

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

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Abstract

The objective of this study was to analyse and compare the concepts *permanent establishment* and *foreign business establishment* in order to make recommendations regarding the required additions and amendments to replace the concept *foreign business establishment* with the internationally recognised and accepted concept *permanent establishment*¹. The proposed replacement of the concept *foreign business establishment* with an internationally recognised and accepted tax concept will enhance the international compatibility of the Income Tax Act 58 of 1962. The use of an internationally recognised and accepted tax concept will provide clarity and certainty regarding the tax implications of section 9D(9)(b) for those affected by it. After comparing the two definitions it was found that, subject to certain suggested additions and amendments, the internationally recognised and accepted concept *permanent establishment* can replace the concept *foreign business establishment* in section 9D(9)(b) of the Income Tax Act 58 of 1962 without having a material impact on the objective of section 9D(9)(b). This replacement is possible due to the mutual objective of and the similar components contained in the definitions of the concepts *permanent establishment* and *foreign business establishment*.

Keywords

Business establishment, foreign business establishment, permanent establishment, controlled foreign company

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1. INTRODUCTION

The on-going globalisation of South African companies and the establishment of South African branches by external companies contribute to the importance of double tax agreements and controlled foreign company legislation ('CFC legislation'), which in turn contribute to the importance of the concepts *permanent establishment* and *foreign business establishment*.

The Organisation for Economic Co-Operation and Development ('OECD') (2008:80) stated that the concept *permanent establishment* is important in the interpretation and application of double tax agreements since it determines a country's right to tax a foreign enterprise's business operations within that country. The concept *foreign business establishment* is important when applying the CFC legislation, since a foreign business establishment is an exclusion from attribution under the CFC legislation in section 9D of the Income Tax Act, Act 58 of 1962 (as amended).

The Katz Commission stated in the Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa ('the Katz Report') that the international compatibility of South Africa's tax system will ensure an international understanding of our tax regime, which will enhance certainty among taxpayers regarding their tax liability (Katz, 1997). The Katz Commission also said that the use of internationally recognised and accepted tax concepts and terms in our local legislation is an important aspect of the afore-mentioned certainty (Katz, 1997).

An analysis of the concepts *permanent establishment* and *foreign business establishment* reveals that the concepts have the same objective: to identify criteria for the existence of legitimate and substantive business activities in the foreign tax jurisdiction. The definitions of the two concepts also have a number of similar components. The use of two separate concepts in order to achieve a similar objective could result in different interpretations by the courts, and could impede clarity and certainty for those affected by it. The question could be asked whether, due to the similarities between the objective of the two concepts and the similarities between the components of the two definitions, the concept *foreign business establishment* should not be replaced with the internationally recognised and accepted tax concept *permanent establishment*.

2. OBJECTIVE

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

3. RESEARCH METHOD AND SCOPE

A non-empirical research method was followed, as the analysis of the concepts *permanent establishment* and *foreign business establishment* can be done with reference to already published data.

The provisos to the foreign business establishment exclusion in section 9D(9)(b) of the Income Tax Act 58 of 1962 are considered to fall beyond the scope of this study since the provisos do not refer to a foreign business establishment or a permanent establishment and subsequently have no influence on the objective of this study.

4. ANALYSIS OF THE CONCEPT PERMANENT ESTABLISHMENT

4.1 Overview of the concept permanent establishment

Income Tax Act 58 of 1962 currently defines the concept *permanent establishment* in section 1 as follows:

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

The status of the OECD MTC was acknowledged by Corbett JA in *Secretary for Inland Revenue v Downing* [1975] 37 SATC 249 as an important model for interpreting concepts used in South African double taxation agreements since the South African double taxation agreements are based on the OECD MTC. Accordingly, while analysing the concept *permanent establishment*, reference is made to, and findings are based on, the guidance provided by the OECD MTC.

4.2 The objective of the concept permanent establishment

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

Article 5 of the OECD MTC contains a definition of a *permanent establishment*. An analysis of the definition of a *permanent establishment* in article 5 of the OECD MTC reveals the criteria for the existence of a *permanent establishment*. Once the criteria for the existence of a permanent establishment are met, it implies that legitimate and substantive business activities take place at the fixed place of business.

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

4.3 The components of the definition of a permanent establishment

The components of the definition of a permanent establishment as defined in article 5

of the OECD MTC are illustrated in **TABLE 1** below.

