REPUBLIC OF SOUTH AFRICA

TAX COURT
Held at Johannesburg

CASE NO: 13276

Reportable: Yes Of Interest To Other Judges: Yes Revised. **15 May 2015** ……………………….. SIGNATURE

In the matter between:

AB LLC and BD Holdings LLC **Appellant**

and

The Commissioner of the South African Revenue Services **Respondent**

JUDGMENT

Vally J (Peter Vundla and Gavin Beckwith concurring)

Introduction

1. International commerce is an essential and integral part of the modern world we inhabit. It is also pervasive. It involves businesses operating simultaneously in various countries. Appreciating and understanding it has resulted in the enrichment of our lexicon by, amongst others, the introduction of the phrase "*globalised world*". It is a phrase that is intended to encapsulate the symbiotic

and co-existent nature of countries which enjoy exclusive legal jurisdiction over their individual territories. In this globalised world commerce is often forced to navigate the choppy political waters of countries, and their ever changing legal rules. One such legal rule, which itself undergoes regular amendment, is that of the tax liability that is made applicable to businesses that operate within the borders of a country. Where a business operates simultaneously within two different national jurisdictions it faces significant challenges when determining whether, and to what extent, it becomes liable for taxation in either or both jurisdictions. At the same time countries are, rightly so, concerned about businesses successfully avoiding the payment of tax in the jurisdiction where it is due by taking undue advantage of the fact that they operate in two or more national jurisdictions at once. This problem has a long standing and deep history. Initially, countries adopted the view that they each had the right to determine their own taxation policies for any resident within their jurisdictions without any regard to what the impact on the other country, or the individual/company affected thereby, was. In the very early stages the United Kingdom (UK), whose residents had dominated the world of international finance and played a significant part in global trade, imposed personal taxation on British residents on their worldwide income regardless of its nature or source.[1] Unsurprisingly, this led to some companies challenging the tax liability imposed upon them by the UK authorities' notion of residence, given that they operated inside as well as outside the UK at the same time. One of the issues arising from this challenge involved the notion of "*residence*" as it concerns corporations.

[1]See: Sol Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation*, (1992) at pp 5-6. This can be downloaded from www.taxjustice.net/cms/front content. php?idcat=149. It was accessed on 17 April 2015

From as early as 1876, the UK Exchequer Court developed what is now widely referred to as the "*central management and control test*" to determine the residence of a corporation for purposes of establishing whether the corporate operating outside the UK is, nevertheless, liable to pay tax in the UK.[2] In 1906 the House of Lords adopted this test in the well-known case of *De Beers Consolidated Mines Ltd v Howe*, where the test was described in the following terms:

> "The decision of Kelly C.B. and Huddleston B. in the *Calcutta Jute Mills v Nicholson* (1) and the *Cesena Sulphur Co. v Nicolson* (1), now thirty years ago, involved the principle that a company resides for purposes of income tax where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule, and the real business is carried on where the central management and control actually abides."[3]

2. The importance of this case lies not only in the adoption of the "*central management and control test*" but also in the facts and conclusion reached, as a result of which it acquired instrumental value. The facts were:

> "The head office (of De Beers) is formally in Kimberley (South Africa), and the general meetings have always been held there. Also the profits have been made out of diamonds raised in South Africa and sold under annual contracts to a syndicate for delivery in South Africa upon terms of division of profits realised on resale between the company and the syndicate. And the annual contracts contain provisions for regulating the market in order to realise the best profits on resale. Further, some of the directors and life governors live in South Africa and there are directors' meetings at Kimberley as well as in London. But it is clearly established that the majority of directors and life governors live in England, that the directors meetings in London are the meetings where the real control is always exercised in practically all the important business of the company except the mining operations. London has always controlled the negotiation of the contracts with the diamond syndicates, has determined policy in the disposal of diamonds and other assets, the working and development of mines, the application of profits, and the appointment of directors. London has also always controlled matters that require to be determined by the majority of all the directors, which include all

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[2] *Calcutta Jute Mills Co Ltd v Nicholson* 1 TC 83; *Cesena Sulphur Co Ltd v Nicholson* 1 TC 88; [1874-80] All ER Rep 1102 (Exch D).
[3] *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455 at 458:

> questions of expenditure except wages, materials, and such-like at the mines, and a limited sum which may be spent by the directors at Kimberley." [4]

Applying the rule established in *Calcutta Jute Mills* and *Cesena Sulphur* the House of Lords found that De Beers was to be treated as a resident of the UK for purposes of taxation. In essence, the principle established by these authorities is that a company's residence is "*in the jurisdiction where its board of directors meets,*"[5] and not where its profits are made or where its operations are based.

3. The finding resulted in the UK tax authorities benefitting from income earned in South Africa. Whether this was at the expense of the South African tax authorities is not clear from the case report. However, if it was not, it would have meant that De Beers would have paid double tax (i.e. to the UK and to South Africa). Either way the outcome produced unsatisfactory results and, for that reason, cried out for attention. The approach adopted in these cases posed a challenge to the countries to establish a system that legitimately imposed taxation upon a business corporation operating on its shores, while simultaneously protecting it from being taxed again on the same profits or income by another country. Not taking action to prevent this would effectively mean that either the corporations would have to bear a burden of a double taxation on the same income[6], or they would pay to one country to the detriment of another, or they could escape paying any tax at all on the profits or

[4] *Id*. at pp 458-459
[5] *Wood v Holden (Inspector of Taxes)*[2005] EWHC 547 (Ch) at [21]
[6] The Organisation of Economic Development (OECD) Model Tax Treaty defines "*Double Tax*" to be *"the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods.*"

income earned. None of the outcomes would be satisfactory to all the parties affected thereby.

