

# **DETERMINING “PERMANENT ESTABLISHMENT” IN THE DIGITAL ECONOMY EPOCH: A CASE FOR SOUTH AFRICA**

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## **SUMMARY**

This contribution analyses the concept of a “permanent establishment” in South Africa in light of the digital economy, and intends to inspire law reform. The analysis critically analyses the meaning of “permanent establishment” as found in sections 1 and 9 of the South African Income Tax Act<sup>1</sup> and in double-tax treaties concluded between South Africa and other countries.

The article analyses whether the South African permanent establishment is sufficiently robust to deal with a virtual permanent establishment. The analysis found that the South African concept of a permanent establishment falls short of capturing permanent establishments created through digital means as a result of digital transformation. This is because the current permanent establishment definition requires that the entity be physically present in the market country for tax purposes. In the digital age, foreign entities require no physical presence to transact in a market country. Foreign entities transact with customers all over the world on a remote basis. While this may be good for trade purposes, it is argued that this seriously erodes the tax bases of market countries (including South Africa) since these foreign entities circumvent paying taxes in market countries where substantial economic activity occurs. The inability to impose a tax on a virtual permanent establishment arguably deprives market countries of substantial revenues.

In light of this gap, the article provides instructive proposals on how South Africa could effect the necessary legislative reforms to impose effective taxes on virtual permanent establishments.

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<sup>1</sup> 58 of 1968.

## 1 INTRODUCTION

The rise of the digital economy (DE) has, among other things, improved worldwide productivity and exposure of multinational companies to new ideas, technologies and new management, as well as new business models.<sup>2</sup> In essence, the DE is a result of the interaction between information and communication technology (ICT), which has “made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy”.<sup>3</sup> It follows that international transactions between businesses and consumers and between businesses are concluded with little or no physical presence in the market (or source country). While worldwide trade appears to have gained momentum under the DE, there seem to be challenges accompanying the DE era. Among other issues is the design of tax policy and administration systems capable of keeping up with these rapid developments.

The question that arises is how to design a tax system suitable to deal with the taxation of corporations that do not have a physical presence in a particular jurisdiction? For international tax purposes, the concept of “physical presence” has played (and still does play) a significant role in establishing taxing rights.<sup>4</sup> Some multinational enterprises (MNEs) conduct trade in jurisdictions through a dependent agent that carries on a trade on behalf of the non-resident MNE.<sup>5</sup> The dependent agent scheme has become a breeding ground for tax avoidance schemes. This is especially evident where the MNE manipulates the agency agreement by formally finalising substantial contracts outside the market country.<sup>6</sup> In the DE context, MNEs

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<sup>2</sup> Notably, most of these digital transformations are driven by the 4th industrial revolution (4IR). There is no single definition of 4IR. The consensus is that 4IR is seen as a combination of numerous innovations that sought to blur the boundaries between the physical, computerised, and organic circles. 4IR grows at a rapid pace, and with this tenacity, it will probably keep policymakers, business specialists, and scholars busy for considerable years to come. See generally on 4IR, Oke and Fernandes “Innovations in Teaching and Learning: Exploring the Perceptions of the Education Sector on the 4th Industrial Revolution (4IR)” 2020 6(2) *Journal of Open Innovation: Technology, Market, & Complexity* 31; World Economic Forum (WEF) *The Future of Jobs Report 2018* (17 September 2018) <https://www.weforum.org/reports/the-future-of-jobs-report-2018> (accessed 2022-04-15).

<sup>3</sup> OECD/G20 Base Erosion and Profit Shifting Project *Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report* (2015) <https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1662632490&id=id&accname=guest&checksum=5AA213B72FB7AD48B20EED64776EB899> (accessed 2020-03-13).

<sup>4</sup> Art 7(1) of Organisation for Economic Co-operation and Development Model Tax Convention “The 2017 Update to the OECD Model Tax Convention” (2 November 2017) <http://www.oecd.org/ctp/treaties/2017-update-model-tax-convention.pdf> (accessed 12 March 2020-03-12) 16; Art 7(1) of United Nations Model Taxation Convention Between Developed and Developing Countries 2017 (2017).

<sup>5</sup> Art 5(5) of the OECD Model TC and UN Model TC; Rohatgi *Basic International Taxation* (2002) 77.

<sup>6</sup> OECD/G20 Base Erosion and Profit Shifting Project *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7: 2015 Final Report* 15 <https://www.oecd-ilibrary.org/docserver/9789264241220-en.pdf?expires=1662633359&id=id&accname>

require no “physical presence” to trade in foreign countries that are required to impose tax where “substantial economic activity” is created. Therefore, the DE poses a risk for the market country, which may lose its taxation right to the country of residence owing to the absence of physical presence. It is worthwhile noting that South Africa is among countries that subscribe to the traditional permanent establishment principle that requires “physical presence” for the purpose of interjurisdictional direct taxes. It is for this reason that this article analyses whether this approach to international taxation is still sound.

There are two recognised international tax conventions, namely the Organisation for Economic Co-operation and Development Model Tax Convention (OECD Model TC) and the United Nations Model Taxation Convention Between Developed and Developing Countries (UN Model TC). The focal discussion evolves around the meaning of permanent establishment (PE) as defined in the OECD Model TC, which forms the basis of the South African definition of PE in section 1 of the Income Tax Act<sup>7</sup> (ITA) and in section 9, which provides for the source rules. For illustrative purposes, reference is also made to the UN Model TC.

It is worthwhile noting that the DE impacts not only corporate income tax (CIT) but it also poses challenges for other forms of tax, such as indirect taxes and value-added tax. One of the challenges with value-added tax is that it is difficult to impose indirect taxes on the goods or services acquired through an electronic domain, particularly when the goods or services are supplied to a private consumer.<sup>8</sup> However, for purposes of this discourse, the focus is on the challenges posed by the DE on CIT and, in particular, with the PE definition.

This contribution analyses the South African PE definition as found in the ITA. As previously mentioned, the DE has improved current technological advances and economic productivity. While this is good, it is important to evaluate the implications that the DE has for the PE definition in South Africa. This is essential because the DE relies heavily on digital platforms that do not require the physical presence that is currently needed for tax purposes. This article used content analysis to assess qualitatively the current definition of PE as provided in the ITA, the OECD Model TC and double-tax agreements (DTA). During this analysis, the definition of PE as stated in the ITA is critically examined in light of the DE, which enables MNEs to operate remotely. The aim is to determine whether the South African PE definition needs to be expanded to capture PEs created through remote operations.

The discussion of the article proceeds as follows: heading 2 briefly discusses the PE definition and its elements; heading 3 outlines the features and characteristics of the DE; heading 4 provides an overview of the issues posed by the DE for international tax principles, accompanied by current

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=guest&checksum=EE11C90E6627EFF327CE45B47733DA1C (accessed 2020-03-13) 10, 15 par 7.

<sup>7</sup> 58 of 1968.

<sup>8</sup> OECD/G20 BEPS Project *Action 7: 2015 Final Report* 120 par 8.1.

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case law indicating shortcomings of the traditional definition of PE; heading 5 analyses the OECD response to the DE challenges; heading 6 comments on the traditional definition of PE; and heading 7 sets out recommendations to remedy the shortcomings.

## 2 DISCUSSION ON PERMANENT ESTABLISHMENT

### 2.1 The traditional permanent establishment concept

Before discussing the shortcomings of the traditional PE concept, it is instructive to illustrate its meaning and importance. What is a PE, and why is it so important? Articles 5(1) of both the OECD Model TC and UN Model TC define PE as a “fixed place of business through which the business of an enterprise is wholly or partly carried on”.<sup>9</sup> Under this definition, PE entails three essentials: a *place of business* that must be *fixed*, and *through which the business* is conducted, wholly or partially.

Wide research has been conducted that critically analyses each of these PE essentials.<sup>10</sup> For purposes of understanding, it is sufficient to note that a “place of business” refers to space that is available at the disposal of the enterprise,<sup>11</sup> irrespective of whether it is owned or rented.<sup>12</sup> The term “fixed” suggests that there must be a “link between the place of business and a specific geographical point”.<sup>13</sup> It follows that the business place should have a degree of permanence at a certain place; this requirement should not be interpreted to suggest that the fixed place must be rigidly immovable, or that the location must be at the exact physical geographic point during the course of business activities.<sup>14</sup> As long as one can establish that there is a nexus between the location and the business activities, as well as some degree of permanence, this might be sufficient to qualify as “fixed”. This requirement is usually established using location and duration tests.<sup>15</sup> Lastly, “through which business is carried on” means that the place must be a place on which the business enterprise is carried on wholly or partially. The words “carried on through” denote that the business activities are conducted at that

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<sup>9</sup> Art 5(1) of the OECD Model TC and UN Model TC.