TABLE 1: Components of the definition of a permanent establishment

<i>Component</i>	<i>Description</i>
1	The general definition:
2	<ul style="list-style-type: none"> • a fixed place of business;
3	<ul style="list-style-type: none"> • a place of business;
4	<ul style="list-style-type: none"> • business carried on through the fixed place of business; and
5	<ul style="list-style-type: none"> • the business of an enterprise. <p>Examples of permanent establishments:</p> <ul style="list-style-type: none"> • a place of management; • a branch; • an office; • a factory; • a workshop; and • a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
6	The construction clause: <ul style="list-style-type: none"> • a building site of construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.
7	Exclusions from the concept <i>permanent establishment</i> : <ul style="list-style-type: none"> • the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; • the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; • the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; • the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise; • the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; and • the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character; and
8	The agency clauses: <ul style="list-style-type: none"> • the activities of an independent agent who acts in the ordinary course of his/her business will not constitute a permanent establishment; and • the activities of an dependent agent who regularly exercises his/her authority to conclude contracts in the contracting state in the name of the enterprise is deemed to be a permanent establishment of the enterprise unless the activities are excluded by article 5(4).
9	The relationship of control: <ul style="list-style-type: none"> • regardless of the level of control exercised by the parent company, a subsidiary company is not a permanent establishment of the parent company, since the subsidiary is a separate legal entity.

Source: Article 5 of the OECD MTC

5. ANALYSIS OF THE CONCEPT FOREIGN BUSINESS ESTABLISHMENT

5.1 Introduction

The concept *foreign business establishment* forms part of section 9D of the Income Tax Act 58 of 1962. Section 9D is an anti-avoidance provision, which determines that certain foreign-sourced income generated by South African CFCs are subject to tax in South Africa. Section 9D applies when the participation rights or voting rights of South African residents in a CFC exceeds 50%. It prevents the resident from converting the taxable income from the investment into non-taxable income and/or from deferring or avoiding domestic taxation by accumulating the income in the CFC (Meyerowitz, 2008). When section 9D applies, the net income of a CFC is attributed to and included in the taxable income of South African shareholders in terms of section 9D(2)(a). The foreign business establishment exclusion in section 9D(9)(b) is the main exclusion from the CFC legislation, resulting in the net income from the foreign business establishment being excluded from the taxable income of South African shareholders.

The Revenue Laws Amendment Act, Act 59 of 2000, replaced all references to the concept *permanent establishment* with a reference to the newly introduced concept *business establishment* in section 9D(9)(b) of the Income Tax Act 58 of 1962. The Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (SARS, 2000) does not provide a reason for the replacement of the concept permanent establishment. The amendments to section 9D was, however, discussed under the heading 'Residence basis of taxation', which implies that the amendments was consequential to this new basis introduced in 2000. This is confirmed in the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002 (SARS, 2002), which states that the introduction of the residence basis of taxation also involved new rules for the taxation of South African-owned foreign subsidiaries (referred to as controlled foreign entities). The concept permanent establishment is used in the United Kingdom as part of their exclusions from their CFC legislation (HM Revenue and Customs, S11998/3081 regulation 5(3)).

An investigation into the history and evolution of the concept *business establishment* reveals that the concept was initially inserted into the Income Tax Act 58 of 1962 in 2000. The business establishment definition was amended in 2002 and then replaced with the definition of a foreign business establishment in 2006. Paragraph (a) of the foreign business establishment definition was replaced in 2009.

5.2 The objective of the concept foreign business establishment

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

The objective of the foreign business establishment exclusion in section 9D(9)(b) is to grant exclusion to income derived from legitimate and substantive business activities, while non-substantive business undertakings remain subjective to the CFC legislation (Olivier & Honiball,

2011). This objective is in agreement with the international use of CFC legislation, since countries with CFC legislation generally do not intend for the CFC rules to interfere with legitimate and substantive business activities (Sandler, 1998).

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

5.3 Components of the definition of a foreign business establishment

TABLE 2 illustrates that the definition of a foreign business establishment can be divided into eight components being the general definition (with six elements), five conditions, the single country requirement relating to a group of companies and the industry-specific requirements.

