

**The Normal Tax treatment of cross-border dealings between various parts of a company in terms of the Income Tax Act, No. 58 of 1962, compared to selected aspects of the Organisation for Economic Cooperation and Development's Model Tax Convention on Income and Capital with a special emphasis on its Discussion Drafts on the attribution of profits to a permanent establishment**

**by**

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Johann Hattingh

Cape Town, February 2006

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## Chapter 1: Introduction

### 1.1 Background

The Revenue Laws Amendment Act, 59 of 2000 fundamentally altered the South African income tax basis. More specifically, residence-based income taxation was introduced whereby natural and legal persons who are considered tax residents of South Africa became liable to comprehensive income tax chargeable on their worldwide earnings.

For non-residents the old basis of income taxation remains intact whereby income tax is only charged on income received or deemed to be received from a source located in South Africa.

In the face of the introduction of the residence basis of taxation a theme in international tax law that has remained relatively unexplored locally is the income tax and capital gains tax (CGT) treatment of cross-border dealings between various parts of a single corporate legal person. For instance, when a South African resident company sells merchandise through an offshore branch, or a non-resident company sells goods through a South African sales agent, these operations may require a reallocation of inventory or the provision of services, intangible property or capital funds from one part of the company located in one country to another part of it located in the other country.

It is unclear whether the general provisions of the Income Tax Act, 58 of 1962 (as amended) ('the Act') hailing from the pre-residence basis era are applicable or flexible enough to accommodate activities within a single corporate person. For example, is the Act's trading stock provision applicable to a determination of a South African branch's income in circumstances where inventory is reallocated internally?

Historically, where a South African company had a sales office in a foreign country, South African source tax rules were not directly concerned with the legal form of a company when a determination of its tax liability was made. The tax determinant was whether the income forthcoming from, for example, foreign sales was received from a source located in South Africa or not - this was the only consideration, which by nature did not primarily have regard to legal corporate form. For the residence-basis of taxation, the focus shifts to the person concerned, and legal corporate form thus becomes an all-encompassing tax determinant.

The general overhaul of South Africa's corporate tax system since 1994 has been supported by the conclusion of a vast number of bilateral double taxation conventions (DTC) with other countries by the fiscal authorities. All of South Africa's DTCs deal explicitly with the tax treatment of intra-company dealings in these bilateral cross-border scenarios.

During this process of reform the cross-border activities or 'dealings' between various parts of a single corporate entity have not been comprehensively addressed by the legislature in the municipal tax system except on a piecemeal basis.

Consequently the provisions of the Act specifically aimed to deal with these kinds of dealings are few and far between. In addition, it is not certain whether the general provisions of the Act (eg the general deduction formula, foreign currency

provisions, recoupments, capital allowances, CGT, etc) can be applied in the context of these kinds of dealings.

Furthermore, under the terms of South Africa's double tax conventions, which to a large extent follow the Organisation for Economic Cooperation and Development's Model Tax Convention on Income and Capital (OECD MTC), and to a lesser extent the United Nation's Model Double Taxation Convention between the Developed and Developing Countries (UN MTC), dealings between various parts of a single corporate entity are treated as if the various parts located in different countries where distinct and separate unrelated legal entities for purposes of establishing the profits taxable in the respective countries. This effectively provides a disregard of legal form on the international tax level.

In the face of rather indiscriminate municipal income tax and CGT rules the stage is set for confusion; for example, does the approach to dealings between a general enterprise (GE) and its offshore permanent establishment (PE) under municipal law reflect or differ from that on the DTC level?

Moreover, since 2001 the OECD has published six reports detailing a reformed approach to the attribution of profits in terms of a DTC to various parts of a single corporate person located in different countries. The methodologies developed in these reports have since become the OECD's authorised approach to this subject and will replace the current approach outlined in the official commentary on the OECD MTC.

This study will show that the municipal approach to intra-company GE-PE dealings is not very clear and open, whilst the approach of the OECD on the DTC level is clearly in a status of flux. Experience since 1994 has shown that South Africa has followed the OECD's approach to international tax matters in a number of instances. If local reform on the income tax and/or CGT treatment of cross-border dealings between various parts of a single corporate entity is desirable on the domestic level, the OECD approach may likely have a significant influence.

This study will also illustrate that in certain cases, adjustments to the municipal income tax and CGT rules are indeed desirable.

## **1.2 Objectives**

The objective of this study is firstly to analyse and restate the income and CGT treatment of cross-border dealings between various parts of a single legal corporate person in terms of South Africa's municipal tax legislation and case law.

This analysis will be placed in the context of the general features of South Africa's corporate income tax system to make the research more accessible and illustrate the integration of the analysis with the taxation system.

The study will conclude with an analysis of the international tax law aspects of South Africa's corporate income tax system as exemplified by the network of DTCs. In this regard, the OECD's approach to the subject of this paper on the international level (ie where a DTC is applicable) will be restated with a view to analyse the interrelationship between the domestic and international systems.

Key objectives of this study include the following questions that will be answered on the various levels of the analysis in chapters 2 to 5:

- Do the general tax principles of South Africa's corporate tax system, on the municipal level, deal systematically with the income tax and CGT treatment of cross-border dealings between various parts of the same corporate entity?
- If dealt with systematically, can any principles be extrapolated from the municipal tax legislation?
- If not dealt with systematically, how is the tax treatment to be understood, and are there any areas resulting in beneficial or detrimental tax results?
- How is profit attribution to permanent establishments dealt with historically and presently in terms of the OECD's MTC?
- How does the OECD propose to deal with PE profit attribution on the DTC level in future?
- Does the proposed future position of the OECD differ from the present and historical position?
- Would adoption of the OECD's new approach to PE profit attribution on the DTC level contract, restrict or prohibit the tax results accomplished under South Africa's municipal income tax and CGT rules?
- What are the implications of the OECD's reform work in general for South Africa?

The methodology used to meet the objectives outlined above mainly involves the consultation of local and international tax law literature and case law on the subject.

This study will be confined to cross-border dealings between various parts of a single corporate body, that is, an entity with a separate legal personality distinct from its members. For this purpose, a company will be used as an example of such an entity throughout the study. Issues involving, for example, hybrid entities such as partnerships clothed by one country with corporate personality and not by another where it operates consequently fall outside the scope of this study.

This study is further confined to exclude special considerations that arise for particular trades such as, for example, the financial services industry (eg banks, insurers, dealers in financial instruments, etc).

The benefit of the research and analysis attempted in this study is mainly two-fold. It is the first comprehensive attempt to restate the municipal income tax and CGT rules on the topic after the general overhaul of South Africa's corporate tax system since 1994. In addition, it is also the first attempt to compare an analysis of the municipal situation with international tax developments in this area, mainly those occasioned by the OECD's reform work performed in respect of profit attribution to PEs since 2001.

### 1.3 Terminology

In this study terminology will as far as possible be uniform without deviating too much from the technical accuracy of terms.

In general, cross-border activities occurring between various parts of the same corporate entity located in different countries will be referred to as 'dealings' (as opposed to transactions), or 'GE – PE dealings', or simply 'intra-company dealings', since legally they occur in the absence of identifiable *causae* such as contractual obligations or rights.

The corporate body to be analysed in this paper will be referred to as the general enterprise (GE), which resides in the 'residence country' or 'home country', being the jurisdiction where its main activities are carried on<sup>1</sup> – colloquially but misleadingly also referred to as the head-office. That part of the GE located in another country (the 'host' or 'source' country) with which it 'deals' will be referred to as a permanent establishment (PE) of that GE. It is obvious that the concept of a PE has a particular meaning for mainly DTC purposes. Dealings between a GE and parts of it that fail to meet the threshold requirements for a PE are not analysed in this study.<sup>2</sup>

The above-mentioned terminology will be used throughout this paper.

The reader familiar with South Africa's municipal tax legislation must be forewarned that this is a deliberate choice of terminology aimed to correspond to DTC concepts that will be encountered in chapter 4 and which will hopefully support the analysis and conclusion sought by this study. In chapter 2, after having restated the general features of the South African corporate income tax system with emphasis on intra-company GE – PE dealings, the delineation of the PE concept will be briefly analysed from a municipal context. Based on this, chapter 3 examines specific categories of dealings between a GE and its PE in the municipal income tax and CGT environment.

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<sup>1</sup> The GE should not be assumed to be automatically located in the corporate entity's country of incorporation, although its main activities or head-office may indeed be located in the same country where it was formed or incorporated. The behaviour of finance or treasury activities carried on by companies forming part of multinational groups are frequent examples where the country of incorporation would not equate with the location of its main activities or head-office - an example springs to mind of a group finance company (ie a company making and receiving loans within a group) incorporated and formed in the British Virgin Islands with no presence there whilst most of its staff is located in Luxembourg and its treasury activities are carried on in Switzerland.

<sup>2</sup> Where a DTC is operative, these types of dealings require no analysis since the source state will in these circumstances be prohibited from taxing the GE's business profits altogether.

## Chapter 2: General features of the South African corporate income tax and CGT system

### 2.1 Principles for the taxation of residents

South Africa's corporate tax rules provide very little guidance on the attribution of profits to a PE, both on the municipal and DTC level, and hence the discussion in this introductory chapter will mainly focus on general income tax and CGT principles.

In terms of the Income Tax Act, 58 of 1962 (as amended) ('the Act') South African tax residents are liable to income and capital gains tax on their worldwide income and gains as from 1 January 2001 and 1 October 2001 respectively.

A person other than a natural person is a tax resident of South Africa when it either has been incorporated, established or formed in South Africa or when its place of effective management is located in South Africa.<sup>3</sup>

For corporate entities tax residents in South Africa, a two-tier system of income taxation is applicable that effectively seeks to tax retained profits at a lower rate than distributed profits. Thus, profits as they are earned are taxed annually at the corporate tax rate of 29%. When a resident company declares a dividend it is liable to pay the secondary tax on companies ('STC') at a rate of 12,5% on, generally speaking, the excess of the dividends declared over dividends received. The effective corporate tax rate may thus be as high as 36,89%.

A company realising a loss for income tax purposes is generally allowed to carry forward and set-off the balance of the assessed loss as long as that company carries on a trade.<sup>4</sup>

Revenue losses incurred by a company from any trade carried on outside South Africa are ring-fenced and cannot be set-off against that company's taxable income arising from a trade carried on inside<sup>5</sup> South Africa.<sup>6</sup> Therefore, broadly speaking,

<sup>3</sup> Paragraph (b) of the definition of a 'resident' in Section 1 of the Act.

<sup>4</sup> Section 20(1) of the Act.

<sup>5</sup> The question as to where precisely the territorial coastal borders of South Africa lie for purposes of proviso (b) to Section 20(1), and the Income Tax Act in general, is a surprisingly difficult one: it appears to be the high or low water mark of each of the approximate 50 coastal magisterial districts as proclaimed over a prolonged period according to Section 103 of the Constitution of the Republic of South Africa, 108 of 1996 (which refers one eventually to the magisterial districts proclaimed in terms of the Magistrates Court Act, 32 of 1944 via Part 1 of the First Schedule to the Constitution of the Republic of South Africa, 200 of 1993). The fact that other revenue statutes of South Africa specifically define the country's coastal territory as inclusive of, for example, the territorial waters, continental shelf, etc (eg the VAT Act, 89 of 1991 and the Customs and Excise Act, 91 of 1964) implicates *a contrario* that the Republic's territory is not inclusive of these spaces. So does the fact that many of South Africa's DTCs provide for specific application in these offshore spaces. The impact of the United Nations Convention on the Law of the Sea (in force since 16 November 1994) and Section 4(2) of the Maritime Zones Act, 15 of 1994 on this question appears to be limited to the extension of South African court's jurisdiction over the territorial waters only, and does not extend the territory of South Africa as such. However, the SARS, in its Interpretation Note No. 16 of 27 March 2003, which deals with the exemption provided for foreign employment income by Section 10(1)(o)(ii) of the Act, holds the contrary view and propagates that South Africa's coastal borders include for income tax purposes the territorial waters, which is the belt of sea within 12 nautical miles beyond the coastline of the country. No reasons are advanced by the SARS for this view. For the reasons mentioned above, the SARS view appears to have no legal basis, and must be rejected.

losses attributable to a foreign PE of a South African tax resident GE can only be utilised in respect of subsequent taxable income attributable to the PE (or any other PEs of the resident), but cannot be set-off against the taxable income of that GE ascribable to its trade carried on inside South Africa.

Tax losses in respect of capital assets are utilised separately and carried forward separately from revenue losses. Capital losses attributable to a foreign PE of a resident GE do not appear to be ring-fenced in the same way that revenue losses of such a PE would be ring-fenced.

South African tax resident companies are liable to tax on their 'gross income' for any year of assessment, which is the total amount in cash or otherwise received by or accrued to or in favour of such company.<sup>7</sup> Excluded from this amount of gross income are receipts or accruals of capital nature, which are calculated separately in the terms of the Eighth Schedule to the Act and then only 50% of the net capital gain is included in the 'taxable income' of the company. The effective CGT rate is therefore 14,5%. A net capital loss is not allowed to be deducted from taxable income, but capital losses are allowed against capital gains.<sup>8</sup>

Against the amount of 'gross income', certain income exempt from tax is deducted and the remaining amount results in the 'income' of the company.

Up to 1 June 2004 the income of a South African GE attributable to a PE situated in a 'designated country' (a 'white' list of countries) and which was subject to tax at a rate of 27% (or 13,5% in the case of capital gains) and which was not deemed to be received from a source located within South Africa was exempt from tax.<sup>9</sup> With the demise of the so-called designated country exemption for years of assessment commencing on or after 1 June 2004, high-tax offshore income attributable to a PE is included in the taxable income of a South African resident GE.

From the 'income' so determined the expenditure is deducted generally and also losses incurred in the production of the company's income resulting in 'taxable income' (as mentioned earlier, at this stage of the computation the amount of any net capital gains is included in 'taxable income'). When considering tax deductions for general business expenses in the context of GE - PE dealings, especially in terms of the general deduction formula,<sup>10</sup> it is important to note that South African courts have remarked that the Act is not concerned with notional expenditure,<sup>11</sup> but only with expenditure and losses 'actually incurred'.

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<sup>6</sup> Proviso (b) to Section 20(1) of the Act. See *Income Tax Case No. 1779/66 SATC 353* for the meaning of the phrase 'trade carried on outside South Africa'.

<sup>7</sup> The definition of 'gross income' in Section 1 of the Act.

<sup>8</sup> Section 26A of the Act and paragraph 8 of the Eighth Schedule to the Act.

<sup>9</sup> The repealed Sections 10(1)(kA) and 9(F)(2) of the Act.

<sup>10</sup> Section 11(a) read with 23(g) of the Act.

<sup>11</sup> *Afrikaanse Verbond Begrafnis Ondernemings Bpk v CIR* 1950 (3) SA 209 (A) at 216 and *Anglo American Corp of SA Ltd v COT* 1975 (1) SA 973 (RAD). See also Meyerowitz, D. 2004. *Meyerowitz on Income Tax*. The Taxpayer: Cape Town at § 11.41.

International double taxation of resident companies liable for foreign taxes in respect of income received from a foreign source is relieved by granting a unilateral tax rebate for the foreign tax paid on such income. The unilateral tax credit is limited up to the amount of South African tax payable on the foreign income.<sup>12</sup> This limitation on the tax credit relief from international double taxation is applied on an overall as opposed to a per-country or basket limitation basis.<sup>13</sup>

Excess unilateral foreign tax credits may be carried forward for up to seven years for purposes of set-off against South African normal tax payable in respect of foreign source income in such later years. No unilateral relief is granted in addition to any relief provided in terms of a DTC to which South Africa is party but may, however, be granted in substitution thereof.<sup>14</sup>

An analysis of South Africa's veritable network of DTCs reveals that the credit method for providing relief from international double taxation is normally used. There are exceptions, and it is necessary to consider each DTC.<sup>15</sup>

The enabling provision of the transfer pricing Section of the Act, which allows the adjustment according to the arm's-length principle of consideration in respect of cross-border connected-party transactions for income tax and CGT purposes, applies in respect of an 'international agreement'.

An international agreement is defined as meaning 'a transaction, operation or scheme' entered into between, *inter alia*:<sup>16</sup>

- (i) a person who is not a resident and any other person who is not a resident, for the supply of goods or services to or by a PE of either of such persons in South Africa, or
- (ii) a person who is a resident and any other person who is a resident, for the supply of goods or services to or by a PE of either of such persons outside South Africa.

<sup>12</sup> Section 6quat of the Act.

<sup>13</sup> Larkin, B. 2001. *International Tax Glossary*: 4<sup>th</sup> edition. Amsterdam: IBFD, at 155 describes these opposing limitation systems on foreign tax credits (termed 'rebates' for South African purposes) as follows: '... the credit may be limited to the amount of domestic tax that would be imposed on the foreign-source income if no credit for foreign tax were given or, if lower, the amount of the foreign tax on that income ('ordinary credit'). An ordinary credit may be contrasted with a full credit, where tax on foreign income may be deducted from domestic tax on income of any kind. Similarly, it may be subject to a per-country limitation, or a source-by-source limitation where the credit may not exceed the domestic income tax computed on income from one particular foreign country, or one particular source, as the case may be. A variation of the latter is where the credit is limited to the domestic tax in respect of a particular category of income that is subject to a foreign tax, eg by way of foreign tax credit baskets. The credit may be subject to an overall limitation where the total foreign tax credit may not exceed the domestic tax on the total of foreign-source income. As a result of the latter, foreign tax is prevented from being used to reduce domestic tax on income from domestic sources.'

<sup>14</sup> Section 6quat(2) of the Act – the choice to opt for unilateral or bilateral relief is that of the taxpayer.

<sup>15</sup> For example, the DTCs with Switzerland (1967) and Germany (1973) apply the exemption method in certain circumstances whilst the old 1971 treaty with the Netherlands (and others) allows for a choice between the credit and exemption method.

<sup>16</sup> The definition of 'international agreement' in Section 31(1) of the Act.

Both 'goods' and 'services' are defined for the above purposes.<sup>17</sup>

It is clear from the enabling definition of an 'international agreement' that the transfer pricing provisions of Section 31 of the Act presupposes a legally recognisable transaction between two separate persons. The transfer pricing provisions of Section 31 are therefore not applicable to 'dealings' between a GE and its PE in so far as a dealing relates to the provision of goods and services.

Although the South African Revenue Service (SARS) apparently concurs with this general statement, its view is that where South Africa has concluded a DTC (presumably one incorporating article 7(2) and 9 of the OECD MTC), it is sanctioned to follow an approach whereby the profits that must be attributed to a PE will be based on the general transfer pricing practice outlined in Practice Note 7 (PN 7), which deals with the application of Section 31 of the Act.<sup>18</sup>

Although the provisions of section 31 of the Act are applicable to persons, which are separate legal entities, the contents of this Practice Note will also apply to determine the arm's length consideration for income tax purposes of cross-border transactions conducted by - ... a person's [GE] with a branch of such person; or a person's branch with another branch of such person, in the application of the tax treaties entered into by South Africa.

The legal status of the SARS's practice notes is that they do not form part of substantive law and hence taxpayers cannot generally derive rights from it nor is the SARS bound to follow its own pronouncements formulated in these notes.<sup>19</sup>

It is doubtful whether the above extract quoted from PN 7 is an accurate reflection of the rules that govern profit attribution to PEs in terms of South African municipal or treaty law, as Section 31 simply does not apply to intra-company dealings.

It is submitted that the work that has been carried out by the OECD since 2001 on the subject of PE profit attribution (the subject of chapter 4) further reveals the flawed nature of the SARS view that the local transfer pricing practice outlined in PN 7 should govern PE profit attribution under South Africa's DTCs. The OECD recognises that its present transfer-pricing methodologies governing related party transactions, upon which PN 7 is to a great extent based, are ill-designed at a fundamental level to apply without modification to intra-company dealings. The transactional focus of related

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<sup>17</sup> Section 31(1) of the Act defines 'goods' as including: 'any corporeal movable thing, fixed property and any real right in any such thing or fixed property'; and 'services' as including *inter alia* 'anything done or to be done' including '(a) the granting, assignment, cession or surrender of any right, benefit or privilege; (b) the making available of any facility or advantage; (c) the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee; (d) the performance of any work; (e) an agreement of insurance; or (f) the conferring of rights to incorporeal property'.

<sup>18</sup> Paragraph 6.4 of Practice Note 7, 6 August 1999. (Available: <http://www.sars.gov.za>). This view was confirmed by a SARS official who spoke at an unpublished seminar organised by the South African Branch of the International Fiscal Association, Cape Town, 21 August 2003.

<sup>19</sup> *ITC 1675 62 SATC 219*. Meyerowitz *supra* at § 3.4 indicates that despite these notes not carrying the force of law, to the extent that the SARS do not adhere to its pronounced practice without due warning of a change, taxpayers prejudiced thereby could raise an objection based on the doctrine of legitimate expectations. The conclusion reached in *Special Board Decision No. 187 9 SASBDR 3* tends to support Meyerowitz's sentiments.

party transfer pricing methodologies is plainly problematical if applied to situations where no transactions are legally possible.

A further problem with the SARS view discussed above concerns those DTCs that predate the publication of PN 7 in August 1999. Case law<sup>20</sup> reveals that South African courts take a rather static approach to the interpretation of DTCs.<sup>21</sup> This approach suggests that our courts may more likely than not follow recent decisions in the United Kingdom<sup>22</sup> that adopted the approach that the DTC negotiators had the text of the OECD and/or UN MTC and the commentary on it open in front of them at the time of the conclusion of the treaty negotiations. If PN 7 did not exist at the time of the negotiations of a DTC, and moreover if its terms are in conflict with the commentary on a model convention, it is highly improbable that our courts would sanction the application of PN 7 to a case of PE profit attribution arising under such a DTC.

In respect of DTCs negotiated after 1992 and based on the OECD MTC, South African courts could, were they to be satisfied that a sound legal foundation exists, adopt a robust approach to DTC interpretation and apply the ambulatory post-1992 OECD MTC.<sup>23</sup> In this way there may be a theoretical basis for DTCs negotiated after August 1999 to apply PN 7 under such a DTC should South Africa not reject the OECD's new authorised approach to PE profit attribution. This would still reflect the position *de lege lata* and the problems regarding the transactional basis of PN 7 would remain. The application of PN 7 in such circumstances would therefore still remain technically flawed.

It will be shown at 4.5.3 and 4.6 that where South Africa's DTCs incorporate article 7(3) of the UN MTC, an irreconcilable situation arises with the OECD's new authorised approach to PE profit attribution, which is based on its existing related-party transfer-pricing methodologies. It follows that were SARS to apply PN 7 under a DTC incorporating article 7(3) of the UN MTC, the same inconsistency would arise. The statement in PN 7 is also suspect for this reason.

<sup>20</sup> *SIR v Downing* 1975 4 SA 518(A), which confirmed the unreported decision in *L.J. Downing v Secretary for Inland Revenue* of 27 October 1972, case number 6737, Natal Income Tax Special Court (text obtainable from the IBFD's on-line Tax Treaty Case Law Database (<http://www.ibfd.org>)).

<sup>21</sup> It was said by Miller, J in the *L.J. Downing* case *supra* that: 'In principle no special approach to the interpretation of tax treaties is required and the norm applicable to international treaties in general should be followed; the principle rule of interpretation is "to get to the real intention" which is primarily to be ascertained from the words used. It may be necessary to have regard to the reasonableness and uniformity when determining the meaning of the words used in a treaty. Thus, the circumstances of any given case involving a tax treaty may be such as to require some modification of locally accepted canons of construction or some degree of deviation of approach in recognition of the international flavour of the treaty.'

<sup>22</sup> *UBS AG v Revenue and Customs* [2005] UKSPC SPC00480 at § 10: 'Our view is that the negotiators on both sides could be expected to have the Commentary in front of them and can be expected to have intended that the meaning in the Commentary should be applied in interpreting the Treaty when it contains the identical wording and neither party had made an observation disagreeing with the Commentary.' See also *IRC v Commerzbank* [1990] STC 285 at 297 to 298; *Memec v IRC* [1998] STC 754 at 766 and *Fothergill v Monarch Airlines Ltd* [1981] AC 251.

<sup>23</sup> See paragraph 9 and further of the Introduction to the OECD MTC Commentary.

At a fundamental level PN 7 is ill-designed to connect income with a jurisdiction, which is the real principal function of the PE profit attribution rule under article 7(2) of the OECD and UN MTCs, as for all intent and purposes PN 7 is designed to connect, in effect, income with a taxpayer.

It is, nevertheless, striking that SARS's propagated approach in PN 7 broadly reflects aspects of the OECD's reform project that dictates, generally speaking, the application with due modification of the OECD's 1995 Transfer Pricing Guidelines for PE profit attribution purposes under article 7(2) of the OECD MTC (discussed in Chapter 4).

A further subset of South Africa's transfer pricing rules is to be found in Section 31(3) of the Act, which affords the SARS discretion to disallow excessive tax deductions for interest charges payable by tax residents to non-residents (the so-called 'thin capitalisation' rule).

From the enabling wording of Section 31(3)<sup>24</sup> it is apparent that the discretion to disallow excessive finance charges only operates in respect of interest payments from one person to another, and hence not in respect of cross-border notional 'interest flows' between various parts of the same legal person.

It therefore appears that strictly speaking none of the South African transfer pricing provisions or practice applies to intra-company GE-PE dealings, both on the municipal and DTC levels.

## 2.2 Principles for the taxation of non-residents

In terms of paragraph (ii) of the definition of 'gross income' in Section 1 of the Act, 'persons other than residents'<sup>25</sup> are liable to tax on the total amount of income—received from a source located or deemed to be located within South Africa.

The Act does not provide guidance on the determination of the source of income and a body of case law has evolved in this regard. South African courts have since the first decisions on the meaning of the 'source of income' cautioned against, and indeed acknowledged the impossibility of defining this concept in an all-encompassing manner.<sup>26</sup>

Nonetheless, in the main the approach adopted in the *Lever Brothers* case has become the yardstick whereby source issues are generally approached, namely by the word 'source' is meant 'the originating cause' of the income. Generally an analysis of the activities and work done that gave rise to the income would point towards the location of its originating cause.<sup>27</sup>

<sup>24</sup> The relevant provision reads: 'Where any person who is not a resident ... has granted financial assistance ... to (i) any connected person ...; or (ii) any other person'.

<sup>25</sup> The shorthand description 'non-resident' will be used in this study.

<sup>26</sup> See the cases of *Rhodesia Metals Ltd v COT* 1940 AD 432 at 436; *CIR v Lever Brothers & Unilever Ltd* 1946 AD 441; 14 SATC 1 at 8; *CIR v Epstein* 1954 (3) SA 689 (A) at 698.

<sup>27</sup> See Danziger, E. 1991. *International Income Tax*. Durban: Butterworths. Part Three and Meyerowitz *supra* at § 7 *et seq.*

An issue that arises if it is determined that the originating cause of income is potentially located in South Africa is whether, if the activities and work done resulting in the income so received are performed partly in South Africa and partly in one or more other countries, the income may be apportioned between these various sources.

There appears to be some authority in decided case law that notionally the originating cause of income may be located in more than one jurisdiction.<sup>28</sup> Even so, courts have indicated that in lieu of case law or a specific provision in the Act providing a basis for such apportionment, the splitting of the source of income is unworkable.<sup>29</sup>

To solve this problematic issue South African courts have resorted to the concept of the main (real, dominant or substantial) source of income.<sup>30</sup> The source of income may therefore lie in the country in which the main activities giving rise to the income have taken place.<sup>31</sup>

The Act deems certain income to be received from a South African source, which includes:

- Amounts received by virtue of the use or right of use of intellectual property in South Africa,<sup>32</sup> and
- Interest derived from the utilisation or application of funds or credit in South Africa.<sup>33</sup>

The general corporate income tax rate applicable to non-residents deriving income from a source located or deemed to be located in South Africa is 29%. Where such a non-resident carries on a trade in South Africa through a branch or agency, the applicable rate is 34%.<sup>34</sup>

It is not clear from the Act whether if the requirements for the 34% rate are met, all the South African source income of a non-resident will be taxed at this rate, or only those items of income ascribable to the local branch of agency trade. For these purposes reference is only made to a 'branch' or an 'agency' and not to a 'permanent

<sup>28</sup> See the *Lever Brothers* case: *supra* at 10.

<sup>29</sup> *CIR v Epstein* 1954 (3) SA 689 (A), 19 SATC 221 at 234. The decision in *ITC 77 (1927)* 3 SATC 72 at 73 to 74 appears to be conflicting: here the court allowed an apportionment of the source of income derived from services – admittedly income from services does not present practical difficulties in this regard as a time-based apportionment appears to be the accepted international and local standard whereby tax claims are allotted between competing jurisdictions.

<sup>30</sup> *CIR v Black* 1957 SA 536 (A) at 543; *Essential Sterolin Products (Pty) Ltd v CIR* 1993 (4) SA 859 (A) at 870.

<sup>31</sup> De Koker, A. 2002. *Silke on South African Income Tax*. Durban: Butterworths, at § 5.4. See also the cases of *Transvaal Associated Hide and Skin Merchants v Collector of Income Tax*, Botswana 29 SATC 97 at 108 *et seq* and *ITC 1103 (1967)* 29 SATC 35 at 40.

<sup>32</sup> Eg patents, designs and other forms of registered intellectual property as well as know-how. See Section 9(1)(b) and (bA) of the Act.

<sup>33</sup> Section 9(6) of the Act. Section 9(7) further deem the place of utilisation or application to be the place where the payer of the interest is resident, which for a natural person is where he/she usually resides and for companies where they are effectively managed.

<sup>34</sup> Item 2(g) of Schedule 1 to Taxation Laws Amendment Act, 9 of 2005.

establishment'. Issues arising as a result of these discrepancies are discussed in greater detail in 2.3.4 below.

For a local PE of a non-resident GE to be able to utilise any revenue losses against taxable income received from a source located in South Africa, the only requirement is that such losses must result pursuant to a trade carried on by the PE inside of the territory of South Africa.<sup>35</sup>

Generally a local PE of a non-resident GE is not taxed in the same way as a local subsidiary of such a GE because:

- (i) it is only subject to tax on income received from a local source as opposed to the worldwide income of the subsidiary,
- (ii) it is not subject to STC whereas the subsidiary would be;<sup>36</sup> and
- (iii) the applicable tax rate is higher in certain circumstances than the normal corporate tax rate.

It is questionable whether the general anti-avoidance provisions of Section 103 of the Act would apply to dealings between a GE and a PE in abnormal tax schemes.

The case of *CIR v King* 14 SATC 184 at 196 is authority for the proposition that Section 103 of the Act cannot be invoked where income is only expected. In this case dealing with a predecessor of Section 103, it was held that the expectation of dividends that *may* accrue from shares were not 'income' alienated when those shares were sold prior the declaration of dividends. The principle that may be deduced from this decision is that Section 103 cannot be invoked in respect of income that does not yet exist.

It follows that where dealings between a GE and a PE only precede eventual actual income, which at the time of those dealings is a legal impossibility, the general anti-avoidance provision of Section 103 cannot be invoked, at least in respect of the application of municipal tax statutes. Whether Section 103 can be invoked in respect of the application of a DTC is a thorny issue. DTCs based on the OECD MTC generally contain sufficient and exhaustive anti-avoidance provisions.<sup>37</sup>

Certain aspects highlighted in the principles for taxation of residents and non-residents specifically relevant to GE-PE dealings are addressed in more detail in the remainder of this chapter, namely:

- The concept of a PE; and
- The 34% tax rate for local branch or agency trades of non-residents, including an assessment of the influence of South African company law.

<sup>35</sup> Section 20(1) of the Act as read with proviso (b) thereto. For a general discussion of the trade and other requirements of Section 20, see 'Interpretation Note 33 – Assessed Losses: The Trade and Income Requirement' issued by the SARS on 5 July 2005 (<http://www.sars.gov.za>). See fn 5 in respect of the question as to precisely where the territorial coastal borders of South Africa lie for purposes of proviso (b) to Section 20(1) of the Act.

<sup>36</sup> Section 64B(2) of the Act.

<sup>37</sup> See paragraph 22 *et seq* of the Commentary on article 1 of the OECD MTC.

## 2.3 The concept of a PE

This study mainly deals with the issue of the profits attributable to a PE in cross-border situations from a South African perspective. It does not primarily consider questions of what constitutes a PE. However, some knowledge of the circumstances that would give rise to a PE is essential to provide a full understanding, as the constituting factors and nature of a PE do have a bearing on the profit attribution question.

The concept of a PE is therefore briefly analysed below.

### 2.3.1 The definition of a PE in the Act

For purposes of income tax and CGT, Section 1 of the Act defines a PE in an ambulatory way as meaning:

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

It is worthwhile to recall the present definition of a PE in article 5 of the 2005 OECD MTC, which reads: <sup>38</sup>

#### Article 5

#### 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.
2. The term "permanent establishment" includes especially:
  - a) a place of management;
  - b) a branch;
  - c) an office;
  - d) a factory;
  - e) a workshop; and
  - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.
4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
  - a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
  - b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

<sup>38</sup> OECD. 2005. *The OECD Model Tax Convention on Income and Capital*. Condensed Version. Paris.

- 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.

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

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

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

Broadly speaking a PE is constituted in one of two ways: when business is carried on (i) through a 'fixed place of business'; or (ii) by a 'dependent agent'.

Article 5 of the OECD MTC also provides for a number of exceptions to the definition of PE, most notably when the activities carried on at a fixed place of business or through a dependent agent is of a preparatory or auxiliary nature, or when an agent is independent.

### **2.3.2 The definition of a PE in South Africa's veritable network of DTCs**

The definition of a PE in Section 1 of the Act applies only in respect of municipal law, namely for purposes of the income tax and CGT provisions of the Act in so far as they rely on the concept of a PE.

Although most of South Africa's DTCs are based on the PE definition of the OECD MTC, which is the same as the definition relevant for municipal law purposes, the model definition is not valid for these DTCs, and each DTC's definition of a PE must be examined to establish its meaning on the treaty level.

As will be shown later in this study (see 4.6), South Africa frequently incorporates elements of the UN MTC in its DTCs when it comes to the taxation of business profits. In this regard, provisions similar to article 5(3)(b) of the UN MTC is recurrently encountered in the definition of a PE in a significant number of South Africa's operative DTCs.<sup>39</sup> This article extends the threshold for PE taxation (as compared to the OECD MTC) through the definition of a PE. Article 5(3)(b) of the UN MTC provides that:

3. The term 'permanent establishment' also encompasses:
  - (b) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period.

The international understanding<sup>40</sup> of both so-called fixed place of business and agency PEs is briefly discussed below.

### 2.3.3 Fixed place of business PE

Article 5(1) of the definition of a PE (quoted above at 2.3.1) is generally understood to contain the following conditions for a PE:

- The existence of a 'business';
- The existence of a 'place' of business, ie facility such as premises or, in certain instances, machinery and equipment;
- This place of business must be 'fixed', that is to say it must be established at a distinct place with a certain degree of permanence;
- The business of the enterprise must be wholly or partly carried on through this fixed place, meaning that, for instance, personnel responsible for carrying on the business of the enterprise must in one way or the other be connected with the alleged place of business.

At the outset it is important to note that undefined elements of the PE definition in article 5(1), such as 'place' or 'business', is interpreted according to the meaning that would attach to those terms in the state which is applying the DTC (based on article 3(2) of the OECD MTC, unless the context otherwise requires).

<sup>39</sup> Eg the present DTCs with Algeria, Belarus, Botswana, Bulgaria, Canada, China, Croatia, Czech Republic, Egypt, Indonesia, Iran, Lesotho, Malta, Namibia, Oman, Pakistan, Seychelles, Swaziland, Thailand, U.S.A., Ukraine and the UK. All these DTCs post-date 1994.

<sup>40</sup> Ie the meaning and interpretations of article 5 of the OECD MTC as formulated in its official commentary and as explained by international commentators.

In many instances involving PE issues in DTCs both the residence and source country would be applying the DTC – for example, the residence country is to establish whether there is a PE and hence whether it should give credit relief for source country taxes in accordance with article 23 of the DTC. The source country is to establish whether its source tax claim is restricted by either there being a PE or not, and if so, what the profits attributable to the PE would be. The point here is that in interpreting these undefined provisions of DTC based on the OECD MTC, countries generally prefer a more international or unified meaning to be attached to these undefined terms on the basis that ‘the context so requires’.

Such an approach seeks to avoid any conflicts of interpretation (eg one state attaching a different meaning to ‘place of business’ than the other state) and generally accords with the public international law approach to the interpretation of international treaties as codified in the Vienna Convention on the Law of Treaties of 23 May 1969 (‘Vienna Convention’).<sup>41</sup> This approach also accords with South African common law.<sup>42</sup>

Accordingly, the interpretation of the articles of the OECD MTC as explained in the official commentary thereon is normally consulted to ascertain the international meaning that states attach to its provisions. A repetition here of the commentary would serve no purpose.

Article 5(2) of the OECD MTC contains a list, by no means exhaustive, of examples each of which can be regarded as *prima facie* constituting a PE (the so-called ‘positive list’). The positive list is a catalogue of examples giving an impression of the kind of premises the term ‘place of business’ of article 5(1) encompasses.<sup>43</sup> As these examples of the positive list are seen against the background of the general definition of a PE in article 5(1), they will only constitute a PE if the requirements of this general definition are met.<sup>44</sup> Thus, for example, ‘an office’ or a ‘branch’ must still meet the requirements of article 5(1) before it may be regarded a PE.

#### 2.3.4 Dependent agent PE

If a fixed place of business PE does not exist, a PE may still be deemed to exist if an enterprise carries on business through a dependent agent according to article 5(5) of the OECD MTC.

Mostly a dependent agent refers to an agent who is bound to follow such instructions of the enterprise as relate to its business, has sufficient authority to bind the enterprise’s participation in the business activity in the host state concerned and who is

<sup>41</sup> See articles 31 and 32 of the Vienna Convention.

<sup>42</sup> De Groot, Hugo. 1625. *De Jure Belli ac Pacis Libri Tres Liber II, Capita XVI*. Paris: [S.i.] See also the unreported decision in *L.J. Downing v Secretary for Inland Revenue* of 27 October 1972, case number 6737, Natal Income Tax Special Court - the text is obtainable from the IBFD’s on-line Tax Treaty Case Law Database (<http://www.ibfd.org>).

<sup>43</sup> Skaar, Arvid. 1991. *Permanent Establishment: Erosion of a Tax Treaty Principle*. Deventer: Kluwer Law at 9.2

<sup>44</sup> *Ibid* at paragraph 12.

also dependent on the latter in a legal and an economic sense.<sup>45</sup> This could of course be the case if the agent is an employee of the enterprise clothed with the appropriate representative powers, but the concept is not restricted to this example.

The dependent agent must also have authority to conclude contracts in the name of the enterprise that is represented.<sup>46</sup>

According to the Commentary on the OECD MTC at paragraph 32.1, 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. Article 5(5) applies equally, according to the Commentary, to an agent who concludes contracts, which are binding on the enterprise even if those contracts are not in the name of the enterprise, or is formally finalised somewhere else.

A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can therefore be said to exercise this authority in the host state even if another person in the other state in which the enterprise is situated signs and/or formally finalises the contract.

It must be noted that since, by virtue of article 5(4) that lists the exceptions to the existence of a PE, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a dependent agent whose activities are restricted to such activities similarly does not create a PE.

### 2.3.5 Exceptions to a PE

Article 5(3) of the OECD Model contains a number of exceptions. These exceptions deem certain business functions not to constitute a PE in another country.

Article 5(3)(e) limits the PE definition and excludes from its rather wide scope a number of forms of business organisations of a preparatory or auxiliary nature which, although they are carried on through a fixed place of business or dependent agent, should not be treated as PEs. The rationale for these exceptions is that although it is recognised that the activities performed in a host country may contribute to the productivity of a non-resident enterprise, those activities performed are so remote from the actual realisation of profits that it is difficult to allocate any profit to the PE in question.

Often it is difficult to distinguish between activities that are preparatory or auxiliary in character, and those that are not. According to the Commentary on article 5(3) the OECD MTC (at paragraph 24) the decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.

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<sup>45</sup> See the U.S. case of *Taisei Fire and Marine Ins. Co. Ltd et al v. Commissioner of Internal Revenue* 104 TC 535, U.S. Tax Court, 1995; IBFD on-line Tax Treaty Database, Case CL:US:1995-05-02:1:DEC at 11 *et seq.*; Paragraph 32 of the Commentary on Article 5 of the OECD Model; Skaar *supra* at §29.

