

**E-COMMERCE – THE CHALLENGE OF VIRTUAL PERMANENT
ESTABLISHMENTS**

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Abstract

The continued growth of world commerce has led to the advance of the permanent establishment principles. These principles are, however, constantly challenged by the developments of e-commerce. This thesis considers the taxing of a permanent establishment and the influence of e-commerce on the concept of a permanent establishment. In 2000, the Organisation for Economic Co-operation and Development (“OECD”) developed and introduced guidelines on how to deal with e-commerce in the context of a permanent establishment. Since the OECD guidelines on e-commerce were issued, the permanent establishment principles have come under further scrutiny. The latest development came about in 2013 with the release of the Base Erosion and Profit Shifting (“BEPS”) Action Plan. This Action Plan addresses the intention of the OECD to deal with the taxing of the digital economy. With the development of e-commerce and the result of e-commerce creating intangible boundaries between countries, the concept of a virtual permanent establishment has emerged. This has resulted in the need to tax a presence of an enterprise in a jurisdiction where no actual physical connection can be established. Various authors have made suggestions on how to ensure that an economy in which business is being carried on is correctly compensated for in the form of taxes. The source of income is the driving force for the imposition of taxation today.

The main goal of this thesis was to explore the alignment of the concepts of a permanent establishment and e-commerce in the digital economy. This study therefore examined the concepts of both permanent establishments and e-commerce, and explored authors’ views and suggestions on how to deal with the inter-related effects of these two concepts. The relevant Action Points in the OECD Action Plan were also considered.

Key words:

Base erosion and profit shifting (BEPS); Double Taxation Agreement; E-commerce; Fixed place of business; Globalisation; Internet; Internet Service Provider; OECD Model; Permanent establishment; Resident; Virtual permanent establishment.

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Chapter 1 – Introduction

1.1 Context

According to Hinnekens (2003), the communication revolution blurs the geographical determination of the taxing jurisdiction as it enhances the mobility of the decision-makers. These decision-makers no longer need to physically meet in one place but may conduct corporate affairs via video conferencing and networking, having access at any time to the corporate information stored anywhere in digital data banks from any remote place. Skaar (1991) is of the opinion that this increase in the use of technology and the globalisation of business has led to the increasing sophistication of international tax principles as the effect of international interaction results in the possibility of double taxation, tax discrimination and in some cases tax avoidance.

Internationally, the two methods of taxation are source-based taxation and residence-based taxation. The concepts of both source and residency are discussed in further detail in Chapter 3 of this thesis. South African tax legislation is based on the principle of residence. In this regard, residents are taxed on their world-wide income. Haupt (2014: 31) refers to this as the territoriality principle. Non-residents on the other hand are taxed on income derived from a source within South Africa under the definition of gross income in section 1 of the Income Tax Act, 58 of 1962. Therefore, a South African resident earning income from various countries will be taxed in South Africa on the income earned both from its operations within South Africa as well as the income earned abroad by its internationally operating entities. Haupt (2014: 8) notes that the residence basis of taxation therefore brings all earnings on a worldwide basis within the South African tax net to be taxed accordingly in South Africa.

In order to avoid double taxation and ensuring that the taxing right arises in a source state, Double Taxation Agreements (“DTAs”) are treaties that have been entered into by two countries, known as the Contracting State and the Other Contracting State, depending on the source of the income earned. The DTAs or treaties assist in determining in which jurisdiction a taxpayer will be liable to pay tax. In other words, the DTAs determine which country will have a taxing right on the business profits earned by a multinational enterprise. For example, under South African legislation, more specifically section 108 of the Income Tax Act, 58 of 1962 sets out that a relevant DTA must be consulted in order to determine which country has a taxing right to business profits.

Two models exist, namely, the United Nations Model Double Taxation Convention between Developed and Developing Countries, 2011 (United Nations Model) or the Model Tax Convention developed by the Organisation for Economic Development (OECD Tax Model) DTAs are based either on the UN Tax Model or the OECD Tax Model or even a combination of both. For purposes of this research, for the most part, the OECD Model is concentrated on. These two models provide the necessary guidance to countries on a worldwide basis regarding the concept of a permanent establishment and how profits earned are to be attributed to these permanent establishments. The OECD highlights in Article 7 (OECD: 2014) that the uniqueness of the permanent establishment principles is that they give a country the right to tax income even though the permanent establishment has no separate legal existence.

When determining the source of income, it is important to consider the concept of a permanent establishment. Since the beginning of the 20th Century, when the concept of permanent establishments was introduced, the principles of a permanent establishment have evolved at a rapid rate. Both substance and continuity have always been required in order to establish the existence of a permanent establishment. A permanent establishment is discussed in detail in Chapter 2 below. However, at this stage it can be noted that a permanent establishment is, according to Haupt, (2014: 35) [a] fixed place of business through which the enterprise's business is wholly or partly carried on.

