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# **“Place of effective management” and “place of business”**

**A critical analysis of whether or not these phrases (as used in the Income Tax Act and Companies Act respectively) should be aligned or have different meanings?**

By

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## **ABSTRACT**

Within 21 days of establishing a “place of business” (“POB”) within South Africa, a foreign company has to register such POB as an external company with the Registrar of Companies.<sup>1</sup> Such external company will then be recognised as a company in South Africa for purposes of company and tax law. Among other compliance requirements, such an external company also has to file an annual income tax return.

In terms of Article 5 of the Organisation for Economic Co-operation and Development’s Model Tax Convention (“OECD MTC”), once a permanent establishment (“PE”) is created in a contracting state, the profits attributable to the PE will be taxable in that state. A PE will be created once a “fixed place of business” is established in terms of Article 5(1). A PE also has the compliance obligation of filing an annual income tax return.

However, neither registration of a foreign company as an external company, nor the creation of a PE, result in the foreign company also being a resident for income tax purposes in South Africa. For income tax purposes a foreign company, i.e. a company not “incorporated, formed or established” in South Africa will only be an income tax resident if it has its “place of effective management” (“POEM”) in South Africa.

Each of these concepts, i.e. POB, “fixed place of business PE” and POEM provides for a different tax liability for the foreign entity in South Africa. An external company is liable to tax only on its South Africa source income; a PE is liable to tax on the profits which can be attributed to it and a foreign company, with its POEM in South Africa, will be taxable on its worldwide income in South Africa.

Taking into account the magnitude of international trade and multinational groups of companies in the world of today, concepts such as “fixed place of business PE” and POEM play an important role to regulate international trade and protect the tax base of all countries involved. These concepts assist in determining the fair share of tax income that is due to each country involved in the business process of a multinational entity.

Similarly, a concept such as POB establishes liability within a country. The external company can be addressed in law under the Companies Act, 61 of 1973 (“Companies

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<sup>1</sup> Section 322 of the Companies Act, 61 of 1973

Act”), thereby protecting South African residents that contracts and do business with the foreign entity.

This dissertation asks whether the alignment of the meanings of these different terms will enhance legal certainty with regards to taxing rights and accordingly promote cross border trade and investment into South Africa.

It is first considered whether the meanings of POB in the Companies Act and “fixed place of business PE” as per the OECD MTC, should be aligned?

Thereafter, thought is given to whether POB, as a requirement that leads to registration as an external company in terms of the Companies Act and POEM, as a guideline for determining the tax residency for non-natural persons in South Africa, should have a similar meaning?

Through guidelines extracted from case law and other comparative sources, it is shown that the criteria for establishing an external company and for creating a PE in South Africa are not aligned. It is also shown that the two concepts, POB and POEM, are not aligned. Furthermore, this dissertation will show that these concepts serve entirely different purposes and were introduced to protect different rights and accordingly also should not be aligned in meaning.



## **GLOSSARY OF TERMS**

2008 Act	The Companies Act, 71 of 2008
CMC	Central management and control
Companies Act	The Companies Act, 61 of 1973
Constitution	Constitution of South Africa, 1996
ITA	Income Tax Act 58 of 1962
DTA	Double Tax Agreement
IN	Interpretation Note
MTC	Model Tax Convention
OECD	Organisation for Economic Cooperation and Development
PE	Permanent Establishment
POB	Place of business
POEM	Place of effective management
Registrar	The Registrar of Companies
SARS	South African Revenue Service
The Commentaries	Organisation for Economic Cooperation and Development Model Commentaries
The Memorandum	Memorandum on the Objects of the Companies Bill 2008
UK	United Kingdom
VCLT	Vienna Convention on the Law of Treaties

# 1 INTRODUCTION

## 1.1 Background

Business today is, with increasing regularity, conducted across borders. This has resulted in an increase in the number of multinational companies. Combined with the ease of international travel and the rapid improvement of communication systems “residency” for both individuals and non-natural persons has become a term which is pliable. Accordingly it is difficult to interpret and even more difficult to apply (OECD, 2001:9).

To identify the exact location where a company can be addressed has also become increasingly difficult – would it be at the registered office, at the seat of the directors or where the actual business is carried on. However, to identify this location has also become increasingly important in order to protect the commercially active citizens of each country. It is also important in order to promote legal certainty with regards to tax liability and to prevent the unfair depletion of income or resources of any one participant in the global economy. In the not too distant past the place of the registered office and where a company was incorporated would coincide with the place where the directors would meet and the place from which the business would operate (OECD, 2001:8). Within this milieu it was rare for a company to be a tax resident and registered in more than one country.<sup>2</sup> However, technology in the 21<sup>st</sup> century and the rapid changes in communication possibilities have changed this single location attitude towards doing business (OECD, 2001:8). For example, meetings of the directors can now be conducted via video conferencing with each director participating from a different continent.

Most countries, South Africa included, employ both a source and residence basis for taxation, i.e. residents of the country will be taxed on their worldwide income while non-residents will be taxed only on income sourced within that country (OECD, 2001:3).

A foreign company conducting its business through a permanent establishment (“PE”) in South Africa will be liable to tax in South Africa with regards to the business profits attributable to that PE.<sup>3</sup> A company which is not incorporated in South Africa but is found to have its place of effective management (“POEM”) here will be liable to tax in South

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<sup>2</sup> Paragraph 21 of the OECD MTC Commentaries on Article 4.

<sup>3</sup> Article 7 of the OECD MTC.

Africa with regards to its worldwide income as a tax resident. However, a foreign company registered as an external company in terms of the Companies Act, 61 of 1973, (“Companies Act”) will only be liable to income tax in South Africa to the extent that its income is derived from a South African source or is attributable to a PE established by the external company in South Africa.

It is therefore clear that POEM as a test for establishing tax residency, carrying on business through a PE and the concept of an external company for Company Law purposes are all factors to consider when determining the liability of a foreign entity in South Africa.

## **1.2 Purpose and value of research**

In terms of section 322 of the Companies Act a foreign company must be registered<sup>4</sup> as an external company with the Registrar of Companies (“the Registrar”) if it is found that a POB has been established. POB is defined in section 1 as:

“the place where the company transacts or holds itself out as transacting business.”

Registration as an external company does not result in the creation of a new corporate entity, but merely in such company being recognised as a body corporate subject to the provisions of the Companies Act in South Africa.

A registered external company is also a “company” as defined in the Income Tax Act, No 58 of 1962, (“ITA”) in terms of the definition in section 1 which reads:

“ ‘Company’ includes –

- a) any association, corporation or company (other than a close corporation) incorporated or deemed to be incorporated by or under any law in force or previously in force in the Republic or in any part thereof, or any body corporate formed or established or deemed to be formed or established by or under any such law; or
- b) any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law; or
- c) ...”

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<sup>4</sup> Registration must be affected within 21 days after a place of business has been established.

It follows that an external company has an administrative obligation to file an annual income tax return. Registration as an external company does, however, not necessarily result in a company being a tax resident in South Africa.

Establishing a PE in South Africa also does not create a separate legal entity from the foreign incorporated entity, similar to an external company. However, a PE is not a company for tax purposes as per the definition quoted above. A PE also has an obligation to file an income tax return, but this again does not mean that the PE is resident in South Africa for income tax purposes.

In terms of Article 5(1) of the Organisation for Economic Co-operation and Development (“OECD”) Model Tax Convention (“MTC”) a PE is established if the company carries on business through a fixed place of business in the other contracting state.

To determine whether an external company or a PE is also a resident for tax purposes within South Africa, one has to turn to the provisions of the ITA. The ITA provides in section 1:

“resident” means any –

(a) [...]; or

(b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic...”

There are no definitions in the ITA for “incorporated”, “established” or “formed”. An external company, being a foreign company will however not be “incorporated, established or formed” in South Africa. A foreign company carrying on a business through a PE in South Africa will also not be subject to these objective tests for residency.

A South African company is registered in South Africa in terms of section 32 of the Companies Act. Thereafter such a company will be a South African resident for income tax purposes due to its formation and / or incorporation. The tests of “incorporation, establishment or formation” are objective, formal tests. The place thereof is easily determined due to the fact that a company has to lodge its statutes and memorandum with the Registrar of Companies where these documents are available for public inspection (Cilliers & Benade, 2001:189).

However, even though income tax residency of non-natural persons in terms of the ITA is easily determined based on these objective tests, the actual economic activity of an entity may be far removed from the country of incorporation. Accordingly the choice of the country of incorporation, establishment or formation, may be made quite arbitrarily. The place of incorporation can also be easily changed through the mere completion and submission of documents without any effect on the way in which the company operates its business. Therefore the only connection with the jurisdiction in which the company is incorporated (or formed or established) is a formal connection (OECD, 2001:11).

A company which is not “incorporated, formed or established” in South Africa can still be an income tax resident in South Africa provided such a company has established its POEM in South Africa. The POEM test is less artificial and cannot so easily be manipulated as the tests of “incorporation, formation or establishment”. It is a test of substance over form (Van der Merwe, 2006:122).

POEM is also not defined in the ITA.

In addition, POEM is also used as the tie-breaker test to determine residency of non-natural persons in terms of the OECD MTC.

All three of the concepts POB, PE and POEM, when determined in relation to a company, are determined on a factual basis and can therefore be interpreted inconsistently. Each case should be considered on its individual factual matrix. Guidelines for interpreting the facts of a case can be found in case law and other comparative sources.

### **1.3 Research problem**

In this dissertation the guidelines for the interpretation of the relevant facts when considering the concepts of POB, PE and POEM, will be critically explored with reference to the available case law and other comparative sources in order to answer the following research questions:

- a) “should the meaning of POB for purposes of the Companies Act and the meaning of “fixed place of business PE” in terms of South African DTA’s, be aligned”?; and
- b) “whether or not POB as a requirement that leads to registration as an external company in terms of the Companies Act of 1973 and POEM as a guideline for

determining the tax residency for non-natural persons in South Africa, should have a similar meaning?”

As stated above, these three concepts, i.e. POB, PE and POEM all result in a different level of tax liability. A POB will be liable to tax on its South African source income, a PE will be liable for tax on the profits attributable to that PE and a POEM will be liable to tax in South Africa on its worldwide income.

As the guidelines for the interpretation of these concepts are analysed, this dissertation will consider whether it would enhance certainty with regards to taxing rights if it is found that the meaning of POB is aligned with the criteria for establishing a PE. Further whether it would promote cross border trade with and investment into South Africa if the establishment of a POB also led to the foreign entity being tax resident in South Africa through having its POEM here.

#### **1.4 Methodology**

In order to address the research problem the interpretive guidelines, as developed through case law and other comparative sources, for POB, PE and POEM will be critically analysed and contrasted to assess their meaning and purposes and whether those purposes should be aligned.

##### **1.4.1 Interpretation of “place of business” – the South African company law tradition**

The definition of POB in section 1 of the Companies Act is of itself very broad and requires further analyses. Guidelines for the interpretation of the POB definition shall be derived from decided cases, both local and from the United Kingdom (“UK”). Our courts are known to utilise precedent from UK case law because many concepts in our company law were inherited from English common law (Cilliers & Benade, 2001:19-21).

The previous Companies Act, 46 of 1926, was in many aspects based on the English Companies (Consolidation) Act of 1908.<sup>5</sup> In instances where our Roman-Dutch common law fails to provide guidance for interpretation, it is accepted practice for our courts to

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<sup>5</sup> Confirmed by O’Hagan, J in *Buckingham and Others v Combined Holdings and Industries Ltd* 1961 (1) SA 326 (E) at 331 that various provisions in our company law have been adopted from English statute law.

utilise precedent from English court cases for interpretative guidance (Cilliers & Benade, 2001:19-21).

A further interpretative guideline is that the source of a legislative provision should be considered when interpreting legislation. In certain instances where the South African Legislature copied legislation from the UK, our courts may find guidance in English court cases, provided the English decisions are in line with our common law (Botha, 2005:89).

Various examples can be found where the courts in South Africa were led by English case law to interpret different sections of our Companies law.<sup>6</sup> Accordingly both South African and UK case law development on the interpretation of POB should be considered in order to derive interpretive guidelines in this regard.

#### **1.4.2 Interpretation of “conduct business” – interpretative assumptions to apply when considering section 23**

The proposed draft Companies Act, 71 of 2008 (“the 2008 Act”), which is to replace the Companies Act,<sup>7</sup> also provides for the registration of an external company with the Registrar within 21 days. However the 2008 Act has replaced the POB criteria with a “conduct business” test, a phrase not defined in the proposed 2008 Act and as yet, untested by our courts.

There is a presumption in the field of interpretation of legislation that new legislation does not aim to change the common law or existing law without due cause. Unless earlier legislation is explicitly recalled, a further presumption provides that an attempt should be made to reconcile the earlier and the newer version of the legislation (Botha, 2005:45-47).

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<sup>6</sup> *Emphy and Another v Pacer Properties (Pty) Ltd* 1979 (3) SA 363 (D) at 365 with regards to section 344(h) of the Companies Act; *Novick and Another v Comair Holdings Ltd and Others* 1979 (2) SA 116 (W); and *Wackrill v Sandton International Removals (Pty) Ltd and Others* 1984 (1) SA 282 (W) at 289 again with regards to section 344(h) of the Companies Act; *The Nantai Princess Nantai Line Co Ltd and Another v Cargo Laden on the MV Nantai Princess and other vessels and Others* 1997 (2) SA 580 (D) at 587 with regards to section 359 of the Companies Act which deals with attachment of an estate after the commencement of winding up procedures and *Howard v Herrigel and Another NNO* 1991 (2) SA 660 (A) at 672 and 674 for purposes of determining the extend of section 424 of the Companies Act.