<sup>46</sup> *SIR v Downing* 1975 (4) SA 518 (A); 37 SATC 249

For example, a PE could be constituted if an enterprise maintains a fixed place of business in order to supply spare parts to customers for machinery supplied to such customers, or to maintain and repair such machinery, as this goes beyond the pure delivery thereof. Since these after-sale organisations perform an essential and significant part of the services of the enterprise *vis-à-vis* its customers, their activities are not merely auxiliary by nature.

This exception only applies to preparatory or auxiliary activities. This would not be the case where, for example, the business does not only give after-sale information but also furnishes plans, advice, etc specifically developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

Moreover, the phrase 'for the purpose of the enterprise' in article 5(3)(e) makes it clear that these preparatory or auxiliary activities must be carried on only for the enterprise. A fixed place of business rendering services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of exception.

As mentioned earlier, the 34% tax rate applicable to non-residents deriving income from a source located in South Africa does not apply in respect of local PEs, but to a local trade carried on through a branch or agency.

The rest of this chapter is devoted to an analysis of the circumstances when the higher tax rate of 34% would be applicable bearing in mind the circumstances where one might have a local PE but not carry on a local trade through a branch or agency.

## **2.4 The 34% tax rate for local branch and agency trades of non-residents**

### **2.4.1 Overview**

Item 2(a) of Schedule 1 to the Taxation Laws Amendment Act, 9 of 2005 provides that the rate of normal tax for any company (resident or non-resident) is 29%. Item 2(g) to this Schedule, however, determines the rate of normal tax:

... on each rand of the taxable income... derived by a company which is not a resident and which carries on a trade through a branch or agency within the Republic, 34 cents.

(Underlining emphasis added)

As explained in 2.2 above, non-resident companies would only be subject to normal tax if they derive income received, or deemed to be received from a source located in South Africa. From the above quoted provision that fixes the rates of normal tax, non-residents would in principle be liable to tax thereon at the rate of 29% unless the income is derived pursuant to a 'trade' in the form of a 'branch' or an 'agency' located inside the territory of South Africa, in which case the tax rate would be 34%.

It is not clear whether all a non-resident's income received from a South African source would be taxed at the rate of 34% if that non-resident carries on a trade in South

Africa through either a branch or agency, or only that local source income which is derived from the branch or agency.

For example, a non-resident may earn income pursuant to sales agent activities carried on inside South Africa, and investment income from South Africa in the form of interest that is not effectively connected to the sales activities. In the case of the investment income, no local branch or agency is present, whilst for the sales activities there is a local trade constituted by the sales agent. It is not clear whether the 34% rate would be applicable only to the sales income, or to the interest income as well.

The discussion below focuses on the circumstances when a 'branch' and an 'agency' may be regarded as present for purposes of applying the 34% rate.

## 2.4.2 Branch

As was seen in the discussion of the definition of a PE in 2.3, a branch can be regarded as a PE, but could also not, either because it does not meet the requirements of article 5(1) of the PE definition of the OECD MTC, or is excluded based on preparatory or auxiliary local activities, or because a non-resident has organised itself in some other form in the host country, eg through a construction site existing for a shorter period than required in terms of the PE definition.

The important question is under what circumstances the local presence of a non-resident could be considered to be a 'branch' of that non-resident. In practice it is frequently accepted that a local branch is created for a non-resident company if it formally organises itself in terms of South African company law. The relevant company law position is therefore discussed below.

### 2.4.2.1 The company law status of non-South African incorporated companies engaged in business activities in South Africa

Section 322 of the Companies Act, 61 of 1973 (as amended) ('the Companies Act') provides that every external company<sup>47</sup>, which is any company or association of persons incorporated outside South Africa, must register its memorandum with the South African Registrar of Companies within 21 days after 'establishing a place of business'<sup>48</sup> in South Africa. An external company is subject to South African law, where appropriate, in terms of Section 2(2) of the Companies Act<sup>49</sup> and will be required to comply with a number of compliance and company secretarial obligations.<sup>50</sup>

<sup>47</sup> Defined in Section 1 of the Companies Act.

<sup>48</sup> Brookes, PEJ. 1986. *The status of foreign juristic persons in South Africa* MB, 91 at 92 points out that the phrase 'place of business' was first adopted in this context (ie to define a 'foreign company') in the erstwhile Transvaal Companies Act 31 of 1909, later to be incorporated in the post-Union Companies Act 46 of 1926.

<sup>49</sup> See *Wiseman v Ace Table Soccer (Pty) Ltd* 1991 (4) SA 171 (W) at 174; Galgut, B. 2005. *Henochsberg on the Companies Act*. Durban: Butterworths, loose-leaf edition at 543.

<sup>50</sup> Including, but not limited to the following:

- It must appoint an auditor for its South African operations;
- It must appoint a South African resident to accept service on its behalf;
- It must lodge within six months of its financial year end a copy of its audited annual financial statements in respect of its financial position, trade and business in South Africa (all that is required

One of an external company's compliance obligations is that it must keep accounting records to fairly present its state of affairs and business *in South Africa* and to explain the transactions concerning its *South African trade and business* and its financial position *in South Africa*.<sup>51</sup> This requirement is generally understood to form the basis for not reflecting in the branch accounts any transactions entered into by the rest of the enterprise outside South Africa, including the disregarding of notional profits in respect of book entries concerning head-office and branch accounting.

It is not clear from the provisions of Section 322 of the Companies Act whether establishment of a place of business in South Africa is a prerequisite for registration as an external company. If Section 322 is interpreted strictly, it only appears to force registration should a place of business be present. The particular choice of wording supports this proposition: 'every external company shall register' *vis-à-vis* wording that could have a different implication such 'provided it establishes a place of business' or 'if it establishes'.

The decision in the case of *Wiseman v Ace Table Soccer (Pty) Ltd* 1991 (4) SA 171 (W) could also be read to confirm this understanding of Section 322. In this case, the court was faced with the question whether it had jurisdiction in winding up procedures over a foreign incorporated company, which was not registered as an external company but nevertheless carried on business in South Africa. The court held (at 177) that the fact of non-registration did not detract from the liquidation procedures of the Companies Act being applicable to external companies and remarked on the nature of Section 322 as follows (at 176):

It seems to me that this particular Section [Section 322] is procedural by nature. It lays down the mechanism for registering an external company under the South African Companies Act. It does not purport to create substantive law by giving legal personality to a body which previously did not have such legal personality. In fact, to the contrary, it recognises that an external company is in fact 'a company' or 'a body corporate'. Prior to its registration under s 322 it merely lays down a peremptory procedure to ensure that an external company —after complying with such procedures will be on equal par with a South African incorporated company. It is noteworthy that neither chap XIII (which deals with

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is so-called branch accounts and not the financial statements of the enterprise as a whole – see Galgut, B. Op cit *supra* at 651)

- It must lodge within six months of its financial year-end a *certified* copy of the whole company's latest complete annual financial statements as required in the jurisdiction where it has been incorporated (although this requirement may be waived by the Registrar on receipt of a suitably motivated application);
- It must conspicuously exhibit outside its place/s of business in South Africa the name of the company and the foreign country in which the company is incorporated, eg 'X International GmbH (incorporated in Y)';
- It must mention the name of the company and of the foreign country in which the company is incorporated, as well as its external company registration number, in legible characters in all bill-heads and letterheads and in all notices, advertisements and other official notices;
- It will be registered as a taxpayer in South Africa, subject to DTC provisions, if applicable.

<sup>51</sup> Section 329(1) of the Companies Act, as read with Section 284(1)(a) to (e) of that Act.

external companies) nor the Act in general declares an external company which has not registered illegal.

Where a foreign company has not established a place of business in South Africa, it is arguable whether it may nevertheless register voluntarily as an external company. As explained above, it does not appear that Section 322 requires as a prerequisite for registration as an external company the establishment of a place of business in South Africa, but only requires registration should a place of business be established.

However, the definition of an external company<sup>52</sup> in Section 1 of the Companies Act appears to require the establishment of a place of business, the non-establishment of which will thus per definition deny external company status to a foreign incorporated company or association of persons.<sup>53</sup> In terms of common law this denial will not contradict the recognition of the foreign incorporated entity as a body corporate in South Africa.<sup>54</sup>

In practice the Registrar of Companies appears to accept registration of foreign incorporated companies or associations of persons as external companies if all the formal procedures (eg appointment of an auditor and a South African resident for acceptance of service) and information (eg registered office address, etc) are complied with and do not require proof of the establishment of a place of business.

A 'place of business' is defined in Section 1 of the Companies Act as meaning any place where the company transacts or holds itself out as transacting business, and

<sup>52</sup> An external company means, unless the context otherwise indicates: 'a company or other association of persons, incorporated outside the Republic, the memorandum of which was lodged with the Registrar under the repealed Act, or which, since the commencement of this Act, has established a place of business in the Republic and for purposes of this definition establishing of business shall include the acquisition of immovable property.' - Section 1 of the Companies Act.

<sup>53</sup> Brookes *supra* at 93 describes the existence of a place of business as a prerequisite for external company status, but does not address this question in any detail.

<sup>54</sup> Brookes *supra* at § 3 and the authorities cited by him at fn 68. This situation is also recognised by Section 2 of the Interpretation Act 33 of 1957 that defines 'person' as *inter alia* 'any company incorporated or registered as such under any law' and 'any body of persons corporate or incorporate'. 'Law' is for these purposes defined as 'any law, proclamation, ordinance, Act of Parliament or other enactment having the force of law'. The non-existence of a place of business may thus cause the foreign company to be regarded as a *peregrinus* necessitating, for example, attachment *ad fundandam jurisdictionem* or *ad confirmandam jurisdictionem*. It appears that other than the situation for a domestic company that resides at its registered office, a foreign company may reside within the jurisdiction of a court if its principal place of business is located in the local area of a court's jurisdiction. This standard is even further relaxed according to the case of *ISM Inter Ltd v Maraldo & Another* 1983 (4) SA 112 (T) at 117B, which suggests that if a foreign company does not have its principal place of business within the area of the court's jurisdiction but some business is nevertheless operated in this area, the recognition of the foreign company as an *incola* poses the question whether or not the cause of action arose out of those local business activities. This position should, however, not be understood to 'attract the inference that the Legislature intended to endow the registered office of an external company with the quality of being the place to which the world can look as the legal home and administrative centre of the external company... an external company cannot be said to be resident at its registered office' – Streicher J. *Joseph and Another v Air Tanzania Corporation* 1997 (3) SA 34 (W) at 38 to 39. See also on this issue Forsyth, C.F. 2003. *Private International Law*. Fourth edition. Cape Town: Juta, at 195 to 196.

includes a share transfer or share registration office or the acquisition of immovable property.<sup>55</sup>

The definition of a 'place of business' is not very precise since the concept of 'transacting business' could be widely interpreted and may, for instance, refer to both scenarios where contractual agreements are concluded locally, or where performance in terms of a contract concluded elsewhere takes place in South Africa. In addition, it is not clear whether a local presence in the form of supportive functions (eg information gathering, liaison, etc) to the transacting of business elsewhere is sufficient enough to say that a foreign company also transacts business through these functions in South Africa.

In circumstances where statutory definitions result in ambiguity about the intended scope of a particular provision that relies on that definition, guidance may be taken from court cases<sup>56</sup>, both local and from other jurisdictions with a similar company law tradition such as the UK. A brief discussion of relevant South African and UK case law on the meaning of the phrase 'establishment of a place of business' read together with its definition as meaning 'a place where the company transacts or holds itself out as transacting business' may thus help in establishing the scope of the definition of an external company and Section 322 of the Companies Act.

In the English case of *Lord Advocate v Huron & Erie Loan and Savings Co* 1911 SC 12 it was held that the mere appointment of an agent for a particular purpose pertaining to a company's affairs is not the establishment of a place of business at the agent's office. In another English case, the court in *Re Oriol Ltd* [1985] 3 All ER 216 (CA) at 220 stated the following about the meaning of the phrase 'an established place of business' in the English Companies Act:

... when the word 'established' is used adjectively ... it connotes not only the setting up of a place of business as a specific location, but a degree of permanence or recognisability as being a location of the company's business ... The concept ... is of some more or less permanent location, not necessarily owned or even leased by the company, but at least associated with the company and from which habitually or with some degree of regularity business is conducted.

In the case of *Lawclaims (Pty) Ltd v Rea Shipping Co SA* 1979 (4) SA 745 (N), the court rejected the proposition that a ship of a foreign company which was stationed temporarily in a South African port to discharge cargo had established a place of business in South Africa.

The view of Galgut, B. 2005 *Henochsberg on the Companies Act*. Loose leaf edition. Durban: Butterworths, at 642 submits that a place of business will be

<sup>55</sup> Blackman, Jooste and Everingham. 2005. *Commentary on the Companies Act*. Juta loose-leaf, Volume 2 at 13 to 14, point out that, since, in terms of Section 324, ownership of immovable property cannot be acquired by an external company unless its memorandum has been registered, 'acquisition of immovable property' in the context of the definition of an external company refers rather to a right to obtain ownership of immovable property.

<sup>56</sup> See Kellaway, E.A. 1995. *Principles of Legal Interpretation*. Durban: Butterworths, at 270.

established even if a foreign company only transacts a minor or incidental part of its business in South Africa. Galgut relies on the English case of *South India Shipping Corp Ltd v Export-Import Bank of Korea* [1985] 2 All ER 219 (CA) for this proposition.

What is clear from the above authorities is that a 'place of business' need not be the main place of business of a foreign company or its head-office<sup>57</sup> but any part of its business.

The concept of operating a 'business' may also assist to characterise the activities carried out in South Africa, although it must be realised that it would not bear on the question whether a place of business has been 'established'. Generally factors such as profit motive, scale of activity, repetition and continuity of activity, commercial character, and system and organisation may indicate that a particular activity constitutes business.

In general, it appears that a place of business is established in South Africa if a company transacts any part of its business on a more or less permanent basis at a specific location in South Africa, even if it is only a minor or incidental part of the business.

It does not appear to be essential that a foreign company must have a legally identifiable arrangement such as a lease whereby it has access to, for instance, an office, before it may be considered to have established a place of business within the meaning of the Companies Act although at the very least it appears that it must have access to some geographically identifiable space suitable to carry on the alleged business activity.

Questions as to whether movable property alone, such as equipment or machinery by itself<sup>58</sup>, or transfer, exchange or registration of securities or maintenance of bank accounts<sup>59</sup>, or the mere holding or storage of intangible property such as patents or software, or the presence of breeding animals, live stock for sale<sup>60</sup> or competing animals<sup>61</sup> could be considered to establish a place of business for a *peregrinus* present particular problems.

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<sup>57</sup> See *Wiseman v Ace Table Soccer (Pty) Ltd* 1991 (4) SA 171 (W) at 175.

<sup>58</sup> Examples may include automated equipment that is able to function without human intervention such as, for instance, vending machines or a pumping station on a transnational gas or oil line.

<sup>59</sup> In Canada and the U.S. courts have held that a bank account does not amount to a PE, since it is not a place of business – *M.N.R. v Tara Exploration and Development Company Limited* 72 DTC 6288 (1972); *Consolidated Premium Iron Ores Limited v Comm'r*. 28 T.C. 127 (1957). The result of the *Iron Ores* case is reflected in enactments in a number of states in the U.S. (§ 106 of the Model Business Corporation Act). The same position apparently applies in Australia (Section 512 of the Companies Act 89 of 1981).

<sup>60</sup> Such animals may serve the business activity as 'inventory'.

<sup>61</sup> Eg racing horses. According to a ruling by the U.S. Internal Revenue Service (Rev. Rul. 58-63 1958-C.B. 624) the participation of a non-US entity's racing horse entered into for a number of races in the U.S. could constitute a PE since the track and stables where it competed would be a fixed place of business. Another example may be a troop of polo horses let by a UK company to a South African polo club for a number of years.

It is apparent that mines, oil or gas wells or rigs or quarries would constitute places of business. Exploration activities could also constitute places of business if they subsist for a significant period.

It is noteworthy that phrases such as 'branch', 'representative office' and 'head-office' are mostly absent from the phraseology adopted by the Companies Act and even from case law on the subject.<sup>62</sup> In popular idiom and in practice, the registration of an external company is frequently referred to as the registration of a branch. The exact meaning of concepts such as branch, head-office and representative office is therefore not very clear.

#### 2.4.2.2 Distinction between a branch and a representative office

In so far as the distinction between a branch and a representative office is concerned, U.S. case law appears to indicate that in the context of insurance business, a branch would be present if the foreign corporate has a licence to conduct insurance business in the U.S. If it does not have a licence and is consequentially barred from carrying on insurance business in the U.S. but nevertheless has an office in the U.S., this presence can only amount to a representative office and not a branch.<sup>63</sup>

The UK decision in *South India Shipping Corp Ltd v Export-Import Bank of Korea*<sup>64</sup> adds an interesting caveat to the position mooted by U.S. case law. In this case, the argument was presented that the activities carried on at a UK representative office of a Korean bank did not constitute a place of business since at no time did those activities involve the conclusion of business within the UK. These activities were restricted to eg information gathering, consulting with correspondent banks and financial institutions, liaison activities, etc.

The court held that it did not matter whether the activities of the UK representative office did not involve the actual contracting of banking business, and appeared to have supported the view expressed in other cases<sup>65</sup> that so long as those activities could be characterised as promoting the object, albeit a supplementary or secondary object of the business, it was part of the company's business. Thus it was held that the activities performed at the London representative office of the Korean Bank stood in direct relation to the bank's function as an export-import bank and was consequently viewed as a place of business.<sup>66</sup>

It appears from the above U.S. and UK cases that the activities carried on at a representative office in the context of the particular type of business will play a decisive

<sup>62</sup> To the author's knowledge only Section 21A(3) of the Companies Act refer to '... a branch, established in the Republic, of— (a) a company or other association of persons, incorporated outside the Republic; or (b) an association of persons which is not incorporated and has its head office in a foreign country, may be incorporated under Section 21'. (Emphasis added)

<sup>63</sup> *Taisei Fire and Marine Ins. Co. Ltd et al v. Commissioner of Internal Revenue*, 104 TC 535, Case number 14296-92, U.S. Tax Court, 1995; IBFD on-line Tax Treaty Database, Case CL:US:1995-05-02:1:DEC at 3.

<sup>64</sup> [1985] 2 All ER 219.

<sup>65</sup> *A/S Dampskib 'Hercules' v Grand Trunk Pacific Rly Co* [1912] 1 KB 222 at 227 to 228.

<sup>66</sup> *Ibid* at 224.

role in deciding whether or not it amounts to a place of business. In other words, the presence of a local representative office could also force registration as an external company in terms of Section 322 of the Companies Act, but would not do so automatically. An analysis of the activities of the representative office must indicate that it amounts to a place of business.

The important point is that registration of a representative office as an external company does not necessarily mean that it is converted into a 'branch' for purposes of establishing whether the 34% tax rate should apply. A branch appears to be something that concerns itself with significant elements of a full-scale business activity in relation to the rest of the enterprise of which it forms part, and not only with supplementary and secondary activities. Much depends of course on the nature of the business of an enterprise.

### 2.4.3 Agencies

For agencies, it may be more obvious when the 34% normal tax rate should apply. It is submitted that the law of agency will dictate when an agency is present or not for purposes of establishing whether the 34% rate should apply, and not the rules and concept of a PE that dictate when a PE is deemed to exist by way of a dependent agent.

In this context the question is whether situations may arise where a person could fall short of being recognised as an agent in terms of South African law of agency, but can still be regarded as a 'dependent agent' for purposes of establishing whether his/her/its activities constitute a PE, or vice versa.

The discussion of dependent agent PEs at 2.3.4 showed that internationally in the DTC context persons that may not legally have the authorisation to bind another, may still be regarded as an agent if their activities correspond in all relevant aspects with those of an agent with sufficient authority despite the fact that a sales contract, for instance, is formally signed by another person in the employ of the entity on whose behalf the agent purportedly acts.

- In analysing this question sight must not be lost of the fact that the expression agency is not a term of art in South African law since it is used to convey a variety of legal situations.<sup>67</sup> Agency could for example refer to *mandatum*, the incomplete synallagmatic agreement in terms of which one person, the *mandatarius* or *procurator*<sup>68</sup> styled the agent, performs some task for another, frequently within the limits of instructions and that other person, the *mandator*, has the right to claim the proceeds of

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<sup>67</sup> LAWSA *supra* at 175.

<sup>68</sup> Initially in Roman law *mandatum* included only the performance of single acts (*unius re, unius negotionis*), eg the *mandatarius* could be directed to provide a guarantee, to lend money to a third person, to act as procedural representative, to buy or sell a slave or a house, or to catch a wild animal in the bush, etc. When the office of *procurator* (originally a freed person that acted as general manager for his *patronus*) and *mandatarius* was merged, *mandatum* acquired a general character according to Gaius 3 155 (cited in De Zaiueta, Francis. 1953. *The Institutes of Gaius*. Volume II).

the command. A feature of *mandatum* was, and still is that the *mandatarius* hands to the *mandator* all rights, proceeds and obligations of the mandate upon its termination.<sup>69</sup>

In this construction 'agency' simply refers to a contract between the *mandator* (principal) and *mandatarius* (agent) with rights and obligations *inter se*.<sup>70</sup>

Similarly, it is also conceivable that parties to a service agreement may be styled principal and agent such as, for example, an employer and employee or any relationship classified as *locatio conductio operarum* or *operis*.<sup>71</sup>

Agency could also refer to an event whereby one person, the agent, acts with the intention *nomine alterius* and concludes a juristic act on behalf or in the name of another person, namely the principal, with a third person. In these circumstances agency is an instance of representation<sup>72</sup> with the result that the rights and obligations created by the act of the agent enure to the person represented.<sup>73</sup> A valid representation is described as follows:<sup>74</sup>

Authorisation is an expression of will by one person that another will have the power to conclude juristic acts on his or her behalf. It is not, as is sometimes suggested, a contract between the principal and the representative, but a unilateral juristic act whereby the principal creates the legal machinery by means of which legal relationships can be created, altered or extinguished

<sup>69</sup> Van der Merwe, CG. 1997. *Romeinse Reg.* Unpublished University of Stellenbosch Notes, cites *Digesta* 17 1 20 Paulus: 'Nothing obtained as a result of a mandate ought to be left in the hands of the person who undertook the mandate'. If this result is to be achieved in modern South African law of obligations, it must be specifically stipulated. In Roman law a claim for the proceeds of the command was achieved through the *actio mandati directa*. If the *mandator* succeeded with his *actio mandati directa*, the *mandatarius* could oblige him to take over all his obligations and make good his expenses with the *actio mandati contraria*.

<sup>70</sup> In Roman law, *mandatum* could achieve instances of indirect representation in circumstances where the *mandatarius* contracted with a third party as required by his mandate and the *mandator* had the right to the proceeds arising from the contract so concluded with the third party. See Zimmerman, R. 1990. *The Law of Obligations: Roman Foundations of the Civilian Tradition*. Cape Town: Juta, at 51-52. As a result of the personal nature of the Roman law of obligations, direct representation could not be achieved.

<sup>71</sup> In classic Roman law *mandatum* derived from the Romans' sense of duty and their emphasis on friendship as a Roman character trait. Hence it was improper to accept a wage or salary in respect thereof. If payment was made it was viewed as *locatio conductio operis*—see *Digesta* 17 1 1 4 Paulus (quoted and translated by Van Der Merwe *supra*): 'There is no mandate unless it is gratuitous. The reason is that it derives its origins from duty and friendship (*nam originem ex officio atque amicitia trahit*) and the fact is that payment for services rendered is incompatible with this duty. If money is involved, the matter rather pertains to hire.' Later the *mandatarius* could demand an *honorarium* that could be enforced by the *cognitio extraordinaria* procedure although it could not operate to reduce a claim in terms of the *actio mandati*.

<sup>72</sup> Agency by representation should be distinguished from contracts in favour of third parties. Where A, the *stipulans*, do not wish to act as agent for B, the *promittens*, he contracts with B in his own name so that B would become obliged to perform to a third person should this third person accept the right so conferred. See De Wet, J.C. & Van Wyk, A.H. 1992. *Kontraktereg & Handelsreg.* 5<sup>th</sup> Edition. Durban: Butterworths, at 103; LAWSA *supra* at § 177.

<sup>73</sup> The concept in law of *procuratio in rem suam* is the historical predecessor of modern direct representation, which originated due to practical necessity according to Voet, Johannes. 1827, 1829. *Commentarius ad Pandectas Parisiis*. Book 17, Title 1 at 9 (quoted and translated by Van Der Merwe *supra*): 'It can also be claimed that the mandatory shall cede to the procurator any actions which have accrued to himself. Nevertheless by our customs there is no need at all for them to be ceded when it has been expressly stated that the mandatory made the contract not in his own name but in that of procurator.'

<sup>74</sup> LAWSA *supra* at § 189.

between him or herself and a third person via the representative. By authorisation the principal not only empowers the representative to act on his or her behalf but also indicates to third persons his or her will to be bound by acts performed on his or her behalf by the representative acting within the scope of authority. The authorisation is by its purpose and function as much an act *vis-à-vis* the third person as it is an act *vis-à-vis* the representative.

Agency is also commonly understood to embrace both a contract between a principal and his agent (eg *mandatum*) and representation, an understanding that should be approached with caution as it attempts to compress into one legal concept two juristic concepts distinct and strictly speaking unrelated to each other.<sup>75</sup> The Commentary on article 5(5) of the OECD MTC (the definition of a dependent agent PE) is fraught with this approach despite the fact that the wording of article 5(5) refers exclusively to agency by representation.<sup>76</sup>

It appears therefore that where the Act refers to a non-resident company carrying on a trade through an agency located within South Africa for purposes of establishing whether the 34% tax rate should apply, the concept of agency embraces situations of *mandatum*, *locatio conductio operarum*, *locatio conductio operis* or representation, or a combination thereof.

A curious situation concerning foreign principals must be considered. De Villiers and Macintosh<sup>77</sup> indicate that a traditional rule existed in English Law that there is a presumption in all cases, unless it could be affirmatively shown not to apply, that where an agent contracts on behalf of a foreign principal the agent has no authority from that principal.

English cases at first diluted the rule since it was only based on usage, and the circumstances or the contract itself could exclude usage.<sup>78</sup> Later on it was doubtful whether the usage still survived and the modern English Law view is that the fact that the principal is foreign is no more than an element in deciding whether the agent is personally liable.<sup>79</sup>

Whether or not this presumption exists in South African law is not clear. De Villiers and Macintosh submit that it can only exist by virtue of usage in Holland

<sup>75</sup> Zimmerman *supra* at 57 to 58.

<sup>76</sup> See paragraph 32.1 of the commentary on article 5(5) of the OECD MTC and the discussion at paragraph 3.3 of this chapter.

<sup>77</sup> De Villiers, J.E. and Macintosh, J.C. 1981. *The Law of Agency in South Africa*. 3<sup>rd</sup> edition by JM Silke. Cape Town: Juta, at 484 *et seq.*

<sup>78</sup> *Ibid* at 484 fn 29.

<sup>79</sup> *Ibid* at 485. Diplock, L.J. said in *Teheran-Europe Co Ltd v S T Belton (Tractors) Ltd* [1968] 2 All ER 886 that: 'The fact that the principal is a foreigner is one of the circumstances to be taken into account in determining whether or not the other party to the contract was willing, or led the agent to believe that he was willing, to treat as a party to the contract the agent's principal, and, if he was so willing, whether the mutual intention of the other party and the agent was that the agent should be personally entitled to sue and liable to be sued on the contract as well as his principal. But it is only one of the many circumstances, and as respects the creation of privity of contract between the other party and the principal, its weight may be minimal'.

imported into South Africa of which there is no trace, or by virtue of new South African usage.<sup>80</sup>

A number of earlier South African cases<sup>81</sup> refer to the presumption, none of which can according to De Wet and Van Wyk<sup>82</sup> be viewed as providing convincing authority that the presumption forms part of our law.

#### 2.4.4 Interaction between the 34% tax rate for local branch and agency trades of non-residents and the OECD/UN MTC definition of a PE

The comparison between the definition of a PE and the circumstances when the 34% tax rate applies is only relevant in situations where a non-resident is liable for South African normal tax and a DTC is applicable in respect of that income.

If no DTC applies, the comparison serves no purpose. However, in such circumstances, knowledge of the requirements for application of the 34% tax rate is still useful, as non-compliance would mean that the default rate of 29% would apply.

The analysis of the circumstances when the 34% normal tax rate for local branch and agency trades of non-residents would apply in comparison to the definition of a PE in the OECD MTC shows that the following scenarios may arise where a local PE may be present, but the 34% tax rate may not apply:

- Where a PE on the DTC level is constituted by the furnishing of services, which is the case if article 5(3)(b) of the UN MTC is incorporated, a branch will not be established. However, depending on the legal nature of the service relationship, the 34% could apply if an agency is

<sup>80</sup> De Villiers and Macintosh *supra* at 485.

<sup>81</sup> *Preston & Dixon v Biden's Trustee* (1880-1884) 1 Buch AC 322; *Sage & Co. vs. Lezard Brothers* (1891) 6 HCG 139 at 143; *Bothomley vs. Siew & Co.* (1902) 9 HCG 207; *Freemantle v. McKenzie* 1915 CPD 568 at 572 to 573 and *Overseas Trust Corporation Ltd v Godfrey* 1940 CPD 177 at 183. The majority decision by the Court of Appeal of the Cape of Good Hope in the *Preston* case appears to suggest that the presumption is not part of our law: De Villiers, C.J. (at 349) said that: 'the liability of an agent for a foreign principal seems to depend after all upon the question whether he intended to bind himself personally, as in other cases; a question of fact in each case ... The cases of *Armstrong v Stokes*; *Elbinger-Actien Gesellschaft v Claye*, and *Huton v Büllock* ... were cases in which the respective liabilities of commission merchants in England and foreign merchants were discussed and decided; but they really have no application to the present case, for the decision in each of them turned upon the question what the usage of trade was. In the present case no such question arises, for Biden's right to bind Puzey does not depend upon any usage of trade, but upon a power of attorney giving Biden full power to do what he has done'. Buchanan, J.P. for the minority, however, said at 327 to 328: 'When the principal was foreign, as well as undisclosed, the case was infinitely stronger; and agents for named foreign principals have been repeatedly held liable'. The strongest authority for the acknowledgment of the presumption in South African law may possibly be extrapolated from the *Bothomley* case (at 211): 'It is clear that the plaintiff understood that the contract was made on behalf of some person resident elsewhere [the British Bechuanaland Protectorate, as it then was] who was to deliver the wood at the railway station [at Kimberley]. Now, while it used to be held that an agent contracting on behalf of an undisclosed principal made himself personally liable, or at all events the other party was entitled to elect to treat him as the responsible party, it now seems settled law that such is not the case when he has clearly contracted as agent alone, as was the case here. There are some exceptions as to the custom of certain trades and as to commission agents known to be acting for foreign principals, but it is not suggested that these exceptions assist the plaintiff in the present case'.

<sup>82</sup> De Wet and van Wyk *supra* at 123. Cf. also LAWSA *supra* at § 220 and De Villiers and Macintosh *supra* at 486.

constituted in terms of South African law. This would be the case if the service relationship between a non-resident and a resident could be classified as *mandatum*, *locatio conductio operarum* or *locatio conductio operis*.

- From the discussion about the company law status of an external company it was seen that the concept of a 'branch' is absent from the relevant provisions of the Companies Act and case law on the establishment of a place of business, which would force registration of an external company in terms of the Companies Act. It appears that a foreign company may not need to establish a place of business to register as an external company, in which case it is unlikely that the scale of activity will constitute a local branch. Registration of an external company may therefore not automatically be regarded as establishing a branch in South Africa. However, in cases where there is clearly a place of business where regular and significant business activities occur, it will invariably be regarded as a branch.
- A PE could be constituted by reason of a local place of management, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. In such cases a local branch will not automatically be established, and hence the 34% tax rate may not be applicable. The enumeration of these instances of *prima facie* PEs alongside and separate from a branch in terms of article 5 of the OECD MTC tends to indicate that a branch should not be equated with any of these other forms of a local presence.
- Where a person present in South Africa does not legally have sufficient representation in terms of South African law on agency to bind a non-resident in name, and none of the other qualifying relationships for South African agency exist (eg *mandatum*, *locatio conductio*, etc), that person will not qualify as an agent for purposes of the 34% tax rate. Such a person could still be deemed to be an agency PE in appropriate circumstances (eg an economic dependent agent);
- Where a person present in South Africa has an authorisation and does not act under another qualifying relationship for South African agency (eg *mandatum*, *locatio conductio*, etc), the authorisation must comply with all the validity requirements of South African municipal law. If for some reason the authorisation, or acts concluded in terms thereof are not valid in terms of South African common or statutory law,<sup>83</sup> the

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<sup>83</sup> The person may, for instance, transgress the terms of his authorisation, may lack capacity to conclude a contract or may be precluded by statute to so act. Examples of the latter category are Section 29(4) of the Marriage Act 25 of 1961, which specifically provides that no valid marriage can be concluded by means of representation; Section 4(1) of the Hire-Purchase Act 36 of 1942 required that a hire-purchase agreement as defined must be signed by the buyer in person, effectively excluding representatives from entering into this type agreement; Section 2(1) of the Alienation of Land Act 68 of 1981 requires a 'written authority' before an agent may enter into a contract of sale of land on behalf of another. See LAWSA *supra* at §180 and 193. Situations may also arise where the authorisation is invalid since the principal may not have the

person's activities may still be considered to give rise to agency PE if, in applying the DTC, the other contracting state does not have similar validity requirements for agency by representation to subsist.<sup>84</sup>

The analysis of the circumstances when the 34% normal tax rate for branches and agencies would apply in comparison to the definition of a PE shows that the following scenarios may arise where the 34% tax rate may apply, but there could be no PE, and hence no source-based tax claim at all:

- The question whether a representative office would be regarded as a branch if it was registered as an external company in terms of the Companies Act is not very clear. However, even though a representative office could be viewed as a place of business and as a branch, it may not always be a PE if the activities carried on are regarded as being preparatory or auxiliary in nature. Preparatory and auxiliary activities carried on at a place of business are deemed not to give rise to a PE in terms of article 5(4)(e) of the OECD MTC (see 2.3.4).
- Where a mandate is considered an agency, but the styled agent lacks an authorisation, the higher normal tax rate of 34% may apply to income derived from the South African activities of this mandate (provided it is considered a trade and the income is received from a local source). In these circumstances and provided a fixed place of business PE in terms of article 5(1) of the OECD MTC is avoided, it is unlikely that the presence of the styled agent would be deemed to be an agency PE in terms of article 5(5) of the OECD MTC because a valid authorisation is, at least in effect, required before a PE will be deemed to exist.
- If a local agent has an authorisation from a non-resident to contract business on behalf of that non-resident in South Africa, the non-resident may be deemed not to have a PE in South Africa if that agent qualifies for independent status in terms of article 5(6) of the OECD MTC. In these circumstances, that person will be viewed as an agent for purposes of the 34% tax rate, but not as a deemed PE.

In conclusion it seems that not all non-resident companies that earn South African source or deemed source income and operate through a PE in South Africa will be subject to the 34% normal tax rate.<sup>85</sup> It may therefore be said that the corporate

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capacity to authorise or does not exist (see *McCulloch v Fernwood Estate Ltd* 1920 AD 204 at 207 to 208 and 213 to 214. For purposes of pre-incorporation contracts concluded on behalf of a company not yet in existence Section 35 of the Companies Act specifically provides for derogation from this general principle).

<sup>84</sup> A hypothetical example may be a person authorised (not in writing) by a non-resident to speculate on behalf of that non-resident in land situated in South Africa. In the country of the non-resident, no written authorisation may be required for these kinds of transactions. From that perspective the agency would be valid, although in South Africa the various land sale agreements would be invalid, because the requirement for a written authorisation appears to be absolute. Representation is also a unilateral juristic act and there appears to be no scope for a choice of law agreement as regard the representation to be reached between the non-resident principal and the local agent.

<sup>85</sup> Popular wisdom dictates that the rationale for the higher normal tax rate of 34% for branches and agencies derives from the fact that STC is not applicable on the remittance of branch or agency profits to a

income tax and CGT system in so far as the tax rate is concerned, appears to be organised in an unsystematic way.

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foreign head-office. Withholding tax on royalties will also not apply to a local branch (it would, however, apply to a local agent – see Section 35(2)(a) of the Act). Whereas STC would apply to a dividend declared by a South African resident company to a foreign shareholder, remittance of branch profits to a foreign head office is not an actual or deemed dividend and so would not fall within the scope of STC. Remittances of agency profits would for the same reason not attract STC, except in the circumstances where the non-resident is also a shareholder of its South African agent. In such circumstances a remittance of agency profits may be considered a deemed dividend in terms of Section 64C(2)(a) of the Act, as it could be 'cash ... transferred by that company [ie the agent] to or for the benefit of that shareholder [ie the non-resident]'.

## Chapter 3: The normal tax treatment of intra-company GE-PE dealings in terms of the Income Tax Act, 58 of 1962.

### 3.1 Introduction

#### 3.1.1 Preliminary

This chapter explores and seeks to describe the municipal normal tax treatment in South Africa of cross-border intra-company dealings between a GE and its PE. The impact of Double Tax Conventions (DTC) on these dealings is the subject of chapter 4.

The general tax principle in respect of intra-company dealings is first explained. Thereafter the remainder of the chapter is devoted to explore the normal tax treatment of specific scenarios of intra-company dealings.

#### 3.1.2 The general tax principle in respect of intra-company dealings

Save for derogations such as those specifically provided for in enacted law,<sup>86</sup> a company, whether incorporated in South African or elsewhere, is always treated as one juristic person and as having *persona standi in iudicio*, namely someone having the capacity to sue or to be party in any action.<sup>87</sup>

Thus when a foreign incorporated company registers in South Africa as an external company under the Companies Act, or where a South African incorporated company effects a secondary registration in another country, in terms of South African law its juristic *persona* is not cleaved by either this registration or the set up of, for example, a South African or foreign branch office.<sup>88</sup>

In the case of *Sackstein NO v Proudfoot SA (Pty) Ltd* 2003 (4) SA 348 (SCA) 348 at 357 it was said by Olivier JA that:

... it must be accepted that registration in the Republic of South Africa of an external company does not result in there being two separate legal *personae*, registered respectively in two countries ... There is only one legal *persona*, registered in two countries.

It is a basic notion of our law that an obligation refers to a legal relationship between at least two persons, described by the well-known binary Romanist expression *vinculum iuris*.<sup>89</sup> There may be, however, esoteric circumstances where one person contracts with him, her or itself in different capacities,<sup>90</sup> but such instances remain highly unusual and contentious.

<sup>86</sup> For example, proviso (ii) to the definition of 'enterprise' in Section 1 of the VAT Act, 89 of 1991 and Regulation 17 of the Exchange Control Regulations, Notice No. R1111 of 1 December 1961. For a comparative example see Section 6(2) of the Kingdom of Lesotho's Income Tax Act (Order 9 of 1993).

<sup>87</sup> Joubert (ed). *The Law of South Africa*. Volume 4(1), First Reissue Volume, Companies, Part 1 at § 20.

<sup>88</sup> *Wiseman v Ace Table Soccer (Pty) Ltd* 1991 (4) SA 171 (W) at 176.

<sup>89</sup> *Institutes* 3.12.pr. De Wet, JC.1992. *Die Suid-Afrikaanse Kontraktereg & Handelsreg*. 5de uitgawe. Durban: Butterworths, at 1.

<sup>90</sup> Van Dorsten, JL. 1993. *South African Business Entities*. 3<sup>rd</sup> edition. Johannesburg: Obiter, at § 4.6.2(b) cites as an example two partnerships with members in common that contract with each other. See also *Strydom v Protea Eiendomsagente* 1979 (2) SA 206 (T) at 210 to 211.

It may thus be said without doubt that the registration of an external company in South Africa does not establish a separate or distinct legal entity or person. This generally also implies that that external company is not able to validly contract with other parts of it registered elsewhere in the world purely as a result of registration as an external company in South Africa. The same conclusion is valid for a South African incorporated company affecting a secondary registration in another country.

For income tax purposes, the case of *Afrikaanse Verbond Begrafnis Onderneming Bpk v CIR* 1950 (3) SA 209 (A) confirms the above general statement of South African law although the issue dealt with in this case was not of a cross-border nature.

The case concerned the taxation of a juristic person carrying on both insurance and non-insurance business (treated differently for South African income tax purposes) through various branch offices located throughout South Africa.