TABLE 2: Overview of the foreign business establishment definition

<i>Component</i>	<i>Description</i>
1	The general definition: <ul style="list-style-type: none"> • a fixed place of business; • a place of business; • the location of the fixed place of business in a country other than the Republic; • the fixed place of business is used or will continue to be used; • the carrying on of the business of the CFC; and • the time requirement of not less than one year.
2	Condition 1: <ul style="list-style-type: none"> ○ The business is conducted through one or more offices, shops, factories, warehouses or other structures.
3	Condition 2: <ul style="list-style-type: none"> ○ The fixed place of business is suitably staffed.
4	Condition 3: <ul style="list-style-type: none"> ○ The fixed place of business is suitably equipped.
5	Condition 4: <ul style="list-style-type: none"> ○ The fixed place of business has suitable facilities.
6	Condition 5: <ul style="list-style-type: none"> ○ The fixed place is located outside the Republic solely or mainly for a purpose other than a tax-related purpose.
7	The single country requirement relating to a group of companies.
8	The industry-specific requirements: <ul style="list-style-type: none"> • prospecting or exploration operations for natural resources; • construction or installation projects; • bona fide farming activities; and • transport entities.

Source: Section 9D, Income Tax Act 58 of 1962

6. COMPARISON OF THE CONCEPTS PERMANENT ESTABLISHMENT AND FOREIGN BUSINESS ESTABLISHMENT

6.1 Comparison of the objectives of the two concepts

The objective of the concepts *permanent establishment* and *foreign business establishment* was discussed in sections 4.2 and 5.2 respectively. **TABLE 3** indicates that the concepts *permanent establishment* and *foreign business establishment* are used in different contexts within the Income Tax Act 58 of 1962 and that the two concepts affect different taxpayers. However, the objective of both the concepts *permanent establishment* and *foreign business establishment* is the identification of criteria for the existence of legitimate and substantive business activities in the foreign tax jurisdiction. This similarity will be further analysed in section 6.2 when the components of the definitions of the two concepts are compared.

TABLE 3: Comparison of the objectives of the concepts permanent establishment and foreign business establishment

	<i>Permanent establishment</i>	<i>Foreign business establishment</i>
Context in which the concepts are used	Provides criteria for the existence of a permanent establishment in order to determine the rights of the jurisdiction to tax the profits of a permanent establishment for the purposes of the application of double tax agreements.	An exemption from the CFC provisions in section 9D of the Income Tax Act 58 of 1962 which determines that income derived from legitimate and substantive business activities is subject to taxation in the hands of South African residents, while non-substantive business undertakings remain subject to the CFC legislation.
Taxpayers affected by the concepts	Applies to an entity of one contracting state which has a permanent establishment in another contracting state.	Applies to the resident shareholders of controlled foreign companies.
Objective of the concepts	Provides the criteria for the existence of legitimate and substantive business activities within a foreign tax jurisdiction.	Provides the criteria for the existence of legitimate and substantive business activities within a foreign tax jurisdiction.

Source: *OECD MTC and Income Tax Act 58 of 1962*

6.2 Comparison of the components of the definitions of the two concepts

6.2.1 Overview of the components

TABLE 4 below lists all the components of the concepts *permanent establishment* and *foreign business establishment* as identified in sections 4.3 and 5.3 above. Similar components are grouped together in order to reveal the similarities of and differences between the two concepts.

TABLE 4: Comparison of the components of the definitions of a permanent establishment and a foreign business establishment

<i>Permanent establishment</i>	<i>Foreign business establishment</i>	<i>Discussed in</i>
A FIXED PLACE OF BUSINESS		6.2.2
<ul style="list-style-type: none"> A fixed place of business. 	<ul style="list-style-type: none"> A fixed place of business. The location of the fixed place of business in a country other than the Republic. The time requirement of not less than one year. The fixed place of business is suitably staffed. The fixed place of business is suitably equipped. The fixed place of business has suitable facilities. 	
A PLACE OF BUSINESS		6.2.3
<ul style="list-style-type: none"> A place of business. 	<ul style="list-style-type: none"> A place of business. 	
THE FIXED PLACE OF BUSINESS MUST BE USED		6.2.4
<ul style="list-style-type: none"> Business carried on through this fixed place of business. 	<ul style="list-style-type: none"> The fixed place of business is used or will continue to be used. 	
THE CARRYING ON OF THE BUSINESS		6.2.5
<ul style="list-style-type: none"> The carrying on of the business of an enterprise. 	<ul style="list-style-type: none"> The carrying on of the business of the CFC. 	
EXAMPLES		6.2.6
<ul style="list-style-type: none"> Examples of permanent establishments: a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. 	<ul style="list-style-type: none"> The business is conducted through one or more offices, shops, factories, warehouses or other structures. Prospecting or exploration operations for natural resources. Bona fide farming activities. Transport entities. 	
THE CONSTRUCTION CLAUSE		6.2.7
<ul style="list-style-type: none"> The construction clause: a building site, construction or installation project will constitute a permanent establishment only if it lasts more than twelve months. 	<ul style="list-style-type: none"> Construction or installation projects which lasts for a period of not less than six months. 	
EXCLUSIONS		6.2.8
<ul style="list-style-type: none"> Exclusions from the permanent establishment definition: activities of a preparatory or auxiliary nature are excluded from the concept permanent establishment. 		
THE AGENCY CLAUSES		6.2.9
<ul style="list-style-type: none"> The agency clauses: provisions relating to a dependent agent and to an independent agent. 		