<sup>7</sup> The effective date of the 2008 Act has been announced by the Department of Trade and Industry as 1 April 2011.

The Memorandum on the Objects of the Companies Bill 2008 (“the Memorandum”) supports this interpretative presumption suggesting that interpretations harmonious with the Companies Act are preferred.

This principle of interpretation was utilised and endorsed by Judge Watermeyer in *Kent NO v SA Railways*<sup>8</sup> at 405:

“In considering that question, it is necessary to bear in mind a well-known principle of statutory construction, viz., that Statutes must be read together and the later one must not be so construed as to repeal the provisions of an earlier one, or to take away rights conferred by an earlier one unless the later Statute expressly alters the provisions of the earlier one in that respect or such alteration is a necessary inference from the terms of the later Statute. The inference must be a necessary one and not merely a possible one.”

This has been held as “the most fundamental of all the presumptions of statutory interpretation”<sup>9</sup> in our courts.<sup>10</sup>

The author will consider the impact of the proposed section 23 of the 2008 Act and whether or not it has the same meaning and purpose as POB in the Companies Act. This high level analysis is included in order to consider the development of the guidelines with regards to external companies as per the view of the South African Legislature.

### **1.4.3 Interpretation of “fixed place of business permanent establishment”**

Consideration is further given to whether the guidelines for establishing a POB in terms of the Companies Act will, when applied to a particular fact set, also result in creating a “fixed place of business PE” in terms of the OECD MTC and the resultant income tax liability attributable to that PE in terms of South African DTA’s.

Even though South Africa is not a member of the OECD, our DTA’s are mostly based on the OECD MTC.<sup>11</sup>

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<sup>8</sup> *Kent NO v SA Railways & another* 1946 AD 398; and confirmed in *Wendywood Development (Pty) Ltd v Rieger and Another* 1971 (3) SA 28 (A)

<sup>9</sup> By Van Heerden J in *Bestuursliggaam van Gene Louw Laerskool v Roodtman* 2004 (1) SA 45 (C) and quoted with approval in *Fish Hoek Primary School v Welcome* [2009] JOL 23458 (C).

<sup>10</sup> *New Modderfontein Gold Mining Co v Transvaal Provincial Administration* 1919 AD 367 at 400 and confirmed in *Minister of Police v Haunawa* 1991 (2) SA 541 (NmS) and *Shozi v Minister of Justice, Kwazulu* 1992 (2) SA 338 (N).



When considering the OECD MTC Commentaries (“the Commentaries”) as an interpretative guide, paragraph 29 of the Introduction to the Commentaries provides that the Commentaries are not meant to be attached to a tax treaty negotiated between parties. However, the Commentaries can assist when questions of application and interpretation arise and therefore have an important role to play when a dispute arises.

The legal status of the OECD commentaries has been the subject of various discussions with varied outcomes. Some interesting arguments have been raised, for example, one author stated that it is hard to understand how you can explain the reservations that member countries lodge against the Commentaries if these countries think that the Commentaries lack any binding force (Weiss, 2008:137).<sup>12</sup>

The author however respectfully agrees with Avery Jones<sup>13</sup> where he established that the Commentaries should be taken into account to determine the ordinary meaning of the treaty provisions in terms of Article 31 of the Vienna Convention. Avery Jones is of the view that the Commentaries, in terms of Article 31(4) create a special meaning between the parties to the Treaty. The parties to the Treaty are deemed to have intended the special meaning as provided in the Commentaries when interpreting an Article of a specific tax treaty based on the OECD MTC, i.e. the Commentaries will have high persuasive value (Avery Jones, 2008:161).

#### **1.4.4 Interpretation of “place of effective management”**

In conclusion, when analysing the meaning of POEM as a criterion for establishing tax residency for a foreign incorporated entity, case law as well as other comparative sources will be considered.

From a South African point of view, there has not been any case where it was necessary for the court to decide on the meaning of POEM. However, case law that considered residency

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<sup>11</sup> At 30 September 2008, South Africa had 68 treaties in place which are all predominantly based on the OECD MTC, with only limited inclusion of elements of the United Nations Tax Convention and other non-MTC based clauses (Hattingh 2009:721).

<sup>12</sup> Acquiescence and estoppel and their application with regards to the Commentaries are also the subject matter of a substantial body of related literature, not to be discussed in detail in this dissertation. It has been submitted by that acquiescence will manifest through conduct, in this case the absence of making a reservation to the Commentaries. Estoppel, on the other hand, requires states to not act inconsistently in their dealings with each other (Weiss, 2008:146).

<sup>13</sup> Avery Jones, J. 2008. *The Binding nature of the OECD Commentaries from the UK point of view* in *The Legal Status of the OECD Commentaries*. IBFD. 161

under our previous source based taxation dispensation can provide guidance on how our courts view residency of corporate entities. Furthermore case law where it was necessary to establish jurisdiction of courts with reference to the residence of a company can also provide guidance (Hattingh, 2009:695).

The case law considered will be both South African and UK case law as the analysis cannot be limited to the South African interpretation. This is in line with the South African Constitution of 1996 (“the Constitution”) which provides in section 233 that our courts must give preference to interpretations of concepts that are in line with the international interpretation, provided that it does not contradict any provisions of the Constitution:

“233) When interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.”

Interpretation Note 6<sup>14</sup> (“IN6”) was issued by the South African Revenue Service (“SARS”) to provide guidance on SARS’s view on the meaning of POEM for South African tax purposes upon the introduction of a residence basis of taxation in 2001.

POEM has been a part of the MTC since 1963 and various reports on the application as well as the Commentaries have been written and commissioned by the OECD. In South Africa our courts have applied the work of the OECD in cases where tax treaties were to be interpreted (Hattingh, 2009:730-731). Olivier and Honiball (2008:33), as regards the Commentaries to the OECD MTC, are of the opinion that:

“Consequently, the OECD MTC probably forms part of South Africa’s customary international law on the basis of its acceptance in South African case law (*opinio juris*) and general use as an interpretative aid for treaties (*usus*), and would therefore be applicable in interpreting treaty provisions in South Africa.”

In terms of the commentaries on the Vienna Convention on the Law of Treaties (“VCLT”), article 31, there is a presumption that the parties to a treaty intended that a clause should have the specific meaning as provided for in the reports and commentaries of the OECD while at the negotiating table (Van Raad, 2009:1520). Therefore, the commentaries to the OECD MTC could contribute towards establishing the “ordinary

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<sup>14</sup> Issued by the South African Revenue Service on 26 March 2002

meaning”, in terms of Article 31(1) of the VCLT, or alternatively, at least an “agreed meaning” in terms of Article 31(4)<sup>15</sup> of the VCLT.

Article 31(1) of the VCLT provides:

“A Treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”

The commentaries on Article 31, paragraph 1, provide that this section emphasises three general principles:

- The first principle is that of interpretation in good faith which finds its origins in the rule *pacta sunt servanda*, i.e. the Common law rule that a contract consented to should be binding in law;
- The second principle is that the parties are deemed to have the intention as identified in the ordinary meaning of the words; and
- Thirdly the principle of common sense and good faith is pronounced in that the ordinary meaning of a term should be determined based on the context of the treaty as well as the object and purpose of the treaty.

It is provided in Article 32 of the VCLT that supplementary means of interpretation may also be utilised to confirm the meaning of a term when applying the principles of Article 31. The commentaries to Article 32 states that by “supplementary” it does not provide for other primary interpretative sources but refers to sources that may merely aid interpretation. It is submitted that the Commentaries to the OECD MTC may be seen as such a supplementary aid (Olivier & Honiball, 2008:34).

The VCLT sets out guidelines for the interpretation of international law and is binding on states even if they did not sign the convention (Olivier & Honiball, 2008:32).

The South African Constitution of 1996 (“the Constitution”) in section 232 provides that:

“Customary international law is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament.”

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<sup>15</sup> Article 31(4) provides: “A special meaning shall be given to a term if it is established that the parties so intended.”

The VCLT constitutes a codification of customary international law and therefore, in terms of section 233 of the Constitution, South African courts should be guided by the VCLT when interpreting tax treaties (Olivier & Honiball, 2008:32-33). Accordingly the Commentaries can provide useful guidance when determining the meaning of POEM.

### **1.5 Limitations on the scope of the research**

With regards to the definition of POB in section 1 of the Companies Act, this dissertation will not address comments with regard to “share transfer or share registration offices”. Furthermore no comments will be addressed to a POB being established through the acquisition of immovable property in terms of the definition of external company in section 1 of the Companies Act and the possible discrepancy with section 324(2) of the Companies Act which requires registration of an external company before immovable property can be acquired and whether section 324(2) only refers to a right to obtain ownership (Henochsberg 2010).

The comments which relate to “conduct business” in the 2008 Act will be limited to a high level discussion. The 2008 Act has not yet been promulgated and a notice published by the Department of Trade and Industry has deferred the effective date to 1 April 2011 (Department of Trade and Industry 2010). In addition, “conduct business” has also not yet been considered by our courts.

The discussion with regards to establishing a PE will be limited to the text of Article 5 of the OECD MTC as discussed in the Commentaries and other comparative sources as relevant. The text of Article 5(1) of the United Nations Model Double Taxation Convention (“UN Model”) is identical to that of the OECD MTC and thus the UN Model is not also discussed in this dissertation. While the discussion will focus on Article 5(1), as a part of the analysis against the guidelines for establishing a POB, a few high level comments will also be addressed with regards to Articles 5(2), 5(3), 5(4) and 5(5).

Only high level comments will be addressed with regards to the source of income.

The scope of this paper does not permit a discussion of residency for both natural and non-natural persons and the discussion will therefore be limited to non-natural persons.

Furthermore the dissertation will only address the POEM test in the ITA definition for company residence and no further comments will be made with regards to “incorporated, established or formed”. These terms also have no bearing on an external company, which by its very nature will not be incorporated in South Africa, or on a foreign company conducting its business through a PE in South Africa.

## **1.6 The way forward**

In Chapter 2 guidelines on the meaning of POB will be considered as supported by case law in order to establish the basis for further analysis. These guidelines will be utilised in the analysis of whether the meaning of POB should be aligned with the meaning of PE as per the OECD MTC in Chapter 3.

A short discussion of the meaning of “conduct business” as per the 2008 Act and a high level analysis of how this concept contrasts firstly to POB and also to the PE concept in the OECD MTC will follow in Chapter 4.

The South African and international guidelines for the meaning of POEM will be discussed in Chapter 5. The criteria listed in IN6 as issued by the SARS as an indication of their view with regards to the meaning of POEM will be utilised as a framework for this discussion. Consideration will also be given to the guidance as provided by the Commentaries to the OECD MTC.

## 2 PLACE OF BUSINESS

### 2.1 Introduction

In terms of section 322 of the Companies Act, Act 61 of 1973 (“Companies Act”) every foreign company shall, within 21 days of establishing a “place of business” (“POB”) in South Africa, register as an external company with the Registrar of Companies.<sup>16</sup> An “external company” is defined in section 1:

“‘external company’ means 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...”

Registration as an external company does not result in the creation of a new entity, but it does result in the external company becoming subject to the provisions of the Companies Act. The effect of registration is not that two separate legal entities are created, but that one legal entity is registered in two countries (Henocheberg, 2010: 646).

An external company is also not considered to be “incorporated, formed or established” in South Africa for purposes of the ITA as an external company is a foreign company incorporated outside of South Africa. Accordingly an external company will only be a tax resident if its “place of effective management” (“POEM”) is also found to be in South Africa.<sup>17</sup>

The definition of POB in section 1 of the Companies Act is of itself very broad and does not provide much interpretive guidance. Section 1 states that the POB of a company is:

“the place where the company transacts or holds itself out as transacting business.”

Interpretational guidance may be found in decided cases on this matter. While local cases carry legal precedence, the persuasive value of United Kingdom (“UK”) case law requires it to also be considered as the South African company law stems, mostly, from the UK and decided cases of that jurisdiction have often been referred to by our courts.

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<sup>16</sup> As part of the registration process, section 322 provides a list of the documents that should be presented to the Registrar which includes the founding documents of the company, a notice of the registered office and postal address, the details of an auditor in South Africa, notice of the financial year of the company and details of the directors and the local manager and secretary of the external company.

<sup>17</sup> Definition of “resident” in section 1 of the ITA.

## 2.2 Factors indicative of establishing a place of business

Whether or not a POB has been established is a question of fact.<sup>18</sup> Therefore criteria can be identified as a guideline, but each criterion will have to be considered together with all other relevant factors.