4. To deal with this problem, double taxation treaties were concluded between countries, and as a result a paradigmatic shift in international tax law occurred. Regarding these double taxation treaties certain Conventions commonly known as Model Conventions on double taxation (more will be said about this in a little while) have been crafted for the benefit of all countries. Using them as templates countries have come to conclude what is commonly referred to as Double Taxation Agreements. These agreements tend to be bilateral in nature. It is said that the purpose of Double Taxation Agreements is to ensure that there is a free flow of trade and investment across countries, as well as a recognition that taxation is not avoided by the latitude afforded by the flow of free trade and investment. To achieve this purpose the two countries that are party to the Double Taxation Agreement agree that one of them will forego revenue. Which one ultimately does so depends on the facts regarding the business enterprise's operations as well as on the interpretation of the terms of the agreement concluded between the two countries.

5. One such agreement is the Double Taxation Agreement between South Africa and the United States of America (the DTA) which was concluded on 17 February 1997. It is the one that consumes our attention in this case. The purpose of the DTA is the avoidance of double taxation and the prevention of fiscal evasion in respect of taxes, whilst allowing and protecting free trade between the two countries. In concluding the DTA the South African

Government acted in terms of section 108(2) of the Income Tax Act, 58 of 1962 (ITA), read with s 231(1) of the Constitution of the Republic of South Africa Act 108 of 1996 (the Constitution).[7] The DTA became part of South African law in terms of s 231(4) of the Constitution, as it was approved by Parliament in terms of section 231(2) of the Constitution, and the arrangements were duly published in the Government Gazette 18553 of 15 December 1997. The provisions of the DTA therefore rank equally with domestic law.[8]

6. There are two companies that have brought this appeal: AB LLC and BD Holdings LCC. They, together with the respondent, have agreed that for purposes of this case they should be treated as one as their separate identities are of no importance for the determination of the case. Thus they are both referred to as "the appellant" in this judgment. The appellant is incorporated in the United States of America. It is an advisory group that has a global reach. It has offices in no less than ten (10) foreign jurisdictions. It concentrates on the airline industry. It came to South Africa in 2007 to perform certain services for X, a company based in and operating from South Africa. To perform these services it concluded a contract with X. Its only purpose for coming to South Africa was to perform its obligations and earn its income or profits in terms of the contract. Having achieved its objective it left the country in 2008. To its

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[7]The relevant sections of the Constitution read:

"231(1) The negotiating and signing of all international agreements is the responsibility of the national executive.

231(2) An international agreement binds the Republic only after it has been approved by resolution in both the National Assembly and the National Council of Provinces, unless it is an agreement referred to in subsection (3)

...

231(4) Any international agreement becomes law in the Republic when it is enacted into law by national legislation: but a self-executing provision of an agreement that has been approved by Parliament is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament."

[8]See also: *Secretary for Inland Revenue v Downing* 1975 (4) SA 518 (A) at 523 *in fin*

surprise, on 14 June 2011 it learned that it had been assessed for taxation purposes for the 2007, 2008 and 2009 years by the respondent, and that the assessments indicated that it was liable to the respondent for a substantial amount of money. It was also informed that the respondent had, in terms of powers conferred upon him by the s 76 of the ITA, decided to impose an additional tax upon it and that he intended to charge it for interest in terms of s 89 quat(2) for the non-timeous payment of the tax.

7. Aggrieved by these assessments, as well as by the imposition of an additional tax and the charge of interest, it lodged an objection in terms of Rule 3 of the Rules promulgated in terms of s 107A of the ITA. The necessary processes for the resolution of the objection were followed and they ultimately culminated in the appeal before this court.

The facts as distilled from the pleadings as well as the evidence presented by the appellant

8. During the course of 2007, the appellant entered into an agreement with X in terms of which the appellant would provide certain strategic and financial advisory services to X ("the agreement"). In terms of the agreement, the services were to be delivered in three phases with the first phase commencing in February 2007 and the third phase ending in May 2008. During this period the appellant made 17 of its employees available, who came to South Africa as and when required. However, there were three employees whose work formed a core aspect of the project and who were each in South Africa, on a rotational

basis, for three-weeks at a time. During the 2007 calendar year the appellants' employees were in South Africa for a period exceeding 183 days. The appellant was granted space inside the premises of X from where it conducted most of its activities, and at times employees of the appellant were based in different geographical areas within the premises of X. The space provided was in the boardroom, where the appellant was provided with four tables and one telephone to be shared by all its employees. The employees only had access to these premises on weekdays and during working hours. Other than providing services in terms of the contract with X, the employees of the appellant did not perform any other work of the appellant. The nature of the work provided, which was consultancy services on a daily basis, required the appellant's employees to be based at the premises of X. For this reason the boardroom where the appellant always had a presence, even if some of its employees were at times located for brief periods in another area of the X premises, constituted the "*hub*" of the appellant's business operations. In the words of the appellant's main witness, Mr S, the boardroom was the "*engine room*" of its business operation. It was where all its employees started their working day. At times, some of them would, for a short period, have to go to another department of X, such as the Human Resources Department, and would therefore move from one area to another for a day or part thereof. It bears mentioning that the X operations are all geographically located in one place, Y. So when the employees of the appellant moved from one department to another they moved in areas within Y. In any event, at all times there would be employees of the appellant working in the boardroom. The appellant did not ever ask for access to the boardroom after normal working hours.

9. The appellant derived income from X for services rendered in South Africa (or earned a profit as a result of the services it sold to X) during its 2007 and 2008 years of assessment, and received additional income (or earned additional profits) during the period 9 April 2008 to 9 November 2009. The latter income (or profit) was not for (or as a result of) any new services it provided during the 2009 year, but was for the success achieved ("success fee") by it during the performance of its obligations in terms of the agreement concluded in May 2007: it was, in other words, part of the income (or profits) it earned for the services provided during 2007 and 2008 years. It was only paid in 2009 because that was when the success was reflected in the accounting records of X. The total taxable amount for these years, although only earned during the period February 2007 to May 2008, according to the respondent, was sixty three million, nine hundred and ninety thousand and six hundred and thirty-nine rands (R63 990 639.00).