1.1.1 Introducing a permanent establishment

Section 1 of the Income Tax Act defines a permanent establishment to include the definition as set out in Article 5 of the OECD Tax Model.

The concept of a permanent establishment is explored in detail in chapter 2. The chapter defines a permanent establishment, setting out what is included and excluded from the definition. Briefly, a permanent establishment is based on two elements. When assessing the potential existence of a permanent establishment in a foreign country, the first factor to be determined is whether the entity has a fixed place of business from which that business operates, in that country. Secondly, the creation of a permanent establishment stems from actions being performed by an agent that are economically and legally dependent on that foreign company whilst operating in the country in question. The result of the existence of a permanent establishment is the creation of a right of a country to tax business profits earned from the operations of the foreign business in that country. The concept exists as a defence against the

erosion of the tax base of the country in which a business is operating and, as such, earning profits from these operations.

The concept of a permanent establishment can be illustrated by way of a simple example. Company X (incorporated and tax resident in South Africa) could employ a person in Russia to sell the products of Company X in Russia. The fact that the employee operates from a registered business address of Company X in Russia, i.e. from an office where the office space is used by the employee to carry out the business of Company X in Russia, would constitute a fixed place of business. In addition, the employee is carrying out the business of Company X on the instruction of Company X in South Africa (therefore being economically and legally dependent on Company X). Without going into detail at this stage, the employee, on face value, could be regarded as a dependent agent of Company X. Both a fixed place of business and a dependent agent, subject to further consideration as is set out in Chapter 2, are the two questions that should be asked when determining whether a permanent establishment exists.

The result of the creation of a permanent establishment is that the business profits earned by the operations of Company X in Russia (i.e. the income earned from sale of Company X's products in Russia) could be taxable in Russia, i.e. Russia has a taxing right to the profits earned. Consideration of the DTA between South Africa and Russia will determine what actions would result in a permanent establishment, how the business profits should be allocated and which country has a taxing right to these profits.

As mentioned above, Chapter 2 of this thesis considers the details of the concept of a permanent establishment. It would be a cumbersome process to analyse the permanent establishment principles in each and every jurisdiction in order to obtain an understanding as to how the concept is treated from a domestic legislative perspective and also from a DTA perspective, should a DTA have been concluded between the two countries in question. Only the emerging market countries have been considered in this study. These emerging markets include Brazil, Russia, India, China and South Africa (the "BRICS"). An analysis is conducted on how these countries, known as the BRICS, treat the concept of a permanent establishment both from a domestic law and DTA or treaty perspective.

When considering the concept of a permanent establishment and where it lies in legislation it is important to note that some countries' domestic legislation contains provisions as to the permanent establishment principles. However, as mentioned above, these principles are based

on either the OECD Tax Model or UN Tax Model, or alternatively on a combination of both models. The UN Tax Model and OECD Tax Model also provide guidance upon which the concept of a permanent establishment is drafted in the DTA's.

Although the UN Tax Model and the OECD Tax Model provide the necessary guidance as to how profits should be attributed, the actual attribution of those profits has become more complex than merely following the provisions set out in the Models. The use of the internet as a primary source of business and exchange, means that there are no tangible boundaries. The influence of technology has contributed to the ease of doing business from anywhere in the world. Therefore, According to Olivier & Honiball, (2008: 10), the alignment of the attribution of profits in an ever-changing society has become more complex than just ticking a box. It is clear that international tax principles need to be aligned with the needs created by globalisation, centralisation, specialisation and technology. According to Owens (Owens: 2001), the OECD took the international leadership in coordinating the work on e-commerce and the taxation thereof.

When reading the OECD Tax Model Commentary, it is apparent that the permanent establishment principles have proven to be flexible in adapting to problems that may have been presented in the past. This adaptability of the permanent establishment principles has been demonstrated in the past where income from professional services and other activities of an independent character were previously dealt with specifically under Article 14 of the OECD Tax Model. Article 14 illustrated the principles applicable to the type of services that would constitute a fixed base. However, this article was deleted in 2000, as it was considered that there was no difference between the concept of permanent establishment and a fixed base. The deletion of this article gave rise to the new permanent establishment definition which included the component of a fixed base.

As it is imperative to rightfully allocate profits earned in a particular country to be taxed in that country, definitive geographical boundaries need to be determined. Concepts such as Electronic Commerce ("e-commerce") and globalisation have clouded the geographical boundaries between countries, causing problems in collecting taxes, which may lead to the erosion of tax bases of particular countries.

Globalisation is defined by Lexicon (Lexicon: 2014) as:

a process by which national and regional economies, societies, and cultures have become integrated through the global network of trade, communication, immigration and transportation.

According to the OECD Tax Model Commentary (OECD, 2009: 97), e-commerce was defined in the 2009 commentary to include:

the performance of business activities through electronic information and communication technologies and/or the sale of electronic products.