### 2.2.1 Location and a degree of permanency

The word “established” in section 322 has been held to indicate a certain degree of permanency. This does not mean that a POB cannot be established if a company does not own the premises from which it is carrying on business. It is enough if a certain location is associated with a company due to it habitually or regularly conducting its business from the location. However, a mere plot of land from which a business is carried on by anyone is not enough to establish a degree of permanency.<sup>19</sup>

Factors that can be indicative of a specific location employed with a degree of permanency could be:

- Entering into a lease, although this is not a necessity;
- Applying for a petroleum or other licence associated with a specific address;
- Correspondence regarding the business being addressed to a certain address; and
- Entering into correspondence over alleged rebates due to the company from that location.<sup>20</sup>

It is unlikely that a foreign company will be deemed to have established a POB at a place where it is only temporarily engaged with business activities. This has been stated to run contrary to considerations of logic and convenience.<sup>21</sup>

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<sup>18</sup> *Rakusens Ltd v Baser Ambalaj Plastik Sanayi Ticaret AS*, Court of Appeal, Civil Division, [2001] EWCA Civ 1820, [2001] 1 BCLC 104 at paragraph 8

<sup>19</sup> *Re Oriel Ltd* [1985] All ER 216 at 223

<sup>20</sup> *Supra* at 224-225

<sup>21</sup> *Dowson & Dobson Ltd v Evans & Kerns (Pty) Ltd* 1973 (4) SA 136 at 141

### 2.2.2 Auxiliary activities combined with other factors indicative of a POB

It has also been held that activities of an auxiliary nature, for example gathering of information and maintaining public relations, could be indicative of a POB when combined with factors that indicate a degree of permanency and a specific location. In this regard the defendant in *South India Shipping Corp Ltd v Export-Import Bank of Korea*<sup>22</sup> was a bank incorporated in Korea which also maintained offices in London.

The activities of the office in London included, among other things:

- Gathering economic, commercial, financial and statistical information relating to the UK;
- Promote the economic relations between Korea and the UK; and
- Conducting preliminary surveys and liaison activities on foreign fund raising activities in London.

The defendant however maintained that the offices in London were purely for gathering information and maintaining public relations with banking and financial institutions in England and Europe. Furthermore that no business was transacted from these offices and that accordingly no POB was established.

Ackner L concluded that:

“In my judgment the facts of this appeal are clear. The defendant bank is an export-import bank, not a high street bank. They have both premises and staff within the jurisdiction. They conduct external relations with other banks and financial institutions. They carry out preliminary work in relation to granting or obtaining loans. They seek to give publicity to the foreign bank and encourage trade between Korea and the United Kingdom, and they consult with other banks and financial institutions on the usual operating matters. They have therefore established a place of business within Great Britain and it matters not that they do not conclude within the jurisdiction any banking transactions or have banking dealings with the general public as opposed to other banks or financial institutions.”

It was accordingly held that the London office of the defendant had established a POB for the defendant. Among other things it also entered into a lease with a London landlord and employed staff for performing its information gathering activities. These facts also contributed to Ackner L’s judgment.

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<sup>22</sup> *South India Shipping Corp Ltd v Export-Import Bank of Korea* [1985] 2 All ER 219



### 2.2.3 Location of general management

The POB of an external company is likely to be found where the general management is situated. For example, merely having a director of a civil engineering company on site on a full time basis does not necessarily confirm that this is where the general management is situated.

In the case of *Dowson & Dobson v Evans & Kerns (Pty) Ltd*<sup>23</sup> the engineering company had an office on site, shared a telephone there with the other consulting engineers, had a bank account in Queenstown, which is the nearest town, and its name appeared on a board set up close to this shared office.

The court found that in this instance one has to distinguish between establishing a POB and carrying on business from a particular site and found that notwithstanding the fact that one of the directors were situated permanently at the project site, it did not establish the project site as the place of management of the firm.

In finding that E&K did not establish a POB the Judge held at 141:<sup>24</sup>

“It seems unlikely that section 215 was intended to confer power to place a company under judicial management in every Division of the Supreme Court within whose territorial jurisdiction a firm of civil engineers is engaged on a contract, however small or transient its activities might there be. In my view the term ‘place of business’ in the section is intended to refer to the place or places where it can be said that the general management of the company is carried out, where the company administers its affairs and where it is established with some degree of permanency. Obvious considerations of logic and convenience favour such a view. The Act surely did not intend to confer jurisdiction on a Court within whose area a company was only temporarily engaged in business activities. A place of business is, in my judgment, a place where the management is situate (although this may well be in more than one place) where the public is invited to communicate with the company for the performance of the company’s business and where – unless the company ceases to do business altogether – it may be expected with reasonable confidence that responsible officials, competent to bind the company, will normally be found, irrespective of the fact that the company’s other employees may elsewhere be engaged on its activities. Not all these elements will necessarily be present in every case, but in my view they are the aggregate of the factors, all or most of which will exist at a place of business of the company.”

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<sup>23</sup> *Dowson & Dobson Ltd v Evans & Kerns (Pty) Ltd* 1973 (4) SA 136

<sup>24</sup> *Supra* at 141

#### 2.2.4 Substance over form

It is the intention of the Legislature that the provisions of the Companies Act will apply to an external company whether or not it becomes registered as such (Henocheberg, 2010: 642).

Accordingly our courts have held that non-compliance with the administrative provisions of section 322, i.e. the obligation to register as an external company within 21 days of establishing a POB, does not negate the consequences of establishing a POB.

The applicant in *Wiseman v ACE Table Soccer (Pty) Ltd*<sup>25</sup> approached the Witwatersrand Local Division for a final liquidation order against the defendant, ACE Table Soccer (Pty) Ltd (“ACE”). ACE was incorporated in the Republic of Bophuthatswana<sup>26</sup> but had its principle place of business in Benoni.

ACE argued that it was never registered as an external company in terms of section 322 of the Companies Act and therefore the Witwatersrand Local Division had no jurisdiction to hear the applicant’s application.

Claassen J considered the different sections of the Companies Act and found that an external company does not get its legal personality from being registered in terms of section 322. Section 322 already recognises the legal personality of the external company and merely lays down the mechanisms for registering an external company. In terms of the definition of an external company in section 1, Claassen J held that the provisions of the Companies Act will apply to an external company as soon as it acquires a POB in South Africa.

Claassen J continued at 175:

“The fact that it has not registered under section 322 may have penal consequences and may be a contravention of section 333 of the Act. Thus, failure to register in terms of section 322 may make every director, officer or agent of such a company guilty of an offence. However, such failure does not seem to me to oust the jurisdiction of the Supreme Court of South Africa which would otherwise have jurisdiction in respect of an external company, to wind it up.”

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<sup>25</sup> *Wiseman v ACE Table Soccer (Pty) Ltd* 1991 (4) SA 171 (W)

<sup>26</sup> In 1994 the Republic of Bophuthatswana was reintegrated into South Africa.

Claassen J concluded that the Witwatersrand Local Division does indeed have jurisdiction to hear the application due to it being common cause that ACE had its POB in Benoni, i.e. within the jurisdiction of the Court.

### **2.2.5 Other general factors**

Other general factors indicative of the establishment of a POB include:

- The place where the public is invited to communicate with the company for the performance of the company's business;
- The place where it can be reasonably expected to find officials with the necessary authority to bind the company;<sup>27</sup>
- Some visible sign or physical indication that the company has a connection with particular premises;<sup>28</sup>
- The place where immovable property is acquired in South Africa;<sup>29</sup> and
- The private residence of the directors could be indicative of a POB for a company, however, the mere presence of the directors at a certain location will not establish a POB for the company.<sup>30</sup>

## **2.3 Factors not leading to the establishment of a place of business**

### **2.3.1 Agency**

Agency is a legal concept where the agent has been authorised by another (the principal) to perform a certain juristic act on his behalf. Such juristic act will result in binding the principal for delivery towards a third party (Van der Merwe, 2003:231).

A company, being a legal entity, needs to employ natural persons as agents who can take and action decisions on behalf of the company. For an agent to be in a position to legally bind a company, the agent needs either express or ostensible authority given by the company. Such authority can be given to the agent through the statutes and memorandum

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<sup>27</sup> *Dowson & Dobson Ltd v Evans & Kerns (Pty) Ltd* 1973 (4) SA 136 at 141

<sup>28</sup> *Deverall v Grant Advertising Inc* [1954] 3 All ER 389

<sup>29</sup> In terms of the definition of external company in section 1 of the Companies Act.

<sup>30</sup> *Re Oriel Ltd* [1985] All ER 216 at 224-225: "Accepting of course, that a limited company's thoughts, plans and ambitions can occur only in the minds of its directorate, that inescapable triumph of nature over legal theory cannot, as it seems to me, by itself convert that director's matrimonial home into the company's established place of business".

of incorporation of the company. The actions of an agent can also be ratified *ex post facto*, i.e. after the fact, by the company, either expressly or implicitly (Cilliers & Benade, 2001: 179-180). An agent can also derive authority from a contract or mandate with the principal. Whether the agent has sufficient authority to act on behalf of a principal or not will have to be determined based on the facts of each particular case (Van der Merwe, 2003:233-235).

It has been established in English case law that an agent of a company cannot by itself establish a POB for purposes of creating the obligation to register as an external company.

The first case in England where the POB phrase was subjected to judicial consideration was *Lord Advocate v Huron & Erie Loan & Savings Co*<sup>31</sup> (“Huron”). The defendant company was incorporated in Canada, but advertised their investment opportunities through Scottish legal firms appointed as agents. The agents were given certain authority through a power of attorney granted by the defendant. The contracts for the debentures were however executed in Ontario, Canada, where the debentures were also issued in exchange for the monies invested from Scotland.

Huron did not own or rent offices in the UK, nor were salaries paid to any employees. The only remuneration paid to the representatives was in the form of commission.<sup>32</sup>

Dunedin L concluded that the Legislature could not have intended that the mere employment of an agent would establish a POB for the foreign company at the agent’s premises.

In a more recent case, *Rakusens Ltd v Baser Ambalaj Plastik*<sup>33</sup> (“Rakusens”), this principle was confirmed.

Interesting facts in *Rakusens* which were considered by the court included that the agent had a business card identifying himself as a representative of the UK Division of the foreign company. The third party also successfully contracted with the agent on three occasions. However, in the agreement between the principal and the agent, the agent was not given any authority of representation. He was merely authorised to find customers on

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<sup>31</sup> *Lord Advocate v Huron & Erie Loan & Savings Co* 1911 S.C. 612

<sup>32</sup> Similar to section 233 of the Companies Act, section 274 of the English Companies (Consolidation) Act of 1908 provided that upon the establishment of a POB by a foreign company, certain documents should be filed with the Registrar in order to register as an external company.

<sup>33</sup> *Rakusens Ltd v Baser Ambalaj Plastik Sanayi Ticaret AS* [2001] EWCA Civ 1820

behalf of the principal who would then proceed to conclude the contracts with the customers.

Arden, J noted that it is important to identify the party for whom a POB is created and he concluded at paragraph 42:

“The Huron case shows in the context of the Companies Acts that an overseas corporation, which has agents with offices here who carry on business here but do not make contracts in the name of the overseas corporation, does not thereby have a place of business here. In this case there was only one agent. In my judgment, for the reasons given above, the agent was carrying on his own business and not that of Baser. In all the circumstances, the agent’s place of business did not become that of Baser.”

Furthermore, if no business is carried on at a company’s registered address, which is the address of an agent or representative who was given a wide power of attorney to accept service on behalf of a foreign company, the agent cannot establish a POB on behalf of the company. This is even more so if the wide power of attorney is revoked by the company.<sup>34</sup>

A foreign company will not establish a POB if it transacts for the purchase of South African goods and the transport thereof to its foreign offices through South African attorneys or brokers. These “human agents” of the foreign company will not through this transaction establish a POB even though business will be transacted or carried on in South Africa (Henochsberg, 2010:644).

### **2.3.2 Carrying on of a business**

It has been held that the carrying on of a business must be distinguished from establishing a POB.

In *Lord Advocate v Huron & Erie Loan & Savings Co* Dunedin L considered that one should distinguish between carrying on a business and establishing a POB. Carrying on a business is so wide a concept that very much every company doing business in the UK will be affected. In order to establish a POB “a local habitation of its own” is needed for the foreign company.<sup>35</sup>

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<sup>34</sup> *Grimshaw v Mica Mines, Ltd* 1912 TPD 450 at 454

<sup>35</sup> *Lord Advocate v Huron & Erie Loan & Savings Co* 1911 S.C. 612

The distinction is best illustrated through the example of a travelling circus which will be carrying on business in every town where it pitches its tent, however, the circus cannot be held to have established a POB in each of these towns.<sup>36</sup>

An agent of a foreign company who regularly holds meetings with clients in the lounge of a hotel in a foreign country provides a further example. Even though it is clear that these agents will be carrying on a business, it will be artificial to conclude that a POB is established in the hotel lounge.<sup>37</sup>

It has also been held that to be employed at a certain place is more akin to carrying on a business there, i.e. the business of the employee. This does not however, establish a POB for the employee at that location.<sup>38</sup>

Other factors indicative of only carrying on a business was identified by Addleson J when considering whether a civil engineering company had established a POB at an assignment site:

- The company will leave the area once the assignment is completed and accordingly there is no degree of permanence to its presence on site (see also paragraph 2.2.1 above);
- It is possible to find one of the directors of the company on site for purposes of contracting with the company, but it is not guaranteed that a director or another person with the necessary authority will be present;
- The letterheads only listed the registered office and made no reference to the site; and
- No administrative work or direction was received from the site.<sup>39</sup>

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<sup>36</sup> *Dowson & Dobson Ltd v Evans & Kerns (Pty) Ltd* 1973 (4) SA 136 at 140

<sup>37</sup> *Re Oriell Ltd* [1985] 3 All ER 216 at 220

<sup>38</sup> *Smith v Smith* 1974 (1) SA 474 (W)

<sup>39</sup> *Dowson & Dobson Ltd v Evans & Kerns (Pty) Ltd* 1973 (4) SA 136 at 141

### 2.3.3 Registered address

Every company must have a registered office and postal address in terms of section 170 of the Companies Act. Section 170 provides:

“170 (1) Every company including every external company shall have in the Republic -

- (a) a postal address to which all communications and notices may be addressed; and
- (b) a registered office to which all communications and notices may be addressed and at which all process may be served.”