<sup>10</sup> Ceballos “The Permanent Establishment Definition” in Brugger and Plansky *Permanent Establishments in International and EU Tax Law* (2011) 63–68; Oguttu and Tladi “E-Commerce: A Critique on the Determination of a ‘Permanent Establishment’ for Income Tax Purposes from a South African Perspective” 2009 1 *Stellenbosch Law Review* 74–96 78–78; Olivier “The Permanent Establishment Requirement in an International and Domestic Taxation Context: An Overview” 2002 *South African Law Journal* 866–883 873.

<sup>11</sup> *AB LLC and BD Holdings LLC v Commissioner of the South African Revenue Services* (SARS) 2015 ZATC 2 par 42.

<sup>12</sup> Commentaries on the Articles of the OECD Model Tax Convention “Commentary on Article 5 Concerning the Definition of Permanent Establishment” (OECD Model TC Commentary) (2010) <http://www.oecd.org/berlin/publikationen/43324465.pdf> (accessed 2020-03-12) 82 par 10.

<sup>13</sup> OECD Model TC Commentary 84 par 21.

<sup>14</sup> Ceballos in Brugger and Plansky *Permanent Establishments in International and EU Tax Law* 65.

<sup>15</sup> Oguttu and Tladi 2009 *Stell LR* 77.

particular fixed place.<sup>16</sup> It appears therefore that there must be a link between the business’s economic activity and the place of business. It should be stressed that determining whether a PE exists will be a factual analysis guided by the above requirements.

The traditional PE definition contains specific inclusions as well as exclusions. Article 5(2), (3) and (4) of the OECD Model TC enunciate inclusions and exclusions, respectively as follows:

<b>Inclusions:</b>	<b>Exclusions:</b>
Art 5(2)	Art 5(4)
a) a place of management	a) the use of facilities solely for the purpose of storage
b) a branch	b) the maintenance of a stock of goods or merchandise solely for storage purposes
c) an office	c) the maintenance of a stock of goods or merchandise solely for processing by another enterprise
d) a factory	d) maintenance of a fixed place of business solely for purchasing goods or merchandise or of collecting information purposes
e) a workshop	e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources	f) the maintenance of a fixed place of business solely for a) to e), provided that such activity or, in the case of subparagraph f, the overall activity if the fixed place of business, is of preparatory or auxiliary character.
Art 5(3)	
A building site or construction installation only if the project lasts more than twelve months. <sup>17</sup>	

The above is the general rule on PE for international tax purposes as enunciated in article 5 of the OECD Model TC. Notably, there is an exception to this, namely that a PE may be created through a dependent agent in terms of article 5(5). According to this provision, where a dependent

<sup>16</sup> Levouchkina “Relevance of Permanent Establishment for Taxation of Business Profits and Business Property” in Hans-Jürgen and Züger (eds) *Permanent Establishments in International Tax Law* (2003) 20–21.

<sup>17</sup> Practice has shown that this twelve-months threshold has given rise to abuse, sometimes MNEs (mainly contractors or subcontractors) split up one contract into several parts, each consists of the period less than twelve month to avoid meeting the PE. As such, anti-abuse rules will be introduced to counter the splitting up of contract, see *OECD Model Tax Convention on Income and on Capital Vol I & II* (Updated 21 November 2017) 21 para 52.

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agent habitually concludes contracts (binding a foreign company) without material modification by the non-resident, the latter is deemed to have created a PE. In that case, the foreign company is deemed to have a physical presence through its dependent agent.

## **2 2 South African definition of permanent establishment**

South Africa subscribes to the PE definition as defined in the OECD Model TC. Section 1 of the ITA describes a PE as one defined from time to time in article 5 of the Model TC. Section 9(2) of the ITA enunciates the source rules. In terms of these rules, an amount that is received or accrued to a person from a source within the country is taxable in the Republic. The amount may be received or accrued to the person in the form of a dividend, interest, royalties, a lump sum, the disposal of assets from a source located within the country. The rationale is that a source of income, being within the country, constitutes a PE that is the necessary legal nexus for tax purposes. Therefore, where a PE is created because the source of income is within the Republic or as defined in terms of article 5 of the OECD Model TC, then the amount so generated is taxable in the country.

This article refers to this approach as traditional. It is traditional since its applicability depends on the physical presence of the source of income within the borders of a market country. By analogy, where the source of income is located outside the borders, a PE cannot be identified.

## **2 3 The relevance of a permanent establishment**

If a non-resident meets one or more of the above PE general rules, it is deemed to have a “physical presence” in the country. Conversely, if none of the above rules is met, arguably, there cannot be a physical presence. Accordingly, no taxing rights accrue to the market country. It follows, therefore, that identifying PEs is relevant for international tax purposes as it allocates taxing rights to the state where business economic activities occur subject to the distributive rules agreed upon by the contracting states. These allocative taxing rules largely depend on the nature of the income generated.<sup>18</sup> Accordingly, identifying PEs is essential because it enables the source or market country to impose taxes on the income generated within its boundaries.

## **3 FEATURES OF THE DIGITAL ECONOMY**

The rise of the DE poses no unique Base Erosion and Profit Shifting Project (BEPS Project) issues. Rather, some of its key features exacerbate BEPS risks or tax challenges.<sup>19</sup> The DE is characterised by its unique features,

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<sup>18</sup> Olivier and Honiball *International Tax: A South African Perspective* 5ed (2011) 279; Olivier 2002 SALJ 869.

<sup>19</sup> OECD/G20 BEPS Project *Action 1: 2015 Final Report* 144, 54, 78.

which include, among others, information technology equipment, cloud services, standardised software for various purposes, web and device applications, and e-commerce and other platforms that are subject to digital commoditisation.<sup>20</sup> The DE also offers significant competitive and productivity-boosting opportunities related to access to *digital products and services* that help optimise processes and production, while it reduces transaction costs, and transforms supply chains.<sup>21</sup> Furthermore, companies such as Google, Amazon, Apple, Microsoft, Baidu, Alibaba, SAP, PayPal, Cisco and others further develop digital services and platforms in which third-party enterprises operate using predefined standards within a given framework.<sup>22</sup> Most of these entities are big, reputable and financially stable. By implication, this intensifies market competition and results in the “winner-takes-all” model in which bigger agents maintain a competitive advantage, keeping them well ahead of digital commodity users. Arguably, this results in their making more profits, the source of which is in various parts of the world. Of course, this triggers taxing rights of the jurisdictions where the profits are generated. Whether taxing rights are in fact attributed to the jurisdictions where the profits originate is another question.

The DE is rightfully characterised by its mobility of intangibles,<sup>23</sup> mobility of users and customers,<sup>24</sup> and mobility of business functions.<sup>25</sup> The MNEs enter market countries through virtual or digital establishments, which render the traditional PE superfluous or vulnerable. Thus it is necessary either to expand the traditional PE concept or introduce a new approach to capturing the virtual PE regime.

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<sup>20</sup> Arbache “Seizing the Benefits of the Digital Economy for Development” (28 September 2018) *VOX CEPR Policy Portal* <https://voxeu.org/print/63359> (accessed 2020-03-30).

<sup>21</sup> Arbache <https://voxeu.org/print/63359>.

<sup>22</sup> *Ibid.*

<sup>23</sup> OECD/G20 BEPS Project *Action 1: 2015 Final Report* 65 par 4.3.1.1 states that “investment in and development of intangibles is a core contributor to value creation and economic growth for companies in the digital economy”. For example, digital companies often rely heavily on software and will expend substantial resources on research and development to upgrade existing software or to develop new software products.

<sup>24</sup> OECD/G20 BEPS Project *Action 1: 2015 Final Report* 65 par 65 4.3.1.2 provides that “[a]dvances in ICT and the increased connectivity that characterises the digital economy mean that users are increasingly able to carry on commercial activities remotely while travelling across borders”. For example, a user can reside in one country, purchase an application while staying in a second country, and use the application from a third country.