1.1.2 Introducing e-commerce

E-commerce has been addressed as a subsection into the OECD Tax Model Commentary (OECD: 2014). The interpretation in the OECD Tax Model Commentary (OECD: 2014) addresses the issue of e-commerce and provides guidelines on how to apply the permanent establishment principles to a business utilising websites, internet service providers and servers to conduct its business. The question relating to a virtual permanent establishment arises when considering e-commerce and the ease with which international business is carried on. The OECD Tax Model Commentary (OECD: 2014) in Article 5 notes that there is no specific definition of e-commerce but that it includes the performance of business activities through electronic information and communication technologies and/or the sale of electronic products.

In light of the discussion above and keeping in mind how globalisation has made doing business from anywhere in the world a feasible option, the relevance of the current permanent establishment principles must be considered. The question that arises is whether the present concept of a permanent establishment is amenable to the development of e-commerce. Sprague & Boyle (2001: 25) state the following:

Since the business transactions that we refer to as “electronic commerce” tend to cross national borders easily, these business models immediately raise international tax questions . . . The question of proper categorization of software revenue provides a good example of the difficulties faced by international businesses.

The current definition of permanent establishment in the OECD Tax Model relies on the existence of either a physical presence (e.g. a factory or office) or a representative presence (e.g. an agent) before source-based taxation can apply. Globalization, spurred on by the advent of e-

commerce, allows substantial business activities to take place in a source state without either physical or human intermediaries, such as brokers, distributors or representatives. This makes it more difficult to identify a permanent establishment based on its traditional formulation under the OECD Tax Model.

E-commerce has been recently addressed again in the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan (OECD: 2013). The Action Plan sets out the strategies to be employed in order to combat the erosion of a tax base in a certain jurisdiction by moving profits to lower tax jurisdictions. The BEPS Action Plan was introduced in 2013 and the public was asked to comment on the Action Plan and the strategies employed in combatting the base erosion and profit shifting. The Action Plan also suggests certain methods of achieving its goals. This includes the application of transfer pricing rules, which is explained in more detail in chapter 5.

This thesis discusses the challenges posed by the concept of globalisation and e-commerce (or the digital economy) on the taxing rights in a country. E-commerce has become the new method of conducting a business. This method of conducting business has become a fundamental requirement for a business to succeed. In order to determine where the blurred boundaries exist, the basic existing concepts must be explored as a starting point. The basic principles of source and residency explained briefly above do not provide clarity on how to attribute business profits in a more complex or virtual environment. Pinto (2006) states that when examining how source can be redefined, it is important to question whether source-based taxation remains theoretically valid in today's globalized business world. According to Burgers (2011), technology has become so sophisticated that the manner in which multinational enterprises carry on their business has made it imperative that the principles applied in determining whether the activities in a country could create a permanent establishment is a high priority for tax practitioners and tax authorities.

With the rise of e-commerce, earning business profits in a particular country has excluded the necessity of actually being present in that country. This study explores the concept of a permanent establishment in its current form, including the concept of e-commerce, which complicates the requirement that a presence in a country is the determining factor in order to attribute business profits to a permanent establishment in a particular jurisdiction.

In this study, the current permanent establishment principles are examined, with specific reference to the BRICS countries (Brazil, Russia, India, China and South Africa), as the

emerging market countries. The selection of the BRICS countries provides a fairly representative sample in analysing how countries treat the concept of a permanent establishment from both a domestic legislative perspective and a treaty perspective as it would be cumbersome to consider the permanent establishment principles and the treatment thereof in all territories.

A recent publication states that the BEPS Action Plan (OECD: 2013) has come to the rescue of many tax authorities in identifying and also understanding what kind of measures taxpayers are adopting in shifting profits out of their jurisdictions and eroding tax base of the source country. The OECD has published an action plan as well as commentary thereon, striving to provide guidance to taxpayers on how to legitimately carry out their business as so as not erode the countries tax base. The concept of BEPS, the action plan and commentary thereon is discussed in detail in this thesis.

1.2 Goals

The main goal of this thesis is to explore the alignment of the concept of permanent establishment and the concept of e-commerce in the digital economy. In doing so, both concepts will be considered in their current form. Then the OECD's commentary on the alignment of these concepts will be explored, as well as recent publications on BEPS in order to understand what is being done to ensure the continued alignment of these concepts within the ever-changing environment resulting from technological advancement.

1.3 Methods, procedures and techniques

An interpretative research approach was adopted for this study as it seeks to understand and describe (Babbie & Mouton, 2009). The research methodology applied provides a systematic exposition of the rules governing a particular legal category (in the present case the legal rules relating to determining the source of income flowing from e-commerce and the existence of a permanent establishment), analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar, 2014).