The registered office is usually the place where a company carries on its business, but that is not always the case. The registered office may also merely be the place where the company accepts notices or summons and the business of the company may be carried on elsewhere. The mere existence therefore, of a registered address does not amount to carrying on a business for the purposes of establishing a POB. This is even more so if no business is carried on at the registered office, no office for the company is found at that address, no money is sent from the address and no instructions relating to the business are received from the registered address.<sup>40</sup>

The provisions of section 170 as relating to external companies were not intended by the Legislature to establish the registered address of an external company as the place where the world can look to for the legal and administrative home of that external company.<sup>41</sup>

## 2.4 Conclusion

The author submits that from the preceding discussion it is clear that a level of presence and activity is necessary in order to establish a POB. It is important to remember that the question of whether a foreign incorporated company has established a POB in South Africa is very fact specific and therefore each case will be determined based on its specific factual matrix.

In the next chapter the criteria for creating a “fixed place of business PE” will be contrasted to the guidelines identified for establishing a POB. Specifically tested is

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<sup>40</sup> *Grimshaw v Mica Mines, Ltd* 1912 TPD 450 at 454

<sup>41</sup> *Joseph and Another v Air Tanzania Corporation* 1997 (3) SA 34 (W) at 38

whether or not the threshold of presence and activity for establishing a POB when compared to that required for creating a fixed place of business PE for purposes of double tax agreements is higher or lower.

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### **3 PERMANENT ESTABLISHMENT – FIXED PLACE OF BUSINESS**

#### **3.1 Introduction**

A non-resident company carrying on business in South Africa will only be liable to tax on income with its source or deemed source in South Africa. A double tax agreement (“DTA”) between South Africa and the country where the non-resident company is registered could provide relief from this tax burden. However, if the business activities are carried on through a permanent establishment (“PE”), the income attributable to that PE will be taxable in South Africa.

The concept PE was first used in Prussian tax law in 1891 and was first used in the tax treaty between Austria/Hungary and Prussia in 1899 (Avery Jones 2006:234). PE is defined in the ITA in section 1 with reference to the definition in Article 5 of the OECD MTC. South Africa’s tax treaties mostly follow the OECD MTC even though South Africa is not a member of the OECD. South Africa was awarded observer status in 2004 (Oguttu 2009:786).

In cross-border transactions, a PE provides clarity with regards to taxation rights between the country where the income is sourced and the country where the owner of the business is resident. Once a PE is established the source country acquires the right to tax the income derived by the PE, notwithstanding the fact that the PE has no separate legal existence, and this right takes precedence over the resident country’s right to tax (Arnold 2003:478). If part of a non-resident business enterprise is registered as a branch in South Africa, a PE will normally exist, but a registered branch is not a requirement for creating a PE (Skaar 1991:1). These provisions are intended to provide legal certainty, but due to worldwide varied interpretations of the concept, such certainty is often not established (Olivier & Honiball 2008:95).

A PE is defined in Article 5(1) of the OECD MTC:

“For 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.”

Skaar<sup>42</sup> states that the “fixed place of business” test can be divided into three cumulative tests. The enterprise must:

- 1) have a “place of business”; with
- 2) the right to use the place of business with a certain degree of permanence (the “duration” test); at
- 3) a distinct geographical place (the “location” test) (Skaar 1991:111).

Furthermore, the non-resident entity must have the “right to use” the place of business, i.e. the place or branch or office must be at the disposal of the entity, and the entity must be able to conduct its business activities “through” the place of business. In this regard it is also necessary to apply the “business connection test” to identify the party whose business activity is served at that place of business, i.e. the activity performed is not necessarily the business of the taxpayer, but of somebody else. Where a principal uses a subcontractor, for example, the work performed at the place of business of the subcontractor may not be the business of the principal (Skaar 1991:328).

It is not a prerequisite for the PE to contribute to the profits of the enterprise (Olivier & Honiball 2008:95). It has also been held that an isolated transaction could suffice as carrying on a business and therefore establish a PE.<sup>43</sup> The PE will commence once the non-resident entity starts to carry on its business through the fixed place of business. Furthermore, temporary interruptions in business activities do not result in the termination of the PE (Olivier & Honiball 2008: 95).

Article 5(2) provides a positive, non-exhaustive list of activities which would result in a PE being established:

“2) The term ‘permanent establishment’ includes especially:

- a) a place of management;
- b) a branch;

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<sup>42</sup> Skaar, AA. *Permanent Establishment: Erosion of a Tax Treaty Principle* Kluwer: The Hague, 1991

<sup>43</sup> *Thiel v Federal Commissioner of Taxation* 89 ATC 4036

- 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.”

In the Commentaries to Article 5(2) it is provided that these listed places of business must also meet the criteria in Article 5(1) before a PE will be established.

A dependent agent can also create a PE for a foreign entity. If the dependent agent has the authority to bind the foreign company and also exercises this authority regularly, a PE could be created. According to the Commentaries an agency PE can exist regardless of whether a fixed location can be attributed to the activities of the agent.

Article 5(4) of the OECD MTC provides that a PE will not be created by a foreign company with a fixed place of business if only preparatory or auxiliary activities, for example the storage of goods, are carried out there.

Below the criteria identified to establish a POB are contrasted against the requirements for creating a fixed place of business PE in order to determine whether or not the meaning of these two concepts should be aligned.

### **3.2 Comparison of criteria: Double tax treaty “permanent establishment” and Companies Act “place of business”**

#### **3.2.1 Introduction – source of income**

A non-resident company will only be liable for income tax on its South African source income, unless it is carrying on business through a PE and the company is resident in a country that has signed a DTA with South Africa. In such a case, the profits attributable to the PE, which can extend beyond the concept of source, will be taxable in South Africa.

A non-resident company which establishes a POB in South Africa has to register as an external company in terms of the Companies Act. Such a “branch” or external company is listed as a potential PE in Article 5(2) of the OECD MTC. However, a branch will only

create a PE if it also complies with the requirements for a fixed place of business per Article 5(1).

The scope of this dissertation does not allow for a detailed discussion of the source of income principles. However, the following few comments are included to provide necessary background. The term “source” is not defined in terms of SA tax legislation, however, SA courts have provided guidance on how to determine the source of income. In this regard, the principle test was determined in the case of *CIR vs Lever Brothers and Unilever*<sup>44</sup> where the court held that the originating cause of the income must be established and, once established, the location of the originating cause must be determined, i.e. where is the work done to earn that income. SA courts have further determined that, where a taxpayer has more than one source for income, the dominant source should be determined.

Overall, there is no steadfast rule when it comes to ascertaining the source of income and each case will be determined by applying the basic principles developed by the courts to the individual set of facts. The location of the conclusion of an agreement of sale, for example, is generally taken to mean the location where the last party to sign the agreement does so<sup>45</sup> and that will be deemed to be the source of the income.

The tests to determine whether or not a PE has been established may be easier to answer as it is more clearly set out than the tests to determine the source of income (Silke 2010:57-58).

### **3.2.2 Fixed location**

It is not necessary for the non-resident company to own the premises from where it is conducting its business activities to create a PE or establish a POB. A POB will be established when a certain location can be associated with the company due to its business activities being carried on from there on a regular basis. However, for creating a PE, the

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<sup>44</sup> 1946 AD Judge Watermeyer held at 441:

“the source of receipts, received as income, is not the quarter whence they come but the originating cause of their being received as income, and that originating cause is the work which the taxpayer does to earn them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital.”

<sup>45</sup> *Kergeulen Sealing and Whaling Co Ltd v CIR* 1939 AD 487.

location must also be at the disposal of the entity (Olivier & Honiball 2008: 97) and the OECD Commentaries provide that the mere presence at a place of business does not satisfy the location requirement for a PE.

With regards to creating a PE it has been shown that if different locations are involved, each location will be considered separately, unless the different locations form a coherent whole from a commercial perspective (Arnold 2003:484).

In this regard, certain factors have been developed in the case law which can indicate the establishment of a POB, although none of these factors in isolation will be sufficient to establish a POB:<sup>46</sup>

- Entering into a lease. This factor is also included in the OECD Commentaries to Article 5 where it is held that it is immaterial whether or not the non-resident company owns or rents the premises, as long as there is a certain amount of space at the disposal of the non-resident company which is used for conducting its business activities.
- Applying for a licence which is associated with a specific address and correspondence regarding the business being addressed to a certain address. Similarly, it has been held that a licence or letterhead with a business address could be a factor indicative of a PE, but cannot in isolation carry enough substance to establish a PE (Skaar 1991:207).
- Some physical indication or visible sign that the company has a connection with a particular physical location.<sup>47</sup> Firm signage in isolation will not create a PE, the term suggests that something more substantial is required, i.e. facilities equipped to carry on the business activities of the entity (Skaar 1991:207).

In the OECD Commentaries certain examples of activities which would establish a PE are provided. A first example is that of an employee occupying an office in the building of a newly acquired subsidiary for an extended period of time in order to align the business of the acquired subsidiary with that of his employer. Another example is that of a painter who paints for three days a week in the large office building of his biggest client.

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<sup>46</sup> *Re Oriel Ltd* [1985] All ER 216 at 224-225

<sup>47</sup> *Deverall v Grant Advertising Inc* [1954] 3 All ER 389

When considering the criteria for creating a PE, it is the purpose of the place of business to serve the business activities and not to be subject thereto and this question will be answered with reference to the connection between the place of business and the taxpayer and more specifically whether the taxpayer has a “right of use” to the place of business. Once a place of business is found, a PE does not exist until compliance with the other criteria is established (Skaar 1991:112).

This “right of use” does not have to be an exclusive right, any legal right as owner or lessee will suffice. In this regard Skaar (1991:158) has shown that the “right of use” test will be satisfied if the taxpayer’s use of the place of business cannot be suspended without the taxpayer’s consent. The OECD Commentaries also provide that a place of business may be situated within the business facilities of another enterprise where the non-resident enterprise has at its disposal certain premises at a client’s place of business.

It is accepted that the place of business does not have to be fixed to the soil to establish a specific geographic spot. In this regard an example would be a stall in a market place to which the vendor returns weekly to sell his goods which could establish a PE for the vendor seeing as he has a location for conducting his business activity within the market place (Skaar 1991:126-127).

The duration of the taxpayer’s presence, the substance of the place of business and the nature of the place of business are all factors that will be considered to determine whether the location test have been complied with (Skaar 1991:151).

Although the same factors will typically play a role in determining whether, with regards to the “location” test, a POB was established or whether a PE was created, it is submitted that the level of presence and activity required for a POB in term of the Companies Act is at a lower threshold than for a PE. In this regard, the fact that the place of business must be at the disposal of the business entity, distinguishes the PE criteria from the POB criteria. A POB could be established where a certain location is merely associated with the business activities of the entity.<sup>48</sup> Accordingly it is submitted that the meanings of POB and PE are not aligned in this regard.

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<sup>48</sup> *Re Oriel Ltd* [1985] ALL ER 216

### **3.2.3 Degree of permanence**

A degree of permanence is a necessary requirement for both the establishment of a POB<sup>49</sup> and a PE.

It has been held that a foreign company has to regularly and habitually conduct its business from a location in order to establish a POB for the purposes of the Companies Act.

With regards to the “duration” test for creating a PE the Commentaries provide that although no hard and fast rule can be provided, experience has shown that where the business is conducted for a period longer than 6 months, a PE may possibly exist. The activities do not have to be exercised with this degree of permanence, but the place of business must be set up to reflect such a degree of permanence (Olivier & Honiball 2008: 99), i.e. there must be an expression of permanence with regards to using the place of business. Furthermore, if the place of business was intended to be used for a longer period of time, but due to a change in circumstances the actual period was much shorter, this will not decide the “duration” leg of the PE test (Skaar 1991:217).

For activities of a recurrent nature, the Commentaries provide that each period should be considered cumulatively in order to determine the degree of permanence.

The author submits that with regards to the “duration” test, the threshold for establishing a POB is again lower than for creating a PE. Furthermore, the six months guidance provided in the Commentaries, compared to the 21 days POB requirement, provides further confirmation that the degree of permanency required to establish a POB is lower. It is therefore submitted that in this regard the criteria for the concepts are again not aligned.

### **3.2.4 Carrying on of a business**

To create a PE the business activities of the enterprise must actually be carried on from the fixed place seeing as this is a test to conclude on the taxing rights with respect to the business profits of an enterprise. The taxing rights are allocated either to the country where the business is resident or where it is conducting its business (Arnold 2003:484).

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<sup>49</sup> *Dowson & Dobson Ltd v Evans & Kerns (Pty) Ltd* 1973 (4) SA 136 at 141

The OECD Commentaries provide that if the nature of the business is such that the activities are constantly moved between locations, a PE can still be created if it can be shown that these locations create a coherent whole commercially and geographically with respect to that business. Carrying on of a business must be distinguished from the establishment of a POB. A travelling circus, for example, will not establish a POB in every country where it pitches its tent, even though the business will be carried on there.<sup>50</sup>

Agents of a foreign company who regularly meet with clients in the lounge of a hotel, will not in isolation establish a POB, even though it is clear that they will be carrying on a business.<sup>51</sup>

Similarly, a PE will only be created in a hotel room if the foreign company regularly conducts its business from there. However, it has been shown that the agent's right to use the hotel room is similar to that of all the guests and therefore the "right of use" test has not been satisfied (Skaar 1991:205).