The court disallowed for tax purposes various book entries between these branch offices that reduced the non-insurance taxable income on the basis that a company cannot incur a liability to itself. Watermeyer CJ held (at 216D) that:

... the Income Tax Act, though it requires the profits of a company carrying on both insurance and non-insurance business to be computed separately, does not treat those two departments of the company's business as separate taxpayers who can have debits and credits *inter se*. It taxes the company and not a department of the company.

A decision by the Rhodesian Appellate Division in the case of *Anglo American Corp of SA Ltd v COT* 1975 (1) SA 973 (RAD) provides support for the principle explained by Watermeyer in the *Afrikaanse Verbond*-case. For Rhodesian municipal income tax purposes, a tax deduction for a loss in respect of a head-office account claimed by a Rhodesian branch of a South African company was denied. One of the reasons provided is in point:<sup>91</sup>

A very pertinent fact ... and which must always be borne in mind in considering this appeal is that the Salisbury office and the Johannesburg office are in law one *persona* and, in law, one individual taxpayer. The accounts with which this case is concerned are simply the inter-office accounts of one individual taxpayer, and how the Salisbury office and the Johannesburg office adjusted their accounts vis-à-vis each other is nothing more than a matter of the internal book-keeping of an individual taxpayer.

The *Anglo American*-case is discussed in detail at 4.7.

The conclusion can be drawn that for income tax purposes in South Africa a registered external company is generally not a separate taxable entity or person. The external company remains one juristic person for tax purposes despite its status and activities in South Africa. The same conclusion is valid for a South African incorporated company registered elsewhere in the world.

<sup>91</sup> At 975 to 976. See also Meyerowitz *supra* at § 11.41

The requirements of Section 66 and 67 of the Act that every external company must register as a taxpayer in South Africa does not detract from these conclusions as these provisions merely relate to the administration of normal tax by SARS and does not impact the legal nature of the persons concerned.

### 3.1.3 Conceptual adjustments and introductory observations

Conceptually South Africa does not tax 'profits' but only 'receipts, accruals and benefits' (collectively referred to as 'income') or 'capital gains' on a net basis. Wherever reference is made in the following chapters to profit attribution, the author refers to the recognition or attribution of receipts, accruals, benefits or capital gains.

As mentioned earlier, on the municipal level the Act contains no specific guidance for calculating profits attributable to a local or foreign PE for purposes of calculating a South African income tax charge. For capital gains tax purposes specific rules govern the reallocation of assets between a GE and PE in certain circumstances, mainly in inbound scenarios (ie to or from a local PE of a non-resident GE).

Income tax and capital gains tax (CGT) are not charged as two separate taxes but both form part of 'normal tax' charged in terms of the Act. Because of the lack on the income tax side of any specific profit attribution rules and the presence of a specific profit attribution rule as regards assets on the CGT side, a curious situation is created and necessitates a brief comment about the relationship and interaction between income tax and CGT.

CGT may in very general terms be described as representing the widest taxing net that does not only apply to the disposal of assets held on capital account, but to all assets of a resident,<sup>92</sup> and only certain assets of non-residents (the distinction between capital or revenue nature is not relevant here).<sup>93</sup> Only when certain rules are met the disposal of an asset is dealt with in accordance with the income tax rules.<sup>94</sup> The specific CGT rules for profit attribution purposes in inbound scenarios must therefore be seen as providing a basic rule as regards reallocations of assets between a non-resident GE and a local PE since it apply in the widest sense. This basic rule will not apply when a transaction falls within the narrower income tax net and where there is no specific basic rule, but only general principles governing PE profit attribution.

The above-mentioned basic CGT rule as regards PE profit attribution applicable to reallocations of assets between a GE and a PE in inbound scenarios basically revolves around a deeming provision that treats such a reallocation as if it constitutes a transaction between independent parties.<sup>95</sup> Thus, for example, if a non-resident GE reallocates an asset to a local PE, it is deemed, for CGT purposes only, to dispose of that asset for consideration equal to the asset's market value and to immediately

<sup>92</sup> Paragraph 2(1)(a) of the Eighth Schedule to the Act.

<sup>93</sup> Paragraphs 2(1)(b) and 2(2) of the Eighth Schedule to the Act.

<sup>94</sup> Paragraph 35(3)(a) (complemented by paragraph 20(3)(a)) of the Eighth Schedule as read with, for example, the definition of 'gross income' in Section 1, the recoupment provisions of Section 8 and the trading stock provisions of Section 22 of the Act.

<sup>95</sup> Paragraphs 12(1) read with 12(2)(b)(i) to (ii) of the Eighth Schedule to the Act.

reacquiring the asset for that market value consideration. The same rule applies to the converse scenario, ie where an asset is reallocated from a local PE to the non-resident GE.

It is evident that if the subject of a dealing between a GE and a PE does not qualify as an asset, the basic rule would be inapplicable. An asset is defined for these purposes as:<sup>96</sup>

- (a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
- (b) a right or interest of whatever nature to or in such property.

The provision of services in inbound scenarios between a non-resident GE and a local PE appears to be one category of dealings that is outside of the scope of the basic CGT rule, as the provision of services generally is confined to performance in terms of some personal right, and does not involve in this context the disposal, creation, extinction, etc of such rights.<sup>97</sup>

It is understood that at least until the introduction of residence-based income taxation in South Africa, it was SARS practice to accept a determination of income and expenses of a local PE of a non-resident GE computed on the basis of separate accounts that accord with generally accepted South African accounting principles. In terms of this practice the local PE was treated on the basis of being an entity separate from its GE when transacting with third parties. In dealings with the non-resident GE, arm's-length independence was not adhered to.<sup>98</sup> It is further understood that in terms of South African accounting practice, notional income or expenses will not be included in the determination of the PE's taxable income.<sup>99</sup> This practice, based on accounting principles, appears to be limited by the SARS statement in its Practice Note 7 (see 2.2.1) that the transfer pricing practice would be applied to GE – PE dealings, which could therefore in appropriate circumstances lead to adjustments to the accounts of a PE.<sup>100</sup>

<sup>96</sup> The definition of 'asset' in paragraph 1 of the Eighth Schedule to the Act.

<sup>97</sup> The precise interaction between personal rights and the purport of the CGT triggering provisions (paragraph 11 of the Eighth Schedule) is not clear. The vague nature of this issue is illustrated by the fact that, for example, a disposal includes the creation of a right. Difficulties arising in this regard are discussed by Swart, Gerrie. 2005. *Interpreting Some Core Concepts Governing the Taxation of Capital Gains*. SA Merc LJ 1 and Williams, Robert. 2005. *Capital Gains Tax – A Practitioner's Manual*. Cape Town: Juta, at 26.

<sup>98</sup> Passos, A. 1986. *Tax Treaty Law*. Cape Town: Juta, at 170; Van As, Stephan. 1996. *Cahiers de droit fiscal international* International Fiscal Association. Boston/Deventer: Kluwer. Volume LXXXIa (see South African chapter).

<sup>99</sup> Everingham, GK and Lomax, AC. 2005. *Financial Accounting*. 6<sup>th</sup> ed. Durban: Butterworths at 216 specifically mentions the principle of eliminating unrealised profits included in a branch's unsold inventory which was invoiced with a mark-up by a head-office to that branch.

<sup>100</sup> Senior officials of the SARS head office were not willing to confirm whether the mentioned practice is presently still followed and were only prepared to state that the subject of PE profit attribution would be best addressed by means of a Practice Note.

As regards outbound scenarios (ie foreign PE of a resident GE) the Act provides no basic rule for profit attribution for either CGT or income tax purposes. Only general principles would apply here. For unilateral double taxation relief purposes, the amount of profit attributable to a foreign PE is arrived at in accordance with these general principles.<sup>101</sup>

The above preliminary remarks are discussed in more detail below in the context of specific intra-company dealings.

Because the Act deals on a piecemeal basis with the cross-border dealings between a GE and its PE, frequently only with reference to general tax principles, the analysis in this chapter is broadly arranged with reference to four categories in which intra-company dealings may occur:

- The reallocation through a physical transfer of assets, both capital assets and inventory
- The making available of intangible assets, especially intellectual property
- The provision of services
- The provision of capital funds

Each of these four categories are examined both as regards a GE tax resident in South Africa with a PE located outside South Africa (the 'outbound scenario') and a non-resident GE with a PE located inside South Africa (the 'inbound scenario').

Both the outbound and inbound scenarios contain the possibility of a reallocation to and from the PE of a particular asset or service by the GE. The methodology adopted in the discussion of each type dealing so identified is standardised to first enquire whether the relevant reallocation will give rise to a tax deduction/allowance or tax charge, and then to examine the consequence thereof under municipal law for double taxation relief purposes (if applicable).

## **3.2 Reallocation of Inventory**

### **3.2.1 ~~The reallocation of inventory between a non-resident GE and a PE located in South Africa: the inbound scenario~~**

#### **3.2.1.1 From the local PE to the non-resident GE**

There is no specific rule dealing with the income tax treatment of a non-resident where inventory of that non-resident's PE located in South Africa is reallocated abroad to a different part of the same enterprise. It is submitted that, save for the possibility of deemed capital gains tax arising (discussed below), the Act does not on general principles provide for an income tax charge in respect of this physical transfer of assets.

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<sup>101</sup> Section 6quat(1).

For a source-based income tax charge the definition of 'gross income' in Section 1 requires that 'an amount' must be 'received by, or accrued to or in favour of' the GE. The reallocation through a physical transfer of inventory does not create a right to claim any amount by or to the benefit of the PE or the GE, and therefore no 'gross income' arises.

#### *Source*

As suggested above, a possible source-based tax charge may arise for the non-resident GE as a result of this reallocation of inventory. As mentioned earlier, source tax claims involve an inquiry into the originating cause of income and whether that originating cause is located in South Africa. In the present scenario, however, there is no income, and the source question can therefore not arise.

The question may be somewhat more complex if income does arise simultaneously or very soon after the reallocation to the non-resident GE. It is understood that the main (real, dominant or substantial) source of such income will generally be in the country in which the main activities or work done regarding the income may have taken place.<sup>102</sup> The facts of *Transvaal Associated Hide and Skin Merchants v CoT, Botswana*<sup>103</sup> illustrates how source was located in a similar scenario.

When, for example, inventory manufactured by a PE located in South Africa is reallocated to a non-resident GE which is sold to a third party immediately after the physical transfer to the GE, it is reasonably apparent that the main activities relating to the income from the sale occurred in South Africa. Hence it appears that the non-resident GE may be liable for tax on that income in South Africa, although not as a result of the reallocation but pursuant to the accrual of the sales income soon after the reallocation.

As indicated above, this is because 'an amount' must accrue to or be received by or to the benefit of the GE. This incongruity may increase the likelihood of the sale transaction going unnoticed from a South African perspective and may, in the above example, be increased if, for instance, the non-resident GE does not sell the trading stock immediately after reallocation, but stores it for a time before selling it. The source claim may even be avoided altogether if significant activities are performed in the GE state after the reallocation of the inventory since the dominant cause of the sales income may accordingly shift from South Africa to the GE home state.

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<sup>102</sup> Cf. Meyerowitz *supra* at § 7.33 *et seq.*

<sup>103</sup> 29 SATC 97(BCA)

It is arguable and largely dependent on the facts of each case whether a South African source-based tax claim may arise when inventory held at a stage by a local PE is subsequently sold in a foreign jurisdiction, as South African income tax law on the apportionment of source-based claims where income has multiple sources, is not settled.<sup>104</sup> If a source claim by South Africa is successful, double taxation may arise if the home state charges income tax on a worldwide basis at the time that the inventory is sold. Relief from international double taxation would be a matter for that state's municipal law or, if applicable, a DTC with South Africa.

### *Capital gain*

As mentioned in 3.1.3, the Act's CGT provisions governing the reallocation of assets from a South African PE to a non-resident GE are in principle also applicable to the reallocation of inventory. This is because paragraph 2(1)(b)(ii) of the Eighth Schedule to the Act, which lays down the scope of CGT, provides that CGT:

... applies to the disposal [of] ... the following assets of a person who is not a resident, namely ... any asset which is attributable to a permanent establishment of that person in [South Africa].

(Emphasis added)

CGT is generally triggered by a disposal, which is broadened by certain deemed disposal.<sup>105</sup> Paragraph 12(2)(b)(ii) of the Eighth Schedule creates one such deemed disposal when:

... an asset of a person who is not a resident ... ceases to be an asset of that person's permanent establishment in the Republic otherwise than by way of a disposal contemplated in paragraph 11.

Paragraph 12(1) of the Eighth Schedule determines that where the above deemed disposal takes place:

... a person [ie the non-resident GE] will be treated for the purposes of this Schedule as having disposed of an asset described in that subparagraph [ie 12(2)] for an amount received or accrued equal to the market value of the asset ... at the time of the event and to have immediately reacquired the asset at an expenditure equal to that market value, which expenditure must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).

Paragraph 13(1)(g)(i) of the Eighth schedule determines that the above deemed disposal in terms of paragraph 12(1) and (2) occurs on the date immediately before the day of the reallocation of the inventory to the non-resident GE.

<sup>104</sup> *Commissioner for Inland Revenue v Black* 1957 (3) SA 536 (A) and *Transvaal Associated Hide and Skin Merchants v CoT, Botswana* 29 SATC 97. For a contrary view see *Commissioner for Inland Revenue v Epstein* 1954 (3) SA 689 (A) at 700; Trevor Emslie and Richard Jooste. 1989. *Causation and the concomitant issue of apportionment with reference to gross income in South African income tax law*. SALJ. 292 at 304 to 307 and David Clegg. 1996. *Source for the goose*. *Tax Planning* vol. 10, no. 41 at 43 to 44.

<sup>105</sup> See the remarks in 3.2.2 on the legal nature of a paragraph 11 'disposals'.

Section 9(2)(b)(ii) deems the above deemed capital gain to be from a source located in South Africa if the asset pursuant to which the deeming provision operates is attributable to the local PE.<sup>106</sup> By applying these provisions it appears that when the inventory is reallocated abroad by the local PE, a capital gain may arise as a deemed disposal takes place for proceeds equalling the market value of that inventory on the date immediately before the day of the reallocation.

Since the acquisition cost of inventory will normally be deducted for income tax purposes in terms of the general deduction formula, the tax base of the inventory (also its 'base cost') would, for purposes of this deemed disposal, be minimal or zero, as such income tax deductions cannot contribute to the base cost of the inventory in terms of paragraph 20(3)(a) of the Eighth Schedule. Hence the deemed capital gain would be equal to the full market value of the inventory when it is reallocated from the PE to the non-resident GE.

It is also apparent from these provisions that the non-resident GE is allowed a 'step-up' in the base cost of the inventory so reallocated to it, as it is deemed to have immediately (on the date preceding the day of the physical transfer) reacquired the stock for expenditure equal to market value. The only reason for this step-up in base cost is, it is submitted, to avoid double CGT arising should this GE, in an unlikely event, decide to reallocate the selfsame stock back to the local PE in order to sell it locally, or even subsequently transfer it abroad for a second time.

There are, on the other hand, arguments that cast doubt on the view that a reallocation of trading stock from a local PE to a non-resident GE (or any other non-SA PE of that GE) will trigger CGT as described above. These arguments include:

(A) Trading stock consisting of immovable property was specifically excluded<sup>107</sup> for purposes of paragraph 2(1)(b)(i) of the Eighth Schedule, the CGT scope provision, subsequent to the introduction of CGT. This amendment, in effect, caused exemption from CGT for non-residents in respect of the disposal of local immovable property held as inventory through a resident company.<sup>108</sup>

Trading stock not consisting of immovable property and held by a non-resident through a local PE was not similarly excluded from the CGT scope provisions. No explanation was provided at the time of the above-mentioned legislative amendment. It can only be surmised whether it was intentionally or unintentionally left unchanged.

The reason why only immovable property held as trading stock is excluded from the CGT net may be an enforcement matter. Immovable property cannot be physically moved or transferred from South Africa, thus it always affords the fiscus the benefit of local assets against which recourse may be had in respect of a non-resident.

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<sup>106</sup> The chargeability of CGT in respect of non-residents is *not* founded on the source-concept, which is employed for purposes of income tax, but rather on the nature of assets (see paragraph 2 of the Eighth Schedule). Strictly speaking this source-deeming rule is therefore not relevant in as far as chargeability of CGT on non-residents is concerned.

<sup>107</sup> By Section 66(1) of Act 60 of 2001.

<sup>108</sup> Paragraph 2(2) of the Eighth Schedule and see clause 66 of the Explanatory Memorandum to Act 60 of 2001.

(B) Paragraph 35(3)(a) determines that the proceeds, including deemed proceeds from a deemed disposal of an asset, must be reduced by amounts of:

... the proceeds ... that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain.

(Emphasis added)

The inclusion of the closing balance of trading stock is taken into account in determining a person's 'taxable income' according to paragraph (a) of the definition of 'taxable income' in Section 1 of the Act. Section 26A provides that 'taxable capital gains' calculated in terms of the Eighth Schedule's provisions are similarly included in a person's 'taxable income'.

Therefore, it is uncertain whether it was intended that the deemed proceeds from the sale of the trading stock in the present scenario should be reduced by the inclusion of trading stock at the end of the fiscal year, since it must be reduced by all amounts that *was* taken into account when determining the taxable income of the non-resident *before* the inclusion of a taxable capital gain.

The fact that the year-end trading stock of the PE will be diminished to a negative inclusion – all things being equal – by the reallocation of stock to the non-resident GE during that year further clouds this uncertainty.

Questions arise as to whether paragraph 35(3)(a) requires causality between the 'proceeds', and in this case 'deemed proceeds', and the inclusion in 'taxable income' that is to reduce those proceeds.

Simply stated, because one deals with 'deemed proceeds', which by nature can never give rise to any other actual inclusion in taxable income, be it on the receipt or accrual basis, or as part of the annual trading stock adjustment, the inclusion of trading stock in gross income does not appear to impact on the calculation of such deemed proceeds.

Another question is whether, if the trading stock inclusion in taxable income is negative (effectively amounting to a deduction), can proceeds still be 'reduced' by this amount?

If the argument is plausible that a reallocation abroad of trading stock from a local PE to a non-resident GE leads to no capital gains tax charge, the result thereof may lead to situations of less than single taxation (or even double non-taxation) if the jurisdiction to where the inventory is reallocated and subsequently sold, treats the foreign GE as having acquired the inventory from the South African PE for market value consideration on the date of reallocation to it.

If the above reallocation does trigger a CGT charge which, is submitted, is the more likely scenario, a beneficial or detrimental situation, depending on the circumstances, may arise in the following way: On the income tax side, the value of the PE's opening stock (assuming it's cost approximates to market value at that time) is tax deductible, whilst zero closing inventory is added back at year-end if the reallocation to the non-resident GE occurs before year-end. The CGT charge as a result of the deemed disposal recaptures the aforementioned income tax deduction, but only partially since the CGT rate (14,5%) is lower than the income tax rate at which the opening inventory was deducted (29%). Yet, this is not the full picture.

A simplistic example should illustrate the overall effect. Widgets are manufactured in South Africa by a local PE of a non-resident GE at a cost of 5. When it is reallocated to the GE, the market value is 10. The home jurisdiction of the GE treats it as acquiring the widgets for a market value consideration of 10 on the date of reallocation. These widgets are eventually sold in the home jurisdiction for 15, whilst no additional cost was incurred in respect thereof by the GE. The result is that an amount of only 5 is subject to tax in the GE state, which could lead to less than single taxation if South Africa does not charge tax on the reallocation to the GE state because economically a profit/gain of 10 is achieved. If the GE sold the widgets for an amount of 10, double non-taxation will result, as no tax would arise in the home state in respect of an overall economic profit of 5.

Should South Africa charge CGT on the reallocation in the above example, a tax charge at the rate of 14,5% would apply in respect of the difference between the market value on the reallocation date and a nil tax base, thus 10. The cost of 5 would have been deducted by the local PE for income tax purposes at the rate of 29%. This could have disastrous results if the PE is realising revenue tax losses, as the income tax loss (29% of 5) cannot be offset against capital gains arising as a result of the deemed disposal. A revenue tax loss so realised in this example may be used if the income from the eventual sale of the inventory is received from a South African source and consequently attracts income tax.

Another possibility is that an income tax recoupment may arise against which the deduction could be utilised to avoid the creation of a tax loss. Section 22(8)(b)(iv) of the Act creates a recoupment for the market value of trading stock when 'any taxpayer has *applied* any trading stock for any other purpose other than the disposal thereof in the ordinary course of his trade'.

The premise of the above recoupment is that trading stock must be 'applied' by the local PE. It does not appear that merely physically relocating inventory from a local PE to another part of the GE located offshore would amount to the application of the inventory. It is submitted that 'applied' must be understood for these purposes to refer to the utilisation, employment, putting to use or into operation of trading stock. Where nothing in respect of the trading stock changes except its location being shifted from the host to the home country, the GE does not appear to have 'applied' it in any way, especially if it is yet to be disposed in the ordinary course of that GE's trade.

It is the view of this study that, based on the present wording of Section 22(8), no recoupment arises as a result of the mere relocation of trading stock from a local PE to a non-resident GE.

The net overall tax result arising in the example discussed thus far could be catastrophic, as the GE may be subject to:

- South African income tax at the rate of 29% in respect of an income of 10;
- South African CGT at the rate of 14,5% in respect of a deemed capital gain of 10; and
- Home country income tax on a profit of 5.

In these circumstances it could be assumed with reasonable safety that the home state would provide international double taxation relief for the South African income tax suffered in the above example, but not for the CGT.

The possibilities illustrated by the above example show the shortcomings of provisions regulating the interaction between income tax and CGT.

Most notably, paragraph 35(3)(a) of the Eighth Schedule, which provides one of the crucial links between income tax and CGT, does not provide sufficient reciprocity. The mechanism employed by paragraph 35(3)(a) is paralysed under circumstances where a deemed disposal of inventory for a local PE occurs prior to a potential source-based income tax charge. Some adjustment of either the CGT rules or the income tax rules is required to cater for such circumstances, either to eliminate the pre-emptive CGT charge when and if a source-based income tax charge arise, or taking the pre-emptive CGT suffered into account against any source-based income tax.

Another problem regarding the interaction between income tax and CGT is that paragraph 35(3)(a) does not cater for all consequences of the income tax computation, specifically regarding the trading stock provisions. The example of inventory relocated from a local PE to a non-resident GE indicates that from a structural and policy point of view, an expansion of paragraph 35(3)(a) is necessary to achieve, in effect, a set-off between the unusable income tax loss arising in these circumstances against the CGT charge brought about by the deemed disposal of the inventory.

### **3.2.1.2 From the non-resident GE to the local PE**

There is no specific rule dealing with the tax treatment of a non-resident GE when its inventory is relocated to a PE located in South Africa.

Generally, the amount to be included in terms of the general trading stock provision (Section 22 of the Act) is the difference between the value (equal to cost price or market value for financial assets) of the trading stock at the end of the fiscal year and the value at the beginning of the year, or if the relocation occurred during the year, the value at that time.

When computing the amount in terms of the general trading stock provision that must be taken into account in determining the non-resident GE's South African taxable income at the end of the fiscal year, the trading stock reflected in the local PE's accounts must be reflected as having been acquired at cost price.

However, Section 22 of the Act does not specify how the cost price of inventory must be determined in the context of GE - PE dealings. If, for example, the non-resident GE is required to carry the trading stock at market value according to the municipal tax laws of its home country, it is not clear whether this value should be considered the cost price at which the PE 'acquired' the stock.

It is considered that Section 22(4), which determines that where any person acquired trading stock for no consideration, that person is deemed to have acquired that trading stock at a value equal to its current market value, does not impact questions of intra-company dealings in inventory. Quite simply, no acquisition takes place as inventory is, in effect, merely physically reallocated by its owner, the GE.

As argued above at 3.1.1, the CGT provisions are applicable to the reallocation of trading stock by reason of paragraph 2(1)(b)(ii) of the Eighth Schedule. The result is that according to paragraph 12(1) read with 12(2)(b)(ii) the PE is deemed to acquire the trading stock for expenditure actually incurred equalling the market value when it 'becomes an asset of the permanent establishment in the Republic otherwise than by way of acquisition'.

When the trading stock held by a local PE is sold (assuming to a third party), the non-resident GE will be liable to tax on the full amount of the sale proceeds provided it is received from a South African source.<sup>109</sup>

In the event that this sales income is not received from a South African source (see previous footnote) but the inventory remains on the other hand attributable to the local PE, the PE will be considered to actually dispose of these assets for CGT purposes. The local PE could realise a capital gain equal to the difference between the sale proceeds and the deemed base cost, ie the market value of the inventory on the date immediately preceding the date of relocation of the inventory to the PE. Section 9(2)(b)(ii) of the Act determines that this gain is deemed to be received from a source located in South Africa if the inventory is attributable to the PE.

This situation hinges conceptually on the question whether the municipal tests for source-based income tax claims have regard to similar considerations that impact the analysis as to whether or not an asset (inventory for present purposes) is attributable to a PE for municipal tax purposes. The analysis in chapter 4 will show that where a DTC is concerned with the circumstances under which an asset is attributable to a PE, the approach is dissimilar to that of the source analysis.

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<sup>109</sup> See the *Transvaal Associated Hide and Skin Merchants v CoT, Botswana* 29 SATC 97(BCA). The decision in this case is apposite to a scenario where a non-resident GE transfers finished goods to a South African PE for the purpose to on-sell those goods through the PE with little value added by the PE. The source of the sale income is likely to be located outside South Africa in such circumstances.

Another question that arises is what happens to the above-mentioned deemed base cost of the asset (ie the trading stock) for CGT purposes when the sales income is subject to income tax (included in 'gross income'<sup>110</sup>) on the basis that it is received from a local source. The apparent answer is that the deemed base cost would in this way give rise to a capital loss.<sup>111</sup>

This possibility of such a seemingly unnecessary capital loss is explained by the following example.

#### Example

A non-resident GE's cost incurred in the manufacturing of trading stock prior to the relocation thereof to its South African PE is 5. The manufactured stock's market value is 10 at the time of reallocation to the PE. The stock is subsequently sold in South Africa to third parties for a consideration of 15, with no further cost incurred in South Africa. The manufacturing, relocation and sale occur in the same year of assessment.

#### Source State (South Africa)

Assuming that the income from the sale is received from a source located in South Africa, the tax consequences will be as follows.

As the full sales proceeds of 15 will be included in the calculation of the non-resident GE's taxable income in South Africa, the 'proceeds' for capital gains tax purposes in respect of the sale of these assets will be zero.<sup>112</sup>

Against the gross income of 15 a deduction in terms of Section 11(a) and 23(g) of the Act of 5 should be allowed. This results in SA taxable income of 10:

Gross income	15
Exempt income / deductions	(5)
Income	<u>10</u>
Inclusion of capital gains	0
Inclusion: iro trading stock...	<u>0</u>
Taxable income	10
Normal tax: rate 29%	2.9

<sup>110</sup> Paragraph 35(3)(a) of the Eighth Schedule determines that for purposes of calculating capital gains or losses, proceeds from the disposal of assets (eg received on the sale of trading stock) must be reduced by any amount of those proceeds included in gross income.

<sup>111</sup> This loss will not be reduced by the parallel provision to paragraph 35(3)(a), namely paragraph 20(3)(a) that determines that the deemed base cost must be reduced by, *inter alia*, any expenditure actually incurred in respect of the cost of acquisition or creation of the inventory and which has been deducted in determining a person's taxable income. The cost of creating or acquiring the inventory will not be claimed by the local PE against the South African tax base, but by the non-resident GE against its home tax base.

<sup>112</sup> Paragraph 35(3)(a).

The relocation of inventory to the local PE from the non-resident GE is a CGT *deemed* disposal in terms of paragraph 12(2)(b)(ii). For the GE the deemed proceeds received in respect of this deemed disposal is outside the CGT net pursuant to the timing rule of paragraph 13(1)(g) read with paragraph 2(2)(b)(ii) of the Eighth Schedule. The implications of the deeming provisions occur at a time when the inventory, in terms of the timing rule, is still with the GE, and not yet attributable to the local PE.<sup>113</sup> For the GE to fall inside the CGT net, the asset (inventory) must have been attributable to the PE. This relocation will also result in a deemed base cost for the inventory. This deemed base cost will only become relevant upon a subsequent disposal of the inventory.

The *actual* disposal of the inventory, subsequent to the relocation to the local PE thereof, will also be a CGT event.<sup>114</sup> In terms of paragraph 4 of the Eighth Schedule, a person's (ie also a non-resident's) capital loss is equal to the amount by which the base cost (including deemed base cost) of an asset exceeds the proceeds received in respect of the disposal of an asset.

The calculation of the non-resident GE's capital loss on the actual disposal of the trading stock held by its local PE will thus be:

Actual proceeds	15
Less: taxable income inclusions ito paragraph 35(3)(a)	(15)
P: Proceeds	<u>0</u>
Deemed base cost ito paragraph 12(2)(b)	10
Less: income tax deductions ito paragraph 20(3)(a)	(5)
B: Base cost	<u>5</u>
Capital loss (P-B)	<u>(5)</u>

The capital loss as calculated in the above table cannot be offset against the PE's liability for income tax<sup>115</sup> but it may be utilised in respect of any<sup>116</sup> future capital gains<sup>117</sup> of the GE (not only the local PE) that falls within the South African CGT net.

<sup>113</sup> The deemed proceeds are also likely not from a South African source for purposes of Section 9(2) of the Act according to the timing rule (namely the day preceding the day of actual transfer) as the inventory is not, at that time, attributable to the PE.

<sup>114</sup> Paragraph 2(b)(ii) read with paragraph 11(a).

<sup>115</sup> Section 26A of the Income Tax Act.

<sup>116</sup> It is submitted that the rule of paragraph 39 of the Eighth Schedule that clogs connected party capital losses (ie it determines that capital losses arising from disposals between connected *persons* may only be utilised against subsequent capital gains arising between those specific persons) does not apply to dealings 'within' one person. The wording of this rule clearly requires the capital loss to be determined in respect of two separate legal *personae*.

### *GE Home State*

For purposes of drawing a pure and balanced comparison, it is assumed that the tax system of state wherein the GE is liable to comprehensive taxation (ie on its worldwide earnings) is identical to the South African normal tax system.

When the trading stock is relocated to the PE, a capital gain will crystallise for the GE as a deemed disposal will take place equal to the difference between market value on the date of reallocation (10) and its cost of acquiring or creating the stock excluding such expenses allowable as income tax deductions, which would be zero in this instance. A taxable gain of 10 will therefore arise on the date of reallocation of the inventory resulting in GE state tax of 1,45 (at similar inclusion and corporate tax rates).

Once the stock is sold to third parties through its South African PE, the GE will be liable to income tax of 2,9 in state GE on its worldwide taxable income of 10 (gross income equals: 15; deductions equal: 5). As this sale will be an actual disposal for CGT purposes, a capital loss would arise in the GE state of 5 (ie proceeds equal: 15 less 15; deemed base cost equals: 10 less 5). Since the reallocation that gave rise to the deemed disposal took place within the same year as the actual disposal (ie the sale thereof), this capital loss may be offset against the earlier gain, the net result being CGT payable of 0,725 in the GE state in respect of the sale.

### *Overall result*

The overall result for the GE is the prospect of a total income tax liability of 5,8 and a CGT liability of 0,725 in respect of an economic profit of 10 (2,9 and 0,725 in its home country and 2,9 in South Africa). This translates into international double taxation and an effective tax rate of 62% in respect of the profit of 10.

The international double taxation of the GE is resolved by the GE's home country either granting unilateral tax relief or relief in terms of a DTC with South Africa, with the result that against the 2,9 GE state taxes, credit should be granted for 2,9 foreign state (ie SA) taxes.

No income tax but 0,725 CGT would then become payable in the GE state and 2,9 income tax in South Africa in respect of the economic profit of 10. Importantly; an unusable capital loss with a tax value of 0,725 will remain in South Africa.

There will thus remain an element of international double taxation on this dealing between the GE and PE in so far as CGT is concerned. The principle that can be extracted from this example is that in symmetrical tax systems, whenever non-taxation occurs, such as through the needless and gratuitous capital loss granted pursuant to the sale of inventory by a South African PE acquired from its non-resident GE, international double taxation will occur in the converse situation.

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<sup>117</sup> It will give rise to a so-called assessed capital loss in terms of paragraph 9 of the Eighth Schedule, which in terms of paragraph 8 of that Schedule must be taken into account when determining a subsequent year's net capital gain.

The deeming rule of paragraph 12 should therefore be considered for amendment to adjust the CGT treatment of dealings in inventory between a non-resident GE and its local PE.

### **3.2.2 The reallocation of inventory between a resident GE and a PE located outside South Africa: the outbound scenario**

There is no specific rule that caters for the income tax or CGT treatment of trading stock reallocated from a South African tax resident GE to its offshore PE.

An income tax charge will only arise when the inventory is disposed to another person, as the basic charging rule of the Act is that no liability for income tax can arise when there is no receipt or accrual or benefit of an amount by a person.<sup>118</sup>

It does not appear that Section 22 of the Act, which deals with the tax treatment of inventory in general, envisages a tax effect on the reallocation of the inventory from the tax resident GE to the foreign PE. The general principle relating to trading stock will apply to the GE, ie in the determination of the taxable income of the GE, the difference between the value of the trading stock on hand, albeit in the hands of the GE or the PE, at the beginning and at the end of the year of assessment will be taken into account. The value of the closing stock should be added to the GE's taxable income, while the value of the opening stock should be deducted. To put it differently, the difference between the values of closing and opening stock should either be added to the taxable income or deducted according to whether the value of the closing stock is greater or less than the value of the opening stock.<sup>119</sup>

Section 22(8)(b)(iv) of the Act creates a recoupment for the market value of trading stock when 'any taxpayer has *applied* any trading stock for any other purpose other than the disposal thereof in the ordinary course of his trade'.

The basis of application for the above recoupment in the present scenario is that trading stock must be 'applied' by the local PE. It does not appear that merely reallocating inventory from a local PE another part of the GE located offshore would amount to the application of the inventory. It is submitted that 'applied' must be understood for these purposes to refer to the utilisation, employment and implementation of trading stock. Where nothing in respect of the trading stock changes except it being reallocated from the GE to its PE, the GE does not appear to have 'applied' it in any way, especially if it is yet to be disposed in the ordinary course of that GE's trade.

In principle it therefore appears that the general rule governing the tax treatment of inventory should cause no effect when trading stock is merely reallocated from a South African tax resident GE to a foreign PE.

<sup>118</sup> Cf. the definition of 'gross income' in Section 1 of the Act; De Koker *supra* at § 2.1 to 2.5.

<sup>119</sup> De Koker *supra* at § 8.111. Where a person ceases to hold assets as trading stock, the corresponding amount taken into account in terms of Section 22 will be deemed to form the base cost of that asset for capital gains tax purposes – cf. paragraph 12(3) of the Eighth Schedule to the Act. It is submitted that this principle is also applicable to assets relocated to a foreign PE on trading account but which the South African GE then holds on capital account through that PE.

For CGT purposes, it may be conceivable that the mere reallocation of the trading stock to the foreign PE could be viewed as a disposal, since disposal is very widely defined as including 'any event ... which results in the ... transfer of an asset'.<sup>120</sup>

It is submitted that this definition is not so wide to include each and every physical transfer of an asset, but rather refers to transfer of ownership or some right or interest in property in a legal sense. The reallocation and physical transfer of assets, including inventory between a GE and PE, has no legal significance regarding ownership. Neither outright ownership nor rights or interests in the assets are affected *vis-à-vis* the legal entity, namely the GE.

The reallocation through the physical transfer of trading stock from a resident GE to its offshore PE should therefore not be viewed as a disposal for CGT purposes. The fact that the legislature specifically created a deemed disposal in the converse situation<sup>121</sup> tends to support this view.

In circumstances where inventory is reallocated from a foreign PE to a resident GE and the state in which the PE is situated, levies tax upon the reallocation of the inventory to the resident GE (popularly referred to as an 'exit charge'<sup>122</sup>), the South African GE will not be able to claim, at that time, a unilateral tax credit for the foreign tax so paid. The reason is that Section 6quat(1)(a) of the Act, which governs unilateral tax credits, stipulates that the unilateral tax credit is only available to a resident 'in whose taxable income there is included any income received by or accrued to such resident from any source outside South Africa'.

Moreover, the unilateral tax credit shall be equal, subject to the general limitation formula,<sup>123</sup> to the foreign tax suffered in respect of the income so included in taxable income.<sup>124</sup>

It is therefore quite clear that, firstly, the foreign tax suffered by the GE (occasioned by the exit charge) is not a tax in respect of 'income' received or accrued, but merely a tax on a notional amount<sup>125</sup> that was not received and did not accrue to the GE.

If we ignore for the moment this first problem, the second problem with Section 6quat(1)(a) is that the source-concept is ill-equipped to decide whether notional amounts were 'received from a source outside South Africa' in circumstances where foreign tax is charged in respect of such a notional amount. Admittedly the phrase 'from

<sup>120</sup> Paragraph 11(1) of the Eighth Schedule to the Act.

<sup>121</sup> Paragraph 12(2)(b) of the Eighth Schedule to the Act.

<sup>122</sup> A provision similar in effect than paragraph 12(2)(b)(ii) of the Eighth Schedule to the Act.

<sup>123</sup> Section 6quat(1B).

<sup>124</sup> Section 6quat(1A).

<sup>125</sup> It should be kept in mind that the basis of the foreign tax charge under consideration may also vastly differ from familiar South African income tax concepts, eg foreign tax may be charged in respect of notional or unrealised profits or other amounts, and not in respect of 'income' as conceived by the Act. This would present fundamental problems to an argument that maintains that the exit charge was suffered in respect of 'income' that will only later be received or accrue to the GE at the time when it actually disposes the inventory.

a source outside South Africa' may be interpreted and understood to not refer to the source-concept as applied for purposes of the gross income definition where it generally refers to the originating cause of the income received. This phrase may, given the context, purpose and legislative history of Section 6quat, merely refer to where the income is received from, and not to the location of the originating cause of the income. Nonetheless, this alternative reading of the source-concept in Section 6quat will not significantly alter the scenario under consideration, as no 'income' is 'received'.

Strictly speaking, for the reasons stated above, Section 6quat's provisions may exclude the possibility altogether to obtain a unilateral tax credit for foreign taxes suffered by a resident GE in the scenario under consideration. This is a very harsh result.

It is conceivable that only in the year of assessment when the inventory is actually disposed by the resident GE could the unilateral foreign tax credit potentially be claimed for the foreign exit tax suffered in a prior tax period in the host country. The problem that could arise in this scenario is that when the inventory is actually disposed by the GE, the income will more likely than not be received from a source located inside<sup>126</sup> South Africa, and not from a source outside South Africa as required by Section 6quat(1)(a) of the Act. In such circumstances international double taxation will arise and remain unresolved in terms of Section 6quat.

For depreciable assets constituting inventory the problem of international double taxation under the present scenario should, however, and very generally speaking, be of minimal impact based on the assumption the exit tax charged by the PE state would be insignificant, if any, as these assets' market value continuously reduces vis-à-vis its foreign tax base.

### **3.2.3 The reallocation of capital equipment between a GE and a PE**

#### **3.2.3.1 Between a local PE and a non-resident GE**

For capital equipment reallocated from a local PE to a non-resident GE, the following CGT rules apply:

- Paragraph 12(2)(b)(ii) of the Eighth Schedule to the Act specifically provides that where a capital asset of a non-resident GE ceases to be an asset of that GE's South African PE otherwise than by way of an actual disposal, it will be deemed to realise a capital gain or loss in respect of that asset;
- Paragraph 13(1)(g)(i) of the Eighth Schedule determines that this gain or loss will be realised on the date immediately before the day that the disposal event (ie the capital asset reallocation) occurs.

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<sup>126</sup> Either because the originating cause of the income is located in South Africa, or, on the alternative reading of the source concept in Section 6quat, because it is received from an actual source in South Africa.

- Paragraph 12(1) of the Eighth Schedule to the Act provides that this deemed disposal of the asset is made for proceeds equal to the market value of the asset at the time of the event.

As explained earlier, paragraph 12(1) further provides for a step-up in the base cost of the non-resident GE's asset in that the GE is deemed to immediately reacquire the asset at expenditure equal to its market value, which must be treated as the cost of acquisition of that asset. This step-up in the base cost of the asset only has relevance for the GE in that it prevents a double capital gain from arising if the asset is again reallocated back to the PE and is thereafter reallocated to the GE for a second time, or sold to another entity.