10. The appellant's income (or profits) earned in SA during the 2007, 2008 and 2009 years were assessed by the respondent for purposes of determining if the appellant was liable for taxation in terms of the ICA. The assessment was based on the provisions of Articles 7(1), 5(1) and 5(2)(k) of the DTA. According to these assessments the appellant is liable for tax for those years for the income it earned in SA during its stay here in 2007 and 2008. Aggrieved by these assessments, the appellant appeals against them.

The relevant provisions of the DTA

11. Article 7(1) of the DTA allows for either the USA or South Africa to require an enterprise that carries on business on its shore to pay taxation for all income or profits earned from that business. It reads:

> "The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."

12. For the appellant to be liable for taxation in South Africa it would have to carry on business in South Africa through a permanent establishment. This raises the question: what is a permanent establishment? Article 5 provides direction for an answer to this question. It reads:

> "5(1) "For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on."
>
> 5(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 other place of extraction of natural resources;
> (g) a warehouse, in relation to a person providing storage facilities for others;
> (h) a store or premises used as a sales outlet;
> (i) a ship, drilling rig, installation or other structure used for the exploration or exploitation of natural resources, but only if it lasts more than twelve months;
> (j) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities lasts more than twelve months and
> (k) the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a period or

> periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned."

13. Articles 5(1) and 5(2)(a) – 5(2)(f) are identical to articles 5(1) to 5(a) – 5(2)(f) of the OECD Model treaty. However, It is the only provisions of articles 5(1) and 5(2)(k) that have a direct and immediate bearing on the outcome of this case. The other provisions of article 5(2), however, are helpful in providing a guide as to what the drafters of this treaty intended by providing those affected thereby with this very specific definition of a *"permanent establishment*", although it has to be said that articles 5(1)(a) to 5(1)(f) really provide very little, if any, margin for controversy. The places of business mentioned there, are really innocuous in the sense that everybody knows what they are.

How to interpret international treaties[9] concerning double taxation

14. There are various model treaties addressing the issue of double taxation. The most commonly known ones are: the OECD Model Tax Convention on Income and Capital (OECD Model), the United Nations Model Double Taxation Convention (UN Model) and the USA Model Tax Convention. The first one was drafted by countries with advanced economies and may be well-suited for their needs and interests. The second one is drafted by countries of more advanced as well as less advanced economies. It is intended to cater for the needs of the countries with less developed economies. The last one is drafted by the USA and is meant to attend to the mutual interests of the USA and its trading partners. The OECD Model, it seems, has served as a basis for many double

[9] The terms "*treaty*", "*convention*" and "*agreement*" tend to be used interchangeably in the treaties as well as in the literature on this topic.

taxation treaties concluded by South Africa and its trading partners.[10] The three model treaties share many similarities and in some cases contain the same articles. If any treaty contains the same article as that of the OECD Model then it would not be uncommon to rely on the commentary of the OECD Model to interpret that article.

15. The articles of a model treaty are designed to guide contracting states, but often they are adopted verbatim in actually concluded treaties between two (2) states. In these circumstances the potential for the articles to be open to more than one interpretation is real, given that the interests of the various contracting countries are so diverse that it is impossible to cater for them all in one model treaty. That said, it bears noting that, in fact, as far back as 2002 it was found that "*there were over 2000 treaties in effect and the number keeps growing.*"[11] Under these circumstances, it would be unusual if the interpretation of similar or same terms or articles is unanimous in the various jurisdictions where these treaties operate. Peculiarities of the tax policies of each country are bound to impact upon the interpretation of a treaty, or article in a treaty. To minimise the potential of this problem rearing its head, a model treaty is published with a commentary on the articles contained therein.

The contentions of the parties

16. It is contended by the appellant that once the requirements of articles 5(2) are met the focus of the enquiry shifts to the requirements in article 5(1), and only if the requirements of article 5(1) are met can it be safely concluded that the

[10] See *Secretary for Inland Revenue,*fn8, at 523A
[11] Lynette Olivier and Michael Honniball, *International Tax: A South African Perspective 2011*, (Fifth Ed), at 271 penultimate para

existence of a "*permanent establishment*" has been proved. On this basis the appellant contends that, even if it were found that the requirements of article 5(2)(k) were met in this case (it specifically eschewed any concession to the effect that they were met), it nevertheless has still to be found that the requirements of article 5(1) had been met in order for it to be held liable for taxation for the income it earned (or the profits it made) from its operations in this country. In this regard it contended that on the facts as relayed above it has to be found that it did not have a "*fixed place of business through which* (its) *business ...* (was) *wholly or partly carried on*" and for that reason it cannot be found that it had a "*permanent establishment"* in this country. It is, therefore, not amenable to being taxed for the income earned (or profits made) during its sojourn in this country. Thus, it asked for the appeal to be upheld and the assessments to be set aside.

17. In this case, as mentioned before, the terms of articles 5(1) and (5)(2)(a)-5(2)(f) inclusive are identical to the same numbered articles in the OECD Model. And, according to the OECD Commentary about the relationship between 5(1) and 5(2)(a) to 5(2)(f):

> "This paragraph (i.e. 5(2)(a)-5(2)(f)) contains a list, by no means exhaustive, of examples, each of which can be regarded *prima facie*, as constituting a permanent establishment. As these examples are to be seen against a background of the general definition given in paragraph 1, it is assumed that the Contracting States interpret terms listed, 'a place of management', 'a branch' 'an office' etc. in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1."[12]

[12] Para 12 of the OECD Commentary on article 5.