<i>Permanent establishment</i>	<i>Foreign business establishment</i>	<i>Discussed in</i>
REQUIREMENTS FOR A GROUP OF COMPANIES		6.2.10
The control relationship between group companies does not contribute to the existence of a permanent establishment	<ul style="list-style-type: none"> The single country requirement for a group of companies. 	
THE BUSINESS PURPOSE TEST		6.2.11
	<ul style="list-style-type: none"> The business purpose: the fixed place of business is located outside the Republic solely or mainly for a purpose other than a tax-related purpose. 	

Source: OECD MTC and Income Tax Act 58 of 1962

6.2.2 A fixed place of business

A fixed place of business

The definitions of a permanent establishment and a foreign business establishment both include a component requiring the existence of a fixed place of business. For the purposes of a permanent establishment, the requirement that the place of business must be fixed implies a connection between the place of business and a specific geographical point (OECD, 2008). The OECD MTC (OECD, 2008) also uses the terms a distinct place, a single place of business and a particular location as alternatives for a specific geographical point. In addition, fixed is also said to involve a degree of permanency (OECD, 2008).

In order to constitute a fixed place of business, the requirements relating to the location and permanency nature of the business must be met. The requirements relating to the location of the fixed place of business are met if geographic coherency exists (OECD, 2008). Alternatively, if activities take place between neighbouring locations, geographic and commercial coherencies need to exist in order for the requirements relating to the location of the fixed place of business to be met (OECD, 2008). Geographic coherency requires the operation of the business activities at a distinct place, single place of business, particular location or specific geographical point, with no regard for a time requirement or any period. Commercial coherency will be achieved if the activities are directly related to one another or if the activities are performed under a single contract (OECD, 2008).

The requirement of permanency refers to the duration of the business activities carried on at the fixed place of business (OECD, 2008).

The time requirement in the Act is a period of not less than one year. In accordance with the explanation of the National Treasury (2002), a business establishment must operate through 'a fixed location that suggests some permanence' in order to ensure that the business is more than a mere mailing address, website or momentary single business project.

It is submitted that the phrase a fixed place of business has the same meaning for both concepts, being the existence of a fixed place of business with geographic coherency, commercial coherency and a degree of permanency. No change will therefore be needed in this regard when the concept *foreign business establishment* in section 9D is replaced with the

concept *permanent establishment*. The implications of this component of the general definition of both a permanent establishment and a foreign business establishment are that the scope of a permanent establishment or foreign business establishment is limited and that the unintended taxation or exemption from CFC legislation of temporary business activities within a tax jurisdiction is prevented.

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

The requirement that the fixed place of business must be located in a country other than the Republic only appears in the definition of a foreign business establishment. Section 9D applies to South African-controlled foreign companies, which implies that the foreign business establishment will be a foreign company and therefore located in a country other than the Republic. Accordingly, it is submitted that the requirement for the location to be in a country other than the Republic in the definition of a foreign business establishment is unnecessary. No change will therefore be needed in this regard when the concept *foreign business establishment* in section 9D(9)(b) is replaced with the concept *permanent establishment*.