For capital equipment reallocated by a non-resident GE to a local PE, the following income tax rules apply:

- Specific allowances are available for machinery and plant used in manufacturing processes;<sup>127</sup>
- If these specific capital allowances are not available, Section 11(e) of the Act allows for capital equipment in general an annual allowance of an amount that the SARS thinks 'just and reasonable' representing an amount by which the 'value' of such assets<sup>128</sup> has diminished. For these purposes the SARS published Practice Note 19 of 30 April 1993 with certain *prima facie* acceptable write-off periods for specific classes of assets. The overall capital wear and tear allowance remains entirely discretionary in nature. Notwithstanding that Section 11(e) refers to a diminution in the 'value' of an asset, it is the practice of the SARS to allow a percentage of historical cost.<sup>129</sup>
- There are additional rules in respect of the Section 11(e) allowance that must be considered in the context of GE-PE dealings for certain type assets, such as Section 11(e)(ix) of the Act that provides:

where any machinery, plant, implement, utensil or article was used by the taxpayer during any previous financial year or years for the purposes of any trade carried on by such taxpayer, the receipts and accruals of which were not included in the income of such taxpayer during such years or years, the Commissioner shall take into account the period of use of such asset during such previous year of years in determining the amount by which the value of such machinery, plant, implement, utensil or article has been diminished.

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<sup>127</sup> Section 12C and 12B.

<sup>128</sup> Machinery, plant, implements, utensils and articles.

<sup>129</sup> Evidenced by the provisions of Practice Note 19 and Practice Note 15 dealing with lessors. This approach was in general not opposed by the Tax Court in *ITC 780 19 SATC 328 (C)*, mainly because it appears that the taxpayer was unable to adduce evidence to arrive at a different value than historical cost.

When a South Africa PE uses capital equipment in a local trade that was provided by a non-resident GE, it appears that the calculation of the wear and tear allowance claimed against the South African source income must be based on the total years for which the GE used the asset in its trade, wherever carried on. For example, if a main frame computer is reallocated to a South African PE after being used for 2 years by the GE, a wear and tear allowance will only be available against South African source income for a further 3 years, as the *prima facie* write-off period for this asset class is 5 years.<sup>130</sup>

- Section 8(4A) of the Act determines that the recapture (or recoupment) provisions of the Act do not apply to capital allowances claimed in terms Section 11(e)(ix) and also cancels the source deeming rule<sup>131</sup> for recoupments in these circumstances. The result is that where capital equipment reallocated to a South African PE is sold for proceeds, which exceeds the aggregate value of the wear and tear allowances claimed in terms of the Act, that difference will not be taxable in the hands of the South African PE as a recoupment.

The following capital gains tax rules must be considered together with the income tax rules for capital equipment reallocated by a non-resident GE to a local PE listed above:

- Paragraph 12(1)(2)(b)(i) of the Eighth Schedule determines that where capital equipment becomes an asset of a local PE, the non-resident GE will be seen to have disposed<sup>132</sup> of that asset for market value consideration and to immediately reacquire it for expenditure equal to that market value on the day immediately preceding<sup>133</sup> the day of the reallocation. Thus for purposes of calculating a subsequent capital gain on the disposal of the asset held through the PE, a step-up in the base cost of that asset is allowed. The GE will only be liable for CGT representing the difference between the sale proceeds and the market value of the asset on its date of reallocation to the local PE.

### 3.2.3.2 Between a resident GE and a foreign PE

A resident GE should not be considered disposing of capital equipment when it is reallocated to or from a foreign PE. As mentioned earlier, the provisions of paragraph 11(1) of the Eighth Schedule to the Act that defines a 'disposal' of any asset as 'any transfer' refers to legal transfer and does not envisage a mere physical movement or reallocation of an asset.

<sup>130</sup> Practice Note 19 *ibid*.

<sup>131</sup> Paragraph (n) of the gross income definition in Section 1 of the Act.

<sup>132</sup> This disposal, and consequently the potential capital gain, is outside the scope of South African CGT – see the text at footnote 113 for the technical reasoning.

<sup>133</sup> This contra-factual timing device contained in paragraph 13(1)(g) of the Eighth Schedule is necessary to place the deemed disposal of the non-resident GE outside the scope of the CGT provisions – cf. paragraph 2(1)(b)(ii) as read with 13(1)(g)(i) of the Eighth Schedule to the Act.

The resident GE may claim for the capital equipment reallocated to or from the foreign PE the tax allowances for wear & tear, scrapping and capital allowances<sup>134</sup> so long as the GE legally owns the equipment and holds it on capital account.

If the asset, be it in the hands of the GE or the PE, ceases to be held as a capital asset and is henceforth held as inventory, a deemed capital gain or loss will crystallise at that moment according to paragraph 12(1)(c) of the Eighth Schedule to the Act.

It does not appear that the mere reallocation of capital equipment to or from a foreign PE will result in a recoupment in terms of Section 8(4) of the Act of, for instance, any of the Act's capital allowances claimed in respect thereof because no actual income or receipt or benefit accrues to the GE in these circumstances.

In circumstances where a capital asset is reallocated from a foreign PE to a resident GE and the state in which the PE is situated levies tax upon the reallocation of the asset to the South African GE (popularly referred to as an 'exit charge'<sup>135</sup>), the South African GE will not be able to claim, at that stage, or even arguably at a later stage, a unilateral tax credit for the foreign tax so paid in terms of Section 6quat of the Act. The reasons for this harsh result are discussed above in 3.2.2.

### 3.3 The reallocation of an intangible asset between a GE and a PE

In circumstances where intangible assets are reallocated between a GE and a PE, the question arises whether that part of the enterprise which so obtained the use of the particular asset, for example a trade mark, should be able to claim a tax deduction for a payment in respect of that use (ie a deemed royalty or licence fee).

It is trite law that the Act is not concerned with notional income and expenses. Moreover, South Africa's transfer pricing provisions does not apply to 'dealings' between different parts of the same legal entity.<sup>136</sup> The answer thus seems that no deemed royalty expense will be allowed for municipal income tax purposes in these circumstances.

The SARS is conversely of the opinion that if a DTC is in place between South Africa and the country where the PE/GE is located, it may apply the statutory related party transfer pricing provisions to such 'dealings' and so possibly recognise a notional charge or deduction for a deemed royalty.<sup>137</sup>

<sup>134</sup> Sections 11(e), 11(o), 12B, 12C, 12D and 12E of the Act. Note that Section 12F and 12G is not available because it only applies to airports or industrial assets located in South Africa respectively.

<sup>135</sup> A provision similar in effect than paragraph 12(2)(b)(ii) of the Eighth Schedule to the Act.

<sup>136</sup> See 2.1

<sup>137</sup> Cf. paragraph 6 of Interpretation Note 7, 6 August 1999. It should also be considered that where one of South Africa's DTCs follow article 7(3) of the UN Model Tax Convention (see the table at 4.6), this argument by the SARS becomes untenable since deemed intra-company royalties are expressly not recognised under such DTCs.

It was shown at paragraph 2.1 that it is doubtful whether the recognition of deemed royalties in terms of the municipal transfer pricing practice by SARS would be legally sound. It is especially questionable whether a corresponding deemed royalty would be recognised by South Africa's treaty partner in circumstances where the SARS requires such a deemed charged/deduction to be made in terms of a DTC and the local transfer pricing practice.

It is the conclusion of this study that based on general income tax principles there is no basis in the Act enabling the SARS to deem a South African PE or resident GE to earn a notional royalty from the use of intangibles by an offshore part of the enterprise.

In inbound scenarios the SARS's practice was apparently to accept a determination of income and expenses of a local PE computed on the basis of separate accounts that accord with generally accepted South African accounting principles.<sup>138</sup> SARS was not prepared to confirm the validity of this practice at the time of the finalisation of this study.

In terms of SARS practice, which now must be viewed as historic in nature, the local PE was treated on the basis of being an entity separate from the GE when dealing with third parties. In so far as dealings with the GE is concerned, arm's-length independence was not adhered to. It is understood that in terms of South African accounting practice, notional royalty income for the use of the intangibles by a non-resident GE or offshore PE will not be included in the determination of the local PE or non-resident GE's taxable income, as the case may be.

It is considered that when a local PE ceases to hold an intangible asset when a reallocation of the same is made to its non-resident GE, depending on the circumstances, such a cessation of use may be viewed as a CGT event by virtue of the deemed disposal provision of paragraph 12(2)(b)(ii) of the Eighth Schedule to the Act.<sup>139</sup>

For example, if a patented formula is developed by a local PE and passed to its GE for exploitation in the latter's manufacturing process, the local PE is regarded as realising a capital gain in respect of the patented formula (eg plans, designs, etc) so reallocated to the GE if the market value thereof at the time of the reallocation exceeds the tax base of the asset.

The question that arises in respect of the paragraph 12(2)(b)(ii) of the Eighth Schedule of the Act (which triggers the deemed disposal) is what circumstances are required for an asset to 'cease to be an asset of a local PE otherwise than by way of a [legally based] disposal'.

It is submitted that circumstances analogous to those prevailing in situations of an outright sale should exist before the circumstances may be ripe for the deemed

<sup>138</sup> Passos *supra* ibid; Van As *supra* ibid.

<sup>139</sup> For the full operation of this rule see the various relevant extracts from the CGT legislation provided above at 3.2.1.1.

disposal to apply. For example, the local PE should relinquish all functional and factual control, possession and interest in the intangible property.

If on the other hand in the above example, the local PE retains some functional interest or control over the patented formula (eg it continuously maintains and also makes it available to other local or foreign branches of the enterprise, or to third parties, or further develops the formula) the circumstances for the deemed disposal may not be triggered. The relationship between the PE and GE as regards the patented formula may then be more akin to that prevailing in terms of a licence arrangement. In other words, for purposes of paragraph 12(2)(b)(ii) the asset could still be attributed to the local PE in some way, and had not ceased to be an asset of the local PE when it was relinquished the use thereof to the GE for exploitation.

It appears that the tax deductions and allowances available for intangible property, for example, those granted by Sections 11(f), 11(gA), 11(gC) or 11(B) of the Act would apply to a local PE because it is available to 'any taxpayer' complying with the stated requirements.<sup>140</sup>

### 3.4 The supply of services between a GE and a PE

As regards inbound scenarios where services are rendered by or provided to the benefit of a local South African PE to or by a non-resident GE, there is no specific provision in the Act that determines how profits should be attributed to the local PE in terms of a DTC.

As explained in 1.1.2, non-residents are liable to tax in South Africa on income received from a local source. Expenditure incurred for the purposes of trade that has been 'actually incurred', may be deducted against such income. For these purposes expenditure is only actually incurred when a taxpayer has an unconditional legal liability and no deduction for notional expenditure can therefore be claimed. Thus only a deduction for direct actual cost of any service will be allowed to a PE or a GE. No tax deduction in respect of any deemed expenses incurred in respect of, for example, the management of a local PE by a non-resident GE will be allowed in terms of the general deduction formula.

As mentioned earlier, the practice of the SARS was to accept a determination of income and expenses of a local PE computed on the basis of separate accounts that accords with generally accepted South African accounting principles. The fiction of the fiscal independence of the PE is not followed in so far as dealings with other parts of the same enterprise occur. Apparently it was the practice of SARS to deny a tax deduction for management fees in respect of services provided by the PE to the benefit of a foreign GE.<sup>141</sup> It follows that, based on this practice, it is unlikely that a deduction for the rendering of any services would be allowed to a local PE save for the direct cost actually incurred by the PE.

<sup>140</sup> See Du Toit, C. 2005. *The International Guide to the Transfers of Technology*. Loose-leaf edition. Amsterdam: IBFD, at 2.1.2 to 2.1.3 of the South African chapter.

<sup>141</sup> Passos *supra* *ibid*; Van As *supra* *ibid*.

As regards outbound scenarios, there is no provision in the Act that requires the resident GE to recognise notional income for the provision of services to an offshore PE, or a notional expense in respect of services rendered to an offshore PE.<sup>142</sup> As stated previously, it is clear that Section 31 of the Act, which enables the application of related party transfer pricing adjustments, provides no legal basis for the SARS to adjust the income of a resident GE to reflect notional or deemed income in these circumstances.

Provided that the normal requirements<sup>143</sup> of the Act are met in so far as the deduction of expenditure actually incurred in the provision of the services at issue is concerned, the resident GE may claim a deduction for the cost in respect of its PE actually incurred.

### **3.5 Reallocation of capital funds between a GE and a PE**

As regards inbound scenarios, there is no specific provision in the Act allowing the recognition for tax purposes of notional or deemed interest flows between a local PE and a non-resident GE.

The general rule governing the deduction of business expenditure will prohibit the deduction by a local PE of notional or deemed interest payments. While for accounting purposes the various branches of one enterprise may be credited or debited with interest in respect of intra company loan accounts, such debits and credits do not constitute expenditure actually incurred for income tax purposes.<sup>144</sup>

As explained earlier, the SARS's apparent practice was to disallow this type of deduction as a determination of income and expenses of a local PE was computed on the basis of separate accounts that accord with generally accepted South African accounting principles. According to this accounting approach the local PE is treated on the basis of being an entity separate from its GE when dealing with third parties. In so far as dealings with the GE is concerned, arm's-length independence is not adhered to. It follows that on the basis of this practice, no notional interest expenditure may be deducted by the South African PE as a result of the reallocation of funds to or from the offshore GE and the subsequent utilisation thereof.

As also explained previously, it is clear that Section 31 of the Act, which enables the application of municipal related party transfer pricing adjustments and the thin capitalisation rule, provides no legal basis for the SARS to adjust the income of the local PE to reflect notional or deemed interest income or expenses in these circumstances. The situation may, of course, be different when a DTC applies. For example, if a DTC incorporates article 7(3) of the UN model convention, an adjustment for deemed interest as between a GE and PE is expressly recognised (see 4.5.3). That position is not addressed in this chapter but in the chapters 4 and 5.

<sup>142</sup> While for accounting purposes the various branches of one enterprise may be credited or debited, such debits and credits do not constitute expenditure actually incurred – cf. Meyerowitz, D. 2001. *Meyerowitz on Income Tax* Cape Town: The Taxpayer at §11.41

<sup>143</sup> Section 11(a) and 23(g) of the Act.

<sup>144</sup> Meyerowitz *supra* at §11.41.

It is unclear whether a local PE may claim a deduction against its South African source income of interest expenses actually incurred by a non-resident GE to a separate creditor in circumstances where the funds so acquired by the GE is allocable to the PE.

In terms of general tax principles the deductibility of interest is governed by the general deductions formula.<sup>145</sup> Therefore, provided *inter alia* that the interest paid to the third party creditor was actually incurred for the purposes of the GE's trade and in the production of South African source income, a tax deduction may be well-founded. In circumstances where the closeness of the link between the actual interest expense and the South African source income becomes increasingly distant, it may be more difficult to be successful with a claim for a tax deduction.

A further factor, strictly unrelated to the question of deductibility in terms of the Act, may nonetheless obscure the argument for tax deductibility of actual interest by the local PE. The confusion is caused by the fact that the non-resident GE will also deduct for tax purposes the interest expenditure against its taxable income in the home state (eg in the computation of its worldwide income). This situation will also arise for the deduction of direct cost in respect of the provision of intra-company services discussed at 3.4.

From a global perspective the apparent double deduction of the finance charge will be neutralised when a determination is made of the profits attributable to the local PE for purposes of calculating the double taxation relief that the GE may claim against its worldwide taxable earnings in its home country. Thus, against the PE income a deduction of the finance charge will be made, which will result in a lesser amount of income, and hence foreign tax that will be taken into account to calculate the GE's tax credit in its home country. Simply put, if the exemption method is adopted by the GE state for purposes of double taxation relief, a lesser amount of foreign income will be exempt, which would effectively recapture one of the interest deductions.

The following example will illustrate this observation.

A non-resident GE earns total worldwide taxable income of 100, whilst it incurs finance charges of 50 and is subject to a corporate tax rate of 30%. In terms of a concluded DTC between the GE home state and South Africa, which is based on the OECD MTC and adopts the credit method, all the profits and finance charges are attributable to the South African PE. In terms of the Act, the 100 profits are viewed as being earned by the GE from a source located in South Africa. The tax computation of the GE in its home country and in South Africa is as follows:

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<sup>145</sup> Section 11(a) read with 23(g) of the Act. See also De Koker *supra* at § 7.34 *et seq.*

Home state (GE):		South Africa:	
Worldwide income	100	Gross income	100
Less: deductions	(50)	Less: deductions	(50)
Taxable income	50	Taxable Income	50
Corporate tax at the rate of 30%	15	Normal tax payable	14,5
Credit relief for SA taxes	(14,5)		
Tax payable in Home State	0,5		
<b>Net result: total tax liability on economic profit of 50</b>			<b>15 [=30%]</b>

This example shows that if the deduction for the finance charge is not allowed against the South African tax base, double taxation would result as the overall effective tax rate in respect of the economic profit of 50 would be 86%.

As regards outbound scenarios, there is no provision in the Act that provides a basis to tax a resident GE on notional interest income earned pursuant to a dealing with a foreign PE. In these circumstances, the fact that the GE may have borrowed capital funds from a third party is irrelevant. As stated previously, it is clear that Section 31 of the Act, which enables the application of municipal related party transfer pricing adjustments, provides no legal basis for the SARS to adjust the income of a resident GE to reflect notional interest income. For reasons previously stated, a tax deduction for notional interest will not be allowed to the resident GE.

In so far as foreign exchange gains and losses in respect of capital funds are concerned, the Act contains complex provisions dealing with the taxable inclusion or deduction of such gains or losses, which is largely contained in Section 24I of the Act. Section 9D(6), Section 25D or Part XIII of the Eighth Schedule to the Act are applicable to persons falling outside the scope of Section 24I.

A comprehensive discussion of all these provisions in respect of GE-PE dealings is beyond the scope of this study and only some general and cursory remarks will be made here.<sup>146</sup>

The provisions of Section 24I apply to both inbound and outbound scenarios.<sup>147</sup> To delineate the application of Section 24I for GE-PE dealings, it may be said that in general terms Section 24I apply to both:

<sup>146</sup> For an overview of the general principles in this regard see Lynette Olivier. 2003. *An overview of principles relating to the taxation of income denominated in a foreign currency* TSAR 3 391, although the legislative provisions upon which this article is based, have been significantly amended since 2003.

<sup>147</sup> The provisions of Section 24I(2)(a) apply to 'any company', which is defined in paragraphs (a) and (b) of that definition in Section 1 of the Act as both local and foreign incorporated or formed companies. The proviso to Section 24I(2) restricts the application of the Section to 'any company' to (i) companies that is South African tax resident, (ii) controlled foreign companies and (iii) non-resident companies where the exchange item, as defined, is attributable to a PE located in South Africa.

- Legally recognisable relationships existing in respect of real transactions concluded between separate persons such as loans denominated in foreign currency, which could be attributed to a local or offshore PE of one or both of those persons party to the said transaction. In these circumstances the focus is not on intra-company dealings and, importantly, the foreign exchange gains or losses arising in respect of those transactions, and not pursuant to the intra-company reallocation of capital funds by one party to such transaction; and
- Foreign exchange items simply held by a person, for example, foreign currency held in an offshore bank account to the benefit of an offshore PE. In terms of this category issues may arise in respect of taxable foreign exchange gains or losses in respect of intra-company dealings.

In inbound scenarios, a local PE will always be subject to taxation in respect of foreign currency gains and losses in respect of foreign exchange items attributable to it except where a particular exchange item is denominated in South African Rand.<sup>148</sup> For this purpose the definition of an 'exchange item' does not recognise notional loans extended to or granted by a non-resident GE to the local PE. The foreign currency gain or loss will, for example, be realised in respect of actual loans with third parties that are attributable to the PE.

For outbound scenarios, the application of Section 24I is somewhat more complex. Where, for instance, funds are reallocated from a resident GE to a foreign PE and those funds are used by the PE to acquire legal tender in the host jurisdiction (eg the funds are held in a foreign currency denominated bank account in the host jurisdiction), the resident GE will not be subject to tax in South Africa in respect of the foreign currency gains or losses realised on the currency so held if that currency denomination is used for financial reporting purposes by the PE.<sup>149</sup> In circumstances where this offshore PE uses a different currency for financial reporting purposes than that of legal tender or if the financial reporting currency generally differs from the currency of any exchange items allocable to the PE, the resident GE will be subject to South African taxation on foreign currency gains and losses in respect of such items.

The arbitrary results resulting from this dispensation can be illustrated by the following example.

A Swiss PE of a South African resident GE, which forms part of a U.S. multinational group, effects sales through a Swiss frank denominated bank account. The PE reports its financial results (ie branch accounts) in Euro because it forms part of

<sup>148</sup> Paragraph (c) of the definition of 'local currency' in Section 24I(1) of the Act as read with the proviso to Section 24I(2) of the Act.

<sup>149</sup> The resident GE will not have an 'exchange item': Paragraph (a) of the definition of 'exchange item' in Section 24I(1) of the Act includes 'an amount in foreign currency which constitutes any unit of currency acquired and not disposed of by that person'. 'Foreign currency' for the foregoing purposes is defined as 'any currency which is not local currency'. 'Local currency' in turn is defined in paragraph (a) of that definition in Section 24I(1) as meaning 'in relation to any exchange item which is attributable to any permanent establishment of a person outside South Africa, the currency used by that permanent establishment for purposes of financial reporting.'

the Africa-European cluster of this U.S. multinational. It appears that in this instance the South African resident company will have an exchange item and would be subject to tax on foreign exchange gains or losses realised in respect of the Swiss francs held in the Swiss bank account.

The South African GE will not be subject to tax on any foreign exchange gains or losses if the Swiss PE simply changes its financial reporting currency to Swiss franc. It is indeed questionable whether such an arbitrary result is desirable.<sup>150</sup>

At the end of each taxable year during which an 'exchange item' is attributable to a foreign PE (legally and strictly speaking held by the resident GE) the corresponding exchange gain or loss generally reflected by the difference between the spot rate at the beginning and the end of that particular year should be included in the taxable income of the resident GE.<sup>151</sup>

The special rules<sup>152</sup> relating to the inclusion or deduction of foreign exchange gains or losses for groups of companies – colloquially referred to as the 10% pooling rule – do not apply in respect of intra-company dealings between a GE and its PE.

### 3.6 Summary

One of the stated objectives of this study is to ascertain whether the Act treats intra-company dealings systematically. The purpose of this chapter was firstly to understand how various scenarios arising as a result of intra-company dealings are taxed, or not, in terms of the Act. The purpose of this summary is to bring together the outcome of each of these scenarios. As will be seen generally a coherent picture emerges from a structural and systematic standpoint. The only exceptions concern the interaction of the income tax and CGT rules as regards certain specific scenarios.

The perspective of the summary is mainly twofold, namely that of a resident and a non-resident GE.

#### 3.6.1 The Normal Tax Treatment of intra-company dealings from the perspective of a resident GE

##### 3.6.1.1 Outbound dealings

The analysis in this chapter focusses on four types of dealings in different asset classes. For a resident GE in outbound scenarios, two issues are addressed in terms of these dealings, namely:

- (i) The determination of worldwide earnings, ie whether a tax charge or deduction/allowance would be recognised at the level of the PE; and
- (ii) Determining the amount of income in respect of which double taxation relief has to be given by the GE state in respect of taxes suffered by the PE.

<sup>150</sup> See Olivier *supra* at 403.

<sup>151</sup> The exemption provided for by Section 24I(10) should always be considered, but, due to its convoluted nature, is not discussed here.

<sup>152</sup> Section 24I(7A)(a) of the Act.

The internal reallocation of capital assets does not constitute a taxable event. When the PE's income is computed for purposes of calculating the double taxation relief that has to be provided by South Africa, it appears that based on SARS's Transfer Pricing practice, the fair market value of the capital asset as opposed to its tax value will be taken into account to determine the appropriate capital tax allowance. This issue is of limited importance where the ordinary credit method is used for the relief of double taxation. However, where the exemption method is used under a treaty (eg the DTC for Switzerland or Germany), it is of importance because a benefit may arise as the hidden reserves, namely the difference between the tax value and fair market value at the time of reallocation in such assets, may remain untaxed in South Africa.

The same comments made above in respect of capital assets apply *mutatis mutandis* to the reallocation of trading stock.

Where an intangible asset acquired or developed by the resident GE is used by its offshore PE, the Act will not recognise deemed royalty income for both of issues addressed under this scenario. Only actual costs and expenses incurred to acquire or develop the intangible asset will be allowed according to the rules governing the tax treatment of these type expenses, either at the GE or PE level depending on the circumstances.

The same comments made above in respect of intangible assets apply *mutatis mutandis* in respect of the provision of services by a resident GE to the benefit of its offshore PE, and in respect of the making available of capital funds by a resident GE to its offshore PE.

Complex tax rules governing the recognition of foreign exchange gains or losses, however, govern the making available of funds by a resident GE to the benefit of its offshore PE. It was shown that the outcome of the application of these foreign exchange tax rules is not always consistent, and may produce arbitrary results.

### 3.6.1.2 Inbound dealings

Like the case for a resident GE in outbound scenarios, two issues were addressed in terms of these dealings for a GE in inbound scenarios, namely:

- (i) The determination of worldwide earnings, ie whether a tax charge or deduction/allowance would be recognised at the level of the GE; and
- (ii) Determining the amount of income in respect of which double taxation relief has to be given by the GE state in respect of taxes suffered by the PE.

Similar to the conclusion for outbound scenarios, the internal reallocation of assets (both capital assets and trading stock) from an offshore PE to a resident GE would not trigger any immediate tax consequences. No income recognition in the GE state (South Africa) in respect of the PE would take place at the time of such a reallocation.

Due to technical reasons, unilateral tax credit relief appears to be unavailable for the GE, at the time of the reallocation, or even at a later time, for any taxes that may be imposed by the PE state, typically in the form of so-called 'exit charges' in respect of

assets reallocated to it from an offshore PE. Double taxation may arise for the GE in this case.

If the unilateral foreign tax credit provisions are applicable (bar the technical difficulties referred to above), a situation of excess foreign tax credits may still arise for the GE in respect of any taxes that may be imposed by the PE state (eg 'exit charges'). Where such excess foreign tax credits cannot be utilised within the present statutory time limit of 7-years, double taxation will almost certainly arise for the GE.

Where an intangible asset acquired or developed by an offshore PE is used by the resident GE, the Act will not recognise deemed royalty expenses for both of issues addressed under this scenario. Only actual costs and expenses incurred to acquire or develop the intangible asset will be allowed according to the rules governing the tax treatment of these type expenses, either at the GE or PE level depending on the circumstances.

The same comments made above in respect of intangible assets apply *mutatis mutandis* in respect of the provision of services by an offshore PE to the benefit of a resident GE, and in respect of the making available of capital funds by an offshore PE to a resident GE.

The Act will and won't tax foreign exchange gains or losses attributable to an offshore PE in the hands of the resident GE according to an arbitrary rule. Thus, according to the particular currency used by an offshore PE for financial reporting purposes, foreign exchange gains or losses could be taxable or not.

### **3.6.2 The Normal Tax Treatment of intra-company dealings from the perspective of a non-resident GE**

#### **3.6.2.1 Outbound dealings**

The reallocation of capital assets from a local PE to a non-resident GE constitutes a trigger event for capital gains tax purposes. The asset is deemed to be disposed of by the PE for market value consideration. The extent of any capital gain arising by virtue of such a deemed disposal of the capital asset depends on the tax base of the particular asset, the extent to which it has been taken into account for tax allowances and whether or not, generally speaking, it is an appreciating or depreciating asset.

The reallocation of trading stock from a local PE to a non-resident GE will not give rise to an income tax charge. The possibility must not be discarded that when such inventory is sold to another person by the non-resident GE, a South African income tax charge could arise based on the source of that sales income. This possibility is strictly speaking unrelated to the reallocation from the local PE. It was found that almost certainly the reallocation from the local PE to the non-resident GE will constitute a capital gains tax event. The consequences would be the same as for capital assets discussed above.

Where an intangible asset effectively connected to a local PE (eg developed or acquired for purposes of the PE's trade) is used by the non-resident GE, no deemed taxable income in the form of a notional royalty would be recognised for the PE. Only

actual costs and expenses incurred to acquire or develop the intangible asset may be allowed for the local PE subject to the rules governing the tax treatment of these kinds of expenses. CGT may arise in the same way as discussed above for the intra-company reallocation of capital assets if the reallocation of an intangible asset is akin to an outright sale. If it is, on the other hand, akin to, for example, the circumstances prevailing in terms of a licence arrangement, no CGT would arise.

The same remarks for intangible assets above would apply *mutatis mutandis* to the provision of services and capital funds by a local PE to a non-resident GE.

### 3.6.2.2 Inbound dealings

The internal reallocation of assets (both capital assets and trading stock) from a non-resident GE to a local PE will, for capital gains tax purposes, be deemed to take place for market value consideration to allow for a step-up in those assets' tax base.

It is not certain whether for income tax purposes the cost price of the inventory reallocated to a local PE will be the market value at the time of the reallocation, or the historical cost price.

It was shown that as regards the interaction between the rules for income tax and capital gains tax the possibility exists that a capital loss may be realised every time that a local PE disposes of trading stock allocated from a non-resident GE (provided the income is received from a South African source). This loss does not appear to be 'ring-fenced' or restricted in any way by the CGT rules. The structure of the normal tax system at this point appears to be in disorder as the allowance of the capital loss does not appear justifiable. In two symmetrical tax systems, this conundrum may lead to instances of double taxation in the converse scenario (see 3.2.1.2).

It was shown that the general capital tax allowance (Section 11(e)) must be based on the total period of use of capital assets reallocated to the local PE by the non-resident GE. The Act's recoupment provisions are not applicable in respect of such capital assets reallocated to a local PE by the non-resident GE upon the subsequent sale of the assets by the local PE.

Where an intangible asset is attributable to a non-resident GE but also used by its local PE, no deemed taxable expense in the form of a notional royalty would be recognised against the PE's liability for normal tax. Questions as to the applicability of the withholding of tax on royalties therefore do not arise.

If services are provided by a non-resident GE to a local PE, no deemed expense in the form of, for example, notional management fees would be allowed. Only actual costs and expenses in respect of such services may be allowed for the local PE subject to the rules governing the tax treatment of these type expenses.

The same comments above regarding services are *mutatis mutandis* applicable to the provision of funds by a non-resident GE to a local PE.

### 3.6.3 Resort to the arm's-length principle

This study concludes that there is no legal basis to invoke application of the arm's-length principle as formulated in Section 31 of the Act and SARS's PN 7 to intra-

company cross-border dealings between a GE and its PE on the municipal or treaty level. The analysis in this chapter identifies numerous general and specific income tax and CGT rules that find application to these dealings. The arm's-length principle as embodied in the local related party transfer pricing practice (PN 7) cannot be used to adjust any tax results achieved through the application of these municipal rules.

In many respects the municipal income tax and CGT rules are not essentially based on the arm's-length principle as perceived for related parties. The consistent denial of deemed or notional expenses or income in respect of dealings as between the GE and PE provides decisive confirmation of this inconsistency.

Questions as to whether the municipal income tax and CGT rules identified by this study are adequate from a tax policy perspective are beyond the scope of this study. However, the study conclusively shows that there is no legal basis to address any perceived shortcomings or inconsistencies in these domestic rules through an indiscriminate and irregular application of the arm's-length principle as contained in Section 31 of the Act and PN 7 in cases where South African has concluded a DTC with the country where the GE/PE is located.

The adjustment of the tax results occasioned by the municipal income tax and CGT rules may only be achieved through the warranted application of the arm's-length principle as provided by article 7(2) of a DTC based on the OECD or UN MTCs. Section 31 and PN 7 do not automatically bear on such an application of the arm's length principle. The next chapter addresses the application of the arm's-length principle as contained in article 7(2) of the model conventions in some detail.

## **Chapter 4: Analysis of selected aspects of the OECD Model Tax Convention with a special emphasis on its Discussion Drafts on the Attribution of Profits to a Permanent Establishment**

### **4.1. Introduction**

#### **4.1.1 Preliminary**

In circumstances where a double tax convention (DTC) is operative between South Africa and another country, it will intersect the municipal tax treatment of intra-company GE – PE dealings, both in South Africa and that other country. Whilst chapter 3 analysed the municipal tax treatment of these dealings in South Africa, this chapter seeks to examine the intersection of international with municipal tax law.

When a DTC is based on a model convention, which is the case for all of South Africa's operative DTCs, an analysis of the relevant provisions of these model conventions is the clear entry point for purposes of discovering the outcome of the crossing of two municipal tax systems via a DTC. South Africa's DTCs are mostly based on the OECD Model Tax Convention (MTC), though some DTCs incorporate elements of the UN model convention.

Article 7 of both these model conventions deal with the taxation of business profits. The analysis in this chapter is as a rule confined to article 7 of the OECD MTC, as the OECD has by far done the most work in this area of international taxation. It is also the most commonly used model clause in so far as the taxation of business profits under DTCs is concerned. Some attention will be devoted to the UN MTC based on the fact that South Africa does incorporate in some of its DTCs certain elements of this model.

An understanding of the function of article 7 of the OECD MTC, which is to guard against the hardship caused by international double taxation of one person's business profits in two states, and the method to reach this aim, is essential to comprehend the full extent of South Africa's international tax system.

Assessing the intersection of international with municipal tax law in so far as GE-PE dealings is concerned is not easy since the DTC juncture adapts a different scheme that is dissimilar to that which is familiar under domestic tax law:

- DTCs fictionalise one legal entity as being two separate corporate bodies vis-à-vis the Act's legal basis of only recognising one corporate person;
- DTCs operate in accordance with different terminology, eg profits as opposed to income, attribution of profits as opposed to the recognition of receipts and accruals; and
- The function of a DTC is diametrically opposed to domestic tax law as it provides for relief from international double taxation vis-à-vis the charging of income tax or CGT.

It is an arduous task to identify a suitable point of entry into the debate surrounding the attribution of profits to a PE in terms of the OECD MTC, mainly because this topic is part of an ongoing discussion since the earliest versions of

DTCs,<sup>153</sup> and is still in flux. It is beyond the scope of this study to give a comprehensive overview of this topic.

This part is substantially introduced by a very brief history of article 7 of the OECD MTC, which is essential for informing an understanding of where the current debate on profit attribution to PEs is heading and why it is progressing in this way. A restatement of the current position as explained by the official Commentary on the OECD MTC and international commentators results in a summary of the reform proposals in this regard that the OECD has formulated since 2001.

As mentioned earlier the UN MTC is briefly discussed since South Africa bases some of its DTCs on elements of article 7 of that model. An overview of South Africa's DTCs is provided to illustrate where this is the case. The chapter is completed by a discussion of a Rhodesian court case in respect of one of South Africa's DTCs on the question of profit attribution to a PE under a treaty.

#### 4.1.2 Introductory remarks on DTCs

For the uninitiated reader not versed in the scheme of DTCs some general features<sup>154</sup> about the OECD MTC should be noted to appreciate the context of the discussion in this chapter.

In the main (as is evident from the naming) DTCs are concerned with questions of international double taxation,<sup>155</sup> which may be divided into, *inter alia*, juridical and economic international double taxation. DTCs only engage with instances of juridical international double taxation, which refers to the imposition of comparable taxes by two (or more) tax jurisdictions on the same taxpayer in respect of the same taxable income.<sup>156</sup> The application of DTCs is further confined to residence-source and

<sup>153</sup> I quote verbatim from a 1929 League of Nations Report (*Fiscal Committee: Report to the Council on the Work of the First Session of the Committee League of Nations, Geneva, October 26<sup>th</sup> 1929, Document number: C.516.M.175*), which followed the 1928 League of Nations Draft Bilateral Convention for the Prevention of Double Taxation (the first Model Tax Convention), where it was said at Part III B that 'the Fiscal Committee should examine the possibility of establishing 'rules for apportionment of profits or capital from industrial or commercial enterprises operating in several countries''. At its first session, the Fiscal Committee held a preliminary discussion of the whole question. It soon came to the conclusion that, in order to do any useful work, it would be essential to have a detailed knowledge of the present practice in the various countries'. The comparative study envisaged in this report culminated in a report compiled by Mitchell B. Carroll in 1933, which informed the Draft Convention on the Allocation of Profits of that same year— both are dealt with in 4.2.

<sup>154</sup> A useful introduction to DTCs is provided by Vogel, K. 1997. *Klaus Vogel on Double Taxation Conventions* The Hague: Kluwer at 29 *et seq* and in respect of South African DTCs by Lynette Olivier *et al.* 2004. *International Tax A South African Perspective* 2e Ed, Cape Town: Siberlink at chapter 15 as well as Adeliade Passos. 1984. *Tax Treaty Law*. Juta.

<sup>155</sup> The title of a DTC normally reads (for example) 'Convention between the Government of the Republic of South African and the Government of the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income' (emphasis added). This phraseology is generally understood to express the object of the convention, which may arguably influence the interpretative position taken on a particular DTC provision. See also paragraphs 1 and 3 of the Introduction to the official Commentary on the OECD MTC.

<sup>156</sup> As opposed to economic double taxation, which refers to the imposition of comparable taxes by two (or more) tax jurisdictions on different taxpayers in respect of the same taxable income – Larkin, B. 2001. *International Tax Glossary*. 4<sup>th</sup> edition. Amsterdam: IBFD at 114.

residence-residence jurisdictional tax conflicts that give rise to international juridical double taxation.

Baker divides the provisions of the OECD MTC into the following categories:<sup>157</sup>

- (i) Scope provisions determining the persons, taxes and time period covered by a DTC;
- (ii) Definition provisions;
- (iii) Substantive provisions which apply to particular categories of income, capital gains or capital;
- (iv) Provisions for the elimination of double taxation;
- (v) Anti-avoidance and associated enterprise provisions; and
- (vi) Miscellaneous provisions such as non-discrimination, diplomats and territorial extension.

This study is primarily concerned with the third category and to a lesser extent with the second and fourth, as article 7 of the OECD MTC, which deals with the taxation of business profits derived by a single legal entity engaged in trade in two contracting states, forms part of the substantive provisions of the OECD MTC.<sup>158</sup>

The substantive provisions of the OECD MTC characterise income according to a closed number of categories<sup>159</sup> and fulfil a distributive function<sup>160</sup> in that each category has its own rules for determining which of the two contracting state's competing tax claims are trumped.

In their own words, the distributive rules of the substantive provisions of the OECD MTC follow a specific pattern: If the rule provides that a particular item of income 'shall be taxable only in', the other contracting State (normally the source country) must exempt this income from its tax base. The other strand of wording involves distributive rules that provide that income 'may be taxed in'. This set phrase always refers to the source state's tax claim that may be allowed or restricted in some way; in other words, it provides for tax-sharing between the two contracting states. For this latter type, the rule itself does not determine the consequences for the residence state, but is completed by

<sup>157</sup> Baker, Philip. 2003. *Double Taxation Conventions and International Tax Law*. London: Sweet and Maxwell, at D-1.

<sup>158</sup> Article 5 of the OECD MTC belongs to the second category, which provides the definition of a PE and is a key ingredient in the scheme adopted by article 7. Article 23 belongs to the fourth category and determines the method for the elimination of double taxation, which is necessary to complete article 7.

<sup>159</sup> Namely income from immovable property, business profits, shipping, inland or waterways transport, and air transport, dividends, interest, royalties, capital gains, income from employment, directors' fees, artists and sportsmen, pension, government service, students and other income. The apparent capricious nature of these categories can only be understood in light of the theory of 'economic allegiance' that underscored the earliest draft model tax conventions – cf. League of Nations. 1923. *Report presented by the Committee of Technical experts on Double Taxation and Tax Evasion*. Geneva: League of Nations, Document EFS 73/F 19 and Hattingh, J. 2004. *Article 1 of the OECD Model Tax Convention on Income and Capital in historical and functional perspective*. SALJ vol. 121, no. 1 at 66 *et seq.*

<sup>160</sup> Vogel *supra* at 30 to 31.

article 23 of the OECD MTC that obliges the residence state to grant relief from double taxation for taxes charged by the source state in accordance with the provisions of the DTC.

Article 23 of the OECD MTC provides for a choice between the exemption<sup>161</sup> and the credit<sup>162</sup> method as ways of eliminating international double taxation.

These general features will be observed in the text of article 7 of the model convention which is provided and discussed below.

#### 4.1.3 The text of Article 7 of the OECD MTC

The text of Article 7 of the OECD MTC (the 2005 version) reads as follows:

##### Article 7

##### BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, ~~including executive and general administrative~~

<sup>161</sup> Described by the *International Tax Glossary supra* at 137 as a 'method of providing relief from international double taxation applied unilaterally or under tax treaties. In general, tax treaties limit the application of the relief to juridical double taxation. Under this method one country, typically the country of residence, exempts income derived from or capital situated in the other country. The exemption generally takes one of two forms, ie a complete exclusion of the income or capital from the tax base, or recognition of the income of capital solely for determining the taxation of the remaining income or capital. The latter method, often referred to as 'exemption with progression', is generally effected by way of a proportional reduction of tax on total income or capital to reflect the exempt income or capital, ie in the ratio that exempt income or capital bears to total income or capital. In cases of progressive tax rates the effect is to exempt the income or capital in question at the average rate of tax on the total income or capital. Where the remaining income is negative, the effect of exemption with progression can be a reduction of losses which would otherwise have been available, eg for carry-forward'.

