares that may be reissued free of some of the formalities of an original issue of shares regarding prospectuses, allotment requirements or pre-emptive rights.³⁰

²⁶ FHI Cassim 'The Repurchase by a Company of its Own Shares: The Concept of Treasury Shares' 2003 SALJ 137.

²⁷ Cassim et al (2011) Contemporary Company Law

²⁸ *ibid*

²⁹ *Borg v International Silver Co* 11 Fed (2d) 147 (1925). AC416 Generally accepted accounting practice.

³⁰ FHI Cassim (n290) at 139.

The position on treasury shares in Australia, New Zealand and Canada is similar to the position in South Africa. The American Model Business Corporation Act of 1979 has rendered treasury shares redundant by requiring that the shares be restored to the status of authorised but unissued, or to be cancelled and eliminated from authorised shares. Treasury shares are permitted in Singapore, Malaysia, the UK and the European Union.³¹

Some is of the view that treasury shares are advantageous in the sense that they afford companies flexibility in managing their capital structure and in adjusting their debt-equity ratio, reduce the cost of raising new capital and are useful for employee share schemes.³²

From this, along with the submission of the taxpayer that the accounting entries in the books of the company would be exactly the same if a buy-back was done, I draw the conclusion that the nature of a redemption of shares and the buy-back of shares are very similar. In the judgement in ITC 1859, the judge also went further to state that in this case it is not necessary to go into the difference between a redemption of shares and a buy-back of shares. It is more important to establish what happens upon the act of redemption of shares. Based on the above analysis it seems that this will also apply when a company 'repurchase' or 'buy-back' shares from a connected party.

³¹ FHI Cassim (n290).

³² Ibid.

4. The impact of the judgement handed down in ITC 1858 on paragraph 64B of the Eighth Schedule

Paragraph 64B came into operation on 1 June 2004 and applies in respect of the disposal of any interest in the equity share capital of any foreign company on or after that date.

A person holding 20% or more of the equity share capital of a foreign company must disregard any capital gain or loss arising on the disposal of those shares. The percentage holding is determined immediately before the disposal. The exclusion applies to a person that has held an interest of at least 20% in the equity share capital of the foreign company for at least 18 months.

If a capital loss arose from the disposal of the equity share capital of a foreign company to another foreign company, and such interest was at least 20% and had been held for at least 18 months prior to the disposal, that capital loss must be disregarded by that person in terms of paragraph 64B(2).

For example:

Effective 31 January 2010, A Limited (the South African company) disposed of its 25% shareholding in B Limited to C (both companies incorporated in the United Kingdom).

The South African company declared a Capital Gains Tax loss of R 10 million as a result of this disposal.

Immediately prior to the disposal of the shares in B Ltd, the South African company (A Ltd) held 100% of the equity share capital, and had held this investment since 1 October 2002.

Since the capital loss arose from the disposal of the equity share capital of a foreign company to another foreign company, and such interest was at least 20% and had been held for at least 18 months prior to the disposal, that capital loss must be disregarded by that person in terms of paragraph 64B(1)(b).

The wording of paragraph 64B(1)(b) includes the preposition 'to':

'(b) that interest is disposed of to any person that is not a resident (other than a controlled foreign company)...'

If the judgement handed down in ITC 1859 is applied to the above example it can be said that the disposal of the equity shares by the South African company (A Ltd) in B Ltd (the foreign company) did not constitute the disposal of the equity share capital of a foreign company *to* another foreign company, and also was not a disposal 'to' any person other than a resident as envisaged in paragraph 64B. The reason being that that there was no disposal 'to' a foreign company as it was a 'share buy-back' (repurchase) by the foreign company of its own shares. The disposal of the shares was not "to" any person as required in terms of paragraph 64B as the repurchased shares will not reach the company that is acquiring the shares.

If the above reasoning is applied when interpreting section 64B and the literal meaning is attached to the preposition 'to' as held in ITC 1859 then section 64B could not be applied in practice, and capital losses that came about in this manner could not be disregarded, as the paragraph envisaged.

SARS's argument suggests that upon redemption, or in this case the 'repurchase' or buy-back' (as it was established earlier that there is not much difference between the two concepts) of shares the assets (or the rights in the

asset) are transferred to the company acquiring the shares and the company then extinguishes them when they are in its possession.³³ This in effect means that in the case of a repurchase of shares there is a further act that has to be performed to extinguish the shares. Therefore the shares are first bought back by the company and a further step needs to be performed to extinguish them. The shares are transferred to purchasing company who only then extinguishes them when they are in its possession. A separate act needs to be performed to extinguish the shares.