The time requirement of not less than one year

In terms of the current definition of a foreign business establishment, a time requirement of not less than one year applies to all activities which fall within paragraph (a) of the definition of a foreign business establishment. It is submitted that the purpose of this time requirement is to exclude temporary and/or once-off activities by quantifying a degree of permanency. The definition of a permanent establishment contains a time requirement of twelve months only for building sites, construction or installation projects. The OECD MTC provides, among other things, for a place of business which only existed for a short period of time to be a fixed place of business if the nature of the business is such that it will only be carried on for that short period of time (OECD, 2008). Due to the absence of a specific time requirement in the general definition of a permanent establishment, the scope of the definition of a permanent establishment is wider than the scope of the definition of a foreign business establishment. Accordingly, when the concept foreign business establishment in section 9D is replaced with the concept *permanent establishment*, the scope of the concept *permanent establishment* needs to be limited for the purposes of section 9D by adding an additional requirement to the exemption from the CFC legislation in section 9D. This additional requirement is discussed in 7 below.

The fixed place of business is suitably staffed, suitably equipped and has suitable facilities

The requirements that the fixed place of business has suitable staff, suitable equipment and suitable facilities are all requirements relating to the nature of the business which is only included in the concept foreign business establishment. The three requirements relating to the nature of the business are also referred to as the economic substance requirements (Olivier & Honiball, 2011).

Neither the Income Tax Act 58 of 1962 nor the Explanatory Memorandum defines what is meant by the words suitably and suitable. Accordingly, the meaning of these words needs to be determined with reference to their ordinary meanings. The Oxford Reference Dictionary (1992:825) defines suitable as 'right or appropriate for the purpose or occasion'. It is submitted that the word suitably is derived from the word suitable and accordingly has the same meaning.

In order to be suitably staffed, full-time employees who take management decisions and full-time employees who take operational decisions need to be present at the foreign business premises (Olivier & Honiball, 2011). The requirement for full-time employees could be

problematic when the actual requirements of the business and practice of the industry suggest that part-time staff could be sensibly employed (Clegg & Stretch, 2009). The requirement to be suitably staffed means that not all activities of the foreign business establishment can be outsourced (Clegg & Stretch, 2009). If outsourcing takes place, a full-time manager with the appropriate knowledge, skills and authority to hire and fire the outsourcing service provider must be employed (Clegg & Stretch, 2009).

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

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

An entity will not be a foreign business establishment if such establishment has no real economic nexus with the country within which it is located (Olivier & Honiball, 2011). The National Treasury (2002) stated that the economic substance requirements ensure that the business is more than a paper transaction or disguised form of passive income. The CFC lacks economic substance if the primary daily operations of the business are conducted by an independent contractor (National Treasury, 2002). If the work performed by independent contractors is merely incidental, it will not negatively impact the economic substance requirements (National Treasury, 2002). Similarly, a fixed place of business requires a physical presence within the foreign jurisdiction and a degree of permanency. Accordingly, it is submitted that the requirement for the existence of a fixed place of business renders the economic substance requirements unnecessary.

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

6.2.3 A place of business

The component a place of business appears in both the definition of a permanent establishment and a foreign business establishment. For the purposes of a permanent establishment, a place of business in the host country implies the physical presence of the enterprise at a particular place in the host country (Olivier, 2002). For the purposes of a foreign business establishment, the place of business must be the place in which the business is carried on (Clegg & Stretch, 2009). Accordingly, an ambulatory business operation which is managed out of an office which carries on only management and support functions will not meet the requirements of a place of business (Clegg & Stretch, 2009). It is submitted that the phrase a place of business has the same meaning in the concepts *permanent establishment* and *foreign business establishment*, namely to require an enterprise to have a particular space at its disposal. No change will therefore be needed in this regard when the concept *foreign business establishment* in section 9D(9)(b) is replaced with the concept *permanent establishment*.

6.2.4 The fixed place of business must be used

For the purposes of a permanent establishment, the business of the enterprise must be carried on through the fixed place of business. The OECD MTC does not give any comment on the meaning

of the word 'through'. The Oxford Reference Dictionary (1992:856) defines through as 'between' and 'among'. The wide meaning of the word through in this component of the definition of a permanent establishment entails that the requirement for the business to be carried on through a fixed place of business does not limit the scope of the concept *permanent establishment* significantly. It can be derived that the main requirement is that the location should be at the disposal of the enterprise and used in order to fulfil the purpose of the enterprise.

The definition of a foreign business establishment requires that the fixed place of business be used or continue to be used. The word use is defined in the Oxford Reference Dictionary (1992:902) as 'to cause to act or serve for a purpose; to bring into service' and also as 'the right or power of using; ability to be used'. It is submitted that the requirement that the fixed place of business is used or will continue to be used requires that the location of the fixed place of business in a country other than the Republic is used for the carrying on of the business. The implications of temporary interruptions for the requirement that the fixed place of business be 'used' or 'continued to be used' are not clear. The National Treasury (2002) determined that the requirement to use the property implies some level of activity with regard to the structure, and that the mere ownership or leasing right is insufficient to meet the requirement that the fixed place of business be used or continue to be used.