<sup>162</sup> Described by the *International Tax Glossary supra* at 86 as: 'a method of relieving international double taxation under which, in general terms, taxes imposed on foreign income may be credited against, ie deducted from domestic tax on that income... The amount of the foreign tax credit is generally subject to one or more limitations, referred to as a foreign tax credit limitation' and at 344 'a deduction from the amount of tax due as opposed to a deduction from the taxable base'.

expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

Before a closer analysis is made of the above provisions of article 7, a brief history is provided that seeks to illustrate why business profits and the attribution thereof to a PE are dealt with in the way currently envisaged by article 7 of the OECD MTC.

## 4.2 A brief history of Article 7 of the OECD Model Tax Convention on Income and Capital

### 4.2.1 The 1928 Draft Model Tax Convention

The earliest version of a model tax convention compiled by one of the OECD's predecessors, the League of Nations, provided as follows for what may be (loosely) termed business profits arising for one legal entity in two contracting states:<sup>163</sup>

Income from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the persons controlling the undertaking or engaged in the trade or profession possess permanent establishments.

The real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a *bona fide* agent of independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country

<sup>163</sup>Article 5 of the Draft Bilateral Convention for the Prevention of Double Taxation, presented in Part I A of *Double Taxation and Tax Evasion – Report Presented by The Committee of Technical Experts on Double Taxation and Tax Evasion* League of Nations, London April 12<sup>th</sup> 1927, Document No: c.216.M.85.1927.II.

Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory.

In the absence of accounts showing this income separately and in proper form, the competent administrations of the Contracting States shall come to an arrangement as to the rules for apportionment.

From the above model clause it appears that the concept of a PE<sup>164</sup> performed a dual function in the earliest version of a model tax convention aimed at the prevention of international double taxation.

It firstly established the connecting factor to a state, which today is generally performed by the concept of tax residency: if an undertaking had a PE in a state (eg an affiliated company or a factory), the specified income could be taxed in that state and, apparently, without restriction. There was seemingly no requirement that that income had to be associated with or attributable to that PE.

Secondly, it also served as a threshold requirement for a source-based tax claim. If a single entity was engaged in undertakings in both contracting states but there was no PE in one or either contracting state, no tax could be charged on the undertaking.

The last paragraph of the model clause also suggests that it is the 'accounts' of a PE that would be consulted to ascertain the income 'produced' in the territory of its location. The model clause also clearly indicates that where an undertaking possessed PEs in both contracting states, each state is restricted to only tax income 'produced' in its territory. The commentary on this model clause states that this restriction is 'an application of the so-called system of apportioning the income according to its source'.<sup>165</sup>

<sup>164</sup> For a historical overview of the concept of a PE, see Corabi, G. 2000. *Permanent Establishment: A Historical Analysis through Model Conventions*. *Tax Planning International Review*, 27(12): 23 to 38. Corabi *op cit* traces the principle of (economic) 'allegiance' as a justification for taxation back to 14<sup>th</sup> century continental laws that exempt the clergy from tax due to their lack of allegiance with a community of *cives* and submits that allegiance is at the heart of the PE concept. Skaar, A.A. 1991. *Permanent Establishment: Erosion of a Tax Treaty Principle*. Deventer: Kluwer at 65 to 101 provides a comprehensive history of the PE concept, and indicates at 72 that PE terminology originated, although in a non-taxing statute, in Prussia in 1845 where it first appeared in an Industrial Code: the term, *Bestiebsstätte*, expressed the total space used for the conduct of a business activity, which was later adopted in a somewhat different form in a tax treaty concluded between Prussia and Saxony in 1869. As to the phrase's general adoption into model DTCs, Skaar *supra* at 67 summarises as follows: 'Thus, international business extensive enough to benefit from a foreign country's organization of labor forces and real capital located there required the maintenance of an establishment in the country. Unlike modern business, where labor forces, machinery and equipment can be transported to the host country, and relocated when the assignment is finished, international business in the wake of the last century [19<sup>th</sup>] and the beginning of this [20<sup>th</sup>] one presupposed some sort of a 'permanent establishment'. It appears, therefore, that PE as an international fiscal concept emerged at a time when production factors were relatively immobile, historically speaking. PE taxation was virtually identical with source-state taxation of all significant industries, except for international shipping, which became subject to special rules. Taxation based on PE rarely led to controversies between the source and residence states, and PE taxation was early accepted by the states of residence.'

<sup>165</sup> At Part B of Double Taxation and Tax Evasion – Report Presented by The Committee of Technical Experts on Double Taxation and Tax Evasion League of Nations, London April 12<sup>th</sup> 1927, Document No: c.216.M.85.1927.II.

As to the rules for apportionment, it stated that these:

will vary essentially according to the undertakings concerned; in certain States account is taken, according to the nature of the undertakings, of the amount of capital involved, of the number of workers, the wages paid, receipts, etc. Similarly, in cases where the products of factories are sold abroad, a distinction is often made between "manufacturing" and "merchandising" profits, the latter being the difference between the price in the home market and the sale price abroad, less cost of transport.

#### 4.2.2 The 1933 Draft Convention on the Allocation of Profits

In 1933, the League of Nations produced a specific draft convention dealing with the allocation of profits to PEs, which laid down much of the principles whereupon the present day article 7 of the OECD MTC is moulded. It determined that:<sup>166</sup>

##### Article 1

An enterprise having its fiscal domicile in one of the contracting States shall not be taxable in another contracting State except in respect of income directly derived from sources within its territory and, as such, allocable, in accordance with the articles of this Convention, to a permanent establishment situate in such State.

If a permanent establishment of an enterprise in one State extends its activities into a second State in which the enterprise has no permanent establishment, the income derived from such activities shall be allocated to the permanent establishment in the first State.

...

##### Article 3

If an enterprise with its fiscal domicile in one contracting State has a permanent establishment in the other contracting State, there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishment. Subject to the provisions of this Convention, such income shall be taxed in accordance with the legislation and the international agreements of the State in which such establishment is situated.

The fiscal authorities of the contracting States shall, when necessary, in execution of the preceding paragraph, rectify the accounts produced, notably to correct the errors or omissions, or to re-establish the prices or remuneration

<sup>166</sup> *Fiscal Committee – Report to the Council on the Fourth Session of the Committee League of Nations, Geneva June 26<sup>th</sup> 1933, Document No: C.399.M.204.1933.II.A*

entered in the books at the value which would prevail between independent persons dealing at arm's length.

If an establishment does not produce an accounting showing its own operations, or if the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or if the rectifications provided for in the preceding paragraph cannot be effected, or if the taxpayer agrees, the fiscal authorities may determine empirically the business income by applying a percentage to the turnover of that establishment. This percentage is fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country.

If the methods of determination described in the preceding paragraphs are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated. This determination is made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors be so selected as to ensure results approaching as closely as possible to those which would be reflected by a separate accounting.

#### Article 4

When determining the net income of banking and financial enterprises in conformity with the principles laid down in Article 3, there shall be applied, despite the provisions in Article 2, the following:

...

(b) Where one permanent establishment of the enterprise is in the position of a creditor or debtor in relation to another permanent establishment of the enterprise, the following provisions shall apply:

(1) If a permanent establishment in one State (creditor establishment) supplies funds, whether in the form of an advance, loan, overdraft or otherwise, to a permanent establishment in a second State (debtor establishment), for tax purposes interest shall be deemed to accrue as income to the creditor establishment and as a deduction from gross income to the debtor establishment, and such interest shall be computed at the inter-bank rate for similar transactions in the country where is situate the creditor establishment.

(2) Contrary to the provisions of the preceding paragraph, from the interest accruing as income to the creditor establishment and deductible from gross income by the debtor establishment there shall be excluded the interest corresponding to the permanent capital allotted to the debtor

establishment whether in the form of advances, loans, overdrafts or otherwise.

The above extracts from the 1933 Draft Model were largely informed by a detailed report<sup>167</sup> compiled by Jones, a professor of accounting at Yale University. Said report in great detail considered allocation accounting principles for the taxable income of industrial enterprises applicable to the question of the resolution of international double taxation.

The principle of separate accounting as the basis for apportioning profits to a PE, embodied in article 3 of the 1933 Draft Convention on the allocation of profits, originated in Prof Jones' report:<sup>168</sup>

If the general rule that each country shall tax the net income earned by establishments within its borders, regardless of the total profits or losses of the enterprise concerned, be adopted ... the method of separate accounting is implied [as opposed to a method of general apportionment]. The aim of separate accounting is to determine for each establishment ... of an enterprise within a given country the net profit which it would have earned if it had operated as an independent concern under similar conditions.'

'The objectives of separate accounting are:

- (a) To assign to each branch the profit (or loss) which it would realise if it were operating as an independent concern under similar conditions;
- (b) To safeguard each branch so far as possible from taxation on profits which have not yet been realised and which may never be realised by the enterprise as a whole;
- (c) To accomplish these results by the use of data which can be verified in the country of location of the branch with the minimum use of figures for the enterprise as a whole.

Many of the principles stated in the above extracts are reminiscent of the current provisions of article 7 (quoted at above at 4.1.3) and the commentary thereon (see 4.3.1 below), which has mostly refined these broad principles.

#### **4.2.3 The 1946 London and Mexico Model Conventions**

After the Second World War the League of Nations resumed its work in the field of model tax conventions. Its Fiscal Committee produced two drafts, the so-called London and Mexico Model Tax Conventions of 1946, each of which was accompanied by a protocol containing guidelines as to its provisions.<sup>169</sup>

<sup>167</sup> Jones, R.C. 1933. *Taxation of Foreign and National Enterprises*. Vol.5, Official Document No. C.425. Geneva: League of Nations.

<sup>168</sup> Jones *supra* at paragraph 3 and 10 respectively of the General Summary.

<sup>169</sup> League of Nations. 1946. *London and Mexico Model Tax Conventions: Commentary and Text*. Geneva November 1946, Document Official No. C.88.M.88.1946.II.A

In addition a general report accompanied the publication of the London and Mexico Model Tax Conventions that contained commentary on aspects of the two drafts. This general report is useful for present purposes because it discusses differences between the London and Mexico versions and contains further clarification of the guidelines contained in the protocols. In so far as the taxation of business profits was concerned, it expressed preference for the London Model,<sup>170</sup> which determined that:<sup>171</sup>

#### Article IV

1. Income derived from any industrial, commercial or agricultural enterprise and from any other gainful occupation shall be taxable in the State where the taxpayer has a permanent establishment.
2. If an enterprise in one State extends its activities to the other State without possessing a permanent establishment therein, the income derived from such activities shall be taxable only in the first State.
3. If an enterprise has a permanent establishment in each of the contracting States, each State shall tax only that part of the income which is produced in its territory.

These provisions of the London Model mirrored the pattern of those presented in the 1933 draft convention (see 4.2.2 above).

Of more interest, though, is the explanation by the protocol and commentary to the London Model of the profit attribution rules that are to be subsumed in Article IV above. A hierarchy of three categories of rules is identified:

- Much like the 1933 draft convention, an approach is adopted whereby profit must be attributed to a PE which it may be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. This attributable profit must in principle be determined on the basis of separate accounts pertaining to such PE;<sup>172</sup> the right of the fiscal authorities concerned being reserved to amend such accounts to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length.<sup>173</sup>
- In circumstances where separate accounts cannot be produced, or do not correspond to normal usages of the trade in the country where the PE is situated, or if the fiscal authorities are unable to rectify the accounts, or if the

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<sup>170</sup> Ibid at 13.

<sup>171</sup> Ibid at 61.

<sup>172</sup> Ibid at 79 A.

<sup>173</sup> Ibid at 79 B. It is a fascinating realisation that what is known today as related party transfer pricing rules, which apply to transactions (or the lack thereof) between connected (separate) legal persons, originated from early profit attribution rules to for PEs. The quoted extract provides one such an example.

taxpayer agrees, the attributable profit could be determined by applying a percentage of the gross receipts of the enterprise.<sup>174</sup>

This percentage is fixed in accordance with the nature of the transactions in which the PE is engaged and by comparison with the results obtained by similar enterprises operating in the country.

Thus, for example, should the nature of the PE's activities be comparable to a general commission agent or broker, the attributable profit could be determined with reference to customary commission received for such services.

- Should the two preceding methods be inapplicable, a third method could be used, the so-called 'fractional apportionment' method, which determines that the attributable profit may be arrived at by.<sup>175</sup>

a computation based on the total income derived by the enterprise from the activities in which such [permanent] establishment has participated. This determination is made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors are so selected as to ensure results approaching as closely as possible those which would be reflected by a separate accounting.<sup>176</sup>

Whilst none of these three alternative profit attribution methods were new – they were all encountered in Article 3 of the 1993 draft convention (see extract at 4.2.2) – their application was for the first time amplified in the Protocol and Commentary to the 1946 London and Mexico Models.

The application of especially the fractional apportionment method was further explained. It will be seen from the discussion in 4.4 that this method with its references to factors such plant and equipment, circulating capital, payrolls, cost of operation, physical output, turnover, etc that had to enter the profit allocation calculation, was a very early indicator of the direction towards which the profit attribution debate would develop. Indeed, currently the OECD's new authorised approach to PE profit attribution (circa 2001) is to abandon the separate accounts principle, and to use a method having regard to functions performed, assets used and risk assumed by a PE to calculate the attributable profit.

<sup>174</sup> *Ibid* at 79 C.

<sup>175</sup> *Ibid* at 80 D.

<sup>176</sup> This method is explained further by the Commentary, *ibid* at 20: 'the earnings of each establishment are computed as a proportion of the entire profits of the enterprise to which the establishment belongs, on the basis of the general balance sheet and profit-and-loss account of the enterprise. Such fractional apportionment may be unlimited or limited. In the first case, it takes as its starting point the total income derived by the enterprise as a whole from all sources. In the second case, reference is made only to that part of the total profits of the enterprise which is derived from transactions in which part has been taken by the establishment whose share in the total profits is to be determined. It is to this second form of fractional apportionment that recourse may be had according to the Protocol ... Examples of factors that may be enter into the apportionment formulae are plant and equipment, circulating capital, payrolls, cost of operation, physical output, turnover.'

The London and Mexico Models also contained special rules for banks and insurance enterprises. As for banks, the rules reflected the principles enumerated in the 1933 draft convention (see 4.2.2) that basically allowed for an exception to the general rule that deemed that deductions for notional interest were not allowed according to the principles of separate accounting. Thus, where one establishment made funds available to another establishment of a single banking enterprise, notional interest income and expenses could be recognised for profit attribution purposes to those establishments, except if the capital so provided formed part of the permanent capital allotted to the 'debtor' establishment.<sup>177</sup>

For insurance enterprises, the general principle of separate accounts applied, but if it could not be used, an apportionment of total income was allowed according to, for example, the ratio existing between gross premiums relating to the permanent establishment and the total gross premiums received by the enterprise.<sup>178</sup>

Currently, the reform project of the OECD again produced two special draft discussion documents in 2003 and 2005 for enterprises engaged in banking and insurance, the only real newcomer being a special draft discussion document for the e-commerce industry.

#### 4.2.4 The 1963 and 1977 OECD MTC

The work of the Fiscal Committee of the League of Nations was continued after its demise in 1956 with the creation of the Fiscal Committee of the Organisation for European Economic Co-operation (O.E.E.C.).

Between 1956 and 1961 the Fiscal Committee of the O.E.E.C. submitted four reports that were to become consolidated as the 1963 Model Tax Convention of the newly created OECD, which replaced the O.E.E.C. in 1960.<sup>179</sup>

The third report of this Fiscal Committee<sup>180</sup> published the contents of five articles agreed upon by the O.E.E.C.'s members, one of which dealt with the allocation of profits to PEs and associated enterprises. The O.E.E.C. Fiscal Committee admitted that it did not invent a new set of rules in this regard but simply readopted the principles enumerated in the London and Mexico Model Tax Conventions of 1946 (see 4.2.3 above).<sup>181</sup> These principles were simply formulated and defined as clearly as possible.

The actual wording and structure of the proposed article 7 provided in 1960 still exists almost in the exact format today save for minor amendments.<sup>182</sup> A repetition here

<sup>177</sup> Ibid at 21 and 81 to 82.

<sup>178</sup> Ibid at 21 to 22 and 83.

<sup>179</sup> Van Den Tempel, A.J. 1967. *Relief from Double Taxation*. Amsterdam: IBFD: VII 10.

<sup>180</sup> O.E.E.C. Third Report of the Fiscal Committee. August 1960. *The elimination of double taxation*. Paris.

<sup>181</sup> Ibid at §18, p 17.

<sup>182</sup> The amendments to the 1963-version *vis-à-vis* the present wording of article 7 of the 2005 OECD MTC are the following: (i) The following phrase has been added to the first sentence of article 7(2): 'Subject to the provisions of paragraph 3, where an enterprise ...'; (ii) The opening wording of article 7(3) has been amended from 'In the determination of the profits ...' to 'In determining the profits ...'; and (iii) The phrase '... in accordance with the principles laid down in this Article' in the last sentence of article 7(4) has been

will serve no purpose (see the quoted text of the present model article 7 above at 4.1.3).

On the basis that the attribution of profits to PEs was an important issue to taxpayers and taxation authorities in 1960, the Fiscal Committee felt itself obliged to prepare an especially detailed commentary on the provisions of the proposed article 7.<sup>183</sup> Much of this commentary to the 1963 OECD MTC is still encountered in the present commentary, although it has been numerous and frequently amended, most notably by the amendments passed by the OECD in 1977, 1992, 1994 and 1995.

The import of this first version of the commentary on article 7 of the OECD MTC is that it firmly entrenched separate accounting as the basis for PE profit attribution and the denial of deemed deductions or income as regards dealings between a GE and PE.

Until at least 2001, the principle of separate accounting as a basis for profit attribution to a PE under a DTC, and, until at least 1995, the general non-recognition of notional cross-border transactions between a PE and a GE for DTC purposes appear to be two important stable and fixed interpretations of article 7(2) of the OECD MTC presented in the commentary thereon. These two interpretations run like a golden thread through the various commentaries on model clauses prepared since the first model clause, ie the League of Nations' 1933 Draft Convention on the Allocation of Profits.

Below the new approach advocated by the OECD since 2001 to article 7 is analysed. It will be shown that this new approach presents a fundamental turnabout in the methodology of profit attribution to PEs. Firstly a closer look is taken at the current approach, which is based on and has evolved from the principles formulated in 1933.

### **4.3 The attribution of profits to a permanent establishment under the current OECD MTC**

#### **4.3.1 The Commentary on Article 7 of the OECD MTC**

The approach in terms of the current official commentary on Article 7 of the OECD MTC on the subject of the attribution of profits to a PE may be best explained at the hand of selected extracts from this commentary.

As regards the commentary on article 7(1) and (2), extracts are quoted verbatim from the OECD MTC commentary:

1. ...when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with

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replaced with '... in accordance with the principles contained in this Article'. (see Van Raad, K. 2005. *Materials on International & EC Tax Law*. 5<sup>th</sup> edition. Leyden: International Tax Centre)

<sup>183</sup> Ibid at § 21, p 17.

the rules to be used in determining the answer to this second question that Article 7 is concerned.'

'Paragraph 1

...

10.1 The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises that are residents of the other Contracting State.'

'Paragraph 2

11. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's-length principle" discussed in the Commentary on Article 9. Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy.'

'12. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organization is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment.'

'12.1 This raises the question as to what extent such accounts should be relied upon when they are based on agreements between the head office and its permanent establishments (or between the permanent establishments themselves). Clearly, such internal agreements cannot qualify as legally binding contracts. However, to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and that those agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities.'

'12.2 In this respect, it should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment (cf. paragraphs 17.1 ff below).'

'13. Even where a permanent establishment is able to produce detailed accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts in accordance with the arm's-length principle (cf. paragraph 2

above). Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this principle, and profits have thus been diverted from the permanent establishment to the head office, or vice versa.'

'... Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts in so far as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed, or the original ones and for this purpose the figures to be used will be those prevailing in the open market.'

(Emphasis added)

#### 4.3.1.1 Absolute or restricted independence?

Before the commentary on article 7 is further considered, it is necessary to reflect on certain aspects of article 7(1) and (2) as explained above by the quoted extracts from the commentary.

It is evident that the separate accounts approach laid down in the 1933 Draft Model Convention on the Allocation of Profits is still regarded as the general rule and starting point for attributing profits to a PE. Furthermore, these accounts are only to be adjusted if they do not reflect the 'economic reality' of the GE – PE dealings. These adjustments must be based on the arm's-length principle, ie they should reflect the behaviour that would occur if the PE had been a separate entity dealing with, instead of the GE or any other PEs of that GE, an independent and separate enterprise under conditions and at prices prevailing in the market applicable to it.

A debate concerning the 'economic reality' of GE-PE dealings that have been ongoing for decades amongst expert commentators, but which are not directly addressed by the commentary on article 7(2), concerns the correct interpretation and scope of the phrases profits which it might be expected to make if it were a 'distinct and separate enterprise' dealing 'wholly independently' with the GE.

Vogel<sup>184</sup> provides a summary of this debate and divides the opposing views into two categories. On the one hand, these phrases may require absolute hypothetical independence of the PE before the arm's-length principle laid down in article 7(2) may be satisfied. For purposes of profit attribution, the PE should be treated similarly to a legally separate and independent subsidiary. This entails that contractual arrangements between the PE and GE should be recognised for tax purposes and treated as if they were contracts between independent parties, as differences in organisation and legal set-up is irrelevant under the fiction of article 7(2). Consequently interest on loans, royalties and rents for the use of intellectual and other property and commission and fees in respect of services should be taken into account to the same extent as would be between either the GE or the PE and an unrelated person.

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<sup>184</sup> Vogel *supra* at 428 *et seq.*

Paragraph 12.1 of the Commentary on article 7(2) of the OECD MTC appears to support this interpretation where it refers to symmetrical accounts that should reflect the functions of the GE and PE as opposed to each other.

On the other hand, there is the view that all that article 7(2) requires is a restricted independence, principally because of the fact that, since the PE is invariably no more than part of the GE as whole, it is unrealistic to comprehensively treat the PE as a separate enterprise.

This approach maintains that when the arm's-length principle is applied to a PE, the application must:<sup>185</sup>

stop short at the point where a head office and permanent establishment, being parts of one and the same enterprise, **actually could not** transact business with each other as if they were unrelated third parties.

As can be expected this approach disregards the possibility that interest on loans, royalties and rents for the use of intellectual and other property or commission and fees in respect of services could be 'paid' between a GE and PE as these arrangements are legally impossible in terms of the law of obligations.

From the overview of the history of the taxation of business profits under model tax conventions in 4.2, it appears that an interpretation of article 7(2) consistent with the restricted independence approach should be preferred.<sup>186</sup> The historical formulation of the separate accounting principle sought to treat PEs, as far as is possible, as independent units (see text at fn 168 in 4.2.2). The earliest analysis of the separate accounts approach based on the arm's-length principle also clearly indicates that this fiction has its limits and it was thus stated by Prof Jones in 1933 when addressing the problem of taxing a PE on unrealised profits:<sup>187</sup>

The problem of unrealised profit in branch inventories appears whenever goods are billed from one branch to another at a price in excess of cost. If branches were treated exactly as independent concerns this unrealised profit would not be eliminated. The fiction of branch independence, however, cannot be fully maintained and an attempt to do so would lead to arbitrary and unreasonable results. It is therefore recommended that international enterprises be allowed to eliminate unrealised profits in branch inventories from the profit shown by the books of the branch from which the goods in question were shipped.

(Emphasis added)

This explanation by Prof Jones indicates, in the author's view, a more accurate basis for denying deemed deductions or income for notional expenses and income such as between a GE and a PE.

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<sup>185</sup> Vogel *supra* at 428.

<sup>186</sup> See also Vogel *supra* at 432.

<sup>187</sup> Jones *supra* at paragraph 14 of the General Conclusions.

The true basis for disregarding these is, as Prof Jones suggests, that otherwise host countries would be allowed to pre-empt tax charges on profits that may, or may not realise in the home or another jurisdiction, as opposed to the (rather simplistic) legalistic view that GE – PE contracts are an objective legal impossibility.

A hypothetical example will illustrate how the recognition of notional income or deductions for GE-PE dealings may result in a tax charge where ultimately an economic profit is not realised by the enterprise as a whole.

If, for example, a PE performs research and development (R&D) activities for purposes of developing software for the benefit of its GE, most host countries would tax a reallocation from the PE to the GE of the prototype product based on the market value thereof at that time (the market value is assumed to be in excess of the cost incurred by the PE). A putative profit or gain is thus taxed in the host country despite no realisation thereof.

The GE subsequently fails to successfully market the software product developed by the PE and realises an overall loss from this venture (ie the developing cost incurred in the host country exceeds the actual income received by the GE).

It is evident that the tax paid by the GE in the host country at the time of the reallocation of the prototype product to it does not bear in mind the economic and commercial reality of the venture. If article 7 of the OECD MTC is interpreted as allowing a dealing to be recognised as between the PE and the GE at the time of the reallocation, and consequently that some 'profit' should be allocable to the PE as a result and at the time of this dealing, the skewed result caused by the host country's municipal law would be perpetuated.<sup>188</sup>

Similarly, the converse position would also result in skewed results, ie where a deduction for a loss (market value less actual expenses) on the reallocation of the prototype is allowed in circumstances where a profit is realised from the marketing of the new product.

#### **4.3.1.2 Approach: functionally separate entity or relevant business activity**

A further debate concerning the 'economic reality' of GE-PE dealings concerns how the phrases in Article 7(1) 'profits of an enterprise' in conjunction with 'only so much of them' should be understood and principally revolves around the methodology whereby the profits available for attribution to a PE should be determined. Two approaches are available in this regard.

One approach is that the attributed profits to a PE cannot exceed the profits that the enterprise as a whole earns from the relevant business activity in which the PE participates. Any limitation on the profits available for attribution to a PE is determined relative to the profits of the relevant business activity: if the relevant business activity

<sup>188</sup> The position of the new approach of the OECD (discussed in 4.4 below) to this problem appears to be that whether or not the host country will be allowed to charge tax on the reallocation of the asset (eg the prototype product in the example) will depend on the behaviour of third parties dealing with each other in similar circumstances. Thus, for example, it is entirely realistic that third parties would transact with each other in these circumstances in terms of a so-called cost-contribution or cost-sharing arrangement, which would not recognise the reallocation of an asset from a PE to a GE at a profit or at its market value.

includes operations by other parts of a GE, and those parts incurred losses, the losses so created by those other parts should reduce the profits that could be attributed to the PE, as such real losses will reduce the 'profits of an enterprise'. The OECD refers to this approach as the 'relevant business activity approach'.

The other approach, termed the 'functionally separate entity' approach, determines that article 7(1) only provides that the host country's right to tax does not extend to profits of an enterprise derived from that state otherwise than through a PE, or what is colloquially referred to as the 'no force of attraction' rule,<sup>189</sup> and that no rule can be derived from the wording that affects the quantum of the profits that are to be attributed according to the rules laid down in the rest of article 7.

The 'functionally separate entity' approach also allows host countries to tax unrealised profits whenever an asset, whether or not trading stock, forming part of the business property attributable to a PE ceases to be so attributable by way of a reallocation thereof to the GE or another PE of the GE located outside the host country (see for a contrary position the quote above at fn 187 from the 1933 Report by Prof. Jones).

In 2004 the OECD expressed, for the first time, preference for the functionally separate entity approach.<sup>190</sup> This choice therefore appears to support an interpretation of article 7 of the OECD which may result in profit being attributed to a PE despite an overall loss situation of the GE.

#### **4.3.2 The 1994 Amendments to the Commentary on Article 7**

In 1994 the Commentary on Article 7 of the OECD MTC was substantially revised and the possibility of recognising certain GE – PE dealings for profit attribution purposes was expressly accepted. The relevant amendments were mainly made to the Commentary on Article 7(3). The Commentary to article 7(2) at paragraph 12.1 should also be considered in this regard (quoted above at 4.3.1).

The following extract from the Commentary explains the interrelationship between article 7(2) and (3) of the OECD MTC and provides a guiding principle to identify the circumstances when intra-company deemed income and deductions arising between GEs and PEs should be taken into account for profit attribution purposes:<sup>191</sup>

Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent

<sup>189</sup> Cf. also paragraph 5 of the Commentary on article 7(1).

<sup>190</sup> See 4.4

<sup>191</sup> Paragraph 17 to 17.2 of the Commentary.

establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.

...

Whilst in general independent enterprises in their dealings with each other will seek to realise a profit and, when transferring property or providing services to each other, will charge such prices as the open market would bear, nevertheless, there are also circumstances where it cannot be considered that a particular property or service would have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate and independent enterprises principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether the internal transfer of property and services, be it temporary or final, is of the same kind as those which the enterprise, in the normal course of its business, would have charged to a third party at an arm's-length price, ie by normally including in the sale price an appropriate profit.

On the one hand, the answer to that question will be in the affirmative if the expense is initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to realise a profit through a permanent establishment. On the other hand, the answer will be in the negative if, on the basis of the facts and circumstances of the specific case, it appears that the expense is initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.

Russo<sup>192</sup> has rightly indicated that the only likely circumstance where independent parties would incur costs without adding a mark-up for purposes of rationalising the overall cost of an enterprise is where a so-called cost-sharing agreement (or, if it is added, a cost contribution agreement<sup>193</sup>) may be concluded.

In the main, apart from the exception of a cost-sharing agreements and like arrangements between independent parties, the commentary on the OECD MTC appears to recognise the possibility of notional income and expenses for profit attribution purposes to a PE.

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<sup>192</sup> Rafeale Russo. 2004. *Tax Treatment of "Dealings" Between Different Parts of the Same Enterprise under Article 7 of the OECD Model: Almost a Century of Uncertainty* Bulletin for International Fiscal Documentation, Amsterdam: IBFD October 2004, 472 at 478.

<sup>193</sup> According to the *International Tax Glossary supra* at 83 this is 'a framework agreed among business enterprises to share cost and risks of developing, producing or obtaining assets, services, or rights, and to determine that nature and extent of the interest of each participant in those assets, services, or rights'.

The modification that was expected to be caused to the practice on profit attribution to PEs by these near revolutionary additions to the commentary in 1994 was, however, greatly compromised by convoluted and contradictory amendments also made in 1994 to the commentary on specific types of dealings between a PE and the enterprise of which it is part.<sup>194</sup> For example, the following is stated by way of amendment in so far as the internal use of intangible rights and notional rents is concerned:<sup>195</sup>

In the case of intangible rights, the rules concerning the relations between enterprises of the same group (eg payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate "ownership" of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise ... In such circumstances it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty.

And for services:<sup>196</sup>

commonly the provision of services is merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it. In such a case it would usually be appropriate to treat the cost of providing the service as being part of the general administrative expenses of the enterprise as a whole which should be allocated on an actual cost basis to the various parts of the enterprise to the extent that the costs are incurred for the purposes of that part of the enterprise, without any mark-up to represent profit to another part of the enterprise.

And lastly for capital funds:<sup>197</sup>

Special considerations apply to payments which, under the name of interest, are made to a head office by its permanent establishment with respect to loans made by the former to the latter. In that case, the main issue is not so much whether a debtor/creditor relationship should be recognized within the same legal entity as whether an arm's-length interest rate should be charged. This is because:

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<sup>194</sup> See Vogel *supra* at 431 for a summary of these 1994 amendments to the Commentary on article 7.

<sup>195</sup> Paragraph 17.4 of the Commentary.

<sup>196</sup> Paragraph 17.7 of the Commentary.

<sup>197</sup> Paragraph 18 of the Commentary.

— from the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is really a formal act incompatible with the true legal nature of a permanent establishment;

— from the economic standpoint, internal debts and receivables may prove to be non-existent, since if an enterprise is solely or predominantly equity-funded it ought not to be allowed to deduct interest charges that it has manifestly not had to pay. While, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed.

For both intangible rights and capital funds, similar explanations are given why notional income and expenses in relation thereto should not be taken into account for profit attribution purposes, ie the hackneyed reason that the true legal nature of GE – PE dealings are incompatible with allocating ownership of intangible rights and recognising an interest-bearing loan within a single legal entity.

The reason given for the denial of notional charges on internal reallocations of capital funds within one enterprise, namely that from an economic standpoint, if an enterprise as a whole is equity funded no deduction for notional interest should be allowed in any jurisdiction where it may be operating, reminds of the limits to the arm's-length principle envisaged by Jones in 1933.<sup>198</sup> However, this reason fails to address the situation of an enterprise that is partly or wholly funded with debt.

Yet, these transaction-specific reasons given for the denial of notional income and expenditure are not reconcilable with the OECD's general approach since 1994 to the profit attribution rules. They render largely unworkable the general recognition (eg at paragraph 12.1 of the commentary) that notional transactions may be recognised for tax purposes between various part of a single enterprise.

This incongruence of the Commentary revealed that the OECD's approach to profit attribution to PEs has become dogmatically unstable since 1994. It can only be surmised that this instability was one of the dominating factors paving the way for the reform work undertaken by the OECD since 2001 in respect of this subject.

#### ~~4.4 The 2001 to 2005 OECD Discussion Drafts on the attribution of profits to a permanent establishment: true reform?~~

##### **4.4.1 Introduction**

The OECD released its first attempt at true reform of the profit attribution rules to PEs in terms of article 7 of the MTC in 2001, which is contained in a voluminous document entitled 'Discussion Draft on the Attribution of Profits to Permanent Establishments – Part I (General Considerations)' ('the 2001 Discussion Draft').

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<sup>198</sup> See text at fn 168.

In the same year a discussion paper entitled 'Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions' was released ('the E-Commerce Draft').<sup>199</sup>

The 2001 Discussion Draft was followed by two further industry and sector specific reform drafts in 2003: the 'Discussion Draft on the Attribution of Profits to Permanent Establishments (PEs): Part II (Banks)' ('the 2003 Discussion Draft on Banks') and the 'Discussion Draft on the Attribution of Profits to Permanent Establishments (PEs): Part III (Global Trading of Financial Instruments)' ('the 2003 Discussion Draft on Financial Instruments').

On 2 August 2004 the OECD released a revised version of the 2001 Discussion Draft ('the 2004 Revised Discussion Draft'), and during July 2005 another industry specific draft was released for the insurance business ('Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment: Part IV (Insurance)' – 'the 2005 Discussion Draft on Insurance').<sup>200</sup>

It is beyond the scope of this paper neither will it serve any purpose to comprehensively summarise or discuss the contents of all these discussion drafts, as the OECD reform project is clearly in a state of flux. The 2004 Revised Discussion Draft attempts to accomplish finality for the general approach of the project. Accordingly the OECD indicated that the principles contained in that draft have become the 'authorised OECD approach'.<sup>201</sup> The broad principles contained in the draft are analysed below.

The 2005 Discussion Draft on Insurance confirms that the principles contained in the 2004 Revised Discussion Draft are now firmly accepted by the OECD as its authorised approach.<sup>202</sup> This draft attempts to illustrate how these principles are to be applied in the context of the insurance industry.

It is anticipated that the deadline for the consolidation and finalisation of the OECD's above-mentioned discussion documents is January 2007. It is expected that by this date it will become clear whether article 7 of the OECD MTC would be amended. What is a certainty is that the contents of the drafts would largely replace the existing Commentary on article 7.

From discussions with senior personnel at the OECD it appears that the main focus up to 2007 will be a refinement of the concept of 'key entrepreneurial risk taking functions', which appears to be the new linchpin of the PE profit attribution rules.

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<sup>199</sup> OECD. 2001. *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions: A Discussion Paper from the Technical Advisory Group on Monitoring Applications of Existing Treaty Norms for the Taxation of Business Profits*. Paris: OECD.

<sup>200</sup> All these drafts are available on <http://www.oecd.org>

<sup>201</sup> Paragraph 6 of the Preface to the 2004 Revised Discussion Draft.

<sup>202</sup> *Ibid* at § 6.

#### 4.4.2 The preferred approach for attributing profit to a PE; first a working hypothesis, now the authorised approach

The 2004 Revised Discussion Draft's point of departure is that in recognition of considerable dissimilarities in the municipal laws of the OECD countries regarding the taxation of PEs, as well as divergent views on the correct interpretation of article 7 of the OECD MTC, a preferred approach was developed for attributing profits to a PE.

This development process entailed consultation with the OECD countries and a number of other stakeholders. It is also explicitly stated that the development of this approach has not been constrained by either the 'original intent or by the historical practice and interpretation of Article 7'.<sup>203</sup>

Against this background a formula, the Working Hypothesis, was devised to achieve the stated goal of developing a suitable and preferred approach to profit attribution in view of 'modern-day multinational operations and trade'.<sup>204</sup> By the time that the 2004 Revised Discussion Draft had been finalised, the OECD felt that the working hypothesis was sufficiently developed to view it as the official new authorised and preferred approach to PE profit attribution under article 7 of the OECD MTC.

In face of the rhetoric dismissive of old and stated principles of PE profit attribution, it was expected that the authorised approach would bring about a revolution in the thinking about PE profit attribution in terms of article 7(2) of the OECD MTC. And indeed the authorised approach represents a near revolution, although not on the strength of its ingenuity or novelty, but in the way the OECD gave substance to it.

The analysis below will show that the authorised approach is nothing more than a strategy to alter, for purposes of the relationship of a PE and the enterprise of which it forms part, the related party transfer pricing methodologies contained in the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995 – 2000)*<sup>205</sup> ('the 1995 TP Guidelines'), which were designed to establish and test the compliance of transactions between two connected parties with the arm's-length principle.

<sup>203</sup> 2004 Revised Discussion Draft at § 3.

<sup>204</sup> *Ibid* at § 4.

<sup>205</sup> OECD. 1995. Paris. For the uninitiated, the TP Guidelines fits into the DTC scheme by reason of article 9 'Associated enterprises', of the OECD MTC. Article 9 allows both contracting parties to the treaty to adjust in appropriate circumstances for tax purposes prices *inter partes* between connected parties so as to achieve consistency with arm's-length behaviour. The tenets used to identify these circumstances and arm's-length prices, and consequently methodologies to accomplish such tax adjustments have come to be known as 'transfer pricing' (see the OECD's report on *Transfer Pricing and Multinational Enterprises (1979)*). The SARS adopted parts of these guidelines in practice by way of Practice Note: No.7, 6 August 1999. The arm's-length principle as developed in the context of multinational enterprises organised as corporate groups has been transformed in this context into a particular allocation method, which could be described as the separate entity or transactional approach (reflected by the various methodologies contained in the OECD TP Guidelines). In terms of this approach, *transactions* between associated enterprises determine the allocation of the revenue and expenses of a multinational enterprise among its corporate group members. The allocation is realised by respecting the legal form of the group members as separate entities that transact with one another at prices that should approximate those between independent enterprises. In this way recognition of a particular transaction at an arm's-length price effectively allocates revenue and expense among taxing jurisdictions.

It must be appreciated that this strategy is not designed to achieve equality of outcome between a PE and a subsidiary in terms of allocable tax profits, but rather to apply the same or similar principles to transactions and to dealings.

The OECD recognises that there are economic differences between the use of a PE and a subsidiary and that the application of the authorised approach should not distort these considerations.<sup>206</sup> For example, it might be expected that business carried on through a PE may be more profitable because of the possibility of efficient capital utilisation, risk diversification, economies of scales, etc.

In the face of all the OECD's discussion documents and prolific academic literature since the 2001 Discussion Draft has been released, the rudimentary and popular question remains, namely whether notional 'head office' income and expenses should be taken into account for profit attribution purposes to PEs. Fundamental changes are envisaged in this regard by the formulation in the 2004 Revised Discussion Draft of the authorised approach, now the authorised approach.

According to the authorised approach, a two-step approach should be followed for purposes of attributing profits to a PE in terms of article 7(2) of the OECD MTC.<sup>207</sup>

- (1) A functional and factual analysis must be performed of the whole enterprise to appropriately hypothesise the PE and the remainder of the enterprise as if they were associated enterprises, each undertaking functions, using assets, and assuming risks.
- (2) An analysis of the TP 1995 Guidelines must be performed so as to identify the relevant arm's-length methodologies that must be applied to the hypothesised separate enterprises undertaking functions, using assets, and assuming risks.