<sup>25</sup> As noted, ICT makes technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy. As a result, corporations increasingly rely on ICT, which allows them to centrally operate their business a location remotely from both “the locations in which the operations are carried out and the locations in which their suppliers or customers are located”; OECD/G20 BEPS Project *Action 1: 2015 Final Report* 65 par 4.3.1.3.

## 4 THE EFFECT OF THE DIGITAL ECONOMY ON INTERNATIONAL TAX POLICY

### 4 1 Violation of the permanent establishment principle

The article analyses challenges posed by the DE in the international tax system. Among other challenges is that goods and services can easily be supplied to market countries in which the supplier has no physical presence. Under the current tax system, the market country has no taxing rights over the profits derived in that state. Why is this a problem? This is a problem because the equity principle (one among other underlying tax principles) may be threatened by the DE. Equity in the international tax context aims to ensure that each country receives an equitable share of tax revenues from cross-border transactions.<sup>26</sup> Also, a taxpayer in a similar position should be subject to the same level of taxation.<sup>27</sup> This principle is still applicable and relevant in the context of virtual presence. Thus, to uphold and preserve these principles requires that the existing PE concept be expanded or a new tax policy reflecting a fair revenue-sharing among nations be invented. This argument is justified on the ground that companies also enjoy the public services offered in the market countries, which include stable judicial and economic systems,<sup>28</sup> access to the market, intellectual property protection and the use of other infrastructure. It appears, therefore, that international trade in the absence of a physical presence undermines the fundamental principles currently underpinning international tax policy.

The following case law manifests the shortcoming of the traditional PE concept.

#### 4 1 1 TA, Paris N 1505165/1-1, July 2017, *Société Google Ireland Limited*<sup>29</sup>

##### (1) Facts

Google LLC is a company resident in the United States (Google US). Google US is a global group providing technology services. Google US generates most of its revenue by delivering relevant online products and services. These products include Android, Chrome, Shopping, Double Click, Google Analytics, Google Cloud, Google Maps, Hardware, Search, Waze and YouTube (Google Ads).

<sup>26</sup> OECD/G20 BEPS Project *Action 1: 2015 Final Report* 21 par 11–12.

<sup>27</sup> OECD "Implementation of the Ottawa Taxation Framework Conditions: The 2003 Report" (2003) <https://www.oecd.org/tax/administration/20499630.pdf> (accessed 2020-03-31) 12.

<sup>28</sup> Goel and Goel "Has the Permanent Establishment Rule Outlived Its Utility in a Digitalized World" 2018 11 *NUJS L Rev* 25–47 43.

<sup>29</sup> Tribunal Administratif De Paris "The Irish Company Google Ireland Limited (GIL) is not Taxable in France for the Period 2005 to 2010" [https://paris.tribunal-administratif/Media/TACAA/Paris/00communiqués\\_de\\_presse/1505113](https://paris.tribunal-administratif/Media/TACAA/Paris/00communiqués_de_presse/1505113) (accessed 2020-03-31).

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Google Ireland Ltd is a company resident in Ireland, having its registered office in Dublin (GIL Dublin). GIL Dublin is an affiliate of Google Ireland Holdings, which is an affiliate of Google US. Google France is a company incorporated under French law having its registered office in Paris (Google Paris). Google Paris is also an affiliate of Google US.

GIL Dublin sold google advertising online directly to its customers in Europe, the Middle East and Africa (EMEA market). The google advertisements are delivered directly to the customers in France using internet services.

On 16 May 2002, a marketing and services agreement (MSA) was concluded between Google US and Google Paris. Under the MSA, Google Paris employees had to provide marketing and sales support to GIL Dublin's teams. In other words, Google Paris provided commercial assistance and advice to GIL Dublin customers in France. Thus, from 2004 onwards, the services sold by the Google group to French customers were subject to the Irish tax rate on commercial companies, which is lower than the French one.

On 12 November 2012, the French tax authority (FTA) raised the tax reassessment arguing that GIL Dublin carried on professional activities through Google Paris, which were taxable in France. FTA investigated and concluded that GIL Dublin was liable for taxes (corporate income tax, value-added tax, withholding taxes) and penalties in the total amount of USD 1.3 billion.

On the other hand, GIL Dublin's defence focused on the PE definition as provided in the French-Irish tax treaty, and was based on two cumulative conditions, namely:

1. the dependence of Google Paris on GIL Dublin; and
2. the power of Google Paris to enter habitually into legally binding commercial contracts on behalf of GIL Dublin.

#### (ii) Legal question

The question before the court was whether GIL Dublin had a PE in France as the FTA alleged.

#### (iii) Judgment

After a careful analysis of all the facts and the tax treaty between France and Ireland, the tribunal ruled in favour of GIL Dublin.

First, the tribunal had to consider whether Google Paris acted as a dependent agent that habitually contracted on behalf of GIL Dublin to bind the latter. As for this consideration, the tribunal ruled that Google Paris did not act as a dependent agent on behalf of GIL Dublin. This was especially so because Google Paris did not have the necessary human resources or technical means to carry out the sales and marketing on its own. As such, Google Paris could not be the dependent agent that could bind GIL Dublin.

Secondly, the tribunal continued to consider the powers of Google Paris to bind GIL Dublin. On this point, it was ruled that Google Paris employees did not have the necessary authority to conclude contracts that were legally

binding between GIL Dublin and French customers. Furthermore, even if the employees had the authority to enter into contracts with clients, the ultimate approvals of the contracts vested with GIL Dublin, which was effectively managed outside France. In addition, according to the tribunal, French clients purchased google advertisements directly from GIL Dublin, which had its PE in Ireland. As such, Google Paris could not legally bind GIL Dublin when concluding contracts in this respect.

For these reasons, the tribunal ruled that GIL Dublin did not have a PE in France. Accordingly, GIL Dublin was not liable to pay these taxes.

#### (iv) Discussion

It should be mentioned that although the tax treaty is based on the traditional PE concept as stipulated in the OECD Model TC, the FTA relied heavily on the extended PE definition introduced by the BEPS Project Action 7,<sup>30</sup> which prevents the artificial avoidance of PE status. As noted above, Action 7 prevents the use of certain common tax-avoidance strategies to circumvent the traditional PE concept – for example, an arrangement through which a taxpayer replaces a subsidiary that normally acted as a distributor with a *commissionaire* arrangement.

*In casu*, the FTA argued that GIL Dublin had a PE in France as provided for in the new BEPS proposal. The tax tribunal rejected the argument that Action 7 was incorporated into the treaty in question. As such, the FTA could not rely on Action 7. The tribunal ruled that if the FTA intended to rely on the provisions of Action 7, the French government must first amend the definition of PE in the treaty to reflect such intention.

GIL Dublin had no physical presence in France in terms of the treaty PE definition at the time. Although the court found that GIL did not have a PE in France, this did not suggest that GIL generated no income in France. GIL Dublin generated some of its revenue from the EMEA market, which includes the French market. Therefore, it does not follow that GIL Dublin was not liable for the tax. Unfortunately, under the PE definition at the time, one could not hold MNEs such as GIL liable for income taxes since the required legal nexus was absent. Although this may seem unjust, it is argued that in principle it is correct. In the absence of a legal basis, to hold otherwise would arguably have diluted international tax principles and possibly created uncertainty. The uncertainty could negatively affect international trade and investment since MNEs would be paying taxes without the necessary legal justification.

It is accordingly submitted that serious unintended repercussions could arise if the court interprets the tax treaty provisions as occurred in *ABB FZ LLC v Deputy Commissioner of Income Tax*.<sup>31</sup> Such interpretation may amount to indirectly amending the tax treaty, since the court interprets it in a manner that the lawmaker did not envisage. An example of such

<sup>30</sup> OECD/G20 BEPS Project Action 7: 2015 Final Report.