The documentary data used for this study consists of:

- legislation: the South African Income Tax Act,
- relevant case law,

- double Taxation Agreements,
- South African Revenue Service Interpretation Note 6, which will be used to clarify tax principles not set out in South African legislation,
- the OECD Model and Commentary on the OECD Model, which will be analysed for the purpose of determining the principles applicable to permanent establishments,
- The OECD's recent commentary on Base Erosion and Profit Shifting,
- articles in accredited journals and
- textbooks and other authoritative writings.

The research is conducted in the form of an extended argument, supported by documentary evidence. The question of the validity and reliability of the research and the conclusions have been addressed by:

- adhering to the rules of the statutory interpretation, as established in terms of statute and common law;
- placing greater evidential weight on legislation, case law which creates precedent or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and concluding, based on a preponderance of credible evidence; and
- the rigour of the arguments.

As all the data is in the public domain, no ethical considerations arise. Interviews have not been conducted but opinions have been considered in their written form. The research does not seek to support or contest any existing theory or standpoint and therefore interpreter bias cannot arise.

1.4 Overview of the chapters

Chapter 1 introduces the topic by considering the current economic world in which business is carried on today. This chapter briefly discusses the concept of a permanent establishment, e-commerce and the effects of globalisation, commenting on double taxation and introducing the OECD Tax Model and the UN Tax Model. It also outlines the goals to be achieved in carrying out the research that was undertaken to complete this thesis. The chapter then describes the methodologies and procedures that have been undertaken in order to achieve these goals.

Chapter 2 focuses on the concept of a permanent establishment and the principles that determine the existence of a permanent establishment. The analysis is based on the OECD Tax Model, with some reference being made to the UN Tax Model. Consideration is given to the specific inclusions and exclusions as well as the tests that are utilized when applying the principles set out in the OECD Tax Model, with particular emphasis being placed on the physical presence test. Furthermore, the existence of an agency relationship and its impact on the existence of a permanent establishment is considered. Consideration is given in this chapter to the treatment of a permanent establishment by the BRICS countries in order to provide a sample of countries' treatment of the concept.

Chapter 3 explores the concept of e-commerce. The chapter sets out how this concept is treated from the perspective of a taxing right in a foreign jurisdiction being created based on presence and agency. The concept of source and residency are also considered in this chapter. In this regard, a server, website and an internet service provider are all considered. As many authors suggest that the source of these services should be the indicating factor as to how to determine the taxing right of a jurisdiction over profits earned.

Chapter 4 discusses the challenges presented by e-commerce to domestic taxing rights and collates certain authors' views on the concept of e-commerce. Suggestions are made by these authors on how to deal with the concepts in the tax environment and consider the possible solutions to the challenges identified, taking into account the flexibility of the current permanent establishment principles, and keeping in mind the suggestions regarding the loopholes identified by the authors.

Chapter 5 explores the more modern view of the concept of BEPS, illustrating the latest principles being developed to combat erosion of the tax bases of countries. This chapter also

considers the challenges that arise as a result of the development of e-commerce in the digital economy and suggestions made as to how these challenges are to be dealt with. Action 1 of the OECD BEPS Action Plan (OECD: 2013) deals specifically with the challenges of a digital economy. Suggestions are made on how to solve the issues posed by the digital economy by applying transfer pricing principles. The strategies of the OECD BEPS Action Plan are also discussed.

Chapter 6 provides a conclusion to the study. This conclusion summarises the findings in the previous chapters and the concept e-commerce as it currently stands, taking into account historical developments and the treatment of the concept in the selected emerging economies. The conclusion sets out the challenges posed by the concept of e-commerce, indicating how the concept has been dealt with by the OECD Tax Model and the suggested solutions for keeping up with the ever-changing environment in which entities carry on their business and therefore allocating profits to be taxed accordingly.

Chapter 2 – Defining a Permanent Establishment

2.1 Introduction

In line with the goal of this research, the current concept of a permanent establishment and the evolution of the concept in reaching its current status, needs to be explored. From a historical perspective it is clear that the concept of a permanent establishment is not new. The evolution of this concept is set out below (see 2.2). The concept of a permanent establishment can be expressed as a definition with specific inclusions and exclusions. The definition can be broken down into certain essential elements that are required in order to constitute a permanent establishment. Then, there are other elements that are specifically excluded from constituting a permanent establishment. These elements are all subject to certain tests which assist in determining to what extent income earned will be taxable in the source state. The three tests are discussed below in detail; these include the location test, the duration test and the business connection test. The business connection test is the link between location and duration tests. The location test draws a geographical nexus to the source country in which the income is being earned. The duration test, on the other hand, indicates the time frame required for the existence of a permanent establishment to come into being; and this depends on the duration of a certain project in the source state. Each of these essential elements, exclusions and tests has been explored further in this chapter.