Due to the similar meaning, it is submitted that this requirement is similar to the permanent establishment requirement that a business be carried on through the fixed place of business. Accordingly, the location should be at the disposal of the enterprise or CFC and used in order to fulfil the purpose of the enterprise or CFC. No change will therefore be needed in this regard when the concept *foreign business establishment* in section 9D(9)(b) is replaced with the concept *permanent establishment*.

6.2.5 The carrying on of the business

It is submitted that the phrase business of an enterprise, which appears in the concept *permanent establishment*, consists of two parts, namely business and enterprise. The words business and enterprise are not defined in Income Tax Act 58 of 1962. Accordingly, the meaning must be determined with reference to its ordinary meaning.

One of the definitions of the word business is 'buying and selling, trade; a commercial house or firm' (Oxford Reference Dictionary, 1992:117). It was held in the Canadian case, *Smith v Anderson [1880] 15 ChD 247*, by Jessel MR that business means 'anything which occupies the time and attention and labours of a man for profit'. Accordingly, the word business has a very wide meaning.

One of the definitions of the word enterprise is 'an undertaking, especially a bold or difficult one; readiness to be included in such undertakings' (Oxford Reference Dictionary, 1992:275). Article 3 paragraph 1(c) of the OECD MTC determines that 'the term "enterprise" applies to the carrying on of any business' (OECD, 2008). Accordingly, the word enterprise has a very wide meaning.

McHugh J (*Thiel v Federal Commissioner of Taxation [1990] 171 CLR 338*) held that the carrying on of any business requires the habitual pursuit of business activities. In a South African context the carrying on of a business is given its ordinary meaning in the commercial sense unless the context indicates otherwise (*Platt v Commissioner for Inland Revenue [1922] 32 SATC 142*, *Stephan v Commissioner for Inland Revenue [1919] 32 SATC 54* and *Estate G v Commissioner of Taxes [1964] 26 SATC 168*). Since no restrictive guidelines or definitions exist, the phrase

business of an enterprise should be given a wide, unrestricted meaning.

It is submitted that the phrase carrying on of the business has the same meaning in the definitions of both permanent establishment and foreign business establishment, which is 'the habitual pursuit of business activities'. The only difference is that the foreign business establishment component refers to 'the CFC', while the permanent establishment component refers to 'an enterprise'. Due to the wide scope of the definition of an enterprise it is submitted that a CFC will be included in the scope of an enterprise. Accordingly, when the concept *foreign business establishment* is replaced with the concept *permanent establishment*, the word enterprise needs to be replaced with controlled foreign company for the purposes of section 9D(9)(b) in order to retain the context in which the exemption applies.

6.2.6 Examples

The definition of a foreign business establishment includes only some of the examples of business establishments found in the definition of a permanent establishment. The examples are not considered to be an essential part of the definition of a permanent establishment since the list is not an exhaustive list and the other requirements contained in the definition still needs to be satisfied in order to constitute a permanent establishment or a foreign business establishment.

A 'place of management' and a 'branch' are not included in the examples contained in the definition of a foreign business establishment. However, a place of management or a branch will constitute a foreign business establishment if the place of management or branch is also used for the carrying on of the business. Accordingly, the fact that a 'place of management' or a 'branch' is not included in the examples contained in the definition of a foreign business establishment will not have any influence if the concept *foreign business establishment* is replaced with the concept *permanent establishment*.

A mine, an oil or gas well, a quarry and any other place of extraction of natural resources are included in the examples of permanent establishments. The definition of a foreign business establishment contains an industry-specific requirement for prospecting or exploration operations for natural resources. It is submitted that the prospecting or exploration operations for natural resources will meet the requirements as per the general definition contained in the definition of a permanent establishment. Accordingly, the replacement of the concept *foreign business establishment* with the concept *permanent establishment* will have no impact on prospecting or exploration operations for natural resources.

The definition of a foreign business establishment also includes industry-specific requirements for bona fide farming activities and transport entities. It is submitted that the general definition of a permanent establishment is sufficient to include both bona fide farming activities and transport activities. Accordingly, the replacement of the concept *foreign business establishment* with the concept *permanent establishment* will have no impact on bona fide farming activities and transport entities.