<sup>31</sup> *ABB FZ LLC, C/o. ABB India Ltd v Deputy Commissioner of Income Tax* (29 November 2017) IT (TP) A.2102/Bang/2016 <https://indiakanon.org/doc/34689739> (accessed 2020-04-01).

interpretation is where the court read certain words into the treaty or when it interpreted treaty provisions in a manner that contradicts the main international tax object.<sup>32</sup> Among other repercussions, it creates instability in the generally accepted international tax principles, especially regarding those tax treaties concluded with a country in which the MNEs are resident. It is trite that tax treaties are concluded based on the principle of good faith. When a court interferes and misinterprets the law, this amounts to a breach of the good-faith principle, which is likely to create dissatisfaction. This displeasure leads to the “proliferation of uncoordinated and unilateral”<sup>33</sup> measures between contracting states. As a result, this will not only undermine the relevance and sustainability of international taxation for cross-border business activities, but will also more broadly adversely impact global investment and growth.<sup>34</sup>

Furthermore, if a court has ruled that a PE exists, this will potentially create two parallel international tax systems – one under the provisions of the tax treaty and the other under legal precedents. It is submitted that the parallel system deviates from the certainty and simplicity principle that still underpins international tax law. Certainty and simplicity principles require that international tax rules be clear and simple to understand to enable a taxpayer to anticipate the tax consequences of a transaction in advance.<sup>35</sup> It can, therefore, be argued that this principle is still applicable and should apply equally to both the traditional and the virtual PE regime.

The traditional PE approach levies tax on MNEs with a physical establishment in the market country. The rationale for this is that these entities must contribute their fair share to the state in which they operate because they benefit from the public services offered. Conducting business through a virtual PE defeats this purpose since MNEs can operate in a market country remotely. As a result, paying taxes in these countries is successfully avoided since the entities do not have the required physical presence. To achieve equal treatment, taxing the income derived from PEs, both traditional and virtual, it is necessary to expand the existing PE rules or develop new rules to capture PEs that are created virtually.

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<sup>32</sup> For example, the international tax objective is to levy corporate income tax on MNEs with a sufficient nexus to the market country, which is currently established through the PE concept. It follows that in the absence of PEs, MNEs cannot be said to have the required nexus. Therefore, if the court interprets the treaty provisions and concludes that a PE exists, clearly this interpretation contradicts the main purport or spirit of international tax principles. See, for example, *ABB FZ LLC v DCIT supra* and the discussion below.

<sup>33</sup> OECD/G20 Inclusive Framework on BEPS “Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising From the Digitalisation of the Economy” (2019) 7 <https://www.oecd.org/tax/beps> (accessed 2020-04-02) 7 par 11.

<sup>34</sup> OECD/G20 Inclusive Framework on BEPS <https://www.oecd.org/tax/beps> 7 par 11.

<sup>35</sup> Vaca-Bohórquez “Virtual Permanent Establishment: An Approach to the Taxation of Electronic Commerce Transactions” 2016 *Revista de Derecho Fiscal* n° 8 *enro-junio* de 89–102 93.

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#### 4 1 2 *ABB FZ LLC, C/o. ABB India Ltd v DCIT*<sup>36</sup>

On 21 June 2017, in India, the Income Tax Appellate Tribunal (Tribunal) delivered an important ruling on a service PE in the *ABB FZ LLC v DCIT* case.

##### (i) Facts

In this case, a non-resident company incorporated in the United Arab Emirates (UAE), the ABB FZ LLC (ABB UAE), rendered commercial services to the value of INR 1.78 billion to an affiliate Indian-resident company, ABB India Ltd (ABB India). The services were intended, among other objectives, to enhance the business and sales performance of ABB India.

ABB UAE offered commercial services such as visits, telephone calls, emails and video-conferences. For purposes of rendering the service, ABB UAE employees visited India for a maximum of 25 days a year. The remaining part of the service was rendered by ABB UAE to ABB India through the Internet from a location outside India.

The UAE has a tax treaty with India. Under the treaty, the relevant provision states that a non-resident has a service PE in the source country (that is, India) if the non-resident furnishes a consultancy service through the presence of its employees or the dependent agent therein. In addition, the provision requires that while rendering the consultancy service, employees need to be present in India for a period exceeding nine months within any twelve-month period. Furthermore, the treaty provides that the source country cannot levy a tax unless the non-resident has a PE either through a fixed place of business (that includes the specific inclusions as noted above under the meaning of PE) or through the presence of the foreign entity's employees rendering consultancy services to the recipient located in India.

As a result of the presence of ABB UAE employees in India, as well as the commercial service offered to ABB India through the Internet, the Assessing Officer (AO) raised an additional tax assessment for the assessment year 2012–13. The AO argued that ABB UAE had a fixed place of business in India. As a consequence, ABB UAE was liable to pay tax on the amount of INR 1.78 billion generated in India.

##### (ii) Legal question

The tax tribunal had to determine if ABB UAE had a PE as contended by the AO.

##### (iii) Judgment

Interestingly, after careful consideration of facts and the definition of a fixed place of business, the court found that ABB UAE had a service PE in India. This decision has been criticised and (it is submitted) for good reason.<sup>37</sup>

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<sup>36</sup> *ABB FZ LLC, C/o. ABB India Ltd v DCIT supra.*

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(iv) Discussion

It is worth mentioning that this case touches upon many relevant international tax issues, such as the tax on royalties, and the availability of tax benefits for treaty purposes. However, this discussion limits itself to commercial services rendered by ABB UAE through the Internet to ABB India.

The court conceded that the visits by ABB UAE employees could not amount to a PE in India as they fell below the minimum number of days required. It was further noted that a substantial part of the commercial service was rendered online from outside India. Therefore, this could not amount to a PE.

At issue was whether the INR 1.78 billion consideration was taxable in India in the absence of a fixed place of business. The point of departure was to consider whether this consideration fell within the taxable forms of income that were covered by the treaty. The court correctly analysed the INR 1.78 billion consideration and classified it as a technical service fee (TSF), which was not provided for, or covered by, the treaty. The court continued to consider the legal position where the treaty provided no answers.

The legal position in India in the absence of a TSF provision in the treaty is that the default position applies (regarding taxation of non-residents) as provided for in the domestic Income Tax Act, 1961 (IT Act). In terms of Explanation 2 of section 9(1)(i) of the IT Act, a non-resident will be taxable in India if it has a “business connection”<sup>38</sup> therein. The business connection definition mirrors the traditional PE definition discussed above. According to the business connection requirement, ABB UAE could not have a PE in India. Therefore, whether one applies the PE as provided for in the treaty or through the business connection requirement, ABB UAE could not have a fixed place of business in India.

Despite the absence of a fixed place of business by ABB UAE, the court nevertheless concluded that ABB UAE had a PE in India. The taxpayer correctly argued that in the absence of a fixed place of business, both in terms of the treaty and the IT Act, the consideration generated in India could not be taxed. After an extensive analysis of the PE rules, surprisingly, the court held that what is required under the law is that the non-resident employees needed to render the service within the minimum nine-month period, not that the employees had physically to stay in India for a period of more than nine months. The fact that the ABB UAE personnel provided the service within the minimum period required to establish a PE was sufficient to create the nexus, as opposed to staying for nine months in the country.

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<sup>37</sup> Goel “Addressing Tax Challenges of the Digital Economy: Fair Play or Foul Play” *Kluwer International Tax Blog* (18 August 2017) <http://kluwertaxblog.com/2017/08/18/addressingtax-challenges-digital-economyfair-play-foul-play/> (accessed 2020-04-01).

<sup>38</sup> According to Explanation 2, “business connection” includes business activities carried out through a person who, acting on behalf of the non-resident, habitually exercises an authority to conclude contracts on behalf of the non-resident in India, or habitually maintains in India a stock of goods or merchandise, or habitually secures orders in India for the non-resident. See also Goel and Goel 2018 *NUJS L Rev* 38.

It is argued that the interpretation adopted by the court in the *ABB UAE* case is incorrect; on a proper reading and interpretation of the traditional PE concept, without a physical presence it cannot be said that there is a PE. The reading of the court singled out a sub-article of the entire treaty and twisted it to yield what the court deemed just, equitable and necessary. This judgment has far-reaching international tax consequences, especially between companies resident in the UAE and India. As noted above, the judgment amounts to an indirect amendment of the tax treaty provision, although the wording remains unchanged. This decision might exacerbate the risk of an incompatible and uncoordinated approach between the UAE and India.