4.1 Paragraph 11(2)(b) of the Eighth Schedule

Furthermore, it seems that paragraph 11(2)(b) of the Eighth Schedule supports this view. Paragraph 11(2)(b) of the Eighth Schedule specifically deals with the disposal of an asset by a company in respect of the issue or cancellation of shares:

‘2) There is no disposal of an asset—

a) by a person who transfers the asset as security for a debt or by a creditor who transfers that asset back to that person upon release of the security;

b) by a company in respect of-

the issue or cancellation of a share or member’s interest in the company; or

the granting of an option to acquire a share or member’s interest in or certificate acknowledging or creating a debt owed by that company;’

This paragraph would have been redundant if there is not supposed to be a disposal to anyone when shares are repurchased. This gives an indication of the intention of the Legislator when dealing with the repurchase or redemption of shares.

³³ ITC 1859 [24]

4.2 The intention of the Legislator in respect of paragraph 39

Any capital loss arising from a transaction between persons mentioned in paragraph 39(1) is not brought into account in calculating those persons' aggregate capital gain or aggregate capital loss for the year in which the disposal takes place. In effect the loss is ring-fenced and can only be deducted from capital gains determined in respect of other disposals during that year or a subsequent year to the same person to whom the disposal giving rise to that loss was made. The person to whom the subsequent disposals are made would at that time still have to qualify as a connected person at the time of the disposals.³⁴

As discussed before it must also be borne in mind that in interpreting anti-avoidance provisions, such as paragraph 39(1), a wider interpretation is required so as to suppress the mischief at which the provision is aimed at and to advance the remedy.

The mischief at which paragraph 39(1) is aimed is clearly to prevent a taxpayer from avoiding or reducing its tax liability by creating a capital loss through the disposal of an asset to a person (including a company) that it is connected to. To allow such losses as a result of disposals to connected persons to be deducted generally would provide fertile ground for the creation of fictitious losses. Tax liability would be reduced while the asset, or the benefit thereof, would still be retained by the disposer, even though through the connected person.

It is my view from the above discussion that the Legislator's aim with the anti-avoidance paragraph 39 is to create a 'clogged loss' in these circumstances that cannot be set-off against other capital gains. By inserting the preposition 'to' in the phrase 'the disposal of an asset to any person' the Legislator did not have the intention to specifically exclude shares. Shares are being excluded (based on the judgement in ITC 1859) because of their specific nature and what happens when they are redeemed or bought back by a company. The same kind of mischief that paragraph 39(1) wants to prevent can be achieved through a company that acquires shares from a connected person and fictitious losses can be created this way. For these reasons I am of the opinion that although the judgement handed down in ITC 1859 is not incorrect, SARS should have concentrated more on the intention of the

³⁴ SARS's Comprehensive Guide to Capital Gains Tax (Issue 4)

Legislator with this paragraph and argued that the preposition 'to' is not the crux of this case.

In addition to the aim of the Legislator, the existence of paragraph 64B and paragraph 11(2)(b) also uphold the view that a disposal to any person takes place when a company acquires its own shares. If not, these paragraphs would either be redundant or could never be applied in practice.

5. The view of the UK in respect of ‘clogged losses’ and share ‘buy-backs’

5.1 Transfers of assets between connected persons in the UK:

In December 2005 the Chancellor of the Exchequer announced the introduction of new targeted anti-avoidance rules (TAAR) to prevent the artificial creation and use of capital losses made by companies (TCGA92 s8(2A) to section 8(2C) and TCGA92 section 184A). With effect for disposals made on or after 6 December 2006 TCGA92 section 8(2A) to section 8(2C) were withdrawn and new targeted anti-avoidance rules were introduced for all taxpayers including individuals, personal representatives, trustees and companies.

The press release issued at the time said that the aim was to block tax relief for artificially created losses, whether the tax advantage would be obtained by the person realising the loss or a third party. The TAAR was intended to apply where tax avoidance was the main purpose (or one of the main purposes) of a transaction or a series of transactions.³⁵

The taxes covered by the TAAR are capital gains tax, corporation tax and income tax.

The UK supports the view that capital losses made between connected persons should be treated as ‘clogged losses’. If you dispose of an asset to, or acquire an asset from, a connected person the price paid should be replaced by the market value of the asset in working out your gain or loss. If you make a loss you can only set that loss against gains made on other disposals to the same connected person. These are known as ‘clogged losses’. They will be included in the total loss figure,

³⁵ United Kingdom: Capital Gains Tax – Targeted Anti-Avoidance Rules for Capital Losses by Smith and Williamson

and a separate record of each clogged loss carried forward to later years should be kept to make sure you deduct it correctly from future gains.³⁶

5.2 The English Company Law:

Successive UK Companies Acts have made it possible for companies to buy their own shares in a number of ways. The current legislation is in Part 18 of the Companies Act 2006.³⁷

Any company may make an 'off-market purchase' of its own shares by way of contract with one or more particular shareholders. The contract must be approved by a special resolution in general meeting. The shares must be cancelled when purchased and this, too, is subject to the rules on finance.