6.2.7 The construction clause

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

resulting in a permanent establishment being present within the tax jurisdiction. The time requirement in the definition of a foreign business establishment for the purposes of construction or installation projects is six months. Accordingly, upon replacement of the concept *foreign business establishment* with the concept *permanent establishment*, the time requirement in the construction clause needs to be amended to six months.

6.2.8 Exclusions

The essential feature of all the exclusions listed in the definition of a permanent establishment is their preparatory or auxiliary nature (Russo, 2007). The definition of a foreign business establishment contains no list of exclusions. The time requirement of less than one year included in the first component (fixed place of business) in the definition of a foreign business establishment (see 6.2.2) implies that exclusions mentioned in the definition of a permanent establishment will also be excluded from the definition of a foreign business establishment if it continues for less than 12 months. Since the preparatory or auxiliary activities listed in the definition of a permanent establishment are unlikely to last for more than 12 months, it is submitted that the replacement of the concept *foreign business establishment* with the concept permanent establishment will not affect the objective of the foreign business establishment-exclusion in section 9D(9)(b). If the preparatory or auxiliary activities listed in the definition of a permanent establishment lasts for more than 12 months it will be excluded (not be a permanent establishment), while those activities would have been included in the scope of a foreign business establishment. Upon replacement of the concept *foreign business establishment* with the concept *permanent establishment* the word 'enterprise' needs to be replaced with the word 'CFC' for the purposes of the definition of a permanent establishment in section 9D(9)(b).

6.2.9 The agency clauses

There are no deeming provisions relating to independent and dependent agents in the definition of a foreign business establishment. The definition of a permanent establishment contains a provision relating to independent agents and a provision relating to dependent agents. Accordingly, the replacement of the concept *foreign business establishment* the concept *permanent establishment* will result in the inclusion of the agency clauses contained in the definition of a permanent establishment in section 9D(9)(b). **TABLE 5** compares the requirements of a dependent agent and an independent agent as per the definition of a permanent establishment.

The agency clauses are alternative tests for the existence of a permanent establishment, since a fixed place of business is not required by the agency clauses for the existence of a permanent establishment. Therefore the inclusion of the agency clauses in section 9D(9)(b) might extend the scope of section 9D(9)(b). Accordingly, upon replacement of the concept *foreign business establishment* in section 9D(9)(b) with the concept *permanent establishment*, a requirement should be added that a fixed place of business also needs to exist in order for the exemption to apply to the activities of a dependent agent.

TABLE 5: Comparison of the requirements relating to a dependent agent with those of an independent agent

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

Source: Article 5 of the OECD MTC

6.2.10 Requirements for a group of companies

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

Since the activities of a single business are often divided between different legal entities, the definition of a foreign business establishment allows for the structures, employees, equipment and facilities of other group companies to be taken into account when determining the existence of a foreign business establishment (SARS, 2009). The concept *permanent establishment* does not include a similar provision. Accordingly, it is submitted that this single country requirement for a group of companies needs to be added to the requirements in section 9D(9)(b) if the concept *foreign business establishment* is to be replaced with the concept *permanent establishment*.

6.2.11 The business purpose test

The business purpose test (that the fixed place of business is located outside the Republic solely or mainly for a purpose other than a tax-related purpose) is not included in the concept *permanent establishment*. This test is included in the concept foreign business establishment since it forms part of an anti-avoidance provision. The business purpose test prevents the relocation of business activities to foreign jurisdictions in order to delay and/or avoid taxation in South Africa. It is submitted that, should the concept *permanent establishment* replace the concept *foreign business establishment* in section 9D(9)(b), the business purpose test should be added to the provision as an additional requirement for the foreign business establishment-exclusion to apply.

7. ADDITIONS AND AMENDMENTS REQUIRED TO REPLACE THE TWO CONCEPTS

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

the definitions of the concepts *permanent establishment* and *foreign business establishment*.