It is not surprising that the courts found themselves in this difficult position. The tribunal is not the first court to come to conclusions with far-reaching implications. The Spanish Tribunal, in the *Dell Products* case,<sup>39</sup> was confronted with similar facts and it reached exactly the same conclusion. Both the *ABB FZ* and *Dell Products* cases have been correctly criticised in that the court's approach amounts to rewriting the provision of the law.<sup>40</sup>

There are two important principles that the Indian courts have emphasised in different cases. First, in *Electrical Materials Center Co Ltd v DIT*,<sup>41</sup> the court held that the stay in India of the taxpayer "was only 90 days and since it is less than 182 days as required under art 5(3)(b) of the India-Saudi Arabia tax treaty, there is no [service] PE". Secondly, in *Booz & Co (ME) FZ-LLC v DDIT*,<sup>42</sup> the court held that there was no dispute that the taxpayer had generated the consideration in India. However, such business receipts are taxable in India only if the taxpayer has a PE in India. These principles ensure that MNEs with a PE are taxable in the market country. This is justifiable since there is a nexus between the income generated and the market country. In addition, the equity principle requires that taxpayers on the same footing be subject to the same tax treatment. Therefore, the above two principles are aligned with the internationally accepted tax rules. Accordingly, in the absence of physical presence, the source country cannot exercise its right to tax.

Importantly, the *ABB UAE* and *Google Ireland* cases highlight huge challenges with the current PE definition at the time of writing. In some

<sup>39</sup> *Dell Products Ltd v General State Administration, Tribunal Supremo, Sala de lo Contencioso*, 20 June 2016, STS 2861/2016, Recurso No: 255/2015, 19 ITLR 633; *In casu*, an Irish company, Dell Production Limited (DPL) sold its goods in Spain via the Internet with its affiliated Spanish company facilitating the online sales. The court invoked the virtual PE theory to hold that DPL had a PE in Spain (even though it did not have a physical presence in Spain and the server on which the website was hosted was located outside Spain). See also *Dell Products v Staten v Skatt øst, Norges Høyesterett*, HR-2011-2245-A (sak nr 2011/755), (2 December 2011) for further discussion.

<sup>40</sup> Sprague "Spanish Court Imposes Tax Nexus by Finding a Virtual PE" *Bloomberg BNA* <https://www.bna.com/spanish-court-imposes-n17179871765> (accessed 2020-04-10); Goel <http://kluwertaxblog.com/2017/08/18/addressing-tax-challenges-digital-economy-fair-play-foul-play/> 39–40.

<sup>41</sup> (2017) 167 ITD 248 Income Tax Appellate Tribunal (Bangalore Bench) (International Taxation) (28 September 2017). See Also *Income Tax Appellate Tribunal (Mumbai Bench) Linklaters LLP v ITO* (2011) 9 ITR 217.

<sup>42</sup> ITA No 4063/Mum/2015 A.Y: 2011–12.

instances, the courts are even prepared simply to disregard the traditional PE requirement when dealing with the cases involving “substantial economic activity” owing to its limited application. For instance, the Madras High Court opined in the *Verizon Communication Singapore Ltd* case<sup>43</sup> that in a “virtual world, the physical presence of an entity has today become insignificant”. According to the court, a tax obligation ought to be imputed to a foreign entity to the extent of its virtual presence in the market country. As much as this is a good suggestion, it is submitted that in principle it is incorrect since it amounts effectively to redrafting the treaty provisions while the substantive part of the law remains unchanged. Moreover, this is likely to trigger a reprisal through uncoordinated and unilateral actions from the other jurisdiction. The best approach is one adopted by the court in *Azadi Bachao Andolan*,<sup>44</sup> namely that this situation ought to be left to the discretion of the government of India as it is dependent upon several economic and political considerations.

The conclusion to be drawn from the above discussion is twofold. First, the *Google Ireland* case shows the limitation of the current PE rules when they are applied in the absence of physical presence. Secondly, while there are limitations to the current PE rules, the *ABB UAE* case reflects an unprecedented and controversial approach to the treatment of the virtual PE regime.

As noted, the South African PE definition and the source rules in section 9 of the ITA are based on the traditional approach. Therefore, the PE definition and source rules must be developed effectively to deal with the taxation of MNEs that have little or no physical presence in the Republic, yet where a “significant economic presence” is created.

## 4 2 Arm’s-length principle challenges

The absence of physical presence not only affects the traditional PE definition currently required under the international tax system, but also affects the arm’s-length principle (ALP). The ALP is universally accepted and internationally employed as a mechanism to “curb[...] tax avoidance through transfer pricing”.<sup>45</sup> Essentially, the ALP sets prices of goods, services and intangible assets when sold between and within related MNEs.<sup>46</sup> In other words, it ensures that business revenues are properly shared among the MNE’s affiliated entities thereby ensuring that tax authorities within the jurisdictions of affected corporations receive their fair share of tax revenues. Accordingly, the ALP principle is defined as the price negotiated by a willing

<sup>43</sup> *Verizon Communication Singapore Pte Ltd (formerly MCI WorldCom Asia Pte Ltd) v The Income Tax Officer, International Taxation I* (Tax Case (Appeal)) Nos 147–149 2011 par 101; Vaca-Bohórquez 2016 *Revista de Derecho Fiscal* n° 8 *enro-junio* de 89–102 98; Butina and Jain “Permanent Establishment Concept: An Indian Perspective” 2014 *IBDF Asia-Pacific Bulletin* 251.

<sup>44</sup> *Union of India v Azadi Bachao Andolan* (2004) 10 SCC 1.

<sup>45</sup> Oguttu “Transfer Pricing and Tax Avoidance: Is the Arm’s-Length Principle Still Relevant in the E-Commerce Era?” 2006 18 *South African Mercantile Law Journal* 138–158 138.

<sup>46</sup> Kamdar “Acceptable Methods for Determining an Arm’s Length Price for Transfer Pricing” 2018 *International Tax* 18–27 19.

purchaser and a willing seller under market conditions. Contracting parties are at arm's length if the prices or conditions agreed upon by the related entities would be on the same conditions upon which unrelated or independent entities would agree.<sup>47</sup> Therefore, the ALP principle requires that the price and conditions set between related entities be substantially the same as the price that independent buyers and sellers would agree upon for the same goods or services.

How then does the DE affect the ALP? As noted above, the DE heavily relies on digital intangible assets that are easily moved from one jurisdiction to another. For instance, pharmaceutical corporations often have valuable, significant and hard-to-value intangibles.<sup>48</sup> Since intangible assets are movable, the ALP principle is weakened in that rights to intangibles and their related returns could be assigned or transferred among related associations for less than the arm's-length price, or to an affiliate in a jurisdiction where income subsequently earned from those intangibles is subject to unduly low or no tax owing to the application of a preferential regime.<sup>49</sup> Therefore, if the allocations of functions, assets, and risks do not correspond to actual allocations, or if less-than-arm's-length compensation is provided for intangibles of a principal company, these structures present BEPS concerns.<sup>50</sup>

## 5 OECD REACTION TO THE TRADITIONAL PERMANENT ESTABLISHMENT DEFINITION AND THE DIGITAL ECONOMY

As a result of the DE, the OECD has reconsidered the traditional PE definition as provided in article 5 of the OECD Model TC. In this regard, Action 7 of the BEPS Project<sup>51</sup> was introduced to improve the traditional PE definition. Action 7 of BEPS proposes the following:<sup>52</sup>

- that the foreign entity will be considered to be a taxable presence in the market country through its agent that regularly concludes contracts unless the agent performs these activities in the course of an independent business;

<sup>47</sup> The term "related" or "associated enterprises" refers to enterprises that are related to each other directly or indirectly. The associated enterprise is found in art 9(1) of the OECD Model TC. In terms of this provision, an associated enterprise means an enterprise of a contracting state that participates directly or indirectly in the management, control, or capital of an enterprise of the contracting state, or that the same persons participate directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting state [...]. See also Oguttu *International Tax Law: Offshore Tax Avoidance in South Africa* (2015) 235.

<sup>48</sup> International Monetary Fund (IMF) "Corporation Taxation in the Global Economy" *Policy Paper* (2019) <https://www.imf.org/external/pp/ppindex.aspx> (accessed 2020-03-31) 13 par 18.

<sup>49</sup> OECD/G20 BEPS Project *Action 1: 2015 Final Report* 81 par 193.

<sup>50</sup> OECD/G20 BEPS Project *Action 1: 2015 Final Report* 80 par 188.

<sup>51</sup> OECD/G20 BEPS Project *Action 7: 2015 Final-Report*.