18. If the logic of this interpretation is to be extended to the article 5(2)(k) then it would mean that even if the requirements of 5(2)(k) have been met the enterprise cannot be said to be holding a permanent establishment unless the requirements of 5(1) have also been met. This interpretation provided in the Commentary has been accepted in many courts with jurisdiction over treaties where these articles of the OECD Model have been adopted verbatim. According to this interpretation the list contained in articles 5(2)(a) – 5(2)(f) does not expand the definition of "*permanent establishment*" but merely "*illustrates*" what a permanent establishment is, and as this is so the fact that a business enterprise may have set up a place of business in the form identified in articles 5(2)(a)–5(2)(f) does not mean that that enterprise has established a "*permanent establishment*". For it to qualify as a "*permanent establishment*" there has still to be compliance with the requirements in article 5(1). This interpretation, in my view, takes no account of the phrase "*includes especially*". This could well be one of the reasons that a leading commentator of this subject of double taxation warned that the interpretation provided by the Commentary may not be adhered to in all jurisdictions. He said:

> "The list is illustrative and the Commentary makes it clear (at para 12) that the place of business will only constitute a permanent establishment if it fulfils the requirements of the general definition in Article 5(1). As the list is illustrative, it is common in specific agreements to add further examples which are more likely to be relevant to the countries in question. (For example, 'farms, 'plantations', 'forestry property').
>
> Since any place of business within the illustrative list must meet the requirements of Article 5(1), one wonders whether the illustrative list serves much purpose any longer. There is the danger that a revenue authority or tribunal might conclude that a place of business within the illustrative list was a permanent establishment even though it did not satisfy all the requirements of Article 5(1)."[13]

[13] Philip Baker QC, *Double Taxation Conventions*, para 5B.14

19. Nevertheless drawing on the OECD Commentary and the comment of Philip Baker, the appellant claims that the same approach must be adopted with regard to article 5(2)(k).

20. The respondent, on the other hand, contended that once it was found that the requirements of article 5(2)(k) were met then *caedit questio.* In terms of its contention, a finding to the effect that the requirements of article 5(2)(k) had been met is automatically a finding to the effect that a "*permanent establishment*" was created by the appellant during its sojourn in this country. In the alternative, it contended that if it is found that the interpretation favoured by the appellant is correct, then, nevertheless, on the facts of this case, the appellant had established a "*fixed place of business through which* (its) *business ...* (was) *wholly or partly carried on*" during the period February 2007 to May 2008. It, therefore, attracted a liability for tax for all income earned (or profits made) during this period regardless of when exactly the income was paid (or profits realised).

21. That then is the binary choice presented to this court.

Interpretation of articles 5(1) and 5(2)(k) of the DTA

22. The explanations provided in the Commentary are of immense value in understanding or interpreting any article contained in the treaty. In fact, some forty years ago, Corbett JA, (as he then was), dealing with an issue of whether

a taxpayer who resided in Switzerland was liable for taxation in South Africa, drew on the Commentary on the OECD Model Tax Treaty to interpret the provisions of a treaty between South Africa and Switzerland on Double Taxation.[14]

23. More recently, however, the SCA has reminded us of the importance of our basic rules of interpretation and emphasised:

> "The need to interpret international treaties in a manner which gives effect to the purpose of the treaty and which is congruent with the words employed in the treaty is well established."

And:

> "As mentioned above the term must be given a meaning that is congruent with the language of the DTA having regard to its object and purpose."[15]

24. Bearing in mind the interpretation "*must give effect to the purpose of the treaty in a manner that is congruent with the words used*", it is, in my view, crucial in the first instance to take note of the prominence of the phrase "*includes especially*" in article 5(2) in order to give intelligent meaning to the concept "*permanent establishment.*" It, therefore, must provide the starting point for our analysis.

25. Adopting this approach, it is necessary to look at the verb "*include*". According to the Collins English Dictionary (Complete and Unabridged), "*include"* means, inter alia,:

> "*to add as part of something else; put in as part of a set group, or category*."

[14] *Secretary for the Inland Revenue v Downing* 1975 (4) SA 518 (A) at 523A
[15] *Commissioner, South African Revenue Service v Tradehold Ltd* 2013 (4) SA 184 (SCA) at [21] and [23]. The cases cited there are omitted.

26. This is also the meaning given to it in judicial pronouncements. As early as 1926 it was held:

> "Now 'includes', as a general rule, is not a term of exhaustive definition; sometimes it is so employed, but, as a general rule, it is a term of extension"[16]

27. In *R v Debele*[17] this approach to treating the word "*include*" as a "*term of extension*" was not only made explicit but was clarified to show that the extended items or factors need not as a matter of ordinary meaning fall into the primary item or factor. However, by enlarging the ordinary meaning of the primary item or factor the word *"include"* embraces the extended items. To put it differently:

> "The word 'include' is often used in the definition of Acts of Parliament for the purpose of enlarging the meaning of a word or phrase by bringing it under something which is not comprehended under the ordinary meaning of that word or phrase."[18]

28. This interpretation of the word "*include*" has a long history. In 1899 Lord Watson stated:

> "The word 'include' is very generally used in interpretation clauses in order to enlarge the meaning of words or phrases occurring in the body of the statute, and when it is so used these words or phrase must be construed as comprehending, not only such things as they signify according to their natural import, but also those things which the interpretation clause declares that they shall include."[19]

29. Thus, the word "*include*" used in a statute is often used to extend or enlarge the meaning of a thing or concept. It brings within the scope of the thing or concept others that are not ordinarily or naturally part of the thing or concept.

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[16] *Jones & Co v Commissioner for Inland Revenue*, 1926 CPD 1 at 5; See also, *Rosen v Rand Townships Registrar*, 1939 WLD 5 at 10

[17] 1956 (4) SA 570 (A)

[18] *Id.* at 575

[19] *Dilsworth v Commissioner of Stamps* [1899] A.C. 99 at pp105-106

30. If this is so then it has to be inferred that by using the term or phrase "*includes especially*", the drafters of the treaty intended that the factors referred to in article 5(2)(k) be made part of the definition referred to in article 5(1). They were particularly drawn towards making sure that those factors are given special attention when determining whether a particular business enterprise can be said to be operating through a "*permanent establishment*" in a non-resident country within which it conducts business or provides services. Otherwise they would not have used the words "*includes especially*". It therefore has to be interpreted that the contents of article 5(2)(k) must be read to mean that they are an integral part of article 5(1). On this analysis, as soon as an enterprise's activities fall within the ambit of article 5(2)(k) it becomes liable for taxation in the non-resident country. There is no need for a further or separate enquiry as to whether the requirements of article 5(1) have been met. The two articles cannot be read disjunctively. The definition, by virtue of the bridging phrase "*includes especially*", is a composite one. This clearly expresses the purpose of the treaty. To break it up and treat the two articles separately would be to ignore the natural and ordinary meaning of the phrase "*includes especially*".