According to the definition for a PE in Article 5(1), the enterprise needs to perform a "business" activity through the PE. This "business activity test" is also supported by the direct exclusion from creating a PE through auxiliary activities, i.e. non-"business" activities (Skaar 1991:229). In the OECD MTC, the term "business activity" is not defined. Accordingly, in treaties where the countries do not specifically define this term, recourse will have to be made to the domestic laws of the treaty parties as per the provisions of Article 3(2) of the OECD MTC.<sup>52</sup> Another part of the "business activity" test is the "business connection" test, i.e. that the business activities of the foreign enterprise must be carried on "through" the fixed place of business. If a foreign company carries on business in South Africa but also has to keep an office in the foreign country for compliance purposes, a PE will not be created in the foreign country because the business of the enterprise is not carried on "through" that office. The "business connection" test can also assist in identifying the party for whom a PE is created at the fixed place of business (Skaar 1991:328).

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<sup>50</sup> *Dowson & Dobson Ltd v Evans & Kerns (Pty) Ltd* 1973 (4) SA 136 at 140

<sup>51</sup> *Re Oriel Ltd* [1985] 3 All ER 216 at 220

<sup>52</sup> Article 3(2) provides: "As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."



According to the OECD Commentaries the wording of this requirement has to be interpreted widely and will include any situation where business activities of the taxpayer are carried on at a particular location at the disposal of the enterprise for that purpose. A PE will exist from the moment that the enterprise conducts its business through a fixed place of business.

A POB will not necessarily be created at a construction site for a civil engineering company. However if business is being carried on there and the world can address this company there a POB could immediately be established at the construction site.<sup>53</sup> This should be contrasted to a construction PE which will be created only if the construction project lasts for longer than 12 months as provided for in Article 5(3).

It is submitted that the “business activity test” is a common criterion for the concepts POB and PE. However, to create a PE both the “right of use” and the “business connection” tests have to be complied with, accordingly confirming that the threshold for establishing a POB is lower than for creating a PE. A further distinction must be made with regards to construction sites which could under certain circumstances establish a POB, but is subject to a “duration” test before creating a PE.

### **3.2.5 Agency**

For purposes of establishing a POB it has been held that the activities of an agent of a foreign company alone cannot establish a POB. The activities of the agent must be combined with a degree of permanence and a fixed location before a POB will be established.<sup>54</sup>

In contrast thereto, the OECD MTC provides for a dependent agent PE as an alternative to the fixed place of business PE. Article 5(5) of the OECD MTC provides:

“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

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<sup>53</sup> *Dowson v Dobson Ltd v Evans & Kerns (Pty) Ltd* 1973 (4) SA 136

<sup>54</sup> *Lord Advocate v Huron & Erie Loan & Savings Co* 1911 S.C. 612; *Rakusens Ltd v Baser Ambalaj Plastik Sanayi Ticaret AS* [2001] EWCA Civ 1820

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.”

The dependent agency test for a PE focuses on the activities of the agent rather than on the geographically fixed place from where these activities are conducted. The activities of the dependent agent must be crucial for the income earning activities of the taxpayer (Arnold, 2003:479).

The regularity of the agent exercising his authority to conclude contracts, and not the length of time that such an authority exists, is important in this respect. In contrast, the fixed PE is measured against the length of time that the place of business is utilised by the enterprise (Arnold, 2008: 230). The OECD Commentaries on Article 5(5) provides that the dependent agent must exercise his authority repeatedly and not only in isolated cases. The Commentaries also provide that lack of active involvement, or the mere rubberstamping of contracts by the enterprise, could also be indicative that the dependent agent has the necessary authority to bind the enterprise.

It is submitted that a POB cannot be established by an agent without a fixed place of business. In contrast thereto, the dependent agency PE is included in the OECD specifically to provide for instances where the business of the foreign company is not conducted from a fixed place of business. It is therefore submitted that in this regard the meaning of POB and PE should not be aligned seeing as the application of the POB and PE agency tests are different. With regards to a POB, an agent is just another criterion to consider together with all other relevant factors. With regard to a PE the dependent agent test is an entirely separate test that can in isolation result in the creation of a PE.

### **3.2.6 Auxiliary or preparatory activities**

Both the fixed place of business PE and the dependent agent PE are subject to the proviso in Article 5(4) which provides that if the activities performed at the fixed place of business or by the dependent agent merely relates to preparatory and / or auxiliary activities, no PE will be established (Arnold 2003:479). The Commentaries provides that these kinds of activities are so far removed from the profits realised by the activities of the enterprise that it would be difficult to allocate profits thereto for the purposes of taxation. The test to determine whether an activity is of a purely auxiliary or preparatory nature is whether the

activity in itself contributes significantly or an essential part to the total business activities of the company.

It has been held that for purposes of evaluating whether a PE is created, the gathering of information will be considered an auxiliary activity unless this is the primary purpose of the entity (Skaar 1991:310).

However, auxiliary or preparatory activities in the nature of gathering economic, commercial and financial information, could establish a POB, especially when the non-resident company also enters into a lease for, or employs staff at, the premises, i.e. creating a fixed location.<sup>55</sup>

It is again submitted that the application of this enquiry is different with regards to the concepts of POB and PE and accordingly the meanings of the concepts should not be aligned. With regards to establishing a POB, it is another contributing factor to consider. In contrast thereto when considering whether the activities are of an auxiliary nature with regards to a PE, the purpose of the enquiry is to negate the presence of a PE.

### **3.2.7 Other general factors**

Registering a foreign company as an external company does not create a new legal entity. The entity registered in South Africa remains a foreign incorporated company and is merely subject to the provisions of the Companies Act.<sup>56</sup>

Similarly a PE also has no separate legal identity apart from the foreign company, i.e. the legal entity remains a non-resident entity. A PE on the other hand does not need to be registered (Arnold 2003:478).

Immovable property in South Africa will create a POB for a non-resident company. For purposes of a PE, immovable property could be indicative of a PE, however, it is still necessary to determine who is carrying on their business through the fixed place of business and that is not necessarily the owner of the immovable property (Skaar 1991:112).

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<sup>55</sup> *South India Shipping Corp Ltd v Export-Import Bank of Korea* [1985] 2 All ER 219

<sup>56</sup> Section 323 of the Companies Act

The private residences of the directors of a company may be indicative of a POB, but is not a factor that can create a POB in isolation.<sup>57</sup> For purposes of a PE, the question that needs to be answered is whether the taxpayer has a “right of use” to the residential home as a place of business. If this is not the case or if the activities conducted through the private residence do not qualify as business activities, no PE will be created for the taxpayer (Skaar 1991:203).

A POB will be established where the general management of the company is found, or where the public can reasonably expect to find officials with the necessary authority to bind the company.<sup>58</sup> A place of management is included as a potential PE in Article 5(2) of the OECD MTC if it is found that there is compliance with the requirements for a fixed place of business.

### **3.3 Conclusion**

It is clear from the discussion above that the meaning of the term POB in the Companies Act and a “fixed place of business PE” as per Article 5(1) of the OECD MTC is not aligned in many instances. It is submitted that the threshold for establishing a POB is lower than for creating a PE with regards to geographic location, degree of permanence as well as the level of business connection required.

With regards to agency and auxiliary activities, it is submitted that the application of the enquiry with regards to a POB and a PE is completely different. When considering a POB the agent combined with a fixed location is an indicative factor. However, when considering the PE concept, the agency test is a completely separate test from the fixed place of business test. Similarly, auxiliary activities from a fixed location can lead to the establishment of a POB, but auxiliary activities will result in excluding a fixed location from creating a PE. These same factors are used to conduct different enquiries depending on whether a POB or a PE is considered.

Furthermore, the purpose of the POB enquiry is to establish liability for a foreign company under the Companies Act and to protect South African traders. The purpose of the PE enquiry is to establish tax liability for the foreign company and to protect the South

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<sup>57</sup> *Re Oriel Ltd* [1985] All ER 216 at 224

<sup>58</sup> *Dowson & Dobson Ltd v Evans & Kerns (Pty) Ltd* 1973 (4) SA 136 at 141

African tax revenue. Accordingly, it is submitted that the meaning of the concepts POB and fixed place of business PE also should not be aligned.

## **4 THE COMPANIES ACT 71 OF 2008 – THE MEANING OF “CONDUCT BUSINESS”**

### **4.1 Introduction**

On 8 April 2008 the Companies Act 71 of 2008 (“the 2008 Act”) was signed into law. The Department of Trade and Industry has announced the effective date for the 2008 Act to come into operation to be 1 April 2011. The Bill preceding the 2008 Act was accompanied by a “Memorandum on the Objects of the Companies Bill 2008” (“the Memorandum”) (Wainer 2009:806).

The Memorandum gave the history to the 2008 Act. In 2004 the Department of Trade and Industry released a policy paper which promised an “overall review of company law” in order to develop a “legal framework based on the principles reflected in the Companies Act, 1973, the Close Corporations Act, 1984, and the common law”. Five objectives were identified that should be set as the goal for each stage of this review process:

- Simplification;
- Flexibility;
- Corporate efficiency;
- Transparency; and
- Predictable regulation.

The Memorandum further explained that the provisions of the current law would be retained, provided these provisions met the criteria of being “appropriate to the legal, economic and social context of South Africa as a constitutional democracy and open economy”. Furthermore, in order to avoid uncertainty, provision was made for the co-existence of the 2008 Act and the Companies Act.

With reference to section 23 of the 2008 Act, the Memorandum states that the requirements of the Companies Act for the registration of external companies are retained in the 2008 Act.<sup>59</sup>

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<sup>59</sup> *Memorandum on the objects of the Companies Bill, 2008*

## 4.2 The provisions of section 23

Section 23 of the 2008 Act provides:

“(1) an external company must register with the Commission within 20 business days after it first begins to conduct business, or non-profit activities, as the case may be, within the Republic-

(a) As an external non-profit company if, within the jurisdiction in which it was incorporated, it meets legislative or definitional requirements that are comparable to the legislative or definitional requirements of a non-profit company incorporated under this Act; or

(b) As an external profit company, if, within the jurisdiction in which it was incorporated, it meets legislative or definitional requirements that are comparable to the legislative or definitional requirements of a profit company incorporated under this Act.”

The interpretation of the phrase “conduct business” is untested by our courts. However, based on the interpretative assumption that new legislation does not aim to change the existing law without due cause, the guidelines derived from the POB case law should be extrapolated to explain the phrase “conduct business” in the context of the 2008 Act.

It is also interesting to note that section 23 of the 2008 Act sets out certain criteria to determine whether a company “conducts business” for the purposes of registering as an external company. Section 23 provides:

“23(2) For the purposes of subsection (1), and the definition of “external company” as set out in section 1, a foreign company is not to be regarded as “conducting business or non-profit activities, as the case may be, within the Republic”, unless that foreign company is engaged in, or has engaged in, one or more of the following activities within the Republic:

(a) Holding a meeting or meetings of the shareholders or board of the foreign company, or otherwise conducting the internal affairs of the company;

(b) establishing or maintaining any bank or other financial accounts;

(c) establishing or maintaining offices or agencies for the transfer, exchange or registration of the foreign company’s own securities;

(d) creating or acquiring any debts, mortgages or security interests in any property;

(e) securing or collecting any debt, or enforcing any mortgage or security interest.

- (f) acquiring any interest in any property; and
- (g) entering into contracts of employment.”

Based on this list of criteria is it submitted that the test for “conduct business” will remain an assessment on the same objective factual basis as POB.

#### **4.3 “Conduct business” and “place of business”**

Even though the meaning of “conduct business” has not yet been tested in our Courts, it is submitted that the threshold for registering an external company in terms of section 23 is much lower than the POB threshold in section 322 of the Companies Act. The guidelines discussed above (see 2.2) for determining whether a POB has been established requires a more substantial presence. Mere agents are not enough to establish a POB for a foreign entity while agencies for the transfer of a foreign company’s securities is enough to satisfy the “conduct business” criteria. Furthermore, a POB is only established when a certain location can be identified with the foreign company, while a meeting of shareholders or the board of directors, which can be easily manipulated with regards to location, is enough to satisfy the “conduct business” criteria.

It is also stated in section 23 that “one or more” of the listed criteria could satisfy the “conduct business” test. However, the enquiry into whether a POB is established involves consideration of all the relevant factors and no single factor was identified that will immediately establish a POB.

#### **4.4 “Conduct business” and “fixed place of business” permanent establishment**

Accordingly it is submitted that the threshold for “conduct business” is also lower than the PE threshold discussed above at 3.2. A fixed place of business, for example, is a requirement for establishing a PE for the non-resident entity while a meeting of the shareholders or the board of directors can satisfy the criteria for “conduct business”. Furthermore, to create a fixed place of business PE, the business of the non-resident enterprise has to be carried on through the fixed place of business, while for purposes of the “conduct business” criteria, merely establishing a bank account or acquiring an interest in property is sufficient.



It is further submitted that the purpose and object of the “conduct business” test are also not aligned to those of the PE test. The purpose of the “conduct business” test will be to establish liability under the 2008 Act and the object to enable South Africans who trade with the foreign company to address such foreign company in law. In contrast thereto the PE concept creates liability under the ITA and enables SARS to collect the South African share of tax revenues from the global operations of a foreign company. Accordingly it is submitted that the meanings of “conduct business” and “fixed place of business” PE should also not be aligned.

University of Cape Town

## **5 PLACE OF EFFECTIVE MANAGEMENT**

### **5.1 Developing guidelines for determining the South African meaning of POEM with reference to Interpretation Note 6 as a frame work**

#### **5.1.1 Background**

South Africa changed from a source-based system of taxation to a residence-based system for years of assessment commencing on or after 1 January 2001.