<sup>52</sup> OECD/G20 BEPS Project *Action 7: 2015 Final-Report* 39–45.

- the introduction of an anti-fragmentation rule to the exceptions of the PE definition which relate to operations that are preparatory or of an ancillary nature so that it is not possible to derive tax benefits by fragmenting the cohesive business operation into several small schemes;
- addressing a situation where the exception applicable to a construction project or building site is circumvented through the splitting up of contracts between closely related entities; and
- further proposals regarding the business profits attributable in terms of the rules under article 7 and whether the rules should entirely be changed to reflect the proposals under Action 7 of BEPS.

These proposals are discussed below.

## 5.1 Artificial avoidance of permanent establishment status through *commissionaire* arrangements

The first change relaxes the rules in article 5(5) relating to a *commissionaire* arrangement. A *commissionaire* arrangement is an agreement through which an individual sells items in a given country in its name, while a foreign company remains the owner of such items. Through the *commissionaire* arrangement, the foreign company can sell these items and make profits without forming a PE to which sales may be attributed for tax purposes. This is because the person who concludes and sells such items is not the owner. Therefore, the profits derived from such sales cannot be taxed, only the portion that the person receives as remuneration – that is, the commission fee.

The old position deemed the foreign company to have a PE in the market country if it had an agent acting on its behalf, habitually concluding contracts to bind the latter without material modifications by the foreign company. According to the OECD, practice has shown that foreign entities circumvented this dependent PE simply by not formally concluding substantial contracts in market countries but finalising them abroad, or by using an independent agent, which is an exception to a deemed PE in article 5(6). This means that foreign entities could avoid paying taxes in the market country since no PE would be created.

To remedy this gap, the new article 5(5) provides as follows:

“... where a person is acting in a Contracting State on behalf of [foreign entity] and, in doing so, habitually concludes contracts, or habitually plays the *principal role* leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are a) in the name of [foreign entity]; or (b) for the transfer of the ownership of, or for the granting of the right to use, property owned by [foreign entity] or that [it] has the right to use, or c) for the provision of services by [foreign entity], that foreign entity shall be deemed to have a permanent establishment in that State.”<sup>53</sup>

<sup>53</sup> Art 5(5) of OECD Model TC (as they read on 21 November 2017); OECD/G20 BEPS Project *Action 7: 2015 Final Report* 15 (own emphasis added).

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A person referred to can either be an individual or an entity. The person does not have to be a resident or have a place of business in the market country. The individual can be an employee of the foreign entity or not. The term *principal role* is defined in neither the *Action 7: 2015 Final Report* nor in the OECD Model TC. The *Action 7: Final Report* provides the nucleus of the new article 5(5). The premise of article 5 is that where a person concluding contracts on behalf of the foreign entity does so, not in the ordinary course of carrying on a business as an independent agent specifically excluded under sub-paragraph 6, such entity creates a PE in the market country. Under the new position, a foreign entity creates a PE when a person habitually concludes contracts that are in the name of the foreign entity or that are to be performed by the foreign entity, or habitually plays the principal role leading to the conclusion of such contracts, which are routinely concluded without material modification by the enterprise. Such a foreign entity creates a PE through the presence of a person, since the person's actions result in the conclusion of contracts and go beyond mere promotion or advertising.<sup>54</sup> According to the OECD, the actions of the person are sufficient to conclude that a foreign entity engages in business activities in the market country.

Therefore, these policy changes intend to confer taxing rights to the market source country, where there are intermediary activities that result in the regular conclusion of contracts to be performed by the foreign entity. In that case, the foreign entity will be considered to have a sufficient taxable-presence nexus in the market country unless the intermediary performs these activities as an independent agent.

## **5.2 Artificial avoidance of permanent establishment status through article 5(4) exclusions**

The old position generally excluded the “preparatory or ancillary” service from being seen as a PE. In other words, the foreign company was deemed not to have a PE in each of these exceptions since it merely conducted preparatory or related services. However, the practice has shown that MNEs may alter their structures to obtain tax benefits by fragmenting a cohesive business operation into several small schemes that appear to be ancillary in nature.

Therefore, the new position introduces the so-called anti-fragmentation rule between related entities. This rule expressly prohibits the piecemeal practice that claims that preparatory services cannot be taxed. Under the new position, a foreign company may be deemed to have a “fixed place of business” in the market country unless the services supplied are strictly preparatory in nature. For example, consider a foreign company (FC) that supplies its affiliated resident company (RC) with certain goods. The FC also has a small warehouse where it keeps and sells similar goods in the RC's country. Customers order directly online from the FC. RC employees fetch these goods from the warehouse and deliver them to customers. The ownership of the items passes from the FC to the RC as soon as they leave

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<sup>54</sup> OECD/G20 BEPS Project *Action 7: 2015 Final Report* 17.

the warehouse. According to the new proposed rules, the exclusion in article 5(4) cannot apply since:<sup>55</sup>

- the FC and RC are closely related entities;
- the FC’s warehouse constitutes a PE since the definition of PE is now extended to include using or maintaining a fixed place of business in that same country; and
- the business activities carried on by the RC at its warehouse and by the FC at its warehouse constitute complementary functions that are part of a cohesive business operation – that is, keeping goods in a storeroom for purposes of delivering these goods as part of the obligations resulting from the sale of these goods through another place in the same country.<sup>56</sup>

### **5 3 Anti-fragmentation in construction projects (article 5(3))**

Under the old position, building sites and construction projects that last more than 12 months are deemed to be PEs. However, practice has shown that entities abuse this rule by splitting up contracts among related enterprises to circumvent the 12-month rule. The new position introduces the Principal Purpose Test (PPT) rule.<sup>57</sup> This rule prohibits granting treaty benefits in inappropriate circumstances where the construction project is split for the sole purpose of avoiding the PE rules. Determining whether activities are connected as provided in article 9(1) of the OECD Model TC, will, of course, depend on the particular facts of each case. However, the guiding factors are:<sup>58</sup>

- whether the contract dealing with different activities was initially concluded with the same entity or closely related entities;
- whether the additional contract between these entities is a logical consequence of a previous contract concluded with that entity or related entities;
- whether the split of the activities would have been covered by a single contract in the absence of tax-planning considerations;
- whether the nature of the contract split is the same or similar; and
- whether the same workers are fulfilling or performing the activities under the contract split.

What happens to those countries that are unable to introduce the PPT rule in their treaties and where domestic anti-abuse rules do not solve the issue of splitting up contracts? In such cases, an automatic rule will be crafted in the OECD commentaries that should be used in tax treaties that do not include

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<sup>55</sup> OECD/G20 BEPS Project *Action 7: 2015 Final Report* 41.

<sup>56</sup> *Ibid.*

<sup>57</sup> OECD/G20 BEPS Project *Action 7: 2015 Final Report* 44 par C1.

<sup>58</sup> OECD/G20 BEPS Project *Action 7: 2015 Final Report* 43–44.

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the PPT rule, or such a rule may be used as an alternative provision by jurisdictions specifically concerned with avoidance by splitting up contracts.<sup>59</sup>

#### **5 4 The existing profit-attribution rules: article 7 of the OECD Model TC**

Article 7 of the OECD Model TC provides for the allocation of taxing rights, ordinarily to the state where the MNE has a PE through physical presence. After the changes (anti-fragmentation in construction projects, and the prevention of artificial avoidance of PE status through article 5(4) exclusions and *commissionaire* arrangements), it was necessary for the OECD to consider whether the changes would have an effect on article 7 rules – that is, on the allocation of taxing rights. It was important to assess whether the new changes would require the rules under article 7 to be expanded to accommodate the changes.

The analysis concluded that there was no need for substantial modifications to the existing article 7 rules. However, more guidance was needed to determine how the newly proposed changes would affect PEs outside the financial sector, and in relation to intangibles, risk and capital.<sup>60</sup>

The OECD's changes need to be applauded because they represent positive steps toward curtailing tax avoidance by MNEs. However, their application has minimal effect. These changes merely broaden the traditional PE concept to cover avoidances that were not previously covered. The changes have minimal effect because their main focus is still on the PE requirement that requires physical presence. As discussed above, the traditional PE concept falls short of effectively capturing a PE created through digital transformation (a virtual PE) as is popular in the DE era. It can be argued that these new rules are an ineffective response to the *Société Google Ireland Limited* or *ABB FZ LLC, C/o. ABB India Ltd v DCIT* case loopholes where MNEs create significant economic presence through a virtual PE and pay no taxes. As such, MNEs that conduct their business largely through the use of digital services with a virtual PE in the market country will still circumvent the physical presence test and source rule. It is therefore submitted that there is still a need for a more robust normative remedy to cover the virtual PE. Such rules are needed now more than ever, since most MNEs thrive with digital transformation. It can be argued that this is partially due to the gap in tax rules taxing a virtual PE.