31. This interpretation is contrary to what is recommended by the OECD Commentary on the relationship between articles 5(1) and 5(2)(a) – 5(2)(f). I am of the view that what is recommended by the OECD for these articles has no bearing on the issue of the relationship between articles 5(1) and 5(2)(k). Article 5(2)(k) is specific and very different from articles 5(2)(a) – 5(2)(f). Unlike articles 5(2)(a) – 5(2)(f) it does not refer to a place of work, but rather to a form of work.

It is a different species. Therefore, the interpretive approach adopted with regard to articles 5(2)(a) – 5(2)(f) cannot be replicated without thought or input. As far as article 5(2)(k) is directly concerned the OECD Commentary is of no assistance. Given that there is no such article in the OECD Model, its silence on the matter is understandable. However, because it is silent does not mean that an inference to the effect that what it says or recommends with regard to the relationship between article 5(1) and articles 5(2)(a) – 5(2)(f) is applicable to the relationship between 5(1) and 5(2)(k). There is no room for such an inference given the material differences between article 5(2)(k) and articles 5(2)(a) – 5(2)(f).

32. In pressing for its contention that article 5(2)(k) cannot be interpreted independently from that of article 5(1), the appellant drew inspiration from what the Canadian Federal Court of Appeal found when interpreting similar articles in Canada – the USA Convention Act, 1984 (the USA/Canada Convention). The case is that of *The Queen v Dudney*.[20] In that case, the taxpayer, William A Dudney (Dudney), an engineer in aerospace and a resident of the USA earned income in the years 1994 and 1995 in Canada by performing services to a Canadian company as an independent contractor. He claimed that his income was exempt from Canadian tax as a result of the operation of article XIV of the Convention. The Canadian tax authorities adopted a diametrically opposing point of view.

[20] WA (2000) D.T.C. 6169

33. The preamble to the USA/Canada Convention indicates that the parties have concluded it in order to avoid double taxation and prevent fiscal evasion. Article XIV of the Convention reads:

> "Income derived by an individual who is resident of a Contracting State in respect of independent personal services may be taxed in that state. Such income may also be taxed in the other Contracting State if the individual has or had a fixed base regularly available to him in that other State but only to the extent that the income is attributable to the fixed base."[21]

34. It was intended that Dudney would work for a Canadian company, OSG, for a year. He was to work at the premises of another Canadian company, PanCan, which had a contract with OSG. He was provided with a small room to perform the services OSG was contracted to perform. After three months he was moved to a larger room which he shared with a number of other consultants. Later still, he was moved to another building also occupied by PanCan employees. He would from time to time provide training to PanCan employees and the training would take place in different parts of the PanCan premises where these employees were based. He could not do any of his own business while located on any of the PanCan premises. He could not use the telephone for any business other than that which was related to the services he was providing to PanCan. His access to the premises was controlled by a magnetic card system and restricted to business hours during week days only. The Appeal Court had to decide whether on these facts it was established that the income earned by Dudney in Canada was "*attributable to a fixed base*". To decide this issue the Court drew upon the Commentary of article 5 of the OECD Model, especially article 5(1). It then found that:

[21] *Id.* at [3]

> "In this case, the Tax Court Judge was correct to consider these factors to be relevant and determinative. The evidence as a whole gives ample support for the conclusion that the premises of PanCan were not a location through which Mr Dudney carried on his business. Although Mr Dudney had access to the offices of PanCan and he had the right to use them, he could do so only during PanCan's office hours and only for purpose of performing services for PanCan that were required by his contract. He had no right to use PanCan's offices as a base for the operation of his own business. He could not and did not use PanCan's offices as his own."[22]

35. Hence, it found that the income derived by Dudney while operating in Canada could not be "*attributable to a fixed base*" as he did not have "*a fixed base regularly available to him*" in Canada.

36. There are, doubtless, significant differences between article 5 of the DTA, which is applicable in our case, and article XIV of the USA/Canada Convention, which was applicable in *Dudney*. In that Convention there is no equivalent of the article 5(2) that is found in the DTA. Articles 5(1) and 5(2) of the DTA taken compositely are materially different from that of article XIV of the USA/Canada Convention. Therefore, to superimpose the interpretation of the Appeal Court in Canada with regard to article XIV of that Convention on to article 5 of the DTA would be wrong. Its instructive value, too, is doubtful given that the two treaties are so different. At best article 5(1) of the DTA bears a resemblance to article XIV of the USA/Canada Convention. But that is as far as it can be taken. Beyond that they share no resemblance. Furthermore, the judgment of the Canadian Federal Court of Appeal, in my view, does not conform with the rules of interpretation applicable in our jurisdiction. Nor does it accord with the interpretation preferred by the Technical Explanation of the DTA. For those reasons, I am not persuaded that it should be followed in this case. However, in

[22] *Id.* at [20]

all fairness to the appellant its reliance on the *ratio* of that judgment is not misplaced if its contention that article 5(2)(k) is not self-standing and cannot be interpreted independently of article 5(1) is found to be correct, for the facts in that case share some similarities to the facts in this case. This is an issue, to which I will return.

37. In the meantime it bears stating as a conclusion on this issue that the interpretation I have given above with regard to the relationship between articles 5(2)(k) and 5(1), and the interpretation proffered by the Technical Explanation (which offers an insight into the understanding of the signatories to the DTA) coincide with one another. The Technical Explanation addresses this treaty only and is addressed to business enterprises and tax authorities in the two countries. This is manifest in the following statement contained in the introductory paragraph of the Technical Explanation:

> "This document is a technical explanation of the Convention between the United States and South Africa which was signed on February 17, 1997 (the "Convention"). ...
> The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention."