The first observation is that the authorised approach aborts the principle of separate accounting per se as the general governing rule and starting point for the attribution of profits to PEs. In this dichotomous scheme, branch accounts is only an aid to perform a functional and factual analysis and one element of the evidential burden placed on a multinational enterprise to keep contemporary documentation recording profit attribution to PEs.<sup>208</sup>

<sup>206</sup> 2004 Revised Discussion Draft at § 54.

<sup>207</sup> Ibid at § 54. Deub, P.M. 2004. *Practitioner offers six step approach to OECD PE Guidance* Tax Analyst on-line <http://www.taxanalyst.com> Reference: WTD 231-8 suggests that in practice this two-step approach means that the following six measures are necessary:

1. Hypothesise the PE as a distinct and separate enterprise;
2. Attribute functions, assets and risks to the PE; identify the key entrepreneurial risk taking functions in order to achieve this attribution;
3. Attribute capital to the PE;
4. Attribute arm's-length funding costs to the PE;
5. Perform a comparability analyses; and
6. Apply the transfer pricing methods by analogy to attribute profits to the PE.

<sup>208</sup> Ibid at § 264 to 265.

If one reflects for a moment on the hypothetical results of an application of the authorised approach, it is evident that generally in this scheme notional income and expenses as between a PE and a GE are logically possible.

It will be shown below that the 2004 Revised Discussion Draft develops detailed considerations aimed at assisting the identification of circumstances where these notional items should be taken into account for profit attribution purposes. It appears to be a real prospect that host countries must recognise at treaty level, according to the authorised approach, as a matter of principle notional items for profit attribution purposes to PEs. This recognition is required even despite the non-recognition thereof under municipal tax law.<sup>209</sup>

The discussion below focuses on how the authorised approach directs the application of the provisions of article 7(2) of the OECD MTC.<sup>210</sup>

#### **4.4.3 The first step of the authorised approach: determining the activities and conditions of the hypothesised distinct and separate enterprise**

The first step in the application of the authorised approach is to functionally and factually analyse a PE so that it may be delineated as a hypothesised distinct and separate enterprise. This functional and factual analysis should be based, with the necessary adjustment, on chapter 1 of the 1995 TP Guidelines.

The justification for directly applying the 1995 TP Guidelines is apparently the following. The application of the authorised approach entails the application of the fiction in accordance with article 7(2), namely to hypothesise the PE as a distinct separate enterprise 'engaged in the same or similar activities under the same or similar conditions'. The link between the underlined wording of article 7(2) with the TP Guidelines lies therein that:<sup>211</sup>

- (i) 'activities' can be equated with 'functions', which in the context of separate entities is used to link the earning of profits with identifiable transactions;
- (ii) 'same or similar' equates with 'comparability' of transactions identified between separate entities; and
- (iii) 'conditions' equates with 'economically relevant characteristics', which are used to adjust transactions between separate entities.

Over and above the principle that the functional and factual analysis should be based on the guidance provided by the 1995 TP Guidelines, the 2004 Revised Discussion Draft introduces an important new element, namely the identification of so-called key entrepreneurial risk taking functions, which should also be considered.

The identification of the key entrepreneurial risk taking functions is to a large extent aimed at identifying the relevant 'activities' that link up with the earning of profits,

<sup>209</sup> Ibid at § 34.

<sup>210</sup> Quoted above at 4.1.3, see also the discussion of the present commentary on article 7(2) at 4.3.

<sup>211</sup> 2004 Revised Discussion Draft at § 72 to 74.

and thus guide the attribution of profits to the various parts of an enterprise where those activities are performed. The concept of 'key entrepreneurial risk taking functions' runs like a golden thread through the 2004 Revised Discussion Draft and the other sector specific discussion drafts. It first appeared comprehensively in the 2003 Discussion Draft on Banks. Its impact will be assessed in the concluding comments to this chapter.

Below each element of the functional and factual analysis is discussed.

#### **4.4.3.1 Functions (activities)**

The authorised approach proceeds from the basis that in order to establish whether a PE performs an identifiable function, regard must be had to the activities performed by it.

To identify PE activities, the activities and responsibilities undertaken by the whole of the enterprise of which the PE forms part must be construed. Only then may it be deconstructed to uncover which of these activities/responsibilities are associated with the PE, and to what extent.

The authorised approach provides two approaches to achieve this process of construction and deconstruction, one according to whether the PE is of the 'fixed place of business' type PE, and the other according to whether it is the 'dependent agent' type PE.<sup>212</sup>

If the PE is of the fixed place of business type, the functions performed at that place of business should be analysed to establish which of the enterprise's activities and responsibilities could be associated with the PE. If the PE is of the dependent agent type, the functions undertaken by the agent should be analysed.<sup>213</sup>

An important consideration in construing the functions is the identification of the people functions of the enterprise as a whole and an assessment of its significance in generating profits for the business. These people functions may consist from the routine to the key entrepreneurial risk taking functions of the business. Evidently, if some of the latter type functions are related to the activities of the PE, they will influence the profit attribution to the PE by reason of the fact that assets and risks associated with the key-entrepreneurial-risk taking function will be attributed to that PE, which, in turn, will lead to the attribution of the income and expenses linked to those assets and risks.<sup>214</sup>

The people functions that would be likened to the performance of the key entrepreneurial risk taking functions are described as those 'which require active decision making with regard to the most important profit generators of the business'.<sup>215</sup>

The application of this approach may have a far-reaching impact on e-commerce operations. For example, it is accepted by the OECD that a server can in certain circumstances be regarded as a PE, as a business function can be performed at

<sup>212</sup> See paragraph 2.3.3 and 2.3.4

<sup>213</sup> 2004 Revised Discussion Draft at § 75.

<sup>214</sup> Ibid at § 81 to 82.

<sup>215</sup> Ibid at § 77.

its location in the absence of personnel.<sup>216</sup> It is evident from the application of a formulation based on people functions that a server cannot undertake key entrepreneurial risk taking functions, and thus very little profit will be so attributed to such a PE, arguably only enough to cover the direct risks and assets associated with the server hardware.

#### 4.4.3.2 Assets used and conditions of use

The 1995 TP Guidelines state that between unrelated parties compensation will usually reflect not only functions performed, but also assets used and risks taken on in performing the pertinent business function. Assets, tangible or intangible, may be solely or jointly owned, leased or used in accordance with a cost contribution agreement by independent parties, and may be acquired or created internally by an enterprise.

In performing a functional analysis of a PE all these factors characteristic of independent parties must be considered because it will determine the characteristics of the assets and the conditions of their use attributable to a PE.

First the assets used as such by the PE in performing its functions must be identified as far as possible. Assets of the enterprise not used by the PE to perform a function must be disregarded.

Secondly, the conditions of an asset's use must be determined because the profits of an independent enterprise that owns an asset will be different to the profits of an enterprise which uses an asset owned by someone else and so has to pay for its use.<sup>217</sup> The determination of the conditions of use of an asset attributable to a PE is thus important for profit attribution under the authorised approach so that a comparable transaction could be correctly identified.

It is submitted that differences between leasing and full ownership mostly relate to the type of cost incurred by the enterprise (ie lease payments as opposed to financing cost, or direct expenses for own developed assets or the opportunity cost of capital) and that net profits, taking all things into account, will not generally speaking be that different when compared.

Nevertheless, the great difficulty in determining the conditions of use for assets employed in the functions performed by PEs is that conditions of use are usually reflected in legal agreements between separate entities such as, for example, in a (finance) lease, a (instalment) sale, cost contribution agreements, etc.<sup>218</sup>

<sup>216</sup> Paragraphs 42.1 to 42.6 of the Commentary on Article 5 of the OECD MTC.

<sup>217</sup> Ibid at § 84.

<sup>218</sup> Brabazon, M. 2003. *The Attribution of Profits and Capital Structure to a Permanent Establishment under the OECD Model Tax Treaty* 18 Australian Tax Forum 347 at 402 very usefully details the most common legal agreements that are concluded between separate enterprises that may assist to identify the typical 'dealings' between a GE and PE for purposes of the separate enterprise analogy and also how these affect the profits of such a separate enterprise:

i. The sale or purchase of trading stock, non-capital items consumed in the regular course of business, raw materials or unfinished goods is generally booked at arm's length or contract price value. These transactions flow directly to a company's profit calculation at the same rates. The supply or acquisition of services is treated similarly.

In the PE context the enterprise of which it forms part is invariably either legally the outright owner, lessor/lessee or entitled in some other way to the use of a particular asset. The particular difficulty is to characterise the PE's relationship in relation to the enterprise taking into account the aforementioned legal possibilities applicable to the enterprise.

The 2004 Revised Discussion Draft suggests that the problem of characterising a PE's conditions of use of an asset may be resolved by the concept of 'economic ownership'. As to the precise content of this notion the general approach appears to be that:<sup>219</sup>

economic ownership ... is determined by a functional and factual analysis, and in particular rests upon performance of the key entrepreneurial risk-taking functions in relation to the asset.

Again the authorised approach resorts to the concept of key entrepreneurial risk taking functions to resolve the issue of where economic ownership of an asset lies within one enterprise.

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- ii. Capital items (tangible or intangible) that are used in the course of a company's business may be acquired in the form of a right of use by lease, licence or similar transaction, or they may be acquired outright:
  - iii. If a company acquires a right of use, the rent, royalties or similar use-payments for that right flow directly to the company's profit calculation by way of an expense at contract or arm's-length rates. If the company grants a use right, the rent, royalties or other payments it derives will flow to profits.
  - iv. If the company acquires the capital item itself it may fund the purchase by debt and/or equity:
    - o If a capital acquisition is funded by debt, the company's balance sheet is affected by corresponding increases in assets and liabilities representing the price of the asset. Interest on the debt affects profit at contract or arm's-length rates. The arm's-length analysis may apply to the principal, if the acquisition is from a related entity, as well as to the interest rate. Depreciation is also allowable in accordance with local law.
    - o If a capital acquisition is funded by equity, the company's capital structure is affected by the assets expended in making the acquisition being replaced by the asset acquired. If fresh equity is subscribed, the share capital of the company is correspondingly increased. Profit is only affected by replacing the earnings of the former assets with the earnings inherent in the use of the new asset and by depreciation of the capital item.
  - v. If the company disposes of a capital asset by sale, its asset structure is affected by the exchange of that asset for the sale price. Depending on the local tax laws, the sale may have capital gains tax consequences or adjustments consequences in income tax, in either case at arm's-length or contract price.
  - vi. Financial capital may be acquired by debt or equity raising:
  - vii. Where financial capital is raised by debt, the results are similar to those for a capital acquisition funded by debt;
  - viii. Where issuing equity raises financial capital, there are corresponding increases in the assets and shareholder equity of the company. Profit is only affected by the earning capacity of the newly raised capital.
  - ix. If a company makes loans, the resulting interest is booked to profit at contract or arm's-length rates.
  - x. Applicable thin capitalisation rules may affect the recognition of deductions for interest payments to a related entity if the company's net equity is inadequate in terms of those rules.

<sup>219</sup> 2004 Revised Discussion Draft at § 86.

Transaction specific remarks concerning the precise content of the economic ownership notion will be returned to in 4.4.4.

#### 4.4.3.3 Risks assumed

The functional and factual analysis under step 1 of the authorised approach is completed by the identification of the risks associated with the PE's business activities. Risks associated with business activities may be divided into various types. The simplest differentiation may be between commercial or profit-making risks that concern the viability of a business *vis-à-vis* legal risks that principally stem from delictual or contractual claims against a particular business entity.

According to the authorised approach it is the latter type of risk that needs to be accounted for when profits are attributed to a PE. The single legal entity context of dealings between a GE and PE poses the problem that it is the enterprise as a whole which legally bears this type of risk, although it may be associated with the functions performed through a PE.

The OECD suggests that any risks inherent or created by the functions performed by a PE and directly related to its activities should be assumed under the fiction of article 7(2) of the OECD MTC to be associated with the PE for profit attribution purposes. A simplistic example of this type of risk is that arising from the negligence of employees engaged in the functions and activities performed by a PE.

More generally the authorised approach suggests that in the absence of contractual terms between the PE and the rest of the enterprise of which it is part, the determination of risks assumed by a PE should be:<sup>220</sup>

deduced from the parties conduct and the economic principles that govern relationships between independent enterprises ... which may be aided by examining internal practices, by making comparison with what similar independent enterprises would do and by examining any internal data or documentation purporting to show how that attribution of risk has been made.

It therefore appears that the determination of risks assumed by a PE is a very ~~factual-enquiry, which is apparent from the recognition that functions performed are~~ evidenced by internal practices.

Once the risks assumed by a PE have been determined, they will influence the profit attribution computation in that the amount of free capital and/or capital adequacy allocable to the PE will be influenced by these risks. According to the OECD, this is because a separate and distinct enterprise assuming material additional risks would need a matching increase in its capital in order to maintain the same creditworthiness.<sup>221</sup> Normally, and under the present approach of the Commentary to article 7 of the OECD MTC, a PE simply enjoys the same creditworthiness associated with the enterprise of which it forms part.

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<sup>220</sup> *Ibid* at § 88.

<sup>221</sup> *Ibid* at § 87.

It is submitted that attributing risks not only impacts the creditworthiness of a PE (if it can indeed have a different creditworthiness from the enterprise of which it forms part), but will also influence the comparability analysis because in arm's-length conditions profits normally follow risk, or, in other words, risk associated with a particular function is essential to complete the characterisation of that function.

For example, where a PE would be expected to carry the risk of its employees' negligence, the service function performed by those employees would be expected to carry greater reward in arm's-length conditions. Whilst creditworthiness is an extremely significant business driver for banks and other financial institutions, it is less so for other industries or business models (eg a contract manufacturer). The OECD's position on a PE's creditworthiness appears to recognise this commercial reality in that the notion of a PE having a separate creditworthiness from the enterprise of which it forms part is in general not accepted save for certain specific exceptions. These exceptions are discussed below.

#### 4.4.3.4 Creditworthiness of a PE

The OECD's approach to the creditworthiness of a PE is that it carries the same creditworthiness enjoyed by the rest of the enterprise of which it forms part. The only exception to this general rule is that if due to regulatory restrictions imposed by the host jurisdiction of the PE, the 'free' capital attributed to that PE is not available to meet liabilities incurred elsewhere by the enterprise, a different creditworthiness may be attached to the PE.<sup>222</sup>

For example, where banking enterprises are required to maintain a minimum capital adequacy ratio in a host jurisdiction where it carries on banking business through a PE, the OECD recognises such a PE as potentially enjoying a different creditworthiness. It is expected that more clarity will however be afforded on this aspect when the revised 2003 Banking Draft is issued. The 2005 Insurance Draft explicitly recognises that a PE of an insurance enterprise may have a distinct creditworthiness or solvency margin.<sup>223</sup>

It follows from the principle approach that if a different creditworthiness of a PE is not recognised, matching 'dealings' in respect of guarantee fees between a GE and PE, or between one PE and another, are not recognised.

It is submitted that creditworthiness of an enterprise is more complex than a simple source of risks; it is a product of several factors, including the aggregate surplus of free capital and the perceived ratio between free capital and the risk of an entity.<sup>224</sup> At least for banks and financial institutions a more thorough analysis is required to determine the precise interrelationship between the utilisation of capital within a single enterprise and the effect on profit allocation to its various constituting parts associated with the utilisation of this capital.

<sup>222</sup> Ibid at § 92.

<sup>223</sup> 2005 Insurance Draft at § 56 and 125.

<sup>224</sup> The 2003 Banking Draft also recognises this and lists at note 7, Section D-1.(ii) as other factors reputation and the perception of management quality.

On the face of it the denial of a different creditworthiness to a PE appears to be at a tangent with the fiction of an analogous separate and distinct enterprise where guarantees are in general recognised. The OECD maintains that it is not inconsistent with the arm's-length principle because:<sup>225</sup>

a key distinction between a separate legal enterprise and a PE is that an enterprise can enter into a legally binding agreement to guarantee the debts of a second enterprise, and third party lenders may take that guarantee into account when assessing the creditworthiness of the second enterprise. For such a guarantee to have substance, the capital needed to support the risks assumed would reside in a separate enterprise from that in which the risk of default occurs. In contrast, one of the key factual conditions of a PE is that capital and risks are not segregated from each other within a single legal enterprise. And if capital is not segregated then there is no basis for guarantee fees.

There may be some value in the recognition of a 'key factual condition' of a PE, namely that counterbalancing attributes (eg capital and risks) are not segregated from each other within a single legal enterprise.

It is submitted that this is one example where the application of the 1995 TP Guidelines to PEs will have a different outcome than an application to separate enterprises. In this regard, it can also be said that the formulation of the authorised approach does still take account of the legal form according to which a multinational enterprise may be organised.

Brabazon explains that the argument for branch guarantee fees does not dispute that PEs have a uniform credit rating with the whole enterprise. He argues that, on the contrary, the uniformity in creditworthiness is the product of notional guarantee fees earned by the enterprise pursuant to making available the credit of the whole enterprise to support the PE in its dealings with its creditors.<sup>226</sup>

The underlying policy issue that arises from Brabazon's explanation is whether this greater creditworthiness that results from the capital aggregation should be attributed to the GE, which will require the recognition of guarantee fees payable by PEs, or shared among the places where the capital is deployed (and if so, whether it should be distributed uniformly or on a weighted basis).

The OECD's authorised approach appears to favour the shared method and uniform distribution of credit rating through a single enterprise. This is probably consistent with the view expressed in the 2003 Banking Draft that the goal with the authorised approach is not to achieve equality of outcome between subsidiaries and PEs in terms of profits, but to rather harmonise the arm's-length principles applicable to both corporate forms. It would be beyond the authorised approach's terms of reference to recognise hypothesised dealings in order to negate an inherent trait of carrying on business through a PE as opposed to a subsidiary, a result irreconcilable with the 'distinct and separate' fiction of article 7(2) of the OECD MTC.

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<sup>225</sup> 2004 Revised Discussion Draft at § 96.

<sup>226</sup> Brabazon *supra* at 380.

On the other hand, there is the view that parts of an enterprise, which are more highly capitalised relative to assets and risk, subsidise the credit rating of other parts of the same enterprise and hence the latter should compensate the former. If this reasoning is followed to its logical conclusion, it would mean that the departures from the average interest rate deriving from the credit rating of the enterprise as a whole, should balance so that the aggregate interest rates of the differing parts of the enterprise equal the entire interest rate of the enterprise. As such, the counterpart to internal guarantees given by and to each PE would not necessarily be the GE, but all other active parts of the enterprise including the GE.

The impact that this proposal is likely to have on the profits attributable to PEs is that those more highly capitalised parts of an enterprise would have enhanced profits and those less capitalised correspondingly lower profits. The result is a weighted distribution of creditworthiness attributable to capital aggregation among the locations where the entity has effectively committed its capital.<sup>227</sup>

It is submitted that the weighted distribution approach to creditworthiness of an enterprise in so far as profit attribution is concerned is reconcilable with the arm's-length principle. It appears that the OECD's uniform approach to the creditworthiness of a PE stops short of applying the arm's-length principle in this scenario, as it tends to ignore the reality of where an enterprise effectively commits its capital.

#### **4.4.3.5 Capital attribution and funding of PE operations**

##### **4.4.3.5.1 Preliminary remarks**

Very generally speaking an enterprise's capital funding of its day-to-day business, the acquisition of assets and credit and market risks may arise from three categories of sources (or a combination thereof): equity contributions by shareholders, retained profits and/or reserves, and borrowings.

Under most municipal income tax systems, tax deductions are normally only allowed for interest payments to the holders of debt capital (subject to thin capitalisation rules), and not in respect of payments made to equity holders.

The authorised approach defines any equity funding obtained by an enterprise and for which the investment return does not result in a tax deduction, as 'free capital'. Since the authorised approach accepts in principle that notional interest payments between a GE and PE should be recognised for PE profit attribution purposes, it becomes important to identify the free capital that should be attributed to the PE to prevent excessive notional interest deductions to ultimately ensure that arm's-length profits are attributed to the PE.

The current OECD commentary on the issue of free capital attribution to a PE is inconclusive because it is confined to banks and their PEs, and simply states that the result will depend on the practice of member countries.<sup>228</sup>

<sup>227</sup> Brabazon *supra* at 381 to 382.

<sup>228</sup> See paragraph 20 of the Commentary on Article 7(3) and the reference there to the 1984 OECD report on this topic.

The 2004 Revised Discussion Draft departs from this inconclusiveness and develops a rather elaborate mechanism to attribute free capital to a PE for purposes of calculating the related funding costs of the PE. This mechanism is summarised below.

#### **4.4.3.5.2 The new OECD approach to the attribution of free capital to PEs**

The starting point for attributing free capital to a PE is the assumption that fictionalising a PE as a separate unrelated entity would entail that it has appropriate capital to support its functions, the assets used in performing these functions and the risks it assumes. It will be recalled that by carrying out a factual and functional analysis, functions and assets are attributed to a PE based on whether or not it has undertaken key entrepreneurial risk taking functions and whether any risks associated with the assets are assumed.

Accordingly, to allocate capital (both debt and equity) in terms of the authorised approach to a PE, a first step involves the measuring of the risks and value of the assets attributed to the PE, and secondly, the determination of the amount of free capital required to cover these risks and support the assets.

##### **4.4.3.5.2.1 Step 1: Measurement of risk and valuation of assets**

The measurement of risk is almost impossible to resolve in a theoretical manner for enterprises that are not regulated financial institutions governed by minimum capital adequacy ratios and solvency ratios such as banks or insurance enterprises.

The 2004 Revised Discussion Draft tries to overcome this difficulty by advising that attempts should be made to analyse risks assumed by a PE by, where available, making use of an enterprise's own measurement tools. It also suggests that, as a rule of thumb, risks should be attributed to a PE where it would be regarded by the market, both as regards market segment and geographical market in which the PE operates, that risks should be covered by capital.<sup>229</sup>

Another approach could be that capital should be attributed by reference only to assets allocated to a PE. The underlying assumption is that for non-financial enterprises, capital would primarily serve a funding purpose (ie of assets) and not a risk-covering purpose.<sup>230</sup> For the valuation of assets, the 2004 Revised Discussion Draft is inconclusive as to specific methods of valuation, but adds that whatever method is used, it should be used consistently from year-to-year for similar asset classes allocated to a PE.<sup>231</sup>

An enterprise is consequently free to use whatever justifiable valuation method fancies it. For example, it could use the historical cost of an asset as a basis for a valuation, or its book value as reflected in the financial statements for a particular period, or its market value in cases where it significantly differs from book value. It is submitted that the inconclusive nature of this aspect of the authorised approach may very likely lead to further work on the part of the OECD, as the valuation of assets

<sup>229</sup> 2004 Revised Discussion Draft at § 107.

<sup>230</sup> Ibid at § 104.

<sup>231</sup> Ibid at §105.

touches the heart of the application of the authorised approach: in the end it's all about putting a number to the result of the analysis, namely to calculate the amount of profit attributable to the PE.

Leaving the valuation issue open-ended would render the authorised approach principally unsatisfactory in practice. The author does not suggest that firm decisions should be taken to, for instance, adopt once and for all a market value-approach or the like, but further analysis may be helpful to look into specific type businesses, assets classes and risk profiles. For example, where a PE located in a low tax jurisdiction undertakes research and development related to a pharmaceutical product, one may find that significant intellectual property (IP) of the enterprise, such as legally protected right in the form of registered formulas and know how, is attributable to the PE.

The first observation is that significant differences in the value of these assets (registered formulas, know-how, etc) can be calculated depending on the method used. The historical cost of these assets can be high or low, depending on the expenses involved in creating the IP, their market value can fluctuate dramatically over time whilst accounting rules, very generally speaking, attempt to value these assets in a way to level out fluctuating market valuations, and so may place a very different value at this point in time on the IP as opposed to its market value at that stage.

Secondly, whilst economic ownership of these assets by itself does not create significant risks for the PE, significant entrepreneurial risks are created for the PE by embarking on the R&D activities, eg the product so developed may never be successful in the market. The GE may thus be justified for all sorts of reasons such as those touched upon in the above example to decide whichever valuation-method or risk-measurement yardstick to use depending on whether or not ultimately it seeks a large or small deemed deduction for an interest expense in the jurisdiction where the PE is located.

In the above example, where the PE is located in a low tax jurisdiction, one would think that minimal interest deductions are preferable, even more so if the exemption method is used for relief from double taxation by the home country. The 2004 Revised Discussion Draft's tolerance of open-ended valuation methods for assets allocable to a PE consequently appears to allow the achievement of tax-driven results in the application of the authorised approach.

#### **4.4.3.5.2.2 Step 2: Determining the 'free' capital attributable to a PE**

Ignoring for the moment any regulatory requirements and tax implications arising from the mix of equity and debt in the funding of business operations, enterprises are generally free to fund their operations entirely through debt. Whilst it may be so that there is no need for a PE to have any free capital, it should be obvious that to allow situations of full debt funding of a PE would lead to magnificent tax avoidance schemes.

For mainly anti-avoidance reasons, the OECD's approach to the determination of free capital and debt of a PE is to expect that an arm's-length amount of free capital should be allocated to a PE.<sup>232</sup>

It is submitted that logically there is an inaccuracy in the attempt to achieve comparability with arm's-length behaviour of independent enterprises in this way: Third parties are, subject to regulatory requirements, normally free to fund operations entirely with debt. In the tax environment, thin capitalisation rules designed to disallow excessive deductions for finance charges generally apply only between connected persons, and not to all independent persons transacting with each other.

In other words, independent parties that are not connected to each other and that are not constrained by regulatory requirements are in reality free to fund their business operations entirely with debt or free capital. It would appear that the arm's-length principle provides a false basis for comparison to work out the attribution of free capital and debt to a PE.

In the face of this false basis for comparison the OECD proceeds to identify four approaches that may be used to calculate the free capital allocable to a PE. All four approaches are subject to the qualification that the identification rules used by the PE's host country to distinguish debt from equity for municipal tax purposes will also apply to identify items of free capital.<sup>233</sup>

#### **4.4.3.5.2.2(a) The capital allocation approach**

This approach seeks to allocate a GE's actual free capital (identified according to the tax rules of the PE state) in the same proportion that that GE's assets and risks are allocated to the PE.<sup>234</sup> The assumption supporting this approach is that the GE itself is adequately capitalised with equity. If this is not the case, appropriate adjustments are required.

Problems with this approach include that capital designated by the GE to acquire new business, or temporary cash surpluses resulting from the sale of businesses, could also be allocated to a PE. The problem may be overcome by segregating these items and putting firm commitments in place to acquire new business or funds earmarked for distribution to shareholders.<sup>235</sup>

#### **4.4.3.5.2.2(b) The economic capital allocation approach**

This approach seeks to identify 'economic' capital which, in the banking industry where this concept originated, is understood to be based only on those risks assumed causing a concern for regulators.

The 2004 Revised Discussion Draft suggests that this approach, although not even well-developed in the banking industry, may be useful to apply to PEs carrying

<sup>232</sup> Ibid at §111.

<sup>233</sup> Ibid at § 113. See for example Sections 8E and 8F of the Act.

<sup>234</sup> Ibid at § 116.

<sup>235</sup> Ibid at § 122.

significant developmental risks<sup>236</sup> (see the example above at 4.4.3.5.2). Exactly how this approach would be useful for PE's carrying developmental risk is not explained.

#### 4.4.3.5.2.2(c) The thin capitalisation approach

This approach would require a comparability analysis that would seek to establish how much free capital would be required by an independent enterprise carrying on the same or similar activities as the PE under the same or similar conditions.

The method of calculating the amount of free capital under this approach would entail in the first place establishing the amount of funding *per se* required by the PE (ascertained in accordance with the content of the factual and functional analysis) and then applying the same method used by the PE's host state to limit interest deductions of associated enterprises (ie connected persons), typically through the application of predetermined debt to equity ratios.<sup>237</sup>

Although this approach is simple to implement, the 2004 Revised Discussion Draft acknowledges several problems with it including that:<sup>238</sup>

- i. It could have the effect of attributing in aggregate more free capital to individual PEs than the total amount of free capital of the enterprise as a whole, since reliance is placed on different countries' debt to equity ratios that might considerably differ from one another;
- ii. It does not consider issues such as the capital structure of the GE as a whole, which may be the result of shareholders' appetite for risk, etc; and
- iii. It does not consider the range of actual capital structures of independent host country enterprises that are comparable to the activities carried on by the PE.

#### 4.4.3.5.2.2(d) The safe harbour/quasi thin capitalisation/regulatory minimum approach

This approach relies on existing free capital requirements for regulatory purposes. The 2004 Revised Discussion Draft is not in favour of this approach and indicates that further work is being carried out in this field.<sup>239</sup>

In the 2005 Insurance Draft, the OECD considers all of the above approaches as 'authorised OECD approaches ... capable of producing an arm's-length result' and defines the role of these approaches as:<sup>240</sup>

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<sup>236</sup> Ibid at § 123.

<sup>237</sup> Ibid at § 126.

<sup>238</sup> Ibid at § 125 to 129.

<sup>239</sup> Ibid at § 130 to 133.

<sup>240</sup> 2005 Insurance Draft at § 167.

articulating the principles under which ... an attribution of surplus [capital] should be made and ... providing guidance on applying those principles in practice ... in a flexible and pragmatic manner.

It would appear that taxpayers are therefore free to adopt any one of the approaches discussed above to determine the free capital attributable to a PE.<sup>241</sup>

#### 4.4.3.5.3 Determining the funding costs of a PE

Once one of the abovementioned approaches to calculate the amount of free capital allocable to a PE has been applied, the balance of the total funding requirement of the PE is the amount by reference to which a possible notional interest expense will be calculated.

Further issues that arise when calculating the notional interest expense concern the recognition of dealings related to such putative interest, the rate of interest and whether any mark up should be recognised on internal dealings related to such interest. The 2004 Revised Discussion Draft states that there are several authorised OECD approaches available for resolving these issues.<sup>242</sup>

The first issue is whether any movements of funds within an enterprise could be said to give rise to a 'dealing', which is the *sine qua non* for a deemed deduction in respect of notional interest charges. It appears that the 2004 Revised Discussion Draft would definitely consider a notional interest charge in cases of 'treasury dealings' between a PE and other parts of the enterprise of which it forms part. The existence of treasury dealings depends on whether or not a factual and functional analysis reveals that a PE undertook key entrepreneurial risk taking functions related to the cash or financial assets of the enterprise so that that PE may be viewed as the economic owner thereof.<sup>243</sup>

Two other approaches to the allocation of finance charges to PEs are the tracing approach and the fungibility approach. Both approaches are described as problematic although they nevertheless remain authorised approaches of the OECD. Tracing entails that any movements of funds internally involving a PE is traced back to the original third party provider of those funds. The actual interest rate contracted with this third party is then applied to the funds allocated to the PE to ascertain the deemed tax deduction for notional interest. Under the fungibility approach, funds provided to a PE are considered to contribute to the whole enterprise's funding needs. Accordingly the actual interest expense of the whole enterprise is allocated to the PE on the basis of some pre-determined allocation key. No regard is thus had to any intra-company interest dealings.

<sup>241</sup> The question should be asked what happens if the host and home countries adopt different approaches, which could understandably result in either double or less than single taxation? The answer is that in terms of article 23 of the DTC (if based on the OECD MTC) these countries will require the home country to accept the host country's domestic rules that are consistent with one of the authorised approaches providing that the result is consistent with the arm's-length principle. See the 2004 Revised Discussion Draft at § 144 and the 2005 Insurance Draft at § 168.

<sup>242</sup> 2004 Revised Discussion Draft at § 147.

<sup>243</sup> *Ibid* at § 150.

The 2004 Revised Discussion Draft concludes regarding the various methods available to determine the funding cost of a PE that it remains open to individual host countries to decide on an appropriate approach, and that home countries should accept the result of any of these approaches. It emphasises that the goal of all these approaches remains the same, namely that the amount of notional interest expense claimed by the PE should not exceed an arm's-length amount and that, at the same time, treasury dealings should be appropriately rewarded.<sup>244</sup>

Moreover, the 2004 Revised Discussion Draft argues that any concern that these authorised approaches may lead to situations of abuse, is abated by the overriding approach that key entrepreneurial risk taking functions must be performed before any dealing as regards internal finance charges will be recognised.<sup>245</sup>

The 2004 Revised Discussion Draft states that to establish the reward for 'treasury dealings' a comparability analysis should be performed through applying by analogy the methods of the 1995 OECD TP Guidelines. This means that a margin may be added to external debt charges of an enterprise in appropriate circumstances where that debt is allocable to a PE. Such a margin should be comparable to margins earned by independent enterprises in comparable circumstances. Accordingly, where a PE acts merely as conduit, ie it borrows funds and simply 'on-lends' to other parts of the enterprise, it may rather be appropriate to reward the PE as an administrative service provider, for example, with a reimbursement of cost incurred on a cost plus basis. Again, key entrepreneurial risk taking functions should be performed by the PE before it will be recognised as the economic owner of the funds that would justify a mark up on the real contracted interest rate.

#### **4.4.4 The second step of the authorised approach: Determining the profits of the hypothesised distinct and separate enterprise based upon a comparability analysis**

The aim of the second step in applying the authorised approach is to undertake a comparison between *dealings* between the PE and the enterprise of which it forms part (identified in the first step – see 4.3), with *transactions* between independent enterprises by applying, by analogy, the methods described in the 1995 OECD Transfer Pricing Guidelines.

To achieve this aim, the issues addressed by the 2004 Revised Discussion Draft can be summarised as follows:

- When should a 'dealing' be recognised;
- How to apply by analogy the transfer pricing comparability methods of the 1995 OECD TP Guidelines;
- Application of the comparability methods, which involves the following:
  - Identifying economic ownership of capital assets and the impact of change of use of these;

<sup>244</sup> Ibid at § 153.

<sup>245</sup> Ibid at § 154.

- Identifying the economic ownership of both internally developed or externally acquired trade or marketing intangible property;
- Addressing the provision of internal services.

These issues are summarised and discussed below.

#### **4.4.4.1 The recognition of 'dealings'**

The 2004 Revised Discussion draft recognises the fact that a GE and PE are legally and economically not separate. The inevitable absence of, for example, legally binding contracts increases the scope for tax motivated reallocations within a single enterprise. It is therefore justified that purported dealings between a GE and PE requires greater scrutiny, which must be translated into a threshold that needs to be passed before a dealing can be equated with a transaction.<sup>246</sup>

The starting point to evaluate whether this threshold has been passed is the accounting records of the enterprise provided it relates to real and identifiable events (eg the reallocation of stock, use of IP, etc). If a dealing is recorded in this way in the PE's accounting records, it must be scrutinised further in light of a factual and functional analysis, which in turn would require that an economic significant transfer of risks, responsibilities or benefits must have occurred. Ultimately the OECD's view is that the factual and functional analysis determines whether a dealing has taken place and not the accounting records or other internal documentation of the enterprise.<sup>247</sup>

This approach runs into a few problems. Normally contractual terms between associated enterprises form the basis of the functional analysis performed for such independent persons. Evidently, in the case of dealings between a GE and a PE, contractual terms are a legal impossibility and the functional and factual analysis cannot rely on this aspect. The proposed solution by the 2004 Revised Discussion Draft is that the 'contractual terms' of a dealing can be gleaned from accounting records and any contemporaneous internal documentation that purport to reallocate assets, risks, responsibilities, etc. For example, the OECD argues that a purported reallocation of risk should be evaluated according to the economic substance of the dealing and the enterprise's conduct, which should generally be taken as the best evidence concerning such a reallocation of risk.<sup>248</sup>

#### **4.4.4.2 The application of the 1995 OECD TP Guidelines for purposes of attributing profits to a PE**

The 2004 Revised Discussion Draft provides two examples of how to apply the 1995 OECD TP Guidelines' five methods to achieve comparability between related and independent party transactions. As to the remaining three methods contained in the 1995 OECD TP Guidelines, it is simply stated that these should be applied in a similar fashion.

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<sup>246</sup> Ibid at § 174 to 175.

<sup>247</sup> Ibid at § 176.

<sup>248</sup> Ibid at § 178.

The two examples concern the application of the Comparable Uncontrolled Price (CUP) and the comparable resale price margin (resale price) methods to a situation where a PE distributes to third parties a product manufactured by the GE in circumstances where the GE also sells the product to third party distributors.

In the application of the CUP method, the price charged by the GE for sales directly to third party distributors is the CUP, which should be used as yardstick when calculating the gross profit attributable to the PE from the sales effected through it. Normally, one would proceed from the gross revenues received from the third party sales through the PE by deducting from it the price charged by the GE to the PE, and adjust the latter for tax purposes if it deviates from the identified CUP.<sup>249</sup>

For the application of the resale price method, it is assumed that the CUP is unavailable. The resale price method would start by applying a comparable resale price margin to the third party sales affected through the PE to arrive at a gross profit attributable to the PE. From this gross profit would then be subtracted expenses incurred by the GE for the purposes of the PE, including, if applicable, expenses reflecting functions performed for purposes of the PE by other parts of the GE.<sup>250</sup>

#### 4.4.4.3 Comparability analysis

The 1995 OECD TP Guidelines identified five factors that determine comparability between controlled and uncontrolled transactions between two persons:<sup>251</sup>

- the characteristics of property or services used
- the functional analysis
- contractual terms
- economic circumstances
- business strategies

The authorised approach seeks to apply the same factors to establish comparability between dealings and uncontrolled transactions for GE-PE dealings. Evidently, a factor such as contractual terms will provide difficulty since it is legally absent in the context of dealings (see 4.4.4.1 above on the 2004 Revised Discussion Draft's approach to this problem).

The authorised approach's general approach is that when the factual and functional analysis determine that there has been a reallocation of goods, services, assets, funds, etc between one part of a GE and a PE, the part of the enterprise that initiated the reallocation should receive a return similar to that which an independent enterprise would seek to recover for making a comparable provision in an arm's-length transaction.

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<sup>249</sup> Ibid at § 182.

<sup>250</sup> Ibid at § 183.

<sup>251</sup> OECD, 1995 to 2000. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris at Part C.i.b.

It is apparent that this approach is underscored by the assumption that independent parties would always seek to recover a return or profit in terms of a transaction. One exception to this assumption, which might even be more prevalent in the context of GE-PE dealings, is cost contribution arrangements (CCA)<sup>252</sup> under which independent parties would not always seek to recover a return from such a transaction.

The 2004 Revised Discussion Draft acknowledges that different parts of an enterprise may structure their dealings in a comparable manner to co-participants to a CCA, and hence intra-company dealings could be treated similar to transactions in terms of a CCA.<sup>253</sup> One practical difficulty that could arise is the absence of contractual agreements, which are paramount in dealing with a CCA between different enterprises.

It is suggested by the 2004 Revised Discussion Draft that the onus rests on the taxpayer to produce internal contemporaneous documentation indicative of the CCA-type dealing between different parts of the same enterprise. It is also suggested that 'intent' on behalf of the enterprise is required before a notional CCA would be recognised, making it impossible to construe it after the fact.<sup>254</sup>

#### 4.4.4.4 Application of the authorised approach: three scenarios

The 2004 Revised Discussion Draft extensively discusses three scenarios in which the authorised approach is tested. These scenarios encompass the use of capital, intangible assets and the provision of internal services. Some of the more relevant remarks in terms of each scenario is summarised below.

##### 4.4.4.4.1 Capital Assets

The 2004 Revised Discussion Draft rightly points out that the starting point in assessing the profit attribution consequences of any reallocation of a capital asset between various parts of the same enterprise is establishing whether or not the enterprise legally owns the asset or not.<sup>255</sup> It is added that it could be useful, for reasons that would become apparent in the discussion below, to establish the nature of the usage rights in circumstances where the enterprise does not own the asset outright.

Where an asset is owned outright by the enterprise, economic ownership thereof must be determined, both at the time when the asset is acquired and when a change of use occurs.

The 2004 Revised Discussion Draft propagates the view that that part of the enterprise which performs the key entrepreneurial risk taking functions in respect of the particular capital asset (as determined by the factual and functional analysis) is the economic owner. For example, a PE would be considered the economic owner of a

<sup>252</sup> The concept of a CCA may be described as an arrangement whereby two or more parties agree to pool resources and/or skills and share risks (without receiving separate compensation for these contributions) with a view to develop, produce or obtain an asset, services or rights. Independent parties would normally require that each participant's contribution to a CCA be proportionate to the participant's share of the overall expected benefits to be received under the arrangement.

<sup>253</sup> 2004 Revised Discussion Draft at § 191 to 194.

<sup>254</sup> Ibid at § 194.