The relevant provisions of the UK Companies Act 2006 are as follows:

Section 693 Authority for purchase of own shares.

'(1) A limited company may only purchase its own shares— .

(a) by an off-market purchase, [F1 authorised in accordance with section 693A or] in pursuance of a contract approved in advance in accordance with section 694; .

(b) by a market purchase, authorised in accordance with section 701. .

(2) A purchase is "off-market" if the shares either— .

(a) are purchased otherwise than on a recognised investment exchange, or .

(b) are purchased on a recognised investment exchange but are not subject to a marketing arrangement on the exchange.

(2) ...'

Section 694 Authority for off-market purchase.

'(1) A company may only make an off-market purchase of its own shares in pursuance of a contract approved prior to the purchase in accordance with this section. .

(2) Either— .

(a) the terms of the contract must be authorised by a resolution of the company before the contract is entered into, or .

(b) the contract must provide that no shares may be purchased in pursuance of the contract until its terms have been authorised by a resolution of the company.

³⁶ HM Revenue and Customs Capital gains summary notes hmrc.gov.uk/sa108

³⁷ UK Companies Act 2006

(2)...'

Section 706 Treatment of shares purchased.

'Where a limited company makes a purchase of its own shares in accordance with this Chapter, then—

(a) if section 724 (treasury shares) applies, the shares may be held and dealt with in accordance with Chapter 6; .

(b) if that section does not apply— .

(i) the shares are treated as cancelled, and .

(ii) the amount of the company's issued share capital is diminished accordingly by the nominal value of the shares cancelled.'

A company may purchase its own shares according to the applicable UK Companies Act, it follows therefore that the seller of such shares must have disposed of such shares to the company. The fact that these shares are treated as cancelled thereafter should not detract from the above.

6. Conclusion

The judgement laid down in *ITC 1859*, in respect of if 'a disposal was made to any person' seems quite fair based on the arguments that were raised by the parties involved. The particular phrase in the applicable paragraph (paragraph 39(1) of the Eighth Schedule) does include the preposition 'to'. And the court decided to attach the literal meaning of the word in the phrase and not to exclude the word. The golden rule of statutory interpretation meant that words in a statute had to be given their ordinary literal meaning within their context in the statute.

When adopting a literal interpretation of paragraph 39(1) the disposal of the asset must be 'in the direction of' or 'so as to reach' the connected person. This implies a disposal of a kind in which the asset (or the rights represented therein, in the case of shares) must be transferred **to** the connected person.

SARS did not argue that the preposition 'to' is superfluous, nor did SARS make out a case for the deletion of the word from the paragraph. And it had not been shown that the ordinary literal meaning of the paragraph (inclusive of the preposition 'to') led to an absurdity or that it would permit the mischief which it intended to prevent by means of that paragraph. I believe more emphasis should have been put on the intention of the Legislator with paragraph 39 of the Eighth Schedule, seeing that paragraph 39 is an anti-avoidance paragraph aiming to suppress mischief.

Taking into account that the effect of the judgement laid down in *ITC 1859* on paragraph 64B of the Eighth Schedule will be that the paragraph could not be applied in practice, I cannot believe it was the intention of the Legislator to specifically exclude the 'repurchase' or buy-back' of shares when applying these two paragraphs (paragraph 39 and 64B). Especially because paragraph 64B specifically refer to transactions where equity shares are bought back.

The court took the view in the judgement laid down in *ITC 1859* that the emphasis should be placed on what happens to a share when it is bought back, repurchased or redeemed. Because of the inherent nature of a share (a bundle of rights) it

became almost impossible to argue that the share was disposed of to any person. A company cannot have a right to claim dividends from itself. It is accepted that upon redemption the assets are extinguished and that no share certificates were handed over and that the shares were dematerialised, they ceased to exist.

SARS argued that there is a separate step or action needed to cancel the shares. SARS suggests that upon redemption the assets are transferred (or pass) to the redeemer who then extinguishes them when they are in his possession. SARS submitted that in terms of the Articles of Association of B Ltd (the connected person), they had to hand over the certificates to be cancelled.

I am of the view that this is supported by paragraph 11(2)(b) that a disposal to any person takes place when a company acquires its own shares. If not, this paragraph would be redundant. The fact that not all shares that are repurchased are automatically cancelled also supports this view. In the case where the company keeps the shares as treasury shares, the shares are never cancelled. They might not carry the same rights as they previously did, but they are not cancelled.

I am of the view that although the judgement seem sound when taking into account that a disposal to any person cannot be possible where the assets (or the rights to the assets) are not transferred to any person and the paragraph specifically states that the disposal should be to any person. But in light of the above discussion the very mischief that paragraph 39(1) wants to prevent will be achieved if the paragraph does not apply when shares are acquired from a connected person.

It is not apparent yet if SARS intends appealing the finding in the judgement.

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