38. The Technical Explanation draws from the Commentary on the OECD Model but as far as the relationship between article 5(1) and 5(2)(k) is concerned it enlightens anyone affected by or interested in the treaty that:

> "As indicated in the OECD Commentaries ..., a general principle to be observed in determining whether a permanent establishment exists (except with respect to the furnishing of services under subparagraph (k)) is that the place of business must be "fixed" in the sense that a particular building or physical location is used by the enterprise for the conduct of its business."

39. In sum then, the Technical Explanation makes it unambiguously clear, that when considering the furnishing of services by an enterprise (article 5(2)(k)) the analysis or interpretation accorded to the place of work (articles 5(2)(a) – 5(2)(f)) is not applicable. It goes on to say that in the case of furnishing of services this does not have to occur within a "*a fixed place of business*" (article 5(1)). Thus, once the provisions of article 5(2)(k) are met, there is no need to further examine whether the provisions of article 5(1) have also been met to determine whether the existence of a permanent establishment has been proved.

<u>The application of the articles 5(2)(k) and 5(1) to the facts of this case</u>

40. It is common cause that the appellant, a resident of the USA, provided consulting services to X in South Africa through its employees (the number of which varied from time to time, but constituted 17 in total) for a period exceeding 183 days during February 2007 and May 2008. On these facts, there is no dispute that the requirements of article 5(2)(k) were met, and if the interpretation given above is correct then it follows that the appellant became liable for taxation in South Africa as its operations fell within the meaning of "*permanent establishment*" as used in the DTA.

41. However, assuming for the moment that the above conclusion is legally untenable then, on the alternative interpretation, it would be necessary to examine whether the requirements of article 5(1) were also met before it can safely be concluded that the appellant established a "permanent establishment" while performing its obligations in terms of its contract with X. Thus, I hold that

even if this interpretation is wrong the facts in this case reveal that the respondent has shown that the requirements of 5(1) were met.

42. There is no doubt that the appellant had a fixed base in the boardroom of X. Throughout its stay in South Africa it had a presence in the boardroom of X even though at times some of its employees moved to other areas of the X premises. This, it must be remembered, is very different from the factual situation in *Dudney*, where Dudney who was a sole individual providing services moved from one area to another. In our case, while some employees moved from one area to another the appellant was, at all times, present in the boardroom during the tenure of the contract. It had exclusive use of this space for the entire duration of the contract. To put it differently, it had at its disposal constant access to the boardroom during working hours. Access during non-working hours was neither necessary nor requested. This flows directly from the fact that compliance with its obligations in terms of the contract required regular intensive interaction with employees of X, which, it goes without saying, was most suitable during normal working hours. There can therefore be no doubt that the appellant had established "*a fixed place of business*" in South Africa while carrying out its obligations in terms of its contract with X.

43. The appellant contended that, as it did not have access to the boardroom after normal working hours, and the fact that it was restricted to solely conduct the business relating to the contract with X, it was not able to conduct any of its business not relating to X. This limitation, it says, demonstrates beyond doubt that it was not able to conduct all its business from the X premises, and

therefore it could not have established "*a permanent establishment*" at the X premises. The difficulty faced by this contention is that it flies in the face of the definition of "*a permanent establishment*" in the DTA. The defining characteristic in terms of article 5(1) is that it must be "*a fixed place of business through which the business of an enterprise is wholly or partly carried on*". Thus, the non-resident party (the appellant in this case) is not required to carry out all its business from the "*fixed place of business*" so established. In this sense, even if it performed some of its obligations in terms of the contract with X from another premises, it would, nevertheless, have established "*a permanent establishment*" if it performed only some of its obligations (i.e. "*partly carried on*") in terms of the contract. In a word, even if it only conducted part of its business from the boardroom, it would have complied with the definition.

44. In sum then, to the extent that it is necessary for there to be compliance with the provisions of article 5(1) before a finding that the existence of a permanent establishment has been proved, such has been proven in this case.

<u>The appeal against the levying of taxation for the 2008 and 2009 years</u>

45. The appellant contends that the 183 day requirement found in article 5(2)(k) must be for "*a twelve month period commencing or ending in the taxable year concerned*". If an entity spends less than 183 days in any twelve month period commencing or ending in a taxable year in a non-resident state then that entity cannot be said to have set up a "*permanent establishment*" in that state. This is also referred to as the "*183 day rule*" in the literature on double taxation treaties.

46. It is common cause that the appellant's presence in South Africa was from February 2007 and the third phase ended in May 2008, that since 1 May 2008 no employees of the appellant were present in South Africa and that the appellant's financial year commenced on 1 January 2007 and ended on 31 December 2007. On these facts the appellants contends that the respondent was correct to assess it liable for taxation for the 2007 year as it had been present in South Africa for more than 183 days during that year. However, as far as the 2008 year is concerned the respondent cannot count any of the days already taken into account when calculating the 2007 year. As it was only in South Africa from 1 January 2008 to 1 May 2008, it was not in South Africa for 183 days during that year. Therefore, it cannot be taxed for the income earned (or profits made) during that year. As far as the 2009 year is concerned, it is common cause that it had absolutely no presence in South Africa during that year. Hence, only the 2007 year assessment passes muster in terms of the 183 day "rule". For these reasons, it asks that its appeal against the 2008 and 2009 years be upheld.