It is clear that a permanent establishment will, although simply put, exist when a non-resident has a fixed place of business in a jurisdiction. Alternatively, should the non-resident employ a person who acts on behalf of that non-resident and subsequently binds the non-resident contractually, a permanent establishment will be created as a result of these actions or representations. This is known as dependent agency. Haupt (2014) indicates that although not predominantly evident in all countries' domestic legislation or treaties, the actions performed when a service is being provided may also lead to the existence of a permanent establishment. Each case, however, needs to be determined on its own facts and merits. It is important to unpack the facts of each case as there are a number of exclusions, for example, where the activities being performed are regarded as auxiliary or preparatory to the core activities of the business.

After careful consideration of the facts of each case, should it be determined that a permanent establishment of an entity exists, the business profits earned by that permanent establishment

will be subject to tax in the state in which the profits are earned. These rules ensure that the source state is correctly compensated in respect of the activities performed. Each of these elements is discussed in detail in this chapter.

2.2 The evolution of the permanent establishment concept

According to Skaar (1991) the history of the concept of a permanent establishment can be dated back to the 19th Century in Prussia, where the existence of a fixed place of business was first included in a tax treaty between Austria-Hungary and Prussia. Following the events of World War I, Cockfield (2003) notes that tax treaties were entered into between two tax jurisdictions in order to ensure that an entity would not be taxed twice in two different jurisdictions. Skaar (1991) illustrates this development in terms of the German Double Taxation Act of 1909 which states that a permanent establishment requires three things: (i) the existence of a place of business, (ii) the location of a business at a specific geographical spot, and (iii) permanence of the business activity.

Huston and Williams (1993) state that further developments of the concept took place and most economies required a branch or a similar presence in order to create a taxing right. Furthermore, Huston and Williams (1993) indicate that the divide between developed and developing countries led to the need for the permanent establishment principles to be revisited in 1980, which expanded the right of countries where the source of the income was, to tax the income earned in that country. The demands of the economy therefore directly dictate the need for the concept of permanent establishment to be revisited on an ongoing basis. Hoffart (2007) explains that when studying the historical development of a permanent establishment, there are two main requirements that led to such development. The first of these requirements is the need for a presence in a country from which the source of income is earned. Secondly, the countries from which the profits were earned were legitimately required to share in these profits earned and therefore had a taxing right over those profits. According to Skaar (1991), having these rules in place on how contacting states are to share in profits earned also led to the encouragement of international trade.

2.3 Defining a permanent establishment

Before an analysis of a permanent establishment can be conducted the following concepts, as set out in Article 3 of the OECD Tax Model (2014: 25), should be noted:

- a person ‘includes an individual, a company and any other body of persons’;
- a company means ‘any body corporate or any entity that is treated as a body corporate for tax purposes’;
- an enterprise ‘applies to the carrying on of any business’; and
- an enterprise of a Contracting State and an enterprise of the other Contracting State are defined respectively as ‘an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State’.

Before an analysis of a permanent establishment is conducted, it must first be determined how a person’s taxable income is calculated. This is illustrated in this thesis by utilising the South African legislations treatment as an example. When determining the taxable income of a natural person or a legal person, the first step is to establish which amounts are to be included in the gross income of that person. Section 1 of the Income Tax Act 58 of 1962 defines gross income as follows:

- (i) in the case of any resident, the total amount in cash or otherwise, received by or accrued to or in favour of such resident, and
- (ii) in the case of any person other than a resident, the total amount in cash or otherwise, received by or accrued to or in favour of such resident, during a year or period of assessment,

excluding receipts or accruals of a capital nature, but including . . . [the special inclusions are not relevant to the present research].

As mentioned and very briefly discussed in Chapter 1 of this thesis, the two methods of taxation are source-based taxation and residence-based taxation. The concepts of both source and residency are discussed in further detail in Chapter 3 of this thesis. For now, and for purposes of South African legislation as an example, it is important to note that South African tax legislation

is based on the principle of residence. In this regard, residents are taxed on their world-wide income, while non-residents are taxed on income derived from a source in South Africa.

In continuing with the example of South African legislation, a resident, in the case of a person that is not a natural person, is defined in terms of section 1 of the Income Tax Act 58 of 1962 as

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

There is no definition in the Income Tax Act 58 of 1962 of 'place of effective management', but the South African Revenue Services ("SARS") provides a definition of 'place of effective management' as follows (SARS Interpretation Note 6, 2002: 701):

The place of effective management is the place where the company is managed on a regular day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets.

The concept of a place of effective management should not be confused with the concept of permanent establishment. The place of effective management is important when determining residency. As mentioned above, it is the place where the day-to-day management of a business takes place. A discussion on the concept of place of effective management is specifically excluded from this study.