<sup>255</sup> Ibid at § 198.

capital asset if it were responsible for the regular maintenance of the asset (whether or not maintenance is a significant cost is also relevant), has to recruit personnel or contract services to perform unforeseen repairs and whether it is responsible for deciding when to replace the asset rather than continue to maintain it.<sup>256</sup> It is important to note that, although not explicitly stated by the OECD, these factors enumerated by the 2004 Revised Discussion Draft appear to give substance to the notion of 'key entrepreneurial risk taking functions', a novel concept employed throughout the authorised approach although the content is not directly defined or delineated.

When a change in use of an asset occurs and it is reallocated to a PE from another part of the enterprise, the enterprise will have to demonstrate that similar responsibilities to those mentioned above have been shifted to the PE before it can be said that the PE acquired the economic ownership of the reallocated asset. If the contrary position prevails, the reallocation would rather lead to the recognition of a notional lease or rental dealing between the PE and the part of the enterprise that remains the economic owner of the reallocated asset.

In circumstances where the enterprise does not legally own the asset, questions of allocating the economic ownership of the asset to a particular part of an enterprise are unnecessary according to the 2004 Revised Discussion Draft. It is hard for the OECD to conceive how the factual and functional analysis could show that one part of an enterprise performed key entrepreneurial risk taking functions in respect of such an asset in these circumstances.<sup>257</sup>

It is submitted that this view oversimplifies commercial realities. A myriad of lease arrangements are possible whereby an enterprise obtains assets in circumstances where it practically has all the rights and responsibilities of an outright owner for the duration of the useful life of the asset, but nevertheless legally only has usage rights in respect of the asset. Examples include financial leases and bare dominium arrangements. Realistically viewed, these arrangements could also afford the lessee autonomy as regards the 'key entrepreneurial risk taking functions' such as the regular maintenance of the asset, recruitment of personnel or contract services to perform unforeseen repairs and decisions as to the replacement of the asset.

It is suggested that the 2004 Revised Discussion Draft's point of departure should thus rather be qualified to extend the scope of the initial investigation to determine not only if the enterprise itself legally owns an asset, but also, if it does not legally own the asset, whether it nevertheless has sufficient usage rights in respect of an asset for the duration of its useful life which would be akin to the position of a legal owner. Differently put, and for want of a better description, whether the enterprise as such is the economic although not legal owner of the asset.

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<sup>256</sup> Ibid at § 204.

<sup>257</sup> Ibid at § 205.

The 2004 Revised Discussion Draft states that it is the fair market value<sup>258</sup> of the asset at the time of its reallocation between different parts of the same enterprise that would be relevant for tax purposes.<sup>259</sup> Accordingly, should the reallocation of the capital asset be recognised as a dealing akin to a sale, the fair market value at that time will, for profit attribution purposes, form the basis of the depreciation allowance granted to the enterprise operating in the country to which the asset was reallocated. The 2004 Revised Discussion Draft is not prescriptive in so far as the situation in the country from which the asset has been reallocated is concerned.<sup>260</sup> For example, in respect of an exit charge for a non-resident (see 3.2.1.2 and 3.2.3.2 for the South African domestic law position).

#### 4.4.4.4.2 Intangible property

In a consumerist society geared to ever-increasing technological feats, intangible property has more than ever before played a significant role in the commercial success of multinational enterprises.

For many enterprises the ability to generate profits is linked to the specialised knowledge and processes at its disposal. The global communications era is causing an ever-increasing emphasis on marketing and brand recognition, which directly relies on specialisms and intellectual property. The creation of new ways of conducting business such as e-commerce is in many respects very reliant on intangible property and less so on physical capital.

All these developments pose a major challenge for both domestic and international taxation systems, such as placing a value on intangible property and estimating the revenue it creates. Given the fluidity of intellectual property, it is common for more than one part of an enterprise to simultaneously utilise it. Historically not much guidance exists on how to treat intangible property in the contexts of GE-PE dealings for profit attribution purposes.<sup>261</sup>

In 2001 the OECD released a discussion paper related to this issue in the context of e-commerce, the so-called E-Commerce Draft. Earlier work of the OECD concluded that a server might in appropriate circumstances constitute a PE, especially where a so-called e-tailing business is carried on through the server.<sup>262</sup> The E-Commerce Draft recognises that such a PE (ie the server) does not only use the hardware and software of the GE as assets, but also its intangible property. The most

<sup>258</sup> See the inconclusive view adopted by the 2004 Revised Discussion Draft above at 4.4.3.5.2 as regards the valuation methods available in respect of assets for purposes of attributing capital to a PE.

<sup>259</sup> Ibid at § 207 to 208.

<sup>260</sup> Ibid at § 208.

<sup>261</sup> Only the current paragraph 17.4 of the Commentary on Article 7 of the OECD MTC discusses this issue.

<sup>262</sup> Committee of Fiscal Affairs. OECD. 2000. *Clarification on the application of the permanent establishment definition in e-commerce – Changes to the Commentary on the Model Tax Convention on Article 5*. Paris: OECD.

obvious form of such intangibles is the GE's own brand name, which will attract customers to the website.<sup>263</sup>

In assessing the impact of the use by the PE of such intangibles it must be determined which part of the GE is entitled to the benefits associated with the use of the intangibles by the PE. The reward associated therewith will not necessarily accrue to the part making use of the intangibles, but rather to that part which has developed or otherwise contributed to it.

The position of the E-Commerce Draft is that in so far as a server PE makes use of the enterprise's software, it must be considered to have notionally acquired a right of use, which would consequently justify the deduction of an arm's-length expense much like a licence fee for the acquisition of this right.<sup>264</sup> In so far as the use of marketing intangibles by the server is concerned, the same position would apply if the activities carried on through the server equate with that carried on by a retail outlet. Where the server activities are more akin to that which a service provider would perform, a notional deduction for the use of the marketing intangible would not be readily recognised.<sup>265</sup>

The 2004 Revised Discussion Draft attempts to address the situation of intangibles by considering the questions: which part(s) of the enterprise is(are) the economic owner(s) of the intangible property, the impact that it(they) would have on profit attributable to a PE and the existence of internal dealings relating to the use of intangibles. These questions are discussed below.

As was the case for capital assets, the 2004 Revised Discussion Draft proceeds from the basis that through a factual and functional analysis the identification of the part of the enterprise that performs the key entrepreneurial risk taking functions in relation to intangible property would reveal the economic owner thereof. To apply this approach to intangibles in practice, the same distinction used in the 1995 OECD TP Guidelines between marketing intangibles and other commercial intangibles (trade intangibles) is used. For each type of intangible, two situations are considered, ie where it is newly developed by the enterprise, and where it has been acquired from another enterprise.<sup>266</sup>

#### **4.4.4.4.2(a) Trade intangibles – internally developed**

The 2004 Revised Discussion Draft rightly points out that generally it is not necessarily the developer of intangible property who is the legal or economic owner, or joint-owner thereof. Rather, the key issue is to identify the enterprise that acts as the entrepreneur in deciding to assume and subsequently bear the risk associated with the development of an intangible,<sup>267</sup> which in the context of GE-PE dealings is similar to the concept of key entrepreneurial risk taking functions.

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<sup>263</sup> E-Commerce Draft at § 50.

<sup>264</sup> Ibid at § 78.

<sup>265</sup> Ibid at § 79.

<sup>266</sup> 2004 Revised Discussion Draft at § 221.

<sup>267</sup> Ibid at § 227.

It is stated that for these purposes the key entrepreneurial risk taking functions are those that require 'active decision-making with regard to the taking on and day-to-day management of individual risk and portfolios of risk.'<sup>268</sup>

The question that has to be resolved in each particular case as a result of this definition is what level of management is responsible for this kind of decision making, which can largely be answered by describing and evaluating the dynamics of a particular research and development programme. Predominantly, the nature of the decision-making process and level at which those decisions are made would be important factors.<sup>269</sup>

A further factor that will indicate which part of an enterprise is the economic owner or co-owner of an intangible is who would bear any losses caused by a failed development process. The probability of failure would also necessitate the attribution of capital to that part of the enterprise to support the risk so assumed.

#### **4.4.4.4.2(b) Trade intangibles – acquired**

Where intangibles are acquired from another enterprise either outright or through a licensing agreement, the key entrepreneurial risk taking functions again would point to the economic owner of the intangible or right of use.

It is an important factor to identify the part of the enterprise responsible for making decisions concerning the acquisition of an intangible asset. Another important factor could be who is intended to use the intangible, as this part of the enterprise would generally bear the risk of unsuccessful use of the intangible.<sup>270</sup>

#### **4.4.4.4.2(c) Marketing intangibles**

The same principles outlined above for trade intangibles apply to marketing intangibles. Factually it might not be possible to apply this approach to marketing intangibles especially where they are global in nature, the reason being that the connection between the performance of functions, initial assumption and subsequent bearing of risks and the creation of a global marketing intangible may be too remote.

For example, the initial decision to create, for instance, a brand name, may be insignificant compared with the ongoing cost of maintaining a global marketing programme for purposes of that brand. The 2004 Revised Discussion Draft appears to indicate that in these circumstances the economic ownership will belong to the whole enterprise and not to any of its constituent parts.<sup>271</sup>

On the other hand, where a marketing intangible is, for instance, specific to a PE's host country, it might be possible to determine the sole or joint ownership of that

<sup>268</sup> Ibid at § 228. This exact description of the concept of key entrepreneurial risk taking functions is also found in the 2003 Banking Draft at § 10, although in a slightly different context where this formulation is used to describe the important functions in managing a loan.

<sup>269</sup> 2004 Revised Discussion Draft at § 231.

<sup>270</sup> Ibid at § 235 to 237.

<sup>271</sup> Ibid at § 240.

intangible, since it would be easier to identify the key entrepreneurial risk taking functions in relation to the brand name in that specific geographical market.

#### **4.4.4.4.2(d) Impact of intangibles on the profits attributed to a PE**

When assessing the impact of intangibles for purposes of determining how much profit should be attributed to a PE, it is important to realise that the return on intangible property of the enterprise is part of its overall return from transactions with third parties. The issue is thus how to attribute this overall return within the enterprise among its constituent parts in accordance with the arm's-length principle.

For example, the profit of a transaction with a third party attributed to a PE as a result of functions performed by that PE, including the use of intangibles, may therefore already include an element of the return on that intangible and therefore there is no need to attribute any additional return to that PE.<sup>272</sup> In other cases, it may be necessary to attribute a separate and additional return to a PE in relation to an intangible, as the principle remains that the economic owner of the intangible should be attributed an arm's-length return. This separate and additional reward may be moulded in accordance with a number of comparable transactions such as a royalty, incorporating a reward in the price of goods sold, or by sharing a part of the overall profit with the intangible owner.

Examples of cases where an additional reward would be required by the arm's-length principle is where a PE carried out particular functions that have led to an increase in the value of a brand name outside the host country and these functions have not been remunerated separately. Conversely, if a PE had benefited from global marketing costs incurred by the enterprise towards which it made no contribution, it must compensate the part of the enterprise that did carry the costs.<sup>273</sup>

#### **4.4.4.4.2(e) Internal dealings relating to the use of intangibles**

Consistent with the general formulation of the authorised approach, the OECD recognises that in appropriate circumstances a functional and factual analysis may show that a dealing could be recognised between a GE and PE in so far as intangibles are concerned. The 2004 Revised Discussion Draft rightly makes the point that it is not simply a matter of whether or not recognition should be given to a notional royalty payment or not, but that the dealing should be characterised in accordance with various known transaction types that occur between independent parties in so far as intangibles are concerned.<sup>274</sup>

The first step in recognising a dealing between the various parts of an enterprise in so far as the use of intangibles is concerned, is to identify any change of use of an intangible within the enterprise. For example, the use of an intangible may be made available to a PE by the GE, which could be characterised in a number of ways: treating the PE as obtaining the intangible asset itself, or an exclusive or non-exclusive notional

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<sup>272</sup> Ibid at § 245.

<sup>273</sup> Ibid at § 246 to 249.

<sup>274</sup> Ibid at § 252.

right to use the intangible, or a beneficial interest in the intangible or the exploitation thereof.

It is also important to know whether the enterprise is the legal owner of the intangible property or if it acquired a right of use in respect thereof from a third party. The 2004 Revised Discussion Draft suggests that the value of the intangible reallocated (eg as joint or outright owner or a beneficial interest) to a PE in the above example should be determined by reference to comparable transactions between independent parties. This generally means that the PE should be treated as having acquired the intangible or interest therein at its fair market value.

Subject to municipal tax law (see 3.3 for the South African municipal tax provisions), the PE should be allowed to depreciate or amortise the intangible based on this fair market value.<sup>275</sup> Where the dealing cannot be characterised as an acquisition of an interest in the intangible, the PE may still be regarded as having obtained a notional right of use analogous to a licence agreement, which would entitle it to deduct an amount (ie a notional licence fee or royalty) for the use so obtained from another part of the enterprise.<sup>276</sup>

#### 4.4.4.4.3 Internal services

Organising the legal form of a commercial concern and carrying on business through one enterprise and a number of PEs naturally require considerable head-office support and infrastructure, which could range from strategic management services to centralised payroll, accounting and compliance functions.

The 2004 Revised Discussion Draft states that these support functions should be considered for profit attribution purposes to PEs. Accordingly the authorised approach and 1995 OECD TP Guidelines should also be applied in this context.<sup>277</sup>

The historical approach in respect of internal services was that only the actual cost incurred in respect of services related to management of the enterprise as a whole could be allocated to a PE. The provision of services with a mark up was restricted to cases where it is, for example, the trade of the enterprise to provide the services concerned to third parties, or where the main activity of the PE is to provide services to the enterprise as a whole.<sup>278</sup>

The 2004 Revised Discussion Draft appears to discard this approach since it commands that the 1995 OECD TP Guidelines should be applied by analogy to determine whether, and if so, to what extent, support services should be rewarded with an appropriate return. The OECD also recognises that dealings in so far as the provision of internal services are concerned, can be characterised to comparable CCA-type activities.<sup>279</sup>

<sup>275</sup> Ibid at § 254.

<sup>276</sup> Ibid at § 255.

<sup>277</sup> Ibid at § 258 to 260.

<sup>278</sup> See paragraphs 17.5 to 17.7 of the Commentary on Article 7 of the OECD MTC.

<sup>279</sup> 2004 Revised Discussion Draft at § 262.

It is important to realise that the application of this approach may result in situations where the return on the internal service may be more or less the same than the costs incurred by the GE to provide the services depending on what the situation would be for comparable transactions between independent parties.

#### 4.4.5 Dependent agent PEs

According to the definition of a PE in article 5 of the OECD MTC, a host country may be allowed to tax a non-resident enterprise in circumstances where it has either a fixed place of business PE or a dependent agency PE in that country (see 2.3.3 to 2.3.4).

The 2004 Revised Discussion Draft states that there is in principle no difference in approach to attributing profits to either type PE, and that the same principles outlined above in 4.1 to 4.4, which is generally predicated on a fixed place of business PE, apply to dependent agency PEs.<sup>280</sup> Agency PEs are typically encountered when enterprises carry on business in host countries through dependent sales agents. The identification in these circumstances of which part of the enterprise performs the key entrepreneurial risk taking functions will dictate the level of profits to be attributed to the sales agent.

Characteristic functions that will influence the risk profile of a dependent sales agent include:<sup>281</sup>

- (i) Contributions to the development of a marketing or trade intangible;
- (ii) The assumption of any inventory risk, such as in respect of stock obsolescence or damages; and/or
- (iii) credit risk, for example in respect of doubtful or bad debts.

It is not common that a mere sales agent would perform any of the abovementioned functions.

Between third parties the so-called *del credere* agent<sup>282</sup> is commercially the agency type that in its normal guise assumes credit risk. A *del credere* agency is sometimes expanded to carry inventory risk and could conceivably also provide for services-related to marketing on the strength of its all-encompassing nature. One would therefore expect that an agency PE should perform the functions and, importantly, the risk associated by analogy with a *del credere* agent before any significant profit from the sales function could be attributed to it, as these functions tend to be typical of entrepreneurial risk taking functions.

<sup>280</sup> Ibid at § 271.

<sup>281</sup> Ibid at § 280 to 284.

<sup>282</sup> Claasen, R.D. 2004. *Dictionary of Legal Words and Phrases*. Durban: Butterworths, quotes Mellish, LJ where he said in *In Re Neville, Ex parte White* (1871) 6 Ch App 397 at 403: 'I apprehend that a *del credere* agent, like any other agent, is to sell according to the instructions of his principal, and to make such contracts as he is authorised to make for his principal: and he is distinguished from other agents simply in this, that he guarantees that those persons to whom he sells shall perform the contracts which he makes with them'. See also *Amm v Mia* 1974 4 SA 145 (T) and *Churchill and Sim v Goddard* [1936] 1 All ER 675.

#### 4.4.6 The Interpretation of Article 7(3) to (5) of the OECD MTC

The 2004 Revised Discussion Draft concludes with a review of the correct interpretation of the provisions of article 7(3) to (5) of the OECD MTC.

##### 4.4.6.1 Article 7(3)

In so far as the interpretation of article 7(3) of the OECD MTC is concerned (see the text quoted above at 4.1.3), two competing views have emerged over the years.

One view is that the provisions of article 7(3) aim to ensure that actual (as opposed to notional) expenses associated with a PE's activities are not disallowed for inappropriate reasons, especially in circumstances where an expense is incurred outside the host jurisdiction of the PE, or is not exclusively incurred for the PE.

The other view is that provisions of article 7(3) provide a *caveat* to the arm's-length principle articulated by article 7(2) in the following way:

- (i) Actual expenses allocable to a PE should be deductible even though they may exceed costs that would prevail in a comparable arm's-length dealing;
- (ii) Other parts of the enterprise cannot recover more than their actual costs with regard to expenses incurred for the purposes of the PE.<sup>283</sup>

Based on a review of the history of article 7(3), principally with reference to the 1933 Draft and 1946 London Model (see 4.2.2 to 4.2.3), the 2004 Revised Discussion Draft concludes that the valid approach to article 7(3) is the first interpretation discussed above, namely that it simply is intended to ensure that relevant expenses would be deducted against the income of a PE, and that it does not contain or justify any conflict or deviation from the arm's-length principle articulated in article 7(2) of the OECD MTC.<sup>284</sup>

##### 4.4.6.2 Article 7(4) and (5)

The 2004 Revised Discussion Draft indicates that the OECD is considering the deletion of both articles 7(4) and (5).<sup>285</sup> The OECD is of the view that article 7(4) is apparently redundant since the authorised approach to the interpretation and application of articles 7(1) to (3) is comprehensive enough to enable attribution in all possible circumstances. The 2005 Insurance Draft confirms this view.

Article 7(5) will be deleted because it is in conflict with the arm's-length principle articulated in article 7(2). For example, third parties contracting with each other would do so for profit when one party undertakes to purchase goods and merchandise on behalf of another.

<sup>283</sup> 2004 Revised Discussion Draft at § 289.

<sup>284</sup> Ibid at § 290 and 293.

<sup>285</sup> Ibid at § 300 and 303.

#### 4.4.7 Comments on the OECD's new authorised approach to the attribution of profits to a PE

As mentioned in the introduction to this chapter, the OECD's new authorised approach to the attribution of profits to a PE for double taxation relief purposes in terms of article 7(1) to (3) of the OECD MTC as articulated by the 2004 Revised Discussion Draft essentially entails an adaptation of the related party transfer pricing methodologies of the 1995 TP Guidelines.

This process of alteration is not an uncomplicated task since the transfer pricing guidelines are essentially transaction-based whereas dealings between an enterprise and its various parts, or PEs, are legally incapable of amounting to transactions. It follows that the main challenge of the OECD's new authorised approach is therefore to develop a methodology whereby an artificial transaction base can be constructed and imputed to the relationship between a GE and PE. It is only after such an imputed transaction basis has been established that the related party transfer pricing, or arm's-length comparability methodologies can be applied.

It was shown that at the heart of the imputed transaction base developed by the authorised approach is the concept of key entrepreneurial risk taking functions, which ascribes the threshold attributes to the imputed transaction base. In other words, a putative transaction can only be imputed to the relationship between a GE and its PE once the threshold for recognition of a dealing has been passed, which is generally the case if either the GE or PE performed a key entrepreneurial risk taking function. Key entrepreneurial risk taking functions is a novel concept that has no equal in the 1995 OECD TP Guidelines.

Below a summary is provided of a list of circumstances where the articulation of the authorised approach in the 2004 Revised Discussion Draft resorts to the concept of key entrepreneurial risk taking functions:

- In the functional analysis in respect of a PE (the starting point used to identify independent arm's-length transactions for comparison purposes), the people functions performed either at the fixed place of business PE, or by the dependent agent PE are important to identify activities (to correspond with transactions) that can be associated with the PE. If these people functions include key entrepreneurial risk taking functions, a greater attribution of assets and risk, and hence income and expenses to that PE would be justified. People functions that amount to key entrepreneurial risk taking functions are described as those 'which require active decision making with regard to the most important profit generators of the business' (see 4.4.3.1 above).
- When an asset has been attributed to the functions performed by a PE, the conditions of use thereof by the PE must be characterised. This is necessary so that the correct type of income or expense could be credited for tax purposes as between the GE and PE, eg a rent, royalty, interest, etc. Since conditions of use are normally reflected in legal agreements between separate entities, which are obviously not present between a GE

and PE, the comparable base suggested by the authorised approach to impute conditions of use between a GE and PE is the concept of economic ownership of assets. To identify which part of an enterprise is the economic owner of an asset, or a right of use, the authorised approach states that it will turn on the performance of key entrepreneurial risk taking functions in respect of the asset or the right of use (see 4.4.3.2 above);

- When determining the funding costs of a PE, the issue is under what circumstances a dealing should be recognised in respect of internal allocations of funds within one enterprise. It is only dealings that are similar to treasury-type transactions that would justify a mark-up, either on enterprise funds or in respect of an external debt charges. The authorised approach states that a treasury dealing would only be recognised if a PE is viewed as the economic owner of funds, which should be the case if the PE performs the key entrepreneurial risk taking functions in respect of those funds. In other words, a dealing will only be recognised as a 'loan', and hence justify a notional interest charge in the aforementioned circumstances. If the PE does not perform key entrepreneurial risk taking functions in respect of funds moved through it, only a service fee determined on a cost plus basis would be justified (see 4.4.3.5.3);
- When determining whether a PE is the economic owner of a capital asset, the authorised approach appears to indicate that the key-entrepreneurial risk taking functions in this context implies the following:
  - (i) Assumption of the responsibility of regular maintenance of the asset. Whether or not maintenance cost is significant is also relevant;
  - (ii) The capacity to recruit personnel or contract services to perform unforeseen repairs to the asset;
  - (iii) The capacity to decide when to replace the asset.

These *indicia* are also important to characterise a change of use of capital assets within the enterprise. If the above responsibilities and capacities shift to a PE, it could be viewed as acquiring the economic ownership of an asset, or if not, only as acquiring a right of use from that part of the enterprise that retains economic ownership (see 4.4.4.1 above);

- When determining whether a PE is the economic owner of an internally self-developed trade intangible such as, for example, a trademark, the authorised approach defines the key entrepreneurial risk taking functions in this context as those that require 'active decision-making with regard to the taking on and day-to-day management of individual risk and portfolios of risk'. This definition of key entrepreneurial risk taking functions directs the investigation of the level of management responsible for this kind of decision making, an analysis and evaluation of the dynamics of, for example, a particular research and development programme and specifically the nature of the decision-making process and level at which those decisions are taken. A further factor that could be viewed as a key

entrepreneurial risk taking function is whether any losses caused by a failed development process would be entertained by the purported economic owner (see 4.4.4.4.2 above);

- When the functions performed by a dependent agent type PE are evaluated to ascertain its risk profile for profit attribution purposes, the authorised approach lists the following key entrepreneurial risk taking functions as being of major importance:
  - (i) Contributions by the dependent agent PE to the development of a marketing or trade intangible of the enterprise;
  - (ii) The assumption by the dependent agent PE of any inventory risk, eg stock obsolescence or damages; and/or
  - (iii) The assumption of credit risk, eg doubtful or bad debts.

(see 4.4.5)

From the above summary of the points where the authorised approach resorts to the concept of key entrepreneurial risk taking functions, the following picture emerges:

- The activities performed by a PE that should enter the profit attribution computation (ie those that may be recognised as 'dealings') refer to those associated with the key entrepreneurial risk taking functions, which must be assessed by looking at the people functions of the PE that make 'active decisions regarding the most important profit generators of the business'.
- Funding activities in respect of internal reallocations of funds will only enter the profit attribution calculation if they amount to dealings, and a dealing is only recognised if key entrepreneurial risk taking functions are performed in respect of that internal reallocation.
- Economic ownership of assets such as between different parts of the same enterprise depends on which part performs the key entrepreneurial risk taking functions in respect of the asset, which will also influence the conditions of use by other parts.
- Key entrepreneurial risk taking functions in respect of capital assets refer to the assumption of maintenance obligations and an autonomous decision-making capacity in respect of that asset.
- Key entrepreneurial risk taking functions in respect of intangible assets refer to the active decisions as regards the risks associated with those intangibles.
- Key entrepreneurial risk taking functions in respect of the activities of a dependent agency PE refer to any contributions to marketing intangibles or the assumption of inventory or credit risk by the agent.

It appears that when this novel aspect of the authorised approach is reduced to its essentials as the above summary attempts to illustrate, not a lot of content is given to the concept of key entrepreneurial risk taking functions. What is quite clear is that the first step of the authorised approach, in effect, revolves around the detection of dealings as a result of certain activities identified on the basis of key entrepreneurial risk taking functions. These dealings then form the imputed transaction base to achieve comparison with third party arm's-length prices under step 2 of the authorised approach.

What is even more apparent is that the concept of key entrepreneurial risk taking functions would cause any residual profits available for attribution in a single enterprise, after providing for appropriate compensation to activities performed by the various parts of an enterprise, to be allocated to that part of the enterprise that performs the key-entrepreneurial risk taking functions. Indeed, this embedded aspect of the authorised approach has been seriously criticised by some commentators and branded as an unwarranted import of a source rule to the scheme of article 7 that could jeopardise the tax base of host countries.<sup>286</sup> Viewed in this light, the concept of key entrepreneurial risk taking functions appears to distort the current allocation balance of residence and source-taxing rights underscoring the scheme of article 7 of the OECD MTC.

There is force in the criticism of the acceptance by the authorised approach of deemed deductions for notional expenses in circumstances where the host (source) country does not impose a withholding type tax on such notional payments or achieves a full or partial recapture in another way, for instance, charging income tax at a higher rate for PEs as for separate entities.

From the South African perspective it could be argued that a partial or full recapture of the erosion of the tax base that would be brought about by the recognition on the treaty level of notional tax deductions between a PE and other parts of the enterprise of which it forms part, is achieved by the higher normal tax rate of 34% that applies to branches and agencies, and therefore to many PEs.<sup>287</sup>

The formulation by the various discussion drafts of the key entrepreneurial risk-taking functions appears to be appropriate to activities that are typically carried on by the financial services industry. The question must be asked of how relevant the content so given to the concept of key entrepreneurial risk taking functions is to business activities carried on through a PE engaged in other industries, for example, mining or oil and gas exploration. For mining or oil and gas exploration activities, the location of the particular resource is the determining factor for localising the source of revenue from its exploitation – clearly an application of the concept of key entrepreneurial risk taking functions to attribute profits to PE operating in these industries could have a vastly

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<sup>286</sup> Edgar, T. and Holland, D. 2005. *Source Taxation and the OECD Project on Attribution of Profits to Permanent Establishments Tax Notes International*. 37: 525 at Part VI.

<sup>287</sup> It was shown at 2.4 that there are circumstances where mismatches may arise as regards the higher tax rate for branches and agencies and the presence of a PE in South Africa.

different result based on its focus on people functions (ie the taking of active decisions concerning risk or main profit generators of the business).

But perhaps the introduction of the authorised approach should be considered at a more fundamental level in the context of the basic scheme of tax allocation adopted by the OECD MTC. Vann describes the taxation of business profits under the OECD MTC very accurately by reflecting on the arm's-length principle in the context of the PE taxation:<sup>288</sup>

The introduction to [the 1995 OECD TP Guidelines] talks about the application of the arm's-length principle in terms of both separate companies and PEs and in both residence and source situations without articulating clearly what is meant. In policy terms, we usually consider that the residence country is the place with which the *taxpayer* has the closest connection, while the source country is the place with which the *income* has the closest connection. When the arm's-length principle is looked at in this light, in the case of separate companies the function of the principle is to connect income with a taxpayer, while in the case of a PE it is to connect income with a jurisdiction.

...The PE rule requires us to connect income with a jurisdiction, and this does not require a transaction to be linked to a taxpayer. Hence there is a reason in the very way in which the PE rule operates to conclude that transactions are not of the essence for PEs. ...there are some deep-seated intuitions that lead us to conceive of the arm's-length principle differently for PEs and separate companies.

In light of these conceptual differences in the application of the arm's-length principle to separate entities and to PEs described by Vann, one may expect that one approach should give way. Indeed, the authorised approach appears to now have made that choice by opting for the transactional separate entity approach for PE taxation congruent with the approach applied to separate entities.

However, the question should always be whether it is necessary to harmonise this difference of how one conceives of the arm's-length principle in these two fundamentally different circumstances. Why can we not live with both approaches?

As illustrated by Vann above, imputing a transaction-base by requiring detection of dealings between a GE and PE is contrary to the way we envision business profits to be taxed by article 7 of the OECD MTC on a fundamental level – dealings as such are not necessary to connect income to a jurisdiction, and, it is added, are quite a poor indicator to achieve justified source-based taxation. It is maybe for these reasons that the novel concept of key entrepreneurial risk taking functions has been introduced.

As mentioned earlier, the concept of key entrepreneurial risk taking functions has no equal the 1995 OECD TP Guidelines. More importantly, it functions as a type of source rule because of the embedded feature that it would ascribe residual profits to the

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<sup>288</sup> Vann, Richard J. in Arnold *et al.* 2003. *The Taxation of Business Profits under Tax Treaties* Toronto: Canadian Tax Foundation, at 142 *et seq.*

residence or home country by way of linking these profits to the part of the enterprise performing the balance of these type functions.

The answer therefore appears to be that the difference of how one conceives the arm's-length principle in the two fundamentally different circumstances of PE taxation and taxation of separate enterprises, has not been fully harmonised because of the introduction of the key entrepreneurial risk taking functions concept. Strictly speaking we therefore will continue to live with two approaches to the application of the arm's-length principle in the case of intra-company dealings and related party transactions, although they are now aligned much closer, at least in appearance and methodology.

Below, some of the problems with the authorised approach of a less fundamental nature are discussed.

The authorised approach does not explore in any detail the very concept of separateness within one entity. Particular questions include whether separateness should be based on the geographical location of a PE's business, or does separateness refer to the business activities attributable to PE, wherever located?

For example, under the scheme adopted by the authorised approach it is not certain whether activities occurring where another part of an enterprise is located in a third country, or the home country, could be viewed as an activity that properly belongs to that performed by the PE if it relates to the business carried on by the PE. Admittedly this may mainly be a question of fact. Guidelines to assist the process of cleaving and sorting the many activities of one enterprise that may simultaneously occur in a number of countries will nevertheless be useful.

When the capital attributable to a PE is calculated (it is required to support functions undertaken, asset used and risks assumed), an enterprise is free to adopt any one of a number of justifiable valuation methods in respect of assets and risks ascribable to the PE (see 4.4.3.5.2). Given the myriad of valuation methods that are all more or less defensible in contemporary business practice, this open-endedness could lead to fairly divergent results. It is suggested that this issue should be addressed since otherwise a theoretically correct application of all the theories and mechanics of the authorised approach could easily be thwarted to achieve abusive results.

From a practical perspective, the authorised approach poses an arduous analysis of the whole of an enterprise's business simply for purposes of attributing profits to one part thereof, namely the PE in question. It has been said that there is an ever-present tendency for tax reforms to put the conceptual cart before the practical horse.<sup>289</sup> Indeed, one wonders how revenue authorities, tax officials, taxpayers and above all, national courts facing decades of entrenched thinking, habit and practice about profit allocation to PEs will react, as the authorised approach has the appearance of a very involved technical exercise at odds with the way article 7 of the OECD MTC is presently perceived to operate. It must be observed that the OECD's reform project appears to be overly ambitious as regards practical implementation.

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<sup>289</sup> Surrey, S.S. 1958. *Tax Administration in Underdeveloped Countries*. Law Review 12(2): 2 158 at 188.

## 4.5 The UN MTC

### 4.5.1 Rational for the UN MTC

It is a known fact that South Africa negotiates to include aspects of the UN MTC in its DTCs, although these DTCs are generally based on the OECD MTC.

The position of the UN MTC as regards PE profit attribution will thus be briefly examined to ascertain whether it would present any problem should South Africa adopt the OECD's new authorised approach.

In the main, the UN MTC gives more weight to the source principle than does the OECD MTC.

The creation of the UN MTC from the OECD MTC was foreshadowed in 1965 when the Fiscal Committee of the OECD acknowledged that:<sup>290</sup>

the traditional tax conventions have not commended themselves to developing countries.

... the essential fact remains that tax conventions which capital-exporting countries have found to be of value to improve trade and investment among themselves and which might contribute in like ways to closer economic relations between developing and capital-exporting countries are not making sufficient contributions to that end ... Existing treaties between industrialized countries sometimes require the country of residence to give up revenue. More often, however, it is the country of source which gives up revenue. Such a pattern may not be equally appropriate in treaties between developing and industrialized countries because income flows are largely from developing to industrialized countries and the revenue sacrifice would be one-sided.

The UN MTC is essentially a copy of the OECD MTC save for certain provisions that provide for expanded source taxing rights. In this way, the UN MTC is meant to be a more appropriate model from a tax policy perspective whereupon developing countries may base their DTCs with developed countries.

In respect of the taxation of business profits, the UN MTC expands source state taxing rights as opposed to the OECD MTC. The following features of the UN MTC indicate such an expansion of source-based taxing rights:

- The threshold for source-based taxation under a treaty is lowered in certain cases by the definition of a PE;
- Source-based taxation of royalties is allowed in much the same way as the OECD MTC allows source-based taxation of interest;
- Provision is made to opt for the force of attraction rule to operate in circumstances where PE source taxation is permitted;

<sup>290</sup> United Nations. 2006. *Introduction to the Commentaries on the articles of the United Nations Model Double Taxation Convention between developed and developing countries*. Amsterdam: IBFD

- Certain categories of deemed profits and deductions are expressly disallowed in respect of intra-company GE-PE dealings for purposes of attributing profit to a PE source tax claim.

For purposes of this study, the discussion below is restricted to the UN MTC's express provisions differing from that of the OECD MTC in so far as PE profit attribution is concerned, namely article 7(1) and (3).

#### 4.5.2 Article 7 of the UN MTC

Article 7(2) of both the UN and OECD MTCs are identical. The formulation of the arm's-length principle for PE profit attribution purposes is thus identical in both models.

However, articles 7(1) and (3) of the UN MTC differ from articles 7(1) and (3) of the OECD MTC in the following way (differences are *italicised*):<sup>291</sup>

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) *sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.*
3. *In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.*

<sup>291</sup> Van Raad, K. 2005. *Materials on International Tax and EC Law* 5<sup>th</sup> Edition. Leyden: International Tax Centre.

Article 7 of the UN MTC also excludes article 7(5) of the OECD MTC, which deals with the question of whether profits should be attributed to a PE by reason of the mere purchase by that PE of goods or merchandise for the enterprise.

As regards the differences between article 7(1) of the UN MTC and that of the OECD MTC, selecting either subparagraphs (b) and (c) of the UN version allows the operation of the so-called force of attraction rule in a host country of a PE. The application of either subparagraphs (b) or (c) is limited to business profits covered by article 7 and does not extend to income from capital (dividends, interest and royalties) covered by other treaty provisions.<sup>292</sup>

The explanation provided for the differences between article 7(3) of the UN and OECD MTCs is as follows:<sup>293</sup>

The application of the arm's-length rule is particularly important in connexion with the difficult and complex problem of the deductions to be allowed to the permanent establishment ... Apart from what may be regarded as ordinary expenses, there are some classes of expenditure that give rise to special problems. These include interest and royalties etc. paid by the permanent establishment to its head office in return for money lent or patent rights licensed by the latter to the permanent establishment. They further include commissions (except for the reimbursement of actual expenses) for specific services or for the exercise of management services by the enterprise for the benefit of the establishment. In these cases, it is considered that the payments should not be allowed as deductions in computing the profits of the permanent establishment. Conversely, such payments made to a permanent establishment by the head office should be excluded from the profits of the permanent establishment.

Some ... members also felt that provisions prohibiting the deduction of certain expenses should be included in the text of a bilateral tax treaty to make it clear that taxpayers were fully informed about their fiscal obligations.

From the text of article 7(3) and the commentaries thereon it is clear that UN MTC's position on the application of the arm's-length principle to the relationship between a PE and the rest of the enterprise of which it forms part undoubtedly differs from that of the OECD under its new authorised approach.

The UN MTC specifically discards the possibility that certain type GE-PE dealings can be recognised for profit attribution purposes. These disallowed dealings appear to be restricted to those concerning the use of intangibles, the provision of services including management, and capital funds. In this way, no possibility arises for deemed profits or deductions of a PE based on notional royalties, commission for services including management, and notional interest.

What is not very clear is the reason why the above types dealings are specifically disallowed by the UN MTC. The commentaries do not provide any

<sup>292</sup> Commentaries of article 7(1) of the UN MTC.

<sup>293</sup> General considerations of the commentaries on article 7 of the UN MTC, and commentaries on article 7(1) of the UN MTC.

substantial reason apart from expressing a position which is at least clear on an otherwise grey area for purposes of certainty.

#### **4.5.3 Article 7(3) of the UN MTC is incompatible with aspects of the OECD's new authorised approach to the attribution of profits to a PE**

Many of the provisions of article 7(3) of the UN MTC are quite clearly incompatible with aspects of the OECD's Discussion Drafts on profit attribution to PEs.

The authorised approach as embodied in the 2004 Revised Discussion Draft specifically differs from article 7(3) as regards the application of the arm's-length principle for purposes of PE profit attribution. As indicated above in 4.5.2, the UN MTC expressly discards the recognition of mark-ups in respect of GE-PE dealings concerning the use of intangibles, the provision of services including management, and capital funds. In contrast, the OECD's new authorised approach expressly recognises that the application of the arm's-length principle mandated by article 7(2) justifies such mark-ups to be taken into account in appropriate circumstances.

Other aspects of the OECD's new authorised approach, such as recognising dealings as regards the provision of capital assets, or change in use of capital assets within one enterprise, is not addressed at all by the UN MTC or its commentaries. Theoretically, such dealings could therefore be recognised where a treaty is based on article 7(3) of the UN MTC. In the face of the attitude and spirit of article 7(3), such a recognition of intra-company dealings not expressly excluded under the UN MTC appears improbable.

For banks exposed to PE source-state taxation, the UN MTC explicitly allows the recognition of GE-PE dealings in so far as the provision of funds are concerned, since it states that deductions and profits in respect of interest can be taken into account in calculating attributable profits to a bank's PE. The commentaries on the UN MTC do not, unfortunately, state anything in respect of this exception allowed to bank PEs. It is therefore quite impossible to say whether the approach mooted by the OECD for calculating deemed interest in respect of a bank's PE would apply under article 7(3) of the UN MTC.

It is understood that the UN has not officially expressed any position on the work undertaken by the OECD since 2001 in respect of profit attribution to PEs. Whether the UN would react, reject or approve of the OECD's new authorised approach to article 7 of the OECD MTC remains to be seen.

Below, the provisions concerning the taxation of business profits under South Africa's veritable network of DTCs are examined to establish under which DTCs the compatibility problem caused by UN MTC's article 7(3) is present.

#### **4.6 Overview of the business profits articles in South Africa's veritable network of DTCs**

The South African fiscal authorities have no pronounced policy on the attribution of profits to a PE under South Africa's DTCs. South Africa also does not have any formally pronounced policy in respect of the conclusion of DTCs and generally bases its DTCs on the OECD MTC.

In line with government's view that South Africa is a developmental state, DTCs are negotiated to incorporate a number of elements of the UN MTC such as incorporating elements of article 5 (definition of PE), 7 (taxation of business profits) and 12 (taxation of royalties) of the UN MTC.

In recent years, South Africa also appears in terms of DTC practice to include a specific article dealing with technical fees in its DTCs. This DTC practice provides a further deviation from article 7 of the OECD MTC. The provisions of technical fees articles contained in South Africa's DTCs are generally based on article 12 of the UN MTC, which deals with royalties and allows taxation by the source state.