47. The respondent, in contrast, maintains that the presence of the appellant in South Africa for the 2008 and 2009 years was established beyond doubt. As for calculating the 183 days for each year, the respondent claimed that as the appellant was in South Africa during the calendar years 1 January 2007 – 31 December 2007 and 1 January 2008 – 31 December 2008, it was in South Africa for two tax years, i.e. 1 March 2007 – 28 February 2008 (the 2007 year) and 1 March 2008 – 28 February 2009 (the 2008 year). The 183 day period has to be calculated forwards from 1 March 2007 to 28 February 2008, for this is

"*the commencing of the fiscal year*" and then again backwards from 28 February 2009 to 1 March 2008, for this is the "*ending of the fiscal year*". This, the respondent concedes, results in some days being "*double counted*". Double counting, he argues, is not only allowed by the treaty but was actually contemplated by the parties to the DTA, and in support of this he drew attention to the OECD Commentary where, in paragraph 4 thereof, the following is said:

> "The three conditions prescribed in this paragraph (i.e. article 5(2)(k) in the DTA) must be satisfied for the remuneration to qualify for the exemption. The first condition is that the exemption is limited to 183 day period. It is further stipulated that this time period may not be exceeded "*in any twelve month period commencing or ending in the fiscal year concerned*". This contrasts with the 1963 Draft Convention and 1977 Model Convention which provided that the 183 day period should not be exceeded "*in the fiscal year concerned*", a formulation that created difficulties where the fiscal years of the Contracting States did not coincide and which opened up opportunities in the sense that operations were sometimes organised in such a way that, for example, workers stayed in the State concerned for the last 5 ½ months of one year and 5 ½ months of the following year. The present wording of subparagraph 2a) does away with such opportunities for tax avoidance. In applying that wording, all possible periods of twelve consecutive months must be considered, even periods which overlap others to a certain extent. For instance, if an employee is present in a State during 150 days between 1 April 01 and 31 March 02 but is present there during 210 days between 1 August 01 and 31 July 02, the employee will have been present for a period exceeding 183 days during the second 12 month period identified above even though he did not meet the minimum presence test during the first period considered and that the first period partly overlaps the second."[23]

48. The respondent is correct in his claim that the signatories to the treaty intended for the computation of the days to allow for double counting of the days in order to do "*away with ... opportunities for tax avoidance*". As pointed out earlier, one of the reasons for countries to conclude these double taxation treaties is to minimise, if not eliminate, the potential for tax avoidance: the DTA is both an anti-double taxation as well as an anti-tax-avoidance measure. In this case,

[23]OECD Commentary, http://www.oecd.org/berlin/publikationen/43324465.pdf.,pp 251-252, accessed on 15 April 2015.

there is no doubt that the appellant earned the income (or made the profit) from carrying its obligations contained in a single contract with X (which may have undergone changes during its lifespan, but these are insignificant for our present purposes) and that it had a presence in South Africa during the entire duration of that contract. The fact that the duration spanned over two fiscal years does not mean that the 183 day period has to be separately calculated for each fiscal year for, as stated in the Commentary on the OECD Model, if the presence in each fiscal year was only 5½ months, then the entity would avoid paying tax to the country in which the income was earned (or profits made) despite the fact that its presence in that country was for longer than 183 days. This interpretation, which is the one we are enjoined by the appellant to adopt, defeats the object of the DTA, is contrary to the intention of the parties and stands in stark contrast to the interpretation proffered in the OECD Commentary. Finally, it bears remembering that double computation of the days in order to cater for the dislocation between the year spent by the non-resident in the Contracting State (South Africa in this case) and the fiscal year of that Contracting State, does not result in the non-resident being taxed twice for the same income (or profit) by the Contracting State. It simply means that the same income (or profit) is divided up and taxed in two parts, but it is never taxed twice. For these reasons, I would have to decline the invitation by the appellant to uphold its appeal against the 2008 tax assessment.

49. Concerning the 2009 tax assessment, while it is correct that the appellant had absolutely no presence in South Africa during any part of that calendar or fiscal year it had only been paid part of its income earned (or profit made) during the

February 2007–May 2008 period when it clearly had "*a permanent establishment*" here. The amount it earned was referred to as "*a success fee*" and which it received in accordance with clause 2.2 of the amended contract it signed with X. It was the result of the operation of the same contract that formed the subject matter of this litigation. It was the money that it would have received upon the completion of its operations in 2008, but which could only be accounted for in 2009. It was not income earned (or profit) made in 2009. In a sense, it was deferred income (or profit) for the February 2007–May 2008 period. This aspect of the income (or profit) is covered by article 7(1) of the DTA which provides that the profits of an enterprise made in a State where it held "*a permanent establishment*" shall be taxable in that State if the profit was "*attributable to that permanent establishment*". This is precisely what the success fee was. The respondent correctly assessed it as part of that income (or profit) earned during 2007-2008, but since it was only paid in 2009 treated it as a 2009 assessment. Therefore, the appeal against the 2009 assessment has to fail.

The levying of additional tax by the respondent

50. The respondent acting in terms of s 76(2)(a) of the ITA levied an additional tax upon the appellant to the tune of 100% of the taxation amounts due for the 2007, 2008 and 2009 years.

51. Section 76(2)(a) of the ITA allowed the respondent, in his discretion, to impose this additional tax if the taxpayer is in default of rendering a return in respect of

any taxable year.[24] The maximum amount that the respondent can levy as an additional tax is 200% of the original tax liability. The respondent can waive all or part of it if he is of the opinion that there were extenuating circumstances justifying the default. In this case, the respondent initially levied the maximum amount (200%) as additional tax, but after taking note of the objection raised by the appellant, agreed that there were extenuating circumstances warranting a reduction of this additional tax to 100%. The respondent does not spell out these extenuating circumstances. He merely stated:

> "I have considered your submission regarding the imposition of additional tax and I have decided in terms of s 76(2) of the Act to reduce that additional tax imposed to 100%"[25]

52. The appellant maintains that the respondent bears the onus to prove the facts upon which he based the penalty of 100%, and since the respondent did not adduce any evidence in this case it did not discharge the onus. No supporting authority was cited for this proposition. The respondent took issue with the imposition of the onus upon him to prove the facts that justified an imposition of a penalty. In my view, there is no need to engage with this controversy as to whether the respondent bore an onus to prove the facts justifying an imposition of a penalty, as it was common cause that the appellant did not render returns for the taxable years 2007, 2008 and 2009. Those are the facts that triggered the application of ss 76(1) and 76(2)(a) of the ITA. The respondent stated that on these facts and in terms of the said sub-sections he was entitled to impose an additional taxation of 200%, but as he found that there were extenuating circumstances in relation to the failure to render a return he deemed it