The OECD Tax Model (2014) states in Article 7 that business profits will not be taxable by a State unless the enterprise has a permanent establishment in that State. The definition of a permanent establishment in section 1 of the Income Tax Act 58 of 1962 follows the definition set out in Article 5 of the OECD Tax Model. Article 5 of the OECD Tax Model provides details of the methods to be employed to determine whether an entity will have a permanent establishment in a certain country and therefore a taxing right on the business profits earned by that permanent establishment. The term 'permanent establishment' is defined in Article 5(1) of the OECD Tax Model (2014: 24) as a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Article 5 of OECD (2014: 24) specifies what a fixed place of business includes. The aspects specifically included are the following:

1. A place of management
2. A branch
3. An office
4. A factory
5. A workshop; and
6. A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

This definition of a permanent establishment contained in the OECD Tax Model is the same in the UN Tax Model, however the duration of a construction project under the UN Tax Model, in order to qualify as a permanent establishment, is shorter than the duration set out in the OECD Tax Model. The duration test is discussed in further detail below. A permanent establishment can also be created from the action of rendering of services. For example, an employee in one country can carry out a service for that company in another country thereby, under certain circumstances, creating a permanent establishment and a taxing right over the profits earned by that person on behalf of the company. The UN Tax Model (2014) makes specific reference to the creation of a permanent establishment which arises from a service being provided by a person for a specified period of time. This is also discussed further below, but for purposes of the definition of a permanent establishment, it is important to note that a permanent establishment can also be created through the rendering of services. Each of the specific inclusions will now be discussed in more detail.

2.3.1 Place of management

The first attribute that specifically constitutes a permanent establishment is a place of management, which the OECD (2014) refers to as the place where the control is exercised and management decisions are executed. As mentioned above, this is different to the concept of place of effective management which determines the place of the core business activities and subsequently the residence of a company in South African legislation. The place of management on the other hand is exactly that: a place where the management of an enterprise takes place, which can include several locations. This ‘place of management’ can be viewed as the ‘catch all’ test which was included in Article 5 to cover all other locations not specifically mentioned.

2.3.2 Branch

A permanent establishment also includes a branch. There is no particular guideline in the definition of a permanent establishment as to what the core activities of a branch should be.

2.3.3 Office

An office is generally deemed to have a location and it is also included in the definition of a permanent establishment. The location test and activity test, which are both discussed further later in this chapter, should specifically be considered with regard to this term.

2.3.4 Factory

The term ‘factory’ in the permanent establishment definition indicates a place where products are produced in a specified quantity.

2.3.5 Workshop

According to the OECD Tax Model Commentary (2014), the term ‘workshop’ in the permanent establishment definition includes a place in which manufacturing or other work is carried on.

2.3.6 Mines, oil or gas wells

The inclusion of mines and oil or gas wells in the definition of a permanent establishment does not give rise to further concerns as they can easily be identified due to the nature of the business activities being carried on.

These physical locations listed above are specifically included in the definition of a permanent establishment. After considering these physical locations, it is important to note that the existence of a permanent establishment can depend on the existence of certain principles alluding to the physical location. These principles are explored below. The OECD Tax Model Commentary (2014) stipulates that three tests need to be taken in order for the concept of a permanent establishment to exist. According to the OECD Tax Model Commentary (2014: 80) the elements that are necessary for a permanent establishment to exist include the following:

1. The existence of a “place of business”, i.e. a facility such as premises or in certain instances machinery or equipment.

2. The place of management must be “fixed”, i.e. must be established as a place with a certain degree of permanence.
3. The business is carried on through this fixed place of business.

Each of these elements will be considered further below.

2.4 Fixed Place of business – the location test

The first requirement for creating a permanent establishment is that the non-resident must have a place of business – i.e. a facility such as business premises available for use.

Honiball (2008) states that a permanent establishment will only exist if the enterprise has a physical presence in the source state. The size of the premises and the equipment will depend on the nature of the business. Vogel (1997) comments that a place of business constitutes all the tangible assets used for carrying on a business, which should in this case include premises. Vogel (1997) further states that a place of business is all that is required to be at the disposal of the enterprise. The place of business need only be sufficient for the permanent establishment to function. In order to qualify for a place of business, the enterprise will require a fixed location from which to operate in the foreign country.

Honiball (2008) states that the universal test relating to a permanent establishment is that it must be fixed in terms of a physical location. Fixed implies that the business must be established at a distinct place with a certain degree of permanence. It follows that the place of business must be linked to a specific location and hence this has been termed the location test. Honiball (2008) notes that the test requires a link between the place of business and the geographical point, although the place of business need not physically be connected to the land.

The location test draws a link between the geographical area in which the place is located and the business which is being carried on from that place. With regard to the geographical requirement, although there is no requirement to have a physical connection to the earth's surface (Shafer, 2006), to create a permanent establishment the place of business needs to constitute a fixed place in which it is required to have a location in a ‘geographical nexus’ (International Fiscal Association, 2009). There have been many debates surrounding the concept of a place of business that is movable by nature and whether these kinds of businesses can constitute a fixed place of business. For example, a ship which is constantly moving has no

geographical consistency in terms of its location. A further example is that of horse racing. Pinto (2003) states that where the horses are continuously racing at different courses this cannot constitute a permanent establishment.

