OECD Proposed expansion of "permanent establishment" definition

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During October 2015, as part of the Organisation for Economic Co-operation and Development ("**OECD**")/G20 Base Erosion and Profit Shifting ("**BEPS**") Project, the OECD issued its final report in respect of Action 7 "Preventing the artificial avoidance of permanent establishment status" ("**BEPS Report**").

In terms of Article 7(1) of the OECD's Model Tax Convention on Income and on Capital ("**Model Tax Convention**"), a Contracting State will only have taxing rights in respect of the business profits of a foreign enterprise which is a resident of another Contracting State if the enterprise has a "permanent establishment" ("**PE**"), as defined in Article 5, in that State to which such profits are attributable.

The BEPS Report is aimed at addressing certain tax avoidance strategies used to avoid the creation of a PE. It details proposed changes to the PE definition of the Model Tax Convention and the OECD's Commentary on the Model Tax Convention ("**OECD Commentary**"), in particular, to Articles 5(5) and 5(6) of the Model Tax Convention which deal with dependent and independent agents. This article focuses on select aspects of the proposed changes to Article 5(5).

Current provisions

Article 5(5) of the Model Tax Convention provides that a person (other than an independent agent, as discussed below) acting on behalf of an enterprise will be deemed to be a PE of the foreign enterprise if, *inter alia*, he has and habitually exercises in South Africa, a general authority to conclude contracts on behalf of the enterprise, unless his activities are limited to certain specific exclusions, such as the purchase of goods or merchandise for the enterprise.

Article 5(6), in turn, provides that an enterprise shall not be deemed to have a PE merely because it carries on business in the Contracting 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.

It is therefore possible for a foreign enterprise to have a PE in a Contracting State, despite not having a “fixed place of business”, if a dependent agent has and habitually exercises an authority to conclude contracts on its behalf. The OECD Commentary provides guidelines to determine whether an agent is independent.

Authority to conclude contracts

The OECD Commentary on Article 5(5) notes that the phrase “authority to conclude contracts in the name of the enterprise” does not only apply to an agent who enters into contracts literally in the name of the enterprise. Furthermore, it notes that a lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. Where the agent is authorised to negotiate all elements and details of a contract in a way which is binding on the foreign enterprise, even if the agreement is signed by another person in the State where the enterprise is resident, the agent can be said to exercise the

authority envisaged in Article 5(5) of the Model Tax Convention.

On the other hand, the OECD Commentary states that the mere fact that an agent participates in negotiations leading to the conclusion of a contract does not on its own create a PE. The extent to which an agent is involved in such negotiations will, however, be a factor which will be considered in assessing the extent of the functions performed by the agent on behalf of the enterprise.

Proposed changes to Article 5(5) of the Model Convention

The BEPS Report proposes new wording for, *inter alia*, Article 5(5), in terms of which an enterprise will, unless an exclusion applies, be deemed to have a PE where a dependent agent acts on its behalf in a Contracting State "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 –

a. are in the name of the enterprise, or
b. for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
c. for the provision of services by that enterprise" (our emphasis).

The proposed OECD Commentary notes that if the above conditions are met, the person's actions on behalf of the enterprise will be sufficient to conclude that the enterprise participates in business activity in the state concerned, since those actions "go beyond mere promotion or advertising". It is stated that a contract may be concluded without any active negotiation of the terms of that contract and that a contract may be concluded in a State even if the contract is

signed outside that State. The test will focus on the substantive activities taking place in a State to include scenarios where a contract is concluded directly as a result of such activities.

The following example is given in respect of the scope of the proposed expansion of Article 5(5):

- a company resident in State R (**"RCo"**) distributes products and services worldwide through its website;
- RCo has a wholly owned subsidiary which is resident in State S ("**SCo**"). The employees of SCo make contact with large organisations in State S to buy the products/services of RCo and are responsible for the large accounts in State S. These employees' salaries are partly determined with reference to the revenues earned by RCo from these clients; and
- when a client is persuaded to buy products, an employee of SCo indicates the price and refers the client to the online contract to be concluded with RCo and explains the standard terms of these contracts, including the price structure.

The BEPS Report states that SCo's employees play the principal role leading to the conclusion of the contract between the client and RCo and that such contracts are routinely concluded without material modification by the enterprise.

South African context

Non-residents of South Africa are subject to South African tax on income that is derived from a source within or deemed to be within South Africa. Whilst determining the "source" of income is a factual enquiry, if a non-resident company sells products to clients in South Africa with the assistance of a South African-based sales team, the sales team may result in a conclusion that at least a portion of the non-resident's income is derived from a source within South Africa. It should

then be considered whether an applicable double tax agreement (“**DTA**”) provides any relief in respect of any such South African sourced income. This should be the case if the non-resident does not have a PE in South Africa to which its business profits or a portion thereof are attributable.

During December 2014, the Davis Tax Committee (“**DTC**”) released its first interim report detailing the South African perspective on BEPS. During May 2015, there was a call for input to assist the DTC BEPS sub-committee with drafting its Second Interim Report on BEPS, which will also focus on Action 7.

If the recommendations of the BEPS Report are implemented in their current form and are incorporated into DTAs entered into by South Africa, in determining whether a dependent agent would trigger a PE for a foreign enterprise, in our view, regard should be had, *inter alia*, to:

- whether the activities of the dependent agent constitute mere advertising or promotion, or whether they constitute, or result directly in, the conclusion of contracts on behalf of the foreign enterprise;
- whether the contracts eventually concluded are materially modified by the foreign enterprise offshore from the form that may have been proposed by the dependent agent;
- whether the dependent agent plays the principal role leading to the conclusion of such contracts; and
- whether the conclusion of such contracts takes place repeatedly or merely in isolated cases.

If the South African sales team creates a PE for the non-resident company in South Africa, that company will be liable for South African tax at a rate of 28% in respect of its taxable income, which is essentially the income attributable to such PE, taking into account the functions and risks of the permanent establishment, less permissible deductions.

It should also be noted that the term “permanent establishment” is defined in the Income Tax Act, 58 of 1962 (“Act”) to mean a PE as defined from time to time in Article 5 of the Model Tax Convention. As such, even if the proposed changes to Article 5 are not incorporated into South Africa’s DTAs in the near future, once the Model Tax Convention has been amended in this regard, such changes would be incorporated into the Act by virtue of the definition of a PE. This definition is important, for example, in the context of determining the source of certain amounts and in determining whether a non-resident may be subject to South African capital gains tax in respect of a disposal of an asset.

Source:

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