### **6 COMMENTS ON THE TRADITIONAL PERMANENT ESTABLISHMENT DEFINITION**

As appears above, the traditional PE definition fails to deal with a virtual PE. To remedy the traditional PE shortcomings, courts have adopted undesirable measures such as reading certain wording into existing tax treaties' PE

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<sup>59</sup> OECD/G20 BEPS Project *Action 7: 2015 Final Report* 42.

<sup>60</sup> OECD/G20 BEPS Project *Action 7: 2015 Final Report* 45 par 19.

provisions,<sup>61</sup> or by applying the so-called virtual PE theory,<sup>62</sup> or by simply disregarding the traditional PE provision when dealing with a virtual PE where a significant economic presence is created<sup>63</sup> in order to create a nexus to the income derived from the source country where no physical presence exists.

The best way to deal with this shortcoming is by changing the traditional PE definition in DTAs or the national tax law. In this regard, the OECD in its ongoing work on the Inclusive Framework intended to release the final report on Pillars One and Two by the end of 2020. Pillar One focuses on the allocation of taxing rights and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules.<sup>64</sup> On the other hand, Pillar Two seeks to deal with the remaining tax issues, including a “tax back” right if one jurisdiction has not exercised its taxing right or taxes minimally.<sup>65</sup> Pillar One and Pillar Two are discussed below.

## 6.1 Unified approach: Pillar One

After the risks posed by the DE had been identified (namely, the mobility of intangibles, of users and customers, and of business functions), proposals were made in the form of Pillar One. In this discourse, the proposals are summarised, recognising that this still forms part of the ongoing work of the OECD.

The key features of the solution sought by Pillar One include:<sup>66</sup>

- *Scope*: this aspect covers highly digital business models and goes as far as to include consumer-facing businesses with further work to be carried out on scope and carve-outs, but excludes extractive industries.
- *New nexus*: since the DE relies heavily on virtual or digital establishments resulting in the generation of substantial profits, the new nexus focuses on the requirement of an establishment that requires no “physical presence” but is largely based on sales such as specific sale thresholds. This new nexus could also be designed to benefit market countries with smaller economies. This clause will be included as a new self-standing treaty provision.

<sup>61</sup> *ABB FZ LLC, C/o. ABB India Ltd v DCIT supra.*

<sup>62</sup> *Dell Products Ltd v General State Administration Dell supra.*

<sup>63</sup> *Verizon Communication Singapore Pte Ltd supra* par 101. Chitra Venkataraman J stated: “In any event, in a virtual world, the physical presence of an entity has today become an insignificant one; the presence of the equipment of the assessee, its rights and the responsibilities of the assessee, vis-a-vis the customer and the customers’ responsibilities clearly show the extent of the virtual presence of the assessee which operates through its equipment placed in the customer’s premises through which the customer has access to data on the speed and delivery of the data and voice sent from one end to the other.”

<sup>64</sup> OECD/G20 Inclusive Framework on BEPS <https://www.oecd.org/tax/beps> 6.

<sup>65</sup> *Ibid.*

<sup>66</sup> OECD *Public Consultation Document: Secretariat Proposal for a “Unified Approach” under Pillar One* (12 November 2019) [www.oecd.org/tax/oecd-invites-public-input-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm](http://www.oecd.org/tax/oecd-invites-public-input-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm) (accessed 2020-04-09) 6–10.

- *New profit allocation rule going beyond the ALP*: this rule creates a new revenue allocation measure applicable to taxpayers within the scope, and irrespective of whether they have an in-country marketing or distribution presence (PE or separate subsidiary) or sell via unrelated distributors. Simultaneously, the new approach retains the current transfer pricing rules based on the ALP,<sup>67</sup> but balances these rules with formula-based solutions in areas where tensions in the current system are the highest.
- *Increased tax certainty delivered via a three-tier mechanism*: this new approach ensures tax certainty for both taxpayers and revenue authorities and consists of three profit allocation mechanisms:
  - Amount A – a share of deemed residual profit allocated to the market country using a formulaic approach (in other words, the new taxing right);
  - Amount B – a fixed remuneration for baseline marketing and distribution functions that occur in the market country and;
  - Amount C – binding and effective dispute prevention and resolution mechanisms relating to all elements of the proposal, including any additional profit where in-country functions exceed the baseline activity compensated under Amount B.

Consider the following illustration in the context of Pillar One proposals:

- Group DE is an MNE group that provides advertising and promotion (A&P) services as its sole source of revenue to thousands of clients located all over the world. The group is performing very well, earning non-routine revenue, and generating significant revenue above the level of competitors in the market.
- D Co (resident in Country A) is the parent company of Group DE. D Co owns all the valuable intangible assets exploited in the group's A&P services enterprise. Thus, D Co is entitled to all the non-routine profits earned by DE Group.
- E Co, a subsidiary of D Co and resident in Country B, is responsible for the marketing and distribution of Group DE's A&P services.
- E Co sells A&P services directly to customers in Country B. E Co has also recently started selling A&P services remotely to customers in Country C, where it does not have any form of taxable presence under current taxation rules.

Applying Pillar One where Group DE has a taxable presence in the market country (Country B):

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<sup>67</sup> SARS Practice Note 7 Determination of Taxable Income of Certain Persons from International Taxation: Transfer (06 August 1999) par 2.1 defines transfer pricing as the process by which related entities set prices at which they transfer goods or services between each other. Furthermore, Oguttu *International Tax Law: Offshore Tax Avoidance in South Africa* 213 also describes transfer pricing as a systematic manipulation of prices to reduce profits or increase profits artificially or cause losses and circumvent taxes in a specific country; Ware and Roper *Offshore Insight* (2001) 178.

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- In country B, Group DE has a taxable presence through the presence of E Co, which is already contracting with and making sales to local clients.
  - Under Amount A (the new taxing rights), it will be necessary to determine if Group DE has a new non-physical nexus in Country B. For purposes of this example, assume that E Co makes sufficient sales in Country B to meet the revenue threshold. Consequently, this will give country B a right to tax a portion of the deemed non-routine revenue of Group DE (Amount A). Therefore, Country B may tax that income directly from the entity that is treated as owning the deemed non-routine revenue (in the example, D Co), with the possibility that E Co will be held jointly liable for the tax due to facilitate administration. The relief from double taxation would be provided once D Co claims a foreign tax credit or an exemption in Country A.
  - E Co would be the taxpayer for the only applicable fixed return for baseline marketing and distribution activities (Amount B). Transfer pricing adjustments would be made to transactions between D Co and E Co to eliminate double taxation.
  - Lastly, if Country B considers that E Co should have additional profits taxed under the ALP because its activities go beyond the baseline activity assumed in the fixed return arrangement for marketing and distribution activities (Amount C), Country B would be subject to robust measures to resolve disputes and prevent double taxation.

Applying Pillar One where Group DE does not have a taxable presence in the market country (Country C):

- As far as the traditional PE rules are concerned, Group DE does not have a taxable presence in Country C. However, E Co is making remote sales in Country C.
- Under Amount A (the new taxing right), it will be necessary to determine whether Group DE has a non-physical nexus to Country C. Assume, for purpose of this example, that Group DE makes sufficient sales in Country C to meet the revenue threshold.
- This will give Country C the right to tax a portion of the deemed non-routine profits of Group DE (Amount A). Country C may tax that income directly from the entity that is treated as owning the non-routine profit (that is, D Co), with D Co being held to have a taxable presence in Country C under the new nexus rules.
- Since, under current rules, Group DE does not have an in-country presence in Country C (branch or subsidiary), Amount B would not apply.

## **6 2 Global Anti-Base-Erosion Proposal (GloBE): Pillar Two**

As part of the ongoing Inclusive Framework, Pillar Two also calls for a coordinated set of rules to address the risks imposed by the DE that allow MNEs to assign or transfer revenues to jurisdictions with low or no taxation at all. Pillar Two focuses on the challenges that are not covered under Pillar One. Pillar Two comprises four parts.