For the purposes of this study, the degree of fixed-ness becomes important in a virtual world where things hypothetically exist. The question that arises is how stationary must a *fixed* place of business be? When considering the case of *DCIT v Subsea Offshore Limited* (61 TTJ Mumbai 339, 1997), the following is noted:

In our opinion, the words ‘permanent establishment’ postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.

2.5 Fixed with a degree of permanence - the duration test

The second test that is applied when determining the existence of a permanent establishment relates to the actual place of business being fixed in terms of duration. Regarding this time requirement, Vogel (1997) states that an enterprise should carry on its operations on a regular basis. It follows that the company’s place of business will be fixed in terms of location and time. A certain degree of permanence is required in order for the duration test to be satisfied. Vogel (1997) states that short periods of time are also acceptable when applying the duration test, as long as there is some degree of frequency.

The OECD Tax Model Commentary (2014) indicates that there are certain basic criteria that can be followed in order to determine whether the duration would be an indication of a permanent establishment. These include the following:

1. A duration of less than six months will probably not be regarded as a permanent establishment.
2. Six to twelve months will potentially be an indication of a permanent establishment.
3. Twelve months or more is most likely to be an indication of a permanent establishment.

Although each case should be considered based on the facts these guidelines assist when considering the duration of a presence leading to the conclusion of the existence of a permanent establishment. A permanent establishment usually begins its life upon the beginning of the operations it is intended for and comes to an end upon the conclusion of the business activities.

The OECD Tax Model Commentary (2014) indicates that certain enterprises attempt to avoid the satisfaction of the duration test by splitting the project into parts. This is done by contracting with many different sub-contractors which each complete their business activities in multiple stages so as to not be regarded as present in terms of the duration test. An example of this is a building site where a business does not wish to create a permanent establishment and sends a different contractor to the site every three months. This will still create a permanent establishment as the OECD (2014) will regard this as one contract which will only end upon the completion of the business activities. The rules specifically provide for the aggregation of time spent on certain projects, as well as a consideration of the total time spent on certain projects. In the case of *Sumitomo Corporation v Deputy Commissioner of Income Tax* (ITA 8084 Income Tax Appellate Division Tribunal March 22, 2010) it was held that where projects are carried out for the same principal or in close proximity in terms of location, this would mean that the projects are considered to be one 'coherent whole' (KPMG, 2010).

2.6 Carry on a business – the business connection test

When considering the elements that make up the definition of a permanent establishment, the third element relates to the need that the place of business must be used to carry on, wholly or partly, the business of the non-resident. For example, where an enterprise sets up a fixed place of business in a country but then rents it out and does not undertake to carry on a business in the premises, there will be no carrying on a business. The OECD Tax Model Commentary (OECD: 2014) indicates that where a business is being carried on by an entity in a jurisdiction, the business activity needs to be carried on under the laws of the country in which it is operating. The reason for this is that in order to obtain the treaty relief for which it may qualify, the business must be operating in that country under the laws specific to that country. The OECD (2014) denotes this test the business connection test and it is used in order to connect a business activity to the business from which it is being carried out.

2.7 Services rendered

According to the OECD Tax Model Commentary (2014: 28),

The provision of services should as a general rule subject to a few exceptions for some types of service be treated the same way as other business activities and, therefore, the same permanent establishment threshold of taxation should apply to all business activities, including the provision of independent services.

With regard to services rendered, some DTAs (OECD, 2014: 40) indicate the following two tests to be applied in order to determine whether an enterprise has a permanent establishment in a particular source state:

[N]otwithstanding the provisions of paragraph 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State:

- a) through an individual that is present in that other state for a period or periods exceeding in the aggregate 183 days in any 12 month period, and more than 50 percent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual; or
- b) for a period or period exceeding in the aggregate 183 days in any 12 month period, and these services are performed for the same project or for connected projects through 1 (one) or more individuals who are present and performing such services in that other State...

then a permanent establishment will exist.

The above commentary is not included in all tax treaties. However, it is important to consider it when determining whether the activities, constituting services would result in a permanent establishment.

The OECD Tax Model (2014: 40) states in the commentary that:

As a general rule, it is important to ensure that only the profits derived from activities carried on in performing the services are taxed; whilst there may be certain exceptions, it

would be detrimental to cross-border trade in services if payments were received for these services were taxed regardless of direct or indirect expenses incurred for the purpose of performing these services.

What is important to note on the above is that the location where the services are performed is the same as the location of where the resulting taxing right is. This means that the mere performance of a service on behalf of an entity for a period exceeding 183 days (as described above), that a permanent establishment is created and hence a taxing right to profits exists.