[24] Except that he must impose the full penalty upon the taxpayer if the taxpayer was found to have deliberately evaded the tax.
[25] Dossier, p 34

appropriate to reduce this additional tax to 100%. The appellant did not take issue with his finding in this regard. It merely said that he must prove the facts justifying the imposition of the additional tax, but as these facts were common cause the ground for its objection disappears. Concerning the fact that it had a strong case for a complete waiver of this additional tax because it did not deliberately ignore the South African law but just misunderstood it, it has to be borne in mind that it is an enterprise that has global reach. It operates in many foreign jurisdictions at once. It is not a novice in the area of tax liability. In fact, it admitted to being aware of the possibility of incurring a tax liability in South Africa and knowing about the DTA. Its case throughout has not been one of ignorance of the law, but of misinterpretation of it. The appellant must accept responsibility for its own error regardless of whether the error was *bona fide* or not. In these circumstances, it cannot be held that the respondent acted erroneously, or failed to exercise his discretion judiciously, when only waiving part of the additional tax he was entitled to impose, or that the imposition of the additional tax at all was unduly harsh. The appellant benefitted significantly from the waiver granted by the respondent. In my judgment, taking the waiver into account, it cannot be said that the additional tax imposed is disproportionately punitive. I find no fault with its imposition. Hence, its appeal against the additional tax must fail.

The appeal against the interest

53. As the appellant failed to declare and pay tax[26] on its income for the years 2007, 2008 and 2009, the respondent, acting in terms of s 89*quat,* deemed it appropriate to charge the appellant interest because of its default. The interest was calculated at R4 303 289.59. The appellant claims that the respondent erred in so imposing interest on the amount that was due but not paid. It is the appellant's case that the respondent ought to have taken note of the fact that it did not act unreasonably by failing to meet its tax obligations in South Africa. The appellant's case is that by failing to take note of this fact the respondent did not properly exercise the discretion conferred upon him by section 89*quat*(3).This ground of appeal, it will be noted, is identical to the one it relied upon for its appeal against the additional tax.

54. Section 89*quat*(3) provides:

> "Where the Commissioner having regard to the circumstances of the case is satisfied that any amount has been included in the taxpayer's taxable income, or that any deduction, allowance, disregarding or exclusion claimed by the taxpayer has not been allowed, and the taxpayer has on reasonable grounds contended that such amount should not have been so included or that such deduction, allowance, disregarding or exclusion should have been allowed, the Commissioner may, subject to the provisions of section 103(6), direct that interest shall not be paid by the taxpayer on so much of the said normal tax as is attributable to the inclusion of such amount or the disallowance of such deduction, allowance, disregarding or exclusion."

55. The question to be resolved is this: did the appellant act reasonably when it did not file a tax return or pay the tax due as a result of the income earned or profits made in South Africa by virtue of the contract it had with X? The appellant, we know, is a major corporation with substantial international business operations in numerous countries. It has conducted international operations in many

[26]Non-payment and underpayment of tax are treated the same for purposes of levying an interest upon such non-payment or underpayment.

countries over many decades. The concept of international taxation is not alien to it. It is, or ought to be, familiar with the ideas and principles concerning double taxation agreements. It is aware that even though it is resident in the USA its operations in other countries may be subject to the taxation laws of those countries should there exist a double taxation agreement between the USA and those countries. It is a fundamental rule of business practice that a business enterprise, especially one that operates on the scale the appellant does, should familiarise itself with the taxation laws of a country in which it operates. Failure to do so would be grossly negligent, and for that reason unreasonable. The respondent claims that it did not know that it would be liable for taxation in South Africa. In fact, it was so certain that it would not be liable for taxation in South Africa, that it declared the income earned from the contract with X to the tax authorities in the USA (where it is a taxpayer, by virtue of its resident status) and paid the necessary taxation in terms of the tax laws applicable in the USA. This, it maintains, demonstrates its *bona fides* in failing to declare the income in South Africa and pay the tax due to the South African authorities. But there is a fundamental misconception in all of this. The appellant unilaterally decided that it is not liable for taxation in South Africa and did not bother to clarify the issue with anyone, least of all the respondent. In this, the appellant’s conduct falls short of what is expected of a reasonable international corporation operating on the scale it does. The fact that it paid tax to the USA authorities for the income or profits generated in South Africa (in circumstances where it held a permanent establishment in South Africa) is of no moment to the determination of the issues in this case. That was a unilateral decision that has no bearing on whether it was liable to the respondent in terms

of South African law, which, of course, includes giving effect to the DTA. A further fact that weighs heavily against the appellant is that it had, and still has, the benefit of the monies retained by it as a result of its non-payment of tax due. It could have earned a return on these monies. In the meantime the respondent was denied the benefit of monies that were due to it.

56. For these reasons, it is difficult for me to conclude that the respondent was wrong or even acted irrationally or unreasonably by refusing to exercise his discretion in terms of s 89*quat*(3) to the advantage of the appellant. Hence, the decision of the respondent not to grant the appellant an indulgence by waiving the interest payment for its default cannot be faulted.

57. It follows that the appeal against the levying of interest by the respondent, too, has to fail.

Order

58. The following orders are made:

    1 The appeals against the 2007, 2008 and 2009 assessments are dismissed.

    2 The appeals against the additional tax imposed for non-payment during the 2007, 2008 and 2009 years are dismissed.

    3 The appeals against the levying of interests for the non-payment of taxes for the 2007, 2008 and 2009 years are dismissed.

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Vally J
Judge: Tax Court, Johannesburg

I agree:

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Gavin Beckwith
Tax Court, Johannesburg

I agree:

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Peter Vundla
Tax Court, Johannesburg

Dates of hearing : 17-19 February 2015
Date of judgment : May 2015