Tax residence of a non-natural person is defined in section 1 of the Income Tax Act, Act 58 of 1962, (“ITA”):

“Any person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic.”

The effect for a tax resident in South Africa is liability for income tax on world-wide income. As stated previously this paper will not address the alternative tests of “incorporated, established or formed” due to their lack of relevance to non-resident companies becoming resident in the Republic.

“Place of effective management” (“POEM”) is not defined in the ITA. Guidance must therefore be sought from case law and other interpretational sources to determine the meaning of the phrase in order to determine tax residence.

SARS issued Interpretation Note 6 (“IN6”) on 26 March 2002, which provides guidance on SARS’s interpretation of POEM. It should be noted that IN6 merely represents SARS’s view on the interpretation of POEM and is not binding law (Huxham & Haupt 2009:13).

IN6 states in the “Background” section, that it is intended to address the inconsistent use of the concepts “managed and controlled”, “managed or controlled” and “effectively managed”.

It is further noted that:

“The term ‘place of effective management’ is not defined in the Act and the ordinary meaning of the words, taking into account international precedent and interpretation, will assist in ascribing a meaning to it.”

Even though the term is also used by the OECD MTC as the tie-breaker test for corporate residency, there is no universal meaning for POEM.

IN6 continues to distinguish between POEM, shareholder-control and control by the board of directors. It states that:

“In order to determine the meaning of ‘place of effective management’, one should keep in mind that it is possible to distinguish between –

- The place where central management and control is carried out by a board of directors;
- The place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day/regular/operational management and business activities;
- The place where the day-to-day business activities are carried out/conducted.”

Therefore, it is stated that POEM is where the company is managed on a day-to-day basis by the senior managers or directors of the company. This is independent from where the board of directors might meet. POEM refers to the implementation of policy and other strategy decisions.

If these strategy decisions are actioned from various locations, SARS is of the view that the POEM will then be where these decisions are actually implemented, i.e. “the place where the business operations/activities are actually carried out or conducted”. If these activities are then conducted from various locations, SARS determines POEM to be where the strongest economic *nexus* can be found.

Finally it is stated that each case will have to be evaluated on its own factual matrix. The test for determining whether the POEM of an entity is in South Africa is therefore also an objective test, similar to the POB and PE tests discussed previously. IN6 lists certain circumstances that may provide guidance:

- “Where the centre of top level management is located;

- Location of and functions performed at the headquarters;
- Where the business operations are actually conducted;
- Where controlling shareholders make key management and commercial decisions in relation to the company;
- Legal factors such as the place of incorporation, formation or establishment, the location of the registered office and public officer;
- Where the directors or senior managers or the designated manager, who are responsible for the day-to-day management, reside;
- The frequency of the meetings of the entity's directors or senior managers and where they take place;
- The experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity;
- The actual activities and physical location of senior employees;
- The scale of on shore as opposed to offshore operations;
- The nature of powers conferred upon representatives of the entity, the manner in which those powers are exercised by the representatives and the purpose of conferring the powers to the representatives.”

In the English case, *De Beers Consolidated Mines, Limited v Howe*,<sup>60</sup> it had to be decided whether a company incorporated in South Africa with its head office in Kimberly could be a resident of England for purposes of income tax. Lord Loreburn held at 458 in an often quoted dictum:

“Now, it is easy to ascertain where an individual resides, but when the inquiry relates to a company, which in a natural sense does not reside anywhere, some artificial test must be applied.”

As stated above, POEM is also used as the residence tie-breaker test in article 4(3) of the OECD MTC. South Africa is only an official observer of the OECD and not a member, but still employs the OECD MTC as a basis when negotiating double tax treaties (Olivier & Honiball 2008:9-10). Furthermore, the definition of tax residency for a non-natural person

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<sup>60</sup> *De Beers Consolidated Mines, Limited v Howe* (Surveyor of Taxes) House of Lords 1906 AC 455

in section 1 of the ITA also provides that if a person is deemed to be exclusively a resident of another country in terms of a DTA, such a person cannot be a tax resident for purposes of the ITA.

In terms of section 108 of the ITA, tax treaties entered into by South Africa for the relief of double taxation will have the same force of effect as the domestic legislation.

Each of the criteria listed in IN6 as indicative of establishing the POEM of a foreign company will be considered in more detail in the sections to follow. These criteria will be used to analyse the meaning of the concept POEM against the guidelines for the interpretation of POB as identified in Chapter 2 in order to determine whether the meaning of these two concepts should be aligned or not.

### **5.1.2 Where the centre of top level management is located**

The “general approach” described in paragraph 3.2 of IN6, states that POEM refers to the regular, day-to-day management by directors through the implementation of policy and strategic decisions communicated down from the board of directors.

This first criterion therefore seems more in line with the international view on the meaning of POEM and does not correspond with the day-to-day management as required by the “general approach” (Van der Merwe 2006:131).

It is however in line with English case law where Lord Loreburn concluded in the *De Beers*<sup>61</sup> case:

“I regard that as the true rule, and the real business is carried on where the central management and control actually abides.”

Based on the facts of the case, he concluded that the company was a tax resident in England which was where the real control was exercised. Persuasive facts were that:

- England was where the majority of the directors resided;
- England was where the negotiations of the contracts with the diamond syndicates were always controlled from; and

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<sup>61</sup> *De Beers Consolidated Mines, Limited v Howe (Surveyor of Taxes)* House of Lords 1906 AC 455

- England was where matters that dependant on a decision by the majority of the directors were concluded.

The “central management and control” test was confirmed in the *Estate Kootcher*<sup>62</sup> case, where Watermeyer J held that the “central management and control” of Standard Bank was in England. This was where Standard Bank was incorporated, had its registered office and where the board of directors met to control the business.<sup>63</sup>

The Commentaries to the OECD MTC provides guidance on the international view of the interpretation of POEM and confirms that the place where the meetings of the board of directors are usually held could be a factor indicative of the POEM.<sup>64</sup>

**(a) Central management and control: “realistic, positive management”**

The first UK case in which the concept of POEM within the tax treaty milieu was considered was the *Wensleydale*<sup>65</sup> case. The appeal was concerned with a simple capital gains tax avoidance scheme where the success of the scheme depended on the trustees of a settlement being resident in the Republic of Ireland (“the Republic”) by reason of its POEM being in the Republic. Factors which led to the court concluding that the POEM of the trust was not in the Republic included:

- The lack of Mrs Smith’s, one of the trustees’, involvement in any of the decision making for the transactions undertaken by the trust. From the evidence it was clear that her role was limited to the signing of documents as and when it was prompted to her.
- The court held that “effective” implies realistic, positive management. It would be found where “the shots are called”.
- Even though there was a signed resolution of the trustees for all the decisions of the trust, from the evidence it was clear that this was the mere rubber stamping of decisions already taken by Mr Wensleydale. The trustees in the Republic did not provide substantial input for any decisions.

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<sup>62</sup> *Estate Kootcher v Commissioner for Inland Revenue* 1941 AD 256

<sup>63</sup> Watermeyer J held at 262: “A useful analogy can again be drawn by considering the case of a human being. He does not acquire a “residence” or a “domicile”, properly so-called, in a country which he does not visit in person, merely by trading in that country; and similarly a corporation cannot acquire a residence in a country merely by carrying on trade through agents in that country.”

<sup>64</sup> Paragraph 24 of the Commentaries

<sup>65</sup> *Wensleydale’s Settlement Trustees v Inland Revenue Commissioners* [1996] STC (SCD) 241

The court therefore found that the centre of top level management with reference to the trust was not located in the Republic.

Vogel in his “*A Commentary to the OECD-, UN- and US Model Conventions for the Avoidance of Double Taxation*” stated that the POEM of a company is very similar to “place of management” as utilised in Germany and German case law holds this to be at the centre where top level management’s important policies are made (Vogel 2003:262).

**(b) Central management and control compared to “place of effective management”**

Another UK case in which the interpretation of POEM was considered was the *Wood*<sup>66</sup> case. It was held that a company, incorporated in the Netherlands, Eulalia Holding BV (“Eulalia”), and inserted into a structure as part of a tax planning scheme, had established its POEM in the Netherlands. The Court noted that even though Eulalia only took two critical decisions, the decision to purchase the shares and thereafter the decision to sell the shares, these decisions taken by the ABN AMRO Trust Company (“ABN AMRO”) who was appointed as the sole managing director of Eulalia, were still relevant to determine where the “central management and control” was exercised. Furthermore, it was held that a management decision does not cease to be so merely because management was privy to little information. Ill-advised decisions taken by management remain management decisions (Desborough-Hurst 2006).

The Court of Appeal noted at paragraph 27:

“In seeking to determine where ‘central management and control’ of a company incorporated outside the United Kingdom lies, it is essential to recognise the distinction between cases where management and control of the company is exercised through its own constitutional organs (the board of directors or the general meeting) and cases where the functions of those constitutional organs are ‘usurped’ – in the sense that management and control is exercised independently of, or without regards to, those constitutional organs. And in cases which fall within the former class, it is essential to recognise the distinction (in concept, at least) between the role of an ‘outsider’ in proposing, advising and influencing the decisions which the constitutional organs take in fulfilling their functions and the role of an outsider who dictates the decisions which are to be taken. In that context an ‘outsider’ is a person which is not, himself, a participant in the formal process (a board meeting or a general meeting) through which the relevant constitutional organ fulfils its function.”

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<sup>66</sup> *Wood and another v Holden (Inspector of Taxes)* Court of Appeal, Civil Division [2006] EWCA Civ 26, [2006] 2 BCLC 210, 78 TC 1

The Court also noted that in determining the POEM a “precise place of effective management” must be identified. This is also confirmed in the Commentaries, paragraph 24, where it is stated that an entity may only have one POEM at any particular time, even if more than one POEM is found.

Furthermore the Judge held that he would find it hard to differentiate between the POEM test and the “central management and control” test and he confirmed that it is a low threshold that the taxpayer needs to pass in order to prove to the court that the directors of the company was not merely rubberstamping decisions, i.e. the amount of activity is not conclusive (Meyerowitz 2007:84).

**(c) Central management and control and place of effective management: the tests serve different purposes**

In the *Smallwood*<sup>67</sup> case, another UK case that considered the concept of POEM, it was held that the two tests serve entirely different purposes, the one, “central management and control” attempts to establish residence in the UK, while the other, POEM, resolves cases of dual residence. “Central management and control” can be seen as a one-country-test, while POEM has to take the actions in both states into account. In this regard the case was distinguished from the *Wood v Holden* case where Chadwick LJ held that it is hard to see how “central management and control” can be distinguished from POEM.

The Special Commissioners concluded that the POEM was found “in which State the real top level management (or the realistic, positive management) of the trustee *qua* trustee is found” (Arnold, 2008:454).

It has been held that the place where the general management is situated could be indicative of where the POB of a foreign company is established.<sup>68</sup> It is submitted that this is however only one of the factors to consider. It is further submitted that the level of management that is indicative of an established POB is lower than the level of management required for establishing the POEM. The general management with regards to POB is more actively involved in the administration of the company’s affairs and not

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<sup>67</sup> *Re the Trevor Smallwood Trust; Smallwood and another v Revenue and Customs Commissioners* Special Commissioners SpC 669; [2008] STC (SCD) 629

<sup>68</sup> *Dowson & Dobson Ltd v Evans & Kerns (Pty) Ltd* 1973 (4) SA 136



necessarily “calling the shots”. Accordingly with regards to the “central management and control” criterion the meaning of the POB concept is not aligned to the POEM concept.

Furthermore, it is submitted that POB is also a one country test in that the test only considers whether a POB has been established in South Africa. The POB test also serves a different purpose than the POEM test. POB establishes liability in terms of the Companies Act while POEM establishes tax residency and liability in terms of the ITA. Accordingly with regards to the “central management and control” criterion the meaning of the POB concept also should not be aligned to the POEM concept.

### **5.1.3 Location of and functions performed at the headquarters**

It has been held that a company can only be resident where the activities for which the company was created is carried on and an indication of where this might be is the place from where the central management and control is exercised.<sup>69</sup>

Paragraph 24 of the Commentaries also lists the location of the company’s headquarters as a factor to consider. This criterion is therefore in line with the international view.

Section 170 of the Companies Act provides that every external company must have a registered address in South Africa. This “headquarter” address is however not necessarily the POB of the foreign company. Furthermore, when considering POB one should distinguish between “carrying on of a business” which is a very wide concept and will include nearly all activities within its ambit, while establishing a POB requires a more permanent level of activity.<sup>70</sup> This is therefore another factor where the meaning of POB and POEM are not aligned.

### **5.1.4 Where the business operations are actually conducted**

In *The Rhodesia Railways Ltd v Commissioner of Taxes (Southern Rhodesia)*<sup>71</sup> the Court had to determine whether the Appellants, The Rhodesia Railways Ltd (“Rhodesia Railways”), The Mashonaland Railway Company Ltd (“Mashonaland”), the Beira Junction Railway Company Ltd (“Beira Junction”) and the Beira Railway Company Ltd (“Beira”)

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<sup>69</sup> *TW Beckett & Co Ltd v H Kroomer Ltd* 1912 AD 324

<sup>70</sup> *Lord Advocate v Huron & Erie Loan & Savings Co* 1911 S.C. 612

<sup>71</sup> *The Rhodesia Railways Ltd and Others v Commissioner of Taxes (Southern Rhodesia)* 1 SATC 133

(the “Appellant companies”), were “ordinarily resident or carrying on business within the territory” in order to determine whether the Appellant companies had been correctly assessed for income tax in Southern Rhodesia. Stratford J concluded that each of these four companies should be subject to income tax in Southern Rhodesia because this is where the business operations were actually conducted.