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The four parts of the GloBE proposal are:<sup>68</sup>

i) An “income inclusion” rule (IIR)

An IIR taxes the income of a foreign branch or a controlled entity if that income is subject to tax at an effective rate that is below a minimum rate. Accordingly, the IIR intends to operate as a minimum tax by requiring a shareholder in a corporation to bring into account a proportionate share of the income of that corporation if that income was not subject to an effective rate of tax above a minimum rate.<sup>69</sup> This rule is likely to supplement a country’s controlled foreign corporation (CFC) rules. As a rule, a CFC is characterised as a foreign entity that is either directly or indirectly controlled by a resident taxpayer. Jurisdictions apply different approaches in determining the resident taxpayer’s control. In South Africa, in terms of section 9D of the ITA, CFC rules will apply if the resident directly or indirectly holds more than 50 per cent of the total participating shares and/or voting rights in the foreign entity.

ii) An “undertaxed payments” rule

This rule operates by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment is not subject to tax at or above a minimum rate. In other words, the undertaxed payments rule prohibits a deduction or a proportionate amount of any deduction for certain payments made to an associated entity unless those payments were subject to a minimum effective rate of tax.

iii) A “switch-over” rule

The switch-over rule will be introduced into tax treaties that would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a PE or derived from immovable property (that is not part of a PE) are subject to an effective rate below the minimum rate.

iv) A “subject to tax” rule

The subject to tax rule complements the undertaxed payments rule by subjecting a payment to withholding or other taxes at the source and adjusting eligibility for treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate.

In summary, Pillar One addresses the allocation of taxing rights between jurisdictions and describes proposals for new profit allocation and nexus rules based on the concepts of “substantial economic presence” and the exploitation of “user participation” and “marketing intangibles” in a jurisdiction. Pillar Two (also referred to as the “GloBE” proposal) requires further development of a coordinated set of rules to address ongoing risks from structures that allow MNEs to shift profit to jurisdictions where they are subject to no or very low taxation.

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<sup>68</sup> OECD *Public Consultation Document: Global Anti-Base Erosion Proposal (“GloBE”) – Pillar Two* (2 December 2019) [www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf](http://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf) (accessed 2020-04-09) 6 par 5–6.

<sup>69</sup> OECD *Public Consultation Document: Pillar Two* 29 par 10.

Owing to the absence of a comprehensive approach to the virtual PE concept, South Africa may consider dealing with the traditional PE shortcomings in terms of the proposals below. At present, it is worthwhile mentioning that this does not imply that South Africa should take uncoordinated unilateral measures to deal with the issue. This should be done in a manner that does not undermine or hamper international investments. It follows that economic and political aspects will play a crucial role in implementing these recommendations.

## **7 RECOMMENDATIONS**

It is noted that the issues raised above affect not only South Africa but also international tax policy worldwide. While conceding that the DE is part of modern life and that it is difficult, if not impossible, to “ring-fence” the digitalised economy from the remainder of the economy for tax purposes, it is instructive to suggest and implement measures to align with the OECD recommendations.

### **7.1 Traditional permanent establishment definition: double tax agreements**

As of 21 November 2017, the OECD made some changes to the existing PE definition. It is submitted that South Africa should also expand its “physical presence” requirement to reflect these changes. Since a treaty overrides the national law in a case of conflict between the two,<sup>70</sup> perhaps South Africa should prioritise re-signing its existing treaties. This means South Africa will have to renegotiate its tax treaties, especially those that are based on the OECD Model TC. Some African countries have started renegotiating tax treaties previously signed with developed countries that appeared to confer inappropriate taxing rights (such as low or zero withholding tax rates).<sup>71</sup> In 2015, South Africa renegotiated its 1997 DTA with Mauritius, it is submitted that South Africa should accelerate this process and renegotiate other tax treaties.

### **7.2 Digital Economy: “substantial economic presence”**

With regard to MNEs with a substantial economic presence but little or no physical presence, the appropriate measure would be to introduce a new

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<sup>70</sup> Arnold “The Interpretation of Tax Treaties: Myth and Reality” 2020 *Bulletin for International Taxation* 667; Du Plessis “Double Taxation Treaty (DTT) Interpretation: Lessons from A Case Down Under” 2020 23 *Potchefstroom Electronic Law Journal* 2–22; Du Plessis “Some Thoughts on the Interpretation of Tax Treaties in South Africa” 2012 1 *SA Mer LJ* 31–52; Olivier and Honiball *International Tax: A South African Perspective* 315.

<sup>71</sup> Oguttu “A Critique of International Tax Measures and the OECD BEPS Project in Addressing Fair Treaty Allocation of Taxing Rights Between Residence and Source Countries: The Case of Tax Base Eroding Interest, Royalties and Service Fees from an African Perspective” 2018 *STELL LR* 314–346 324 and 335.

rule that specifically deals with a “digital establishment”. For instance, in the SA-USA tax treaty, the new rule could be crafted as follows:

2. The term permanent establishment includes especially:

- a) a place of management;
- b) a branch;
- c) an office;
- d) a factory;
- e) a workshop;
- f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;

The new rule may be inserted and read as follows:

*2A A digital establishment*

Notwithstanding anything contained in [Article 5(1), Article 5(2)(a) to (k) above],

an enterprise of a Contracting State shall be deemed to have a digital establishment in the other Contracting State for the purpose of this provision [being Article 5(2A)] if the enterprise carries on business activities in the other Contracting State through digital or electronic means, and the total revenue of the enterprise from such business activities exceeds [\*\*\*\*\*] in a financial year, or if the enterprise habitually enters into contracts with residents of the other Contracting State [...].<sup>72</sup>

This provision will not only assist in creating a PE but will also combat tax avoidance where foreign company employees do not meet the minimum number of days required in treaties.<sup>73</sup>

### **7 3 Section 1 of the PE definition and the section 9 source rule of the ITA**

Finally, the definition of the traditional permanent establishment, as well as the source rules in section 9, will have to be suitably expanded to reflect both the OECD extended PE scope and to incorporate the concept of a digital establishment with a “substantial economic presence”.

## **8 CONCLUSION**

It is evident in the discussion above that the current South African PE definition is unlikely to tax all business models effectively, particularly those that lack a physical presence in the source country. It is noted that in the DE era, various international businesses transact almost all of their transactions

<sup>72</sup> Goel and Goel 2018 *NUJS L Rev* 45.

<sup>73</sup> See *ABB FZ LLC, C/o. ABB India Ltd v. DCIT supra*.

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on the digital platform. These businesses no longer pass the physical presence tests. Rather, they rely heavily on virtual PEs. Virtual PEs allow these entities to transact in the market country in a digitally transformed way; as a consequence, they can circumvent the physical presence requirement needed for tax purposes. This seriously erodes the tax base of market countries, particularly developing countries with constrained tax administrations, including South Africa.

It is submitted that South Africa will have to make the necessary changes to keep up with the ever-changing computerised economy. The changes may include renegotiating existing tax treaties to include digital establishments, and to introduce the new OECD rules, especially those relating to taxing MNEs where a substantial economic presence has been created.

It is further noted that some of the above recommendations are subject to the upcoming OECD final report on the taxation of corporations conducting business activities through digital establishments.<sup>74</sup> It is also essential to bear in mind that changing the provisions in treaties might not be an easy task. However, an attempt to change the rules is always better than nothing. What is important when it comes to treaty renegotiation is that it should be done in a manner that does not lead to an “unparallel, uncoordinated and unilateral” reaction that will negatively affect international investment.

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<sup>74</sup> See generally on the progress made thus far, OECD/G20 *Inclusive Framework on BEPS: Progress Report July 2020–September 2021* (2021) <https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-on-beps-progress-report-july-2020-september-2021.htm> (accessed 2021-07-02); and OECD/G20 *Inclusive Framework on BEPS: Progress Report July 2019–July 2020* (2020) [www.oecd.org/tax/beps-oecd-g20-inclusive-framework-on-beps-progress-report-july-2019-july-2020.htm](http://www.oecd.org/tax/beps-oecd-g20-inclusive-framework-on-beps-progress-report-july-2019-july-2020.htm) (accessed 2020-08-09).