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

- A time requirement of not less than one year should be added to the definition of a permanent establishment for the purposes of section 9D(9)(b) (see 6.2.2). This addition will ensure that the net income related to temporary and once-off activities remains subject to the CFC legislation in section 9D.
- If it is intended that the activities of a dependent agent (which does not require the existence of a fixed place of business) should not provide exemption from the CFC legislation in the absence of a fixed place of business, it should be added to the definition of a permanent establishment for the purposes of section 9D(9)(b) that a fixed place of business needs to be present in order for the exemption to apply to dependent agents. (see 6.2.9).
- The single country requirement for a group of companies which is included in the current definition of a foreign business establishment (see 6.2.10) should be added to the definition of a permanent establishment for the purposes of section 9D(9)(b) upon the replacement of the two concepts. This is required so that the structure, employees, equipment and facilities of the other companies in the group can be considered when determining if the section 9D(9)(b) exemption applies.
- The business purpose test, which is currently included in the concept *foreign business establishment*, should be added to the definition of a permanent establishment for the purposes of section 9D(9)(b) in order to ensure that the place of business is located outside South Africa solely or mainly for a purpose other than a tax-related purpose (see 6.2.11).

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

- The exclusion in section 9D(9)(b) is used in the context of the CFC legislation. Accordingly, the definition of a permanent establishment for the purposes of section 9D(9)(b) needs to be amended in order to retain the context in which the exclusion applies. This is achieved by replacing the word 'enterprise' in the definition of a permanent establishment with the word 'CFC' (see 6.2.5).
- The time requirement for construction or installation projects needs to be changed to six months (see 6.2.7).

8. PROPOSED DEFINITION OF A PERMANENT ESTABLISHMENT FOR THE PURPOSES OF SECTION 9D(9)(B)

The proposed definition below is based on the definition of a permanent establishment in the OECD MTC. Proposed additions to the OECD definition are underlined, while proposed omissions are shown in brackets:

- (1) For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of [an enterprise] a CFC is wholly or

partly carried on for a period of not less than one year.

- (2) The term 'permanent establishment' includes especially:
 - a) a place of management;
 - b) a branch;
 - c) an office;
 - d) a factory;
 - e) a workshop; and
 - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
- (3) A building site or construction or installation project constitutes a permanent establishment only if it lasts more than [twelve] six months.
- (4) Notwithstanding the preceding provisions of this article, the term 'permanent establishment' shall be deemed not to include:
 - a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the [enterprise] CFC;
 - b) the maintenance of a stock of goods or merchandise belonging to the [enterprise] CFC solely for the purpose of storage, display or delivery;
 - c) the maintenance of a stock of goods or merchandise belonging to the [enterprise] CFC solely for the purpose of processing by another [enterprise] CFC;
 - d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the [enterprise] CFC;
 - e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the [enterprise] CFC, any other activity of a preparatory or auxiliary character;
 - f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
- (5) Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of [an enterprise] a CFC and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the [enterprise] CFC, that enterprise shall, provided that a fixed place of business exists, be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the [enterprise] CFC, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.
- (6) [An enterprise] A CFC shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

- (7) The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.
- (8) Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a CFC may take into account the utilisation of structures, employees, equipment, and facilities of any other company –
- a) if that other company is subject to tax in the country in which the fixed place of business of the CFC is located by virtue of residence, place of effective management or other criteria of a similar nature;
 - b) if that other company forms part of the same group of companies as the CFC; and
 - c) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the CFC.
- (9) The fixed place of business must be located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic.

9. CONCLUSION

The concepts *permanent establishment* and *foreign business establishment* are currently used in different contexts within the Income Tax Act 58 of 1962 where it affects different types of taxpayers. However, both concepts have the same objective, namely the identification of criteria for the existence of legitimate and substantive business activities in the foreign tax jurisdiction.

The comparison of the components of the definitions of a permanent establishment and a foreign business establishment in 6.2 above reveals that the definitions of a permanent establishment and foreign business establishment contain many similar components and/or contain components which have the same meaning.

It was found that, subject to certain additions and amendments, the concept *foreign business establishment* in section 9D(9)(b) can be replaced with the concept *permanent establishment*. It is submitted that the concept *permanent establishment* is more suitable than the concept *foreign business establishment*, as the requirement for a degree of permanency, as contained in the definition of a permanent establishment, is more suitable in the modern business environment than the fixed time requirement of 12 months as *per* the definition of a foreign business establishment. The components of the definition of a permanent establishment are also better defined than those of a foreign business establishment. The concept *permanent establishment* is an internationally recognised and accepted tax concept. Accordingly, the use of the concept *permanent establishment* in the Income Tax Act 58 of 1962 enhances the international compatibility of the Income Tax Act 58 of 1962. Since the concept *foreign business establishment* is not an internationally recognised and accepted concept, the concept *permanent establishment* should have preference.

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