Facts that persuaded Stratford J were:

- Mashonaland owned 170 miles of railway line and Rhodesia Railways owned 797 miles of railway line in Rhodesia;
- The general manager and the staff in charge of working the lines for all the companies were operating from the Mashonaland offices in Bulawayo;
- Mashonaland managed the railway lines on behalf of the other companies in accordance with a working agreement;
- With regards to Rhodesia Railways a supplemental agreement expressly indicated Mashonaland as the agent of Rhodesia Railways for purposes of working and controlling the railway lines to the benefit of Rhodesia Railways;
- Other general management activities conducted from the Mashonaland office in Bulawayo included issuing tickets, making contracts for the carriage of goods and employing/discharging of employees;
- The working relationship between Beira Junction, Beira and Mashonaland was that of a partnership where Mashonaland fulfilled the role of maintaining the railway line; and
- In this partnership, Mashonaland also had the responsibility to manage the rolling stock for the railway and acting on staffing needs.

Another case decided on where the business operations were actually carried on was the *Appleby*<sup>72</sup> case where Hoexter J held that the company was resident in Johannesburg by “virtue of the business which it carries on at its branch” there.

The POB of a foreign incorporated company will also be established where the business operations are actually carried on. In this regard the POB criterion and the South African view of POEM are aligned. It is however submitted that this factor for establishing POEM

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<sup>72</sup> *Appleby (Pty) Ltd v Dundas Ltd* 1948 (2) SA 905 (E) at 912 and quoted with approval in *Frank Wright (Pty) Ltd v Corticas “BCM” Ltd* 1948 (4) SA 456 (C)

is not aligned the international view of POEM. Furthermore, the threshold of activity that is required to establish a POB is submitted to be lower than for establishing POEM with regards to this criterion.

#### **5.1.5 Where controlling shareholders make key management and commercial decisions in relation to the company**

The statutes of a company will prescribe which functions will be under the exclusive authority of the board of directors and which functions will be governed by the shareholders. Once the statutes attribute a certain function to the exclusive jurisdiction of a certain organ of the company, such function may only be exercised by that organ. It is customary that a company will be subject to the control of the board of directors. The authority of the shareholders will be limited according to the statutes. However, the shareholders may remove directors in terms of section 220 of the Companies Act (Cilliers & Benade 2001:84-88). When the shareholders therefore do become involved in the corporate decision making process, it will not be in the day-to-day management of the company, but in a more controlling function (Van der Merwe 2006:132).

This criterion therefore again does not accord with the “general approach” set out in section 3.2 of IN6, i.e. the regular, day-to-day management by directors. It does however align to the international meaning of POEM, i.e. where the key decisions are made.

In *A Company v The Commissioner of Taxes*<sup>73</sup> the Judge made a distinction between the meaning of “effective control and management” in a popular sense and in a legal sense. He held that if the popular meaning was to be followed, he would probably find that the company is resident in South Africa. This is where the company that held the majority of shares was registered. From the evidence it was also established that the Appellant Company was in a sense controlled by way of advice and suggestion from this South African shareholder. The South Africa shareholder controlled the following matters:

- The appropriation of profits;
- The amount of the dividend to be declared in any year;
- The appointment of directors;
- The scheme for the payment of pensions to employees;

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<sup>73</sup> *A Company v The Commissioner of Taxes* 1941 SR 79

- The payment of bonuses and gratuities to employees;
- The construction of dwelling houses for employees; and
- The payment of donations.

However, in the end it was “beyond doubt” that the directors of the Appellant company remained the ones invested by law with the legal management and control of the Appellant company. Even though the directors seemed to be under the influence of the directions received from the South African shareholder, the statutes and articles of association of the Appellant Company still vested the direction and management of its affairs in the directors.

In the *De Beers*<sup>74</sup> case, even though the general meetings of the shareholders were always held in Kimberley, South Africa, weighed against all the other relevant factors, this was not enough to establish income tax residency in South Africa.

In Paragraph 24 of the Commentaries, as an indication of the international view, it is also held that the POEM is:

“the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made.”

This was confirmed in the *Wensleydale* case<sup>75</sup> where it was held that “effective” implies “realistic positive management”. It was also confirmed in the *Smallwood* case where it was held that POEM refers to where the “key” decisions are made, in terms of the Commentaries. In *Smallwood* it was held at paragraph 145:<sup>76</sup>

“We conclude that the state in which the real top level management, or the realistic, positive management of the trust, or the place where key management and commercial decisions that were necessary for the conduct of the trust’s business were in substance made, and the place where the actions to be taken by the entity as a whole were, in fact, determined between 19 December 2000 and 2 March 2001 was the United Kingdom.”

It is submitted that the location of this high level decision maker, i.e. the shareholder, will not be indicative of establishing a POB. The definition of POB in the Companies Act identifies it as the place where the foreign company is transacting its business. This is

<sup>74</sup> *De Beers Consolidated Mines, Limited v Howe (Surveyor of Taxes)* House of Lords 1906 AC 455

<sup>75</sup> *Wensleydale’s Settlement Trustees v Inland Revenue Commissioners* [1996] STC (SCD) 241

<sup>76</sup> *Re the Trevor Smallwood Trust; Smallwood and another v Revenue and Customs Commissioners*, Special Commissioners, SpC 669; [2008] STC (SCD) 629

indicative of the presence of a much lower level of decision maker than for establishing the POEM of a company. In this regard it is therefore submitted that the meanings of POB and POEM should not be aligned seeing as POB identifies where the business of the foreign company is transacted, while POEM identifies where the key decision making of the foreign company is taking place. The two concepts are utilised to identify a different aspect of the governing structure of a foreign company.

#### **5.1.6 Legal factors such as the place of incorporation, formation or establishment, the location of the registered office and public officer**

A company which is incorporated, formed or established in South Africa will be a resident for tax purposes and there will be no need to continue to examine the POEM of the company. This is however also a factor to take into account (Van der Merwe 2006:133).

In the *De Beers*<sup>77</sup> case Lord Loreburn held at 458, in an often quoted dictum:

“In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad.”

The court considered a variety of factors and Lord Loreburn concluded that despite being incorporated in South Africa, the real control of the company was exercised from England and that was where the company was deemed to be resident for income tax purposes.

It is submitted that incorporation alone will not, when weighed next to other factors, be enough to establish residency.<sup>78</sup>

The *Diary Board*<sup>79</sup> judgment created uncertainty in South African law regarding whether a company could have more than one residence. Until this case, it was held, relying on the *TW Beckett*<sup>80</sup> case that a company could only have one residence, either where it is

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<sup>77</sup> *De Beers Consolidated Mines, Limited v Howe (Surveyor of Taxes)* House of Lords 1906 AC 455

<sup>78</sup> *TW Beckett & Co Ltd v H Kroomer Ltd* 1912 AD 324

<sup>79</sup> *Dairy Board v John T Rennie & Co (Pty) Ltd* 1976 (3) SA 768 (W)

<sup>80</sup> *TW Beckett & Co Ltd v H Kroomer Ltd* 1912 AD 324

registered or where the central management and control is situated. However, Eloff J held that a company could have more than one place of residence, i.e. at the registered address and, if applicable, also at the place of central management and control (Hattingh 2009:619). Eloff J concluded at 771:

“In my view, a company registered in South Africa resides in law where the registered office is. If its principal place of business is situated elsewhere it may also reside at the latter place.”

This issue came under dispute again in the *Bisonboard*<sup>81</sup> case. The basic issue of dispute between the two groups of judges were whether the decision in the *Dairy Board* case above was correct or not. The judges were divided three to two in their decisions. Hoexter J, who led the majority, confirmed the *Dairy Board* decision and that is where our law now stands since 1991, i.e. for purposes of finding jurisdiction for a court of law, a company will reside at its registered address, but if applicable the company will also reside at the place of central management and control.

As stated earlier, the Commentaries provide that a company can only have one POEM.

In the business world of today where management activities can be conducted from anywhere across the globe, the POEM of a company can be established where the business choose and does not have to be related to where the company is incorporated.

In the Commentaries, paragraph 24, certain factors indicative of where the POEM is established is listed, among others:

- The country which laws govern the legal status of the company;
- Where the accounting records are kept; and
- Where there will be a risk of an improper use of the provisions of the OECD MTC if it is found that the company is a resident of one Contracting State and not the other.

It has been held that the registered address of a foreign company will not automatically be where the POB of the foreign company is established. It could be indicative of the POB, but it has to be weighed together with all the other relevant factors.<sup>82</sup> It is submitted that

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<sup>81</sup> *Bisonboard Ltd v K Braun Woodworking Machinery (Pty) Ltd* 1991 (1) SA 482 (A)

<sup>82</sup> *Grimshaw v Mica Mines, Ltd* 1912 TPD 450

these formal indicators of where a company can be found, i.e. registered address, place of formation or incorporation, should be considered together with all the relevant facts when considering whether either a POB or POEM of a foreign company is established.

#### **5.1.7 Where the directors or senior managers or the designated manager, who are responsible for the day-to-day management, reside**

It could probably be argued that these directors or senior managers should reside close to the physical place where the day-to-day management takes place. However, through modern communication technology this factor can also be manipulated if these individuals fulfil their duties via electronic communications. Therefore this factor will not always carry the same weight when determining the POEM (Van der Merwe 2006:133).

It has been held that if the directors were to reside in different countries, the country where the majority of the directors reside could be indicative of income tax residency, especially if a decision of the board in one country has never been overturned by the directors in the other country.<sup>83</sup>

Similarly, with regards to POB, it has been held that the matrimonial home of the directors of a company can be a factor when deciding whether a POB has been established.<sup>84</sup> However, the presence of the directors in isolation is not enough, and for example, business activity should also be present. Accordingly, with regards to this aspect the meaning of the concepts POB and POEM do seem to align.

#### **5.1.8 The frequency of the meetings of the entity's directors or senior managers and where they take place**

In the *De Beers*<sup>85</sup> case the court considered the fact that board meetings were held both in England and in South Africa. Certain decisions had to be made by the directors in South Africa according to the statutes of the company, for example, the technical management of the operations at the mines and expenditure for wages. Other decisions were decided by a majority vote of the directors, for example, the policies with regards to the disposal of diamonds, the future development and required output of the mines and how the profits of

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<sup>83</sup> *De Beers Consolidated Mines, Limited v Howe (Surveyor of Taxes)* House of Lords 1906 AC 455

<sup>84</sup> *Re Oriel Ltd* [1985] All ER 216

<sup>85</sup> *Supra* 76

the company should be applied. Minimum four of the directors had to be resident in England. In the history of the company it had never before happened that a decision of the directors in England was overturned by the South African board. Where the board meetings took place was not a conclusive factor but the decisions governed mostly by the board in England also constituted the “central control and management” decisions and therefore the company were found to be resident in England.

It is submitted that the meetings of the directors will not be a factor indicative of an established POB. The levels of activity and decision making where the directors are involved are not indicative of where the actual business of the foreign company is transacted. The meaning of POB and POEM are therefore not aligned with regards to this criterion.

It should further be noted that holding a meeting of the board could be indicative of “conduct business” in terms of the 2008 Act. This factor should still be considered together with all the relevant facts of the particular case. It should also be noted that the threshold for “conduct business” and registering an external company in the 2008 Act is lower than for establishing a POB in terms of the Companies Act.

#### **5.1.9 The experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity**

This factor could be useful to identify an attempt at manipulating the POEM, i.e. if these individuals are not adequately qualified for the functions they purport to fulfil (Van der Merwe 2006:133).

In the recent *Laerstate*<sup>86</sup> case it was noted that the activities of directors of a company can be sorted on a sliding scale. At the one extreme end you will have an agreement that is put before the directors who proceed to sign without any consideration thereof. The next level is where the directors know the content of an agreement before they sign, but do not pause to consider the effects of signature. Next level is that at which the directors merely have the absolute minimum of information and follow the wishes of the shareholder after considering this minimum of information. The other extreme is where the directors have ample information to make an informed decision.

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<sup>86</sup> *Laerstate BV* [2009] UKFTT 209 (TC)



The Tax Tribunal had to decide where the Appellant had its POEM. The Tax Tribunal confirmed the distinction set out in the *Smallwood*<sup>87</sup> case where it was held that “central management and control” is a one country test in order to determine whether a company is resident in the United Kingdom or not.

The Tax Tribunal concluded at paragraph 50-51:

“We have found that Mr Bock’s activities were concerned with policy, strategic and management matters throughout the time when he was a director of the Appellant and also after he ceased to be a director. We find that his activities constituted the real top level management (or the realistic positive management) of the Appellant and Mr Trapman’s activities were limited to signing documents when told to do so and dealing with routine matters such as the accounts. As the place of effective management was in the UK. Accordingly we find that the Appellant was resident in the UK both in domestic law and under the double taxation agreement throughout the relevant period...”

The importance of this case lies therein that the Tax Tribunal developed a substantive test for locating the central management and control of a company through the sliding scale approach towards director’s actions. The legal structure is distinguished from the substance, i.e. the taxpayer may have been formally managed and controlled in the Netherlands, but the real “mind” of the taxpayer was directed by Mr Bock, from the UK. This resulted in substance winning over legal form (Davies 2010:5).