The question is whether a general approach or policy relating to PE profit attribution could be gleaned from an examination of the actual provisions of South Africa's DTCs. The table below therefore lists South Africa's operative DTCs and attempts to show a number of aspects which tend to indicate an expanded appetite for source-based taxation as opposed to the position of the OECD MTC.

Thus, in respect of each treaty, an indication is given of whether business profits are dealt with in accordance with one of the model tax conventions. If article 7(3) of the UN MTC is followed, it is indicated whether the exception for bank PEs is allowed as regards the recognition of GE-PE dealings in funds. It is also indicated whether technical fees are dealt with separately from the taxation of business profits.

	<b>Country and year of conclusion</b>	<b>Article 7 (or similar) based on</b>	<b>Notional interest expressly allowed for bank PEs</b>	<b>Technical fees separately handled</b>
1	Algeria 2000	1992 - 2003 OECD MTC; article 7(3) follows the UN Model	Yes	No
2	Australia 1999	1992 - 2003 OECD MTC with some additions	No	No
3	Austria 1997	1992 - 2003 OECD MTC with some additions	No	No
4	Belarus 2004	1992 - 2003 OECD MTC	No	No
5	Belgium 1998	1992 - 2003 OECD MTC	No	No
6	Botswana 2004	1992 - 2003 OECD MTC; articles 7(3) and (5) follow UN Model	Yes	Yes
7	Bulgaria 2005	1992 - 2003 OECD MTC with some adjustments	No	No
8	Canada 1997	1992 - 2003 OECD MTC	No	No
9	China 2001	1992 - 2003 OECD MTC	No	No
10	Croatia 1997	1992 - 2003 OECD MTC	No	No
11	Cyprus 1998	1992 - 2003 OECD MTC	No	No
12	Czech Republic 1998	1992 - 2003 OECD MTC	No	No
13	Denmark 1995	1992 - 2003 OECD MTC	No	No
14	Egypt 1998	1992 - 2003 OECD MTC	No	No
15	Finland 1995	1992 - 2003 OECD MTC without the article 7(4) equivalent.	No	No
16	France 1995	1992 - 2003 OECD MTC without	No	No

<b>Table of South Africa's DTC network (October 2005): Overview of business profit provisions</b>			
<b>Country and year of conclusion</b>	<b>Article 7 (or similar) based on</b>	<b>Notional interest expressly allowed for bank PEs</b>	<b>Technical fees separately handled</b>
	the article 7(4) equivalent.		
17	Germany 1973	Resembles 1946 London Model	No
18	Greece 2003	1992 - 2003 OECD MTC without the article 7(4) equivalent	No
19	Hungary 1996	1992 - 2003 OECD MTC	No
20	India 1997	1992 - 2003 OECD MTC	No
21	Indonesia 1999	1992 - 2003 OECD MTC; article 7(1) follows the UN Model	No
22	Iran 1998	1992 - 2003 OECD MTC	No
23	Ireland 1997	1992 - 2003 OECD MTC	No
24	Israel 1979	1977 OECD MTC with some modifications and additions	No
25	Italy 1999	1992 - 2003 OECD MTC	No
26	Japan 1997	1992 - 2003 OECD MTC	No
27	Korea 1996	1992 - 2003 OECD MTC without the article 7(4) equivalent	No
28	Lesotho 1997	1992 - 2003 OECD MTC	No
29	Luxembourg 2000	1992 - 2003 OECD MTC without the article 7(4) equivalent	No
30	Malawi 1971	Resembles 1946 London Model	No
31	Malta 1997	1992 - 2003 OECD MTC with some additions	No
32	Mauritius 1997	1992 - 2003 OECD MTC; article 7(3) follows the UN Model.	Yes
33	Namibia 1999	1992 - 2003 OECD MTC; article 7(3) follows the UN Model.	Yes
34	Netherlands, the 1971	1963 OECD MTC	No
35	New Zealand 2004	1992 - 2003 OECD MTC with some additions	No
36	Norway 1996	1992 - 2003 OECD MTC	No
37	Oman 2004	1992 - 2003 OECD MTC; article 7(3) follows the UN Model	Yes
38	Pakistan 1999	1992 - 2003 OECD MTC; article 7(3) follows the UN Model	Yes
39	Poland 1996	1992 - 2003 OECD MTC	No
40	Romania 1995	1992 - 2003 OECD MTC	No
41	Russia 2000	1992 - 2003 OECD MTC without the article 7(4) equivalent	No
42	Seychelles 2003	1992 - 2003 OECD MTC; article 7(3) follow the UN Model	Yes
43	Singapore 1998	1992 - 2003 OECD MTC without the article 7(4) equivalent	No
44	Slovakia 1999	1992 - 2003 OECD MTC	No
45	Swaziland 2005	1992 - 2003 OECD MTC	No
46	Sweden 1995	1992 - 2003 OECD MTC	No
47	Switzerland 1967	1963 OECD MTC with some	No

<b>Table of South Africa's DTC network (October 2005): Overview of business profit provisions</b>				
<b>Country and year of conclusion</b>		<b>Article 7 (or similar) based on</b>	<b>Notional interest expressly allowed for bank PEs</b>	<b>Technical fees separately handled</b>
		additions		
48	Tanzania 1960	Resembles 1946 London Model	No	No
49	Thailand 1996	Article 7 UN Model	No	No
50	Tunisia 1999	1992 - 2003 OECD MTC without the article 7(4) equivalent; article 7(3) follows the UN Model	Yes	Yes
51	U.S. 1997	1992 - 2003 OECD MTC: articles 7(1), (2), (4), (5) and (6); UN Model: article 7(3); US Model: article 7(7)	No	No
52	Uganda 2001	1992 - 2003 OECD MTC without the article 7(5) equivalent; article 7(3) follows the UN Model with some modifications	Yes	Yes
53	UK 2002	1992 - 2003 OECD MTC without the article 7(4) equivalent	No	No
54	Ukraine 2005	1992 - 2003 OECD MTC; article 7(3) follows the UN Model	Yes	No
55	Zambia 1960	Resembles 1946 London Model / League of Nations	No	No
56	Zimbabwe 1965	Resembles 1946 London Model / League of Nations	No	No

It appears from a comparison of the business profits provisions of South Africa's network of DTCs that in 20% of the DTCs, article 7(3) of the UN MTC is followed, most notably in the DTC with the U.S.A. The DTCs incorporating elements of the UN MTC all post-date 1994.

– As discussed in 4.5.3 above, it is quite clear that when a DTC is based on article 7(3) of the UN MTC, the recognition of certain GE-PE dealings in terms of the OECD's new authorised approach to PE profit attribution would not be able to find application under that DTC, except in the case of notional interest income and charges for banking enterprises. A further observation is that there appears to be a trend to omit article 7(4) of the OECD MTC from South Africa's DTCs as a matter of DTC policy. Article 7(4) provides for an alternative basis for PE profit attribution based on apportionment of total profits to the various parts of an enterprise. This position is congruent with the OECD's authorised new approach, as the 2004 Revised Discussion Draft suggests the deletion of article 7(4) of the OECD MTC.

In most of South Africa's DTCs the definition of a PE incorporates the extended source taxing provisions encountered in the UN MTC's PE definition, most frequently that of article 5(3) of this model. It therefore seems that, since 1994, the South African fiscal authorities have had a certain bias to prefer DTC provisions that provide for extended source-taxing rights compared with those granted under the OECD MTC in so

far as business profits and related type income (ie royalties and technical fees) are concerned.

Moreover, the adoption by South Africa since 1994 of article 7(3) of the UN MTC in approximately 20% of its operative DTCs, could suggest reluctance and/or difficulty to adopt the OECD's authorised new approach to PE profit attribution as articulated in the various discussion drafts published on this subject since 2001. Consequently, should South Africa adopt the OECD's new approach to PE profit attribution, our courts are likely to experience problems in establishing the legal basis for applying this approach under existing DTCs.

There is no local case law in respect of the application of the arm's-length principle for purposes of attributing profits to a PE under one of South Africa's DTCs. There is, however, a Rhodesian case that concerned the application of the arm's-length principle for purposes of attributing profits to a PE in respect of a DTC to which South Africa was party. This chapter is concluded by a discussion of the Rhodesian case.

#### **4.7 The decision in *Anglo-American Corporation of SA Ltd v Commissioner of Taxes***

A decision in 1974 by the Rhodesian Appellate Division in the case of *Anglo-American Corporation of SA Ltd v Commissioner of Taxes*<sup>294</sup> concerned the application of the PE profit attribution rule contained in the 1965 South Africa – Rhodesia DTC.

The case is analysed below since it is the only case of which the author is aware, that addresses in some detail questions concerning PE profit attribution in terms of one of South Africa's DTCs. Although the case provides no binding authority in respect of this issue on the South African courts, it is nonetheless important based on our court's general willingness to consider judgements delivered on taxation matters in neighbouring countries pursuant to the similarity of these countries income tax systems and common legal heritage.

##### **4.7.1 Facts**

The appellant, the *Anglo-American Corporation of SA Ltd*, was incorporated in South Africa. It had its head office in South Africa and a branch office in the former Rhodesia, now Zimbabwe.

The appellant had a number of subsidiaries and associated companies in both South African and Rhodesia, and acted as a treasurer for and collection agent on behalf of these companies:

- Money was lent to these companies on interest-bearing loan accounts and interest-bearing deposits placed in current or call accounts were accepted from these companies;
- Moneys were collected by the appellant in South Africa and in Rhodesia on behalf of both South African and Rhodesian subsidiaries and associated companies. A commission was charged by the appellant for the provision of

<sup>294</sup> 1975 (1) SA 973 (RA); 37 SATC 45

this service. Moneys so collected were, for example, in respect of dividends or interest owed to subsidiaries or associated companies.

In so far as the collection agent services were concerned, the modalities of the relevant transactions giving rise to the dispute before the court were as follows. When moneys were collected in Rands in South Africa by the appellant's head-office on behalf of, for example, one of its a Rhodesian subsidiaries, the account of that subsidiary with the Rhodesian branch of the appellant was immediately credited with the Rhodesian dollar equivalent amount of the Rand amount collected in South Africa. These entries were irreversible. A credit note was simultaneously issued by the branch to the Rhodesian subsidiary, which, together with credit entry in its account with the branch, constituted payment to that subsidiary by its agent, the appellant.

The South African head office and the Rhodesian branch kept inter-office accounts that recorded the sums collected in respectively South Africa or Rhodesia for the benefit of subsidiaries or associated companies in one or the other country. Moneys collected by one office were never actually physically transmitted to the other office. These monies were not held in separate trust or special accounts, but became part of the appellant's funds in South Africa and Rhodesia.

Differences in the balances of the inter-office accounts between the head-office and branch were cleared by book entries. For example, when the South African head-office collected an amount on behalf of a Rhodesian subsidiary, the Rhodesian branch would have a credit balance with the head-office after it effected payment of that amount to that Rhodesian subsidiary. If the Rhodesian branch subsequently collected an amount on behalf of a South African subsidiary, the credit arising for the head-office on the branch accounts as a result of it having effected payment of this amount to that South African subsidiary, would be cleared against the branch's credit balance on the head-office account.

At the end of 1971, the Rhodesian branch office was in credit with the South African head-office by the amount of R 1 467 683. The Rand was devalued at that time as against the Rhodesian Dollar. After the said devaluation, the Rhodesian Dollar equivalent of the credit balance was \$ 1 287 441 instead of \$ 1 467 683, which it had been before the devaluation. The appellant claimed a tax deduction for the difference of \$ 180 242 as a foreign exchange currency loss against the taxable income of the Rhodesian branch. The Rhodesian tax authorities disallowed the deduction against the branch's Rhodesian income of the foreign exchange currency loss occasioned by branch's credit balance with the South African head-office.

The appellant relied on clause III(2) of the Double Tax Convention concluded by South African and Rhodesia in 1965 (the DTC) for the suggestion that the business carried on through the Rhodesian branch had to be considered as though it were 'an independent enterprise'.

The appellant's line of reasoning was that as an existing independent enterprise, the branch was entitled to be reimbursed for payments made to Rhodesian creditors (ie subsidiaries or associated companies) by the appellant's independent enterprise in South Africa, namely the head-office. With the devaluation of the South African Rand,

so the appellant argued, its Rhodesian branch, as an independent enterprise, suffered a tax deductible loss in respect of reimbursements denominated in the devalued currency which it received from its other independent enterprise, the South African head-office.

Article III(2) of the DTC determined as follows:

Where an enterprise of one of the territories is engaged in trade or business in the other territory through a permanent establishment situated therein –

(a) there shall be attributed to that permanent establishment the industrial and commercial profits which it might be expected to derive in that other territory if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment.

#### 4.7.2 Issues for decision

The court had to determine whether the Rhodesian branch of the appellant was allowed to claim a tax deduction in terms of article III(2) of the DTC on the basis that:

- The Rhodesian branch of the appellant suffered a foreign exchange loss in respect of its credit balance with the appellant's South African head-office; or
- The Rhodesian branch of the appellant, as an independent enterprise, suffered a loss in respect of reimbursements received from the South African head-office for expenses incurred on behalf of and in respect of creditors of that head-office.

#### 4.7.3 Decision

The court held that the Rhodesian branch of the appellant was not allowed to claim a tax deduction in terms of article III(2) of the DTC on the basis that it suffered a foreign exchange loss in respect of its credit balance with the appellant's South African head-office, or on the basis that it suffered a loss, as an independent enterprise, in respect of reimbursements received from the South African head-office for expenses incurred in respect of creditors of that head-office.

#### 4.7.4 Reasons

The court's majority decision, delivered by Judge President Macdonald (Judge of Appeal Lewis concurring), provided the following reasons for the above-mentioned decision.

The collection agent dealings (eg credit or debit entries) between the South African head-office and Rhodesian branch of the appellant were not legally 'transfers' of money. Such dealings were dictated by 'practical business considerations', and not by a necessity arising on a legal ground to reimburse the branch for a particular payment made by it on behalf of the head-office.

The court held that the fact that the appellant could be required in terms of Rhodesian foreign exchange regulations to physically remit funds to the Rhodesian branch in circumstances where it held a foreign exchange balance outside Rhodesia,

such as its credit balance with the South African head-office, did not in any way alter the legal nature of the dealings between the head-office and the branch. The amount of any such physical remittance required by the Rhodesian exchange control authorities would relate to the general state of a foreign exchange balance, and not to a particular transaction of the branch or head-office.

In respect of the DTC, the majority reasoned that article III(2) thereof requires that an 'independent enterprise' must be regarded, for purposes of assessing its profits under the treaty, as though it were:<sup>295</sup>

engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment.

The majority held that, dealing at arm's length, the Rhodesian branch could never be considered to agree that a claim for reimbursement of the expense of \$ 1 467 683, paid out on behalf of the South African head-office, could be satisfied with a payment of \$ 1 287 441.

It was inconceivable to the majority that 'independent enterprises' would enter into an agreement for the mutual discharge of each other's debts in their respective countries and agree that the risk of currency devaluation would fall on the party who made the payment to a creditor, and not on the party at whose request the debt is discharged. The evidence tendered by the appellant showed that such an arrangement never existed between the head-office and the branch.

The court held that even if such an arrangement did exist, it would not be binding on the Rhodesian tax authorities in light of article III(2) of the DTC. In other words, the tax deduction claimed by the branch would not be allowed since the arrangement as to currency risk did not accord with arm's-length behaviour between independent enterprises. The majority also held that the method chosen by the appellant to record the collection agent transactions in its books of account in South African and Rhodesia did not affect its conclusion.

The reasons provided by minority judgement, delivered by the Chief Justice Beadle, differed from the majority's reasons although the court order was agreed. The minority of the court recognised that in so far as the inter-office book keeping as between the Rhodesian branch and the South African head-office was concerned, it did not coincide with the collection of moneys by, for example, the South African head-office and the simultaneous payment by the Rhodesian branch office to a Rhodesian subsidiary or associated company of the appellant. The amount collected in South Africa remained on the head-office books as a credit to the Rhodesian branch until such time as moneys were collected in Rhodesia by the branch on behalf of South African subsidiaries, which amount was then 'set-off' against the branch's credit in the head-office books.

The minority held that the reality of the dealings between the branch and the head-office was that when the branch of the taxpayer company had paid out an amount

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<sup>295</sup> 37 SATC 45 at 54.

to, for example, one of its Rhodesian subsidiaries, a 'claim' immediately accrued to the branch for the currency equivalent collected in South Africa by the head-office of the appellant. This 'claim' did not accrue at some other arbitrary later date when, for example, a balance was struck between the branch and head-office accounts, or when a debt owed to the head-office was 'set-off' against a debt owed to the branch. The minority held that that Rhodesian branch had incurred no loss, as it had never paid out any more Rhodesian dollars than the Rand currency equivalent collected by the South African head-office.

The devaluation of the South African currency only intervened, according to the minority judgement, on an entirely artificial basis:<sup>296</sup>

the important factor to be borne in mind in this case is that we are dealing with one individual taxpayer and the internal accounts of that taxpayer and not with transactions between different personae ... an individual taxpayer ... obviously cannot make agreements with himself which will effect his tax liability. It would certainly be most anomalous if a taxpayer was permitted to so adjust his business by making agreements with himself (assuming such a thing to be legally possible) so as to avoid the incidence of tax or to claim deductions from tax which he would not otherwise be entitled to do.

As to article III(2) of the DTC, the minority judgement recognised that the Rhodesian branch should in effect be regarded as a separate persona 'so far as taxing the profits which have their source in one or other of the countries is concerned' and that it 'is, however, a necessary provision in order to avoid the incidence of double taxation'.

The minority went on to say that article III(2) of the DTC does not influence its conclusion that the manner in which the appellant chose to keep its inter-branch office accounts was not decisive in determining whether it could claim a tax deduction in the way it did.

#### 4.7.5 Comment in respect of the majority judgement

The *Anglo-American* case is the only court decision that gives some indication of how Southern African courts would approach the question of profit attribution to PEs under DTCs. It is significant that both the court's majority and minority judgments rejected the accounting records of the appellant's branch in so far as dealings with its head-office were concerned in order to establish whether its taxable income was correctly assessed.

Since 1933, when the League of Nations produced a first Draft Convention on the Allocation of Profits (see 4.2.2) up to at least the OECD's reform project initiated in this area in 2001, branch accounting generally formed the basis for purposes of profit attribution to PEs under DTCs (see 4.2.4 and 4.3.1.1).

Until at least 1999, it was the practice of the South African tax authorities to assess PEs on the basis of separate branch accounts, with necessary adjustments for

<sup>296</sup> 37 SATC 45 at 52.

head-office expenses, in circumstances where a DTC was applicable. This aspect of the judgement confirms that separate branch accounts are thus not the ultimate for establishing the taxable profits of a PE under a DTC based on the model conventions of the League of Nations, OECD or UN.

As regards the majority decision, the court appeared to disallow the deduction for a loss on the reimbursement received by the branch from the head-office on the basis that an arrangement to this effect was not reconcilable with article III(2) of the DTC because it did not accord with arm's-length behaviour of independent parties. It is quite clear that the majority judgement recognised that the application of the arm's-length principle underscores the PE profit attribution issue on the DTC level.

It is significant that this identification of the role of the arm's-length principle took place in the context of a municipal income tax system which, at the time of this decision, contained no statutory embodiment of the arm's-length principle on the municipal level, not even between connected parties. What is not entirely clear from the majority's judgement is whether the court was prepared to allow the deduction on the reimbursement basis if evidence were to be provided to show that such an arrangement may be consistent with independent party behaviour. It seems that the court was prepared to do so were it provided with convincing evidence.

It is, for example, conceivable that independent parties could enter into an arrangement for the mutual discharge of each other's debts in their respective countries, similarly to the arrangement between the branch and head-office in the present matter, and agree that the risk of currency devaluation would fall on the party who made a payment to a creditor on behalf of the other. The pertinent agreement between such independent parties could be that the party so carrying the foreign currency risk would receive an appropriate fee for assuming this risk. This would mean that, whilst a deemed deduction would be allowed in terms of article III(2) of the DTC for any loss occasioned by a devaluation of the currency of the reimbursement, an appropriate deemed remuneration in respect of the currency risk assumed would also have to be taken into account for purposes of attributing profits to the branch under the DTC.

Reading the majority judgement in this way means that a deduction for a deemed expense would be justified under article III(2) of the DTC. Whilst this proposition appears to be irreconcilable with the minority judgement in this case, it must be remembered that the theory on profit attribution to PEs internationally, especially the work in recent years of the OECD on article 7(2) of the OECD MTC, has increasingly moved towards the full recognition of 'dealings' between a head-office and branch, as this chapter sought to indicate.

Consequently the majority judgement in the *Anglo-American* case, at the very least, does not exclude the possibility of tax deductions for deemed expenses of a PE under DTC profit attribution rules, and, on a parity of reasoning, the recognition of deemed income for PEs. In this regard, the majority judgement concurs more with present theories on profit attribution to PEs under DTCs than that of the minority judgement.

#### 4.7.6 Comment in respect of the minority judgement

The minority judgement is clear on the legal basis why, in terms of domestic law, the accounting loss of the appellant's branch could not be deducted for tax purposes (see the quoted reasons above at 4.7.4). The reason provided by the minority judgement why article III(2) of the DTC did not alter the conclusion reached under domestic law, is, on the other hand, rather vague.

The court appeared to regard the situation of the appellant as one which does not concern an instance of actual international double taxation, and for this reason, the application of the arm's-length principle could not be invoked under article III(2) of the DTC (In a later decision by the Natal Income Tax Special Court,<sup>297</sup> and confirmed by the Appellate Division in the *Downing*-case,<sup>298</sup> the occurrence of actual double taxation was rejected as a general pre-requisite for a taxpayer to rely on treaty exemption from source state taxation of business profits).

To try and understand the argument of the minority, some background information about the national tax systems of South Africa and Rhodesia, at the time when this dispute arose, is necessary. Both countries charged income tax on the basis of the source of income, and not on the basis of the residence of a taxpayer. The practice under these systems was that tax deductions were only allowed in respect of income received from a local – thus taxable – and not a foreign, non-taxable source.<sup>299</sup>

Considering the source rules applicable to the type of income (eg dividends or interest) collected by the head-office in South Africa on behalf of Rhodesian subsidiaries, the source thereof in all probability was located in South Africa. Hence the Rhodesian branch, in effect, appears to have claimed a deduction against foreign source, non-taxable income. This meant that for DTC purposes, the branch had no Rhodesian taxable 'profits' in respect of the collection agent activities.

The minority judgement probably indicated that the DTC could not be applied to allow a loss for the branch in circumstances where no loss would have been allowed in terms of Rhodesian municipal tax law. Nonetheless, the reasons provided by the minority judgement in the *Anglo-American* case relating to the DTC issues unfortunately remain rather sketchy.

#### 4.8 Concluding remarks

The point of departure for the analysis in this chapter was the identification of the function of article 7 of the OECD MTC, namely the attribution of profits to a PE for the two-fold purpose of calculating the limit on a host country's source-based tax claim, and calculating the amount of profit which the home/residence country is obliged to take into consideration when relief by way of credit/exemption is afforded for double taxation of the GE's worldwide business profits.

<sup>297</sup> *L.J. Downing v Secretary for Inland Revenue* Unreported decision of 27 October 1972 in case number 6737 of the Natal Income Tax Special Court; the text is obtainable from the IBFD's on-line Tax Treaty Case Law Database (<http://www.ibfd.org>).

<sup>298</sup> *SIR v Downing* 1975 (4) SA 518 (A); 37 SATC 249

<sup>299</sup> *Passos supra* at 132.

From the overview of the history of article 7, it was established that under the international model conventions of the League of Nations, the O.E.E.C., OECD and UN the method exemplifying the arm's-length principle whereby profits are attributed to a PE for the above-mentioned purposes, has and continues to be essentially based on separate accounting from 1933 to at present. The objectives of separate accounting for this aim were originally formulated in 1933 as:

- (1) To assign to a PE the profit (or loss) which it would realise if it were operating as an independent concern under similar conditions;
- (2) To safeguard a PE so far as possible from taxation on profits which have not yet been realised and which may never be realised by the enterprise as a whole;
- (3) To accomplish these results by the use of data that could be verified in the country of location of the PE with the minimum use of figures for the enterprise as a whole.

It was shown that the present approach to the attribution of profits to a PE as articulated by the commentary on article 7 of the OECD MTC accepts the principle of separate accounting as the basis for the current profit attribution practice. However, presently the commentary is at variance with the second aim of separate accounting listed above by recognising in principle that in certain circumstances deemed tax deductions for notional profits and expenses could be recognised as between a PE and a GE for purposes of an application of article 7(2). This would not be the case in typical branch accounting since it would not allow a tax charge at a time when profits are only anticipated and not yet actually realised. Nonetheless, although this variance appears to be at odds with separate accounting, express non-recognition by the present commentary on article 7 of deemed tax deductions for notional interest, royalties and services fees are congruent with the principles of separate accounting.

The OECD's new authorised approach to the arm's-length principle in respect of intra-company dealings as articulated in the various discussion drafts presents a fundamental reform in respect of the accepted wisdom on how the arm's-length principle in article 7(2) of the OECD MTC is to be understood and applied. Defining indicators of this near revolution includes, as a starting point, the abandonment of separate accounting as basis for the practical application of the arm's-length principle contained in article 7(2) of the OECD MTC. Novel features include the imputation of a transaction basis between a GE and a PE to allow application with due modification of 1995 OECD TP Guidelines and consequently the recognition for tax purposes of, for example, notional interest, royalty and services expenses.

The concept of key entrepreneurial risk taking functions plays an essential role in identifying the imputed transaction base and its attributes as between a GE and PE.

Although not very comprehensively defined, the concept of key entrepreneurial risk taking functions focuses on people functions and basically seeks to locate the decision-making function within an enterprise as regards the profit-drivers of a business carried on by a PE.

It was also shown that the concept of key entrepreneurial risk taking functions appears apposite to the financial industry, but an application thereof to other industries such as mining, oil and gas, agriculture, etc could have a vastly divergent outcome than is presently the accepted norm.

At a fundamental level, the OECD's new authorised approach appears to depart from the hitherto time-honoured perception of how the function of the arm's-length principle's in article 7 is perceived, namely that it attempts to link business profits to a source or host country, and not to a taxpayer and its residence country. This departure is occasioned by the imputation of a transaction basis as between a GE and a PE.

From a tax policy perspective, the concept of key entrepreneurial risk taking functions has the embedded feature of linking residual business profits to a taxpayer after other parts of the enterprise has been sufficiently rewarded. The OECD's new authorised approach therefore appears to allow taxation of an enterprise's residual business profits by the residence state of that taxpayer and in this way would reduce source-based PE taxation of business profits.

The new approach to profit attribution under article 7(2) as articulated by the various discussion drafts appears to be an involved technical exercise and practically requires information concerning the total worldwide activities of a single enterprise for purposes of assessing the activities of a PE. These aspects pose particular challenges for the implementation of this new approach, which has been the official authorised approach of the OECD since 2004.

In respect of South Africa, no binding case law exists to indicate whether our courts would accept the OECD's new authorised approach to PE profit attribution as a valid interpretation of article 7(2) of the existing DTC network. The decision of the Rhodesia Court of Appeal in the *Anglo-American* case could possibly be read to provide support for the new position mooted by the OECD.

It was shown that South Africa will have difficulty in applying the OECD's new authorised approach to PE profit attribution – should it wish to implement it – under those existing DTCs that incorporate article 7(3) of the UN MTC. More generally, it appears that South Africa has since 1994 been inclined to negotiate DTCs that allow expanded source taxing rights in respect business profits. In effect, it appears that the new position introduced by the OECD would contract source-based tax claims in respect of business profits attributable to a PE. These factors could suggest some reluctance on the part of South Africa to accept the OECD's new approach in an unchanged form.

## Chapter 5: General concluding remarks

This study does not attempt to predict whether the South African authorities would adopt the OECD's new authorised approach to PE profit attribution fully, partially or at all. As a non-member of the OECD, it is entirely up to the South African authorities to choose to embrace or reject the OECD's new approach once it is finalised early in 2007 according to expectations.

This study also does not conclude on the many implementation issues that will arise should the South African authorities wish to put into practice the OECD's new authorised approach, although these are no doubt very important aspects.

The research, analysis and conclusions of this study are confined to substantive issues. In the main, the study illustrated the position of the municipal normal tax treatment of intra-company GE-PE dealings *vis-à-vis* OECD's new authorised approach under article 7 of the model convention.

Chapter 2 set out general municipal income tax and CGT principles applicable to both a resident and non-resident GE with an offshore or onshore PE. Intra-company GE-PE dealings are generally not recognised and consequently there is a lack of specific rules as regards the income tax treatment of GE-PE dealings. A few specific rules as regards the CGT treatment of GE-PE dealings in cases of a non-resident GE with a local South African PE do, however, exist.

Chapter 2 also identified specific scenarios in terms of which it might be possible that a local PE of a non-resident GE will not be taxed at the higher normal tax rate of 34% applicable to branch and agency trades of non-residents. Depending on the circumstances, STC at the rate of 12,5% will also not apply to such PEs subject to the general normal tax rate of 29%. These erratic results are caused by a lack of integration between South Africa's municipal international normal tax system and its international obligations under its network of DTCs as regards profit attribution to PEs.

Chapter 3 established the comparative basis from which the municipal tax system's treatment of intra-company GE-PE dealings was compared with the OECD's new authorised approach to PE profit attribution dealt with in chapter 4.

The income tax consequences of GE-PE dealings were analysed based on intra-company reallocations of inventory, capital assets and provision of services or funds in respect of which an internal mark-up would be justified. It was shown that the municipal income tax system does not recognise at all any intra-company GE-PE dealings in any of these categories to establish the (i) tax liability of a non-resident GE operating through a local PE, or (ii) for purposes of calculating the amount of foreign tax that should be credited for purposes of unilateral international double taxation relief of a resident GE operating through an offshore PE.

The position under the OECD's new authorised approach to PE profit attribution is vastly different to that of South Africa's municipal income tax system. According to the OECD's new authorised approach, GE-PE dealings would be recognised under appropriate circumstances for both purposes (i) and (ii) mentioned above, namely to establish the extent of the source-country's taxing right, and the extent of the residence

country's obligation to provide bilateral international double taxation relief. This means that tax deductions for deemed expenses and notional profits would be recognised pursuant to GE-PE dealings in terms of article 7(2) of the OECD MTC.

The municipal CGT consequences of GE-PE dealings differ from the income tax position in so far as the CGT system recognises certain GE-PE dealings for purposes of the so-called exit charge for dealings between a non-resident GE and a local PE.

Examples of GE-PE dealings that were analysed in light of the municipal CGT regime are the reallocation of capital assets, as well as inventory. It was shown that the CGT exit charge in respect of inventory will create international double taxation in a symmetrical tax system to that of South Africa, and may also cause creation of capital losses in South Africa in certain circumstances. This study submits that this inconsistency operates unduly harsh and is not justified from a tax policy perspective, as the established body of source rules would provide sufficient protection in the ordinary course to the South African tax base in the case of inventory reallocated from a local PE to a non-resident GE.

Apart from the case of CGT exit charges, GE-PE dealings are generally not recognised for CGT purposes. Again the OECD's new authorised approach to PE profit attribution would recognise GE-PE dealings concerning capital assets under appropriate circumstances for purposes to establish the extent of the source country's taxing right, and the extent of the residence country's obligation to provide bilateral international double taxation relief.

The analysis in chapter 4 showed that the CGT exit charge in respect of assets attributable to a local PE would be impacted by the OECD's new authorised approach when it concerns a reallocation of such assets to the non-resident GE. The reason is of a structural nature because article 7 of OECD/UN MTC governs the extent of a source country's taxing right in respect of a PE, namely the CGT exit charge in this case.

The basis of the CGT exit charge of a local PE is that the allocable PE asset is deemed to be disposed for market value consideration upon its reallocation to the non-resident GE. This approach of municipal law and the consequent tax result would not necessarily be the same as the approach and tax result under a DTC in accordance with the OECD's new authorised approach to PE profit attribution.

On the DTC level, the general questions in terms of the OECD's new authorised approach would be (i) whether the reallocation of the asset could be viewed as a dealing and if so, (ii) whether independent parties would price that dealing according to the asset's market value, or if not, what other value.

To decide on the first step, the important basic issue is whether key entrepreneurial risk taking functions in respect of the asset was performed by the PE. If so, the PE would be viewed as the economic owner of the asset, thus justifying the recognition of a dealing with the GE in respect of that asset for the benefit of the PE.

The second step concerns the comparability issue, namely whether the reallocation of the asset from the PE to the GE goes hand in hand with the reallocation of functions and risks in respect of that asset. This is necessary to classify the dealing

as akin to, for example, an outright sale or the grant of a right of use for purposes of appropriately pricing the dealing. In this regard, the comparability methodologies of the OECD's 1995 TP Guidelines must be applied *mutatis mutandis*.

South Africa's municipal income tax and CGT rules as well as the OECD's new authorised approach appear to have definitely abandoned branch accounting as the basic guideline for the PE profit attribution calculation. Under the OECD's new authorised approach branch accounts are only one of the documentation requirements that may aid the establishment of an imputed transaction basis for intra-company dealings, as they assist in establishing through a functional and factual analysis whether any dealings have taken place. In a broader context, one could surmise that this far-reaching development is an example of the current general uneasiness of the accountancy profession in the post-Enron age.

There is no binding existing case law on the approach to PE profit attribution under South Africa's DTCs. Nevertheless, the general picture painted by the majority judgement in the *Anglo-American* case, delivered by the Rhodesian Appellate Division in respect of one of South Africa's DTCs, appears to provide support for an approach under a DTC consonant with the OECD's new authorised approach in so far as the recognition of GE-PE dealings are concerned. The court in this case expressly rejected the taxpayer's branch accounts as a basis to claim a tax deduction under a treaty provision similar to article 7(2) of the OECD MTC in respect of intra-company dealings. The court did recognise the possibility of GE-PE dealings should evidence be provided that they are in accordance with the arm's-length principle. Regrettably the decision in this case did not give any other indications of the circumstances under which it would be appropriate to recognise intra-company GE-PE dealings.

Indeed, the analysis in chapter 4 of the OECD's new authorised approach to PE profit attribution gives extensive guidance regarding the circumstances under which it would be appropriate to recognise intra-company GE-PE dealings that satisfy arm's-length behaviour. This guidance is far from perfect or exhaustive, especially the way in which the linchpin concept of key entrepreneurial risk taking functions is formulated. In spite of this, one cannot deny that the OECD has established a whole new framework for the application of the arm's-length principle under article 7(2) of the OECD MTC, which differs both from the historical practice and from the transfer pricing practice in so far as the arm's-length principle is applied to related parties.

The general conclusion of this study is that the application of the OECD's new authorised approach to PE profit attribution contains the possibility of altering the extent or precluding altogether municipal income tax and CGT charges in respect of intra-company dealings of residents and non-residents operating through an offshore or onshore PE, as the case may be.

Commentators on the OECD's new authorised approach to PE profit attribution indicate that from a policy perspective the novel concept of key entrepreneurial risk taking functions embeds a contraction of source-taxing rights under article 7(2) of the OECD MTC.

The analysis in chapter 4 of the taxation of business profits under South Africa's veritable network of DTCs shows that South Africa preferred to negotiate for expanded source taxing rights under approximately 20% of its existing DTCs. This is mainly born out by the incorporation under these DTCs of provisions of the UN MTC dealing with source-based PE taxation of business profits.

This study therefore suggests that from a policy perspective there might be some reluctance on the part of the South African fiscal authorities to adopt the OECD's new authorised approach to PE profit attribution in its present form. On the other hand, the South African fiscal authorities and their counterparts worldwide will come under pressure to adopt the OECD's new position given the persuasive influence and authoritative nature of the OECD MTC.

Particular difficulty would be brought about by those DTCs that incorporate article 7(3) of the UN MTC as a result of the above-mentioned looming policy dilemma. It was shown in chapter 4 that article 7(3) of the UN MTC is irreconcilable with the OECD's new authorised approach to PE profit attribution in so far as it expressly rejects certain types of GE-PE dealings having any tax consequences.

If South Africa were to adopt the OECD's new authorised approach, it would not find application under the DTCs incorporating article 7(3) of the UN MTC. It must be mentioned that in the main this situation would not cause treaty shopping in circumstances where South Africa's DTC partner operates a residence or comprehensive tax system. From the perspective of a GE, any contraction of a source-tax claim under a DTC based on the OECD's new approach would be offset by lesser relief in the residence country for international double taxation in respect of that PE's profits in the home country. There would thus be no benefit involved in choosing to fall under a DTC based on the OECD as opposed to the UN MTC. Tax sharing under a DTC mainly concerns the two competing tax bases, and not the taxpayer *per se* whose only concern is the overall net result.

Although this study does not conclude on implementation and practical issues that would arise should South Africa wish to adopt the OECD's new approach, pressing and important questions do arise which cannot be ignored.

It seems that should South Africa implement the OECD's new authorised approach to profit attribution other than through individual protocols to existing DTCs, this new approach would not be valid for existing DTCs. South African case law on the appropriate interpretive approach to DTCs suggests that the intention of the treaty partners at the time of the conclusion of the DTC must be established. The commentaries on the OECD/UN MTC at that time will no doubt form part of this common intention. This suggests a rather static approach and one cannot realistically expect our courts to accept that the negotiators of a DTC, intended subsequent vastly different approaches to article 7(2) of the OECD MTC to override the pre-existing approach. Under the post-1992 ambulatory OECD MTC scope might exist to adopt a more robust approach.

On a practical level the OECD's new authorised approach to PE profit attribution appears to be very technical in nature and arduous to carry out. For instance, the whole

of a GE must be analysed factually and functionally as a starting point to calculate the attributable profit to a PE, whereas presently the accounts of the PE were basically the starting point, and in many cases the only consideration to perform the profit attribution computation.

It is extremely difficult to define the actual present approach of the South African authorities to the PE profit attribution question under a DTC. What now appears to be the historical practice of the South African authorities, ie branch accounting, is well-known and is in accordance with international practice. However, the South African authorities are silent as to the future and the OECD's reform in this area. The only resort for taxpayers is to the confused statement in PN 7, which attempts to justify application of the local related party transfer pricing practice to intra-company GE-PE dealings. As was shown, resort to PN 7 is unfounded for a number of reasons.

This study illustrates that the time has arrived for the South African fiscal authorities to address over the course of the next few years the topic of profit attribution to PEs. The current SARS practice of addressing this topic on an *ad hoc* basis is insufficient. The goals of any reform in this area should at least be focused on paving the way for a more open position on the taxation of PEs in South Africa and most importantly, minimisation of unanticipated tax results. These are essential goals to attain certainty with regard to prospective inbound investment and offshore expansion.

## SUMMARY

The study provides a comprehensive analysis of South African municipal income tax and capital gains tax (CGT) rules that apply to cross-border dealings between various parts of a company. The analysis established that there are few specific income tax or CGT rules applicable to such intra-company dealings. The lack of specific legislative rules reflects the general tax principle in respect of intra-company dealings, which focus on the legal nature of corporate bodies and transactions, and provides for a complete disregard of intra-company dealings. There are instances where specific CGT rules, for example, recognise intra-company dealings. Where these specific CGT rules interact with the income tax rules in cases of intra-company reallocations of trading stock, unduly harsh tax results are brought about.

The study compares the analysis of South Africa's municipal income tax and CGT rules applicable to cross-border intra-company dealings with the position of the OECD's new authorised approach to the attribution of profits to a permanent establishment (PE). This comparison is achieved by analysing the historical and present position of the OECD on this subject against its new authorised approach.

The above-mentioned comparison between South Africa's municipal income tax and CGT rules and the new position mooted by the OECD showed that the tax results achieved under the municipal system could be restricted or precluded in appropriate circumstances under the OECD's new approach. The possibility of such a result was in general more remote under the OECD's past approach to the question of profit attribution to a PE.

The analysis of the OECD's new authorised approach to the question of profit attribution to a PE suggests that this approach could in general contract source-based taxing rights compared to the past position of the OECD. An analysis of South Africa's double tax convention (DTC) network revealed that since 1994 the South African fiscal authorities seem to negotiate DTCs on the basis of securing extended source taxing rights in respect of business profits as compared to the extent allowed by the OECD. This study therefore suggests that from a tax policy perspective some reluctance may be expected from the South African fiscal authorities to adopt the OECD's new approach in an un-amended form. Despite such obstacles, the study shows that the need exists for the South African fiscal authorities to address the topic of this study to achieve a more open position on the taxation of intra-company dealings and to minimise unexpected tax results.

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