When determining whether a POB has been established, the enquiry will not necessarily consider whether the directors were making informed decisions. As stated above, the decision making process of the directors is not usually indicative of establishing a POB because the POB enquiry focuses on where the actual business of the company is carried on. The decisions of the directors are directed at a higher level of governance than what is involved in a POB investigation.

However, the skills and expertise of the general management could be a factor to consider when determining whether a POB has been established. It is submitted that if the appointed general management cannot fulfil their function it could be an indication that the POB is to be found somewhere else.

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<sup>87</sup> *Re the Trevor Smallwood Trust; Smallwood and another v Revenue and Customs Commissioners* Special Commissioners SpC 669; [2008] STC (SCD) 629

### **5.1.10 The actual activities and physical location of senior employees**

This factor places the test at a lower level of management than the “central management and control” test as used by the English courts. The senior employees of a company will be involved in the management of the business and not the management of the company (Huxham & Haupt 2009:29).

According to paragraph 24 of the Commentaries, the place where the senior day-to-day management is carried on and the place where the chief executive officer and other senior executives carry on their activities could be indicative of the POEM.

The POB of a foreign company will be found where that company carries out its general management and administration. Similarly to this criterion of POEM, it will be from where the business is managed and not from where the company is managed. This criterion is therefore common for both tests.

### **5.1.11 The scale of onshore as opposed to offshore operations**

In the *De Beers*<sup>88</sup> case the court had to weigh the fact that the mining of the diamonds, being the basis for realising profits for the company, happened in South Africa. On the other hand the finance and diamond committees of the company met and acted from England and all contracts with the diamond syndicates responsible for the sale of the diamonds were always negotiated in and from England. The court continued to weigh all these onshore and offshore activities and found that the residence of the company was in the UK because eventually that is where the profits were realised notwithstanding that the diamonds came from a South African source.

It has been held that the auxiliary nature of activities, when combined with a degree of permanence and business activity could create a POB at the office of a foreign company. The court held that even though the London office did not perform the activities of a high street bank, the activities conducted still satisfied the conditions for establishing a POB.<sup>89</sup> Accordingly weighing and comparing the offshore and on-shore activities is a factor that should be considered when determining whether a POB or POEM has been established. In this regard the meanings of the two concepts are aligned.

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<sup>88</sup> *De Beers Consolidated Mines, Limited v Howe (Surveyor of Taxes)* House of Lords 1906 AC 455

<sup>89</sup> *South India Shipping Corp Ltd v Export-Import Bank of Korea* [1985] 2 All ER 219

### **5.1.12 The nature of powers conferred upon representatives of the entity, the manner in which that powers are exercised by the representatives and the purpose of conferring the powers to the representatives**

In *TW Beckett & Co Ltd v Kroomer Ltd*<sup>90</sup> the court had to determine the residence of a company with its registered office in Pretoria, where the managing director also resided. However, a branch was operated in Johannesburg, managed by three joint managers. The residence of the company had to be determined in order to establish jurisdiction within the Witwatersrand Local Division.

The three managers in Johannesburg had a wide power of attorney for the following actions:

- To sue for and recover sums of money due to the company from any persons and also to follow up with legal processes if necessary;
- To defend or commence any actions or suits of law; and
- Also to choose the *domicilium citandi et executandi* to manage and transact the affairs of the company in Johannesburg.

Despite these wide powers of the managers in Johannesburg, the court still concluded that the residence of the company was in Pretoria based on the facts that that was where the administration of the business as a whole was conducted from. Furthermore, the company had its registered head office in Pretoria and based on the facts, Pretoria was also the site of the parent establishment.

An agent cannot in isolation create a POB for a foreign company.<sup>91</sup> Without a location and a degree of permanence, the mere employment of an agent should not establish a POB. Furthermore, if the agent does not have the necessary authority to bind the offshore corporation, a POB cannot be created for the offshore entity.<sup>92</sup>

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<sup>90</sup> *TW Beckett & Co Ltd v H Kroomer Ltd* 1912 AD 324

<sup>91</sup> *Lord Advocate v Huron & Erie Loan & Savings Co* 1911 S.C. 612

<sup>92</sup> *Rakusens Ltd v Baser Ambalaj Plastik Sanayi Ticaret AS* [2001] EWCA Civ 1820

Accordingly, the POB of a foreign company is where the public can find employees or representatives with the necessary authority to bind the company.<sup>93</sup>

With regards to this factor the meaning of the concepts POB and POEM seems to be aligned. For both concepts this factor will have to be weighed together with all the relevant factual evidence before a judgement can be made.

## **5.2 A few summary comments on place of effective management**

The guidelines as identified in IN6 and discussed above are all tools enabling a meaningful investigation into the link between a company and a country. It seems that the factors should be weighed together and that no individual guideline should be decisive (Van der Merwe, 2006:133). SARS also indicated a clear intention in the IN to decide each case based on its particular factual matrix.

It has been held that IN6 describes a lower level of management, i.e. the management of the business, compared to the international view, i.e. the management of the entity (Huxham & Haupt, 2009:29).

It is possible that SARS considered the changing nature of business and the fact that the place where decisions are taken can be easily manipulated in the modern multinational management structures and within the electronic business environment (Van der Merwe, 2006:125). In fact, where electronic communications lead to management functions being executed at different locations, the IN provides that the POEM must be deemed to be “where the day-to-day operational management and commercial decisions taken by senior managers are actually implemented.”

The OECD released a discussion draft in 2003, *Place of effective management concept: Suggestions for changes to the OECD Model Tax Convention*, wherein one of the suggestions was to apply a hierarchy of tests. Included third in the hierarchy is an economic nexus test. The draft amendments to the Commentaries suggests that this test will indicate the State where the entity’s “economic relations are closer”, i.e. the State in which the entity is making the most use of economic resources. Alternatively it could be explained as the State “in which the entity’s business activities are primarily carried on”.

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<sup>93</sup> *Dowson & Dobson Ltd v Evan & Kerns (Pty) Ltd* 1973 (4) SA 136

IN6 acknowledges that business operations and activities can be conducted from various locations and therefore also includes the economic nexus test. In *Kerguelen Sealing & Whaling Co Ltd v CIR*<sup>94</sup> it was held that countries justify taxation on the residence-basis because public goods are consumed and infrastructure is utilised by the persons who are residents of a country. The use of the economic nexus test as a means to determine residence has been criticised because it is not stated as such in the ITA, however, if it is advanced as a deemed POEM, it could be useful (Van der Merwe, 2006:128).

This divergence of views between the SARS and the international view, i.e. where the managerial decisions are implemented against where these decisions are taken, considerably complicates tax planning in corporations where the business is carried on across borders (Integritax, 2009), which is not ideal in a country like South Africa wishing to enhance foreign direct investment.

SARS's interpretation also differs from the interpretation adopted in the UK. Furthermore, in terms of the OECD MTC commentaries the POEM is established where the key management decisions are taken which is also different from the SARS view (De Koker, 2010:56). Due to these differences with regards to the international views when interpreting POEM, the IN may have limited application when interpreting POEM either for the purposes of establishing residence in terms of section 1 of the ITA or when considering the tie-breaker clause in a treaty (Van der Merwe, 2006:137).

It should be noted that IN6 is merely SARS's view on POEM and is not legally binding. SARS's view is however at odds with certain international precedent which appears to put the test at a higher level than that suggested by the IN. The international precedent puts the POEM at the level of management of the company as a whole, rather than at the level of "execution and implementation" as suggested in IN6 (Van der Merwe, 2006:123).

### **5.3 Should the meanings of "place of business" and "place of effective management" be aligned?**

There are instances where the factors indicative of POB and POEM are aligned in its application. There are also various instances where the factors are not aligned.

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<sup>94</sup> *Kerguelen Sealing and Whaling Co Ltd v Commissioner for Inland Revenue* 1939 AD 48

In the *In Re Oriel* case, for example, it was held that the residence of the directors of a company cannot in itself establish a POB, however, for POEM purposes the residence of the directors as the key decision makers of the company could be a determining factor if the majority of directors reside in South Africa and their decisions are never overturned by the other offshore directors. While the frequency of directors meetings and where they take place could be a factor indicative of the POEM of a company, these meetings will not necessarily be an indication for establishing a POB, seeing as the POB will be where the actual business activities of the foreign company is conducted. Another factor where the meaning of the two concepts is not aligned is when the scale of the onshore and offshore activities is compared. A majority of offshore activities could confirm that the POEM is not in South Africa, while it has been held that extensive auxiliary activities conducted by an offshore office could be a contributing factor to creating a POB.

It is submitted that the meaning of these two concepts also should not be aligned.

First, the level of activity that is required to establish a POB, i.e. the daily business activities of the company as governed by general management is different from the level of activity required to establish the POEM of a foreign company. The POEM is where the key decisions are made and not where these decisions are implemented, which is likely to be where the POB would be established.

Furthermore, the POB test and the POEM test serve different purposes. The POB test establishes liability in terms of the Companies Act, while the POEM test establishes liability in terms of the ITA. The purpose of section 322 is to identify an address where the foreign company can be addressed for legal purposes in order to protect the South African commercial community. The purpose of establishing tax residency is to determine the rightful revenue that is due to South Africa from a foreign company conducting business here, in order to protect the South African tax base.

## 6 CONCLUSION

This dissertation asks whether the meaning of POB, fixed place of business PE and POEM should be aligned.

It could be argued that by aligning the meanings of these concepts certainty with regards to the South African company law and tax liability that will be attributed to the activities of a non-resident entity will be promoted. Such certainty could arguably promote foreign direct investment in South Africa and enhance international trade.

Whether the criteria for any of these three concepts have been fulfilled is a factual enquiry and will depend on the particular facts and circumstances.

It was shown in Chapter 3 that the meaning of POB and PE are not aligned. Although there are certain similarities in the criteria for establishing a POB and creating a PE, the threshold with regards to the “location” and “duration” tests are submitted to be lower for establishing a POB.

It was furthermore shown that the meaning of the two concepts also should not be aligned. The activities of an agent, for example, is an entirely separate test in terms of the PE definition, while in terms of the POB concept, an agent together with a degree of permanence and a location could establish a POB. Furthermore, the performance of auxiliary activities at a fixed location could be a factor indicative of an established POB, while it is a criterion that excludes a fixed location from the PE definition.

With regards to the 2008 Act and the “conduct business” criteria, it is also submitted that the threshold for registering an external company is lower than the PE threshold and that the meanings of the two concepts are accordingly not aligned. In terms of the 2008 Act, for example, the non-resident company could be seen to “conduct business” once a meeting of the shareholders or directors is held in South Africa while to create a PE in South Africa a fixed location and business activities are required.

The further question asked is whether or not POB as a requirement that leads to the registration of an external company in terms of the Companies Act and POEM as a guideline for determining the tax residency for non-natural person in South Africa, should have a similar meaning?

It is submitted that these two criteria should also not be aligned.

First it is clear that the meanings of the concepts are not aligned. The level of management indicative of establishing a POB, for example, is lower than the level of management that would establish a POEM. Also, the threshold for business activity required to establish a POB is submitted to be lower than the level of business activity that could be indicative of a POEM.

Furthermore, the POB and POEM tests also should not be aligned as it was held in the *Smallwood*<sup>95</sup> case that the purpose of POEM is to solve cases of dual residency, i.e. it is a two country test. It is submitted that whether a POB has been established is a one country test because such registration does not affect the residence of the company, neither in its country of incorporation, nor in South Africa.

Furthermore, it was shown that the POEM of a company will be found where the “central management and control” is located, i.e. where the strategic decisions are taken, be that by the board of directors, or on management level, i.e. where the key decisions of the business are made. However, the business of a company is not necessarily carried on where the strategic decisions are taken. The guidelines gathered from the case law on POB establish the POB at the place where the actual activities of the company are carried out with a certain degree of permanency. The POEM of a company is therefore found where a higher level of management is active than what is required to establish the POB and accordingly the enquiry focuses on an entirely different management level of corporate activities.

The level of management activity required by the 2008 Act in order to register as an external company seems to align with the international view on POEM in that a foreign company could be seen to “conduct business” when holding a meeting of the shareholders or board of directors. This is however only one of the criteria listed in the 2008 Act and should be considered together with all other relevant facts.

It is further submitted that the three concepts considered in this dissertation serve entirely different purposes and accordingly should not be aligned.

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<sup>95</sup> *Re the Trevor Smallwood Trust; Smallwood and another v Revenue and Customs Commissioners* Special Commissioners SpC 669; [2008] STC (SCD) 629



The POB concept in the Companies Act ensures that an external company will be subject to the provisions of the Companies Act and treated similar to South African companies.

The purpose of the concepts PE and POEM is to establish taxing rights with regards to the foreign entity. Different tax liabilities are attributed to non-resident entities that carry on business in South Africa. The tax liability will depend on the level of presence and activity which a non-resident entity maintains here. An external company will be taxable only on the South African source income earned. A foreign company that established a PE in South Africa will be liable to tax on the profits attributable to that PE only. If the POEM of a foreign company is established in South Africa, such company will be tax resident here and liable to tax in South Africa on its worldwide income.

The concepts also serve to protect different rights. The POB concept serves to protect the business community of South Africa by establishing a fixed place where the foreign company can be addressed in law. The concepts of PE and POEM protect the South African tax revenues through attributing taxing rights to SARS.

Seeing as the tests were introduced with different purposes and objectives in mind, it is submitted that the meaning of POB, PE and POEM should not be aligned. Accordingly, it is submitted that legal certainty and foreign direct investment will not be promoted through the alignment of the meanings of these three concepts.

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