2.8 Exclusions

The term permanent establishment, as defined in Clause 1 of Article 5 of the OECD Tax Model (OECD: 2014) is subject to certain exclusions that are contained in Clause 4 of Article 5. The OECD Tax Model Commentary (OECD: 2014) sets out these exclusions in Clause 4. This clause excludes certain activities from creating a permanent establishment. These exclusion are as follows:

- The use of facilities solely to store, display or deliver goods or merchandise that belongs to an enterprise will not create a permanent establishment.
- The maintenance of a stock of goods belonging to an enterprise solely for the abovementioned purpose, as well as processing by another enterprise, will not create a permanent establishment.
- The maintenance of a fixed place of business solely for the purpose of carrying on for the enterprise any other activity of preparatory or auxiliary character will not create a permanent establishment.
- In addition, a combination of the above activities will not give rise to a permanent establishment if the combination results in the overall activity being preparatory or auxiliary in nature.

Preparatory or auxiliary in nature

Paragraph 4(f) of the OECD Tax Model (OECD: 2014) specifically states that a combination of the activities referred to in that paragraph will also not give rise to a permanent establishment if the activities are considered to be auxiliary or preparatory in nature. Honiball (2007) states that if each activity does not constitute a permanent establishment on its own; a combination of these

activities, if not considered auxiliary or preparatory, may still result in a permanent establishment. In this regard, the OECD Tax Model (2014) states that the criterion that is decisive on whether or not a particular activity is said to be the essential and significant part of that particular activity rests on the consideration of the activity of the entity as a whole. In addition to this, The OECD Tax Model also maintains that a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise does not exercise a preparatory or auxiliary activity.

Fay (2006) explains that the State Administration of Taxation of the People's Republic of China issued Circular 35 in 2006 to assist with the interpretation of the permanent establishment principles, specifically relating to whether an activity will be regarded as being auxiliary or preparatory in nature. Three considerations are set out in the Circular (Fay: 2006) and should be considered when determining whether the activities of a fixed place of business in China are preparatory or auxiliary in nature:

- whether the fixed place of business provides services exclusively to its head office, or whether business relationships are conducted with other persons or entities;
- whether the nature of the business activities carried out by the fixed place of business is the same as that of the head office; and
- whether the activities provided by the fixed place of business are a crucial part of the business activities of its head office.

The OECD Tax Model Commentary (OECD: 2014) classifies auxiliary or preparatory in nature as the activity of an enterprise keeping a stock of goods and merchandise for storage, display, delivery or processing by another enterprise. A fixed place of business in a country will be deemed not to be a permanent establishment if the fixed place of business is set up in the country for the purpose of carrying on an activity that is auxiliary or preparatory in nature. An example would be where a storage facility is used in Mauritius for the distribution of goods on behalf of its headquarters in South Africa. When the auxiliary activity is combined with the core activity, the exclusion no longer applies. It is often difficult to distinguish between those activities that are of a preparatory or auxiliary nature and those that are not. In addressing this difficulty, the OECD Tax Model Commentary (OECD: 2014) provides that the decisive

criterion is whether or not the activity of the fixed place of business forms an essential and significant part of the activities of the enterprise as a whole.

2.9 Agency

The OECD Tax Model Commentary (OECD: 2014) identifies a further exclusion from the concept of a permanent establishment, which is contained in Clauses 5 and 6 of Article 5 of the OECD Tax Model. The activities of a business may be carried on by an agent. The OECD Tax Model recognises two types of agents; namely, a dependent agent and an independent agent. The services of an independent agent will not give rise to a permanent establishment (OECD: 2014). However, a dependent agent's activities are based on the existence of that agent acting in a State on behalf of the enterprise.

Dependent Agents

The OECD (2014) stipulates that where a person has the authority, and continuously exercises this authority, to conclude contracts on behalf of the enterprise, this will create a permanent establishment for that enterprise in the State in which the agent exercises such authority. This will only apply if the agent is acting on behalf of the company in its ordinary course of business.

Paragraph 33 of the OECD Commentary (2014: 94) states:

[A] person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority in that State, even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation.

Paragraph 33 therefore specifies that the contracts concluded must relate to the primary and core business operations. If the criteria are not met for a 'fixed place of business', the revenue authorities will try to determine if a dependent agent exists and creates a permanent establishment. The OECD (2014), in its Commentary to the Tax Model, notes that the agency test is sometimes termed the secondary test, when determining the existence of a permanent establishment.

In the case of *SET Satellite (Singapore) Pte Ltd. v. DDIT Nr 944 of 2008*, a company which was incorporated in Singapore utilised an agent to market the company's products in India. Even though the company did not have any income that should have been taxable in India, the court

concluded that the agent was in fact dependant on the company and therefore created a permanent establishment in India and the company was therefore liable for tax in India on its business profits earned (KPMG, 2010).

Independent agents

Paragraph 37 of the OECD Commentary on Article 5 of the OECD Tax Model (2014: 100) states as follows:

A person will come within the scope of paragraph 6, i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:

a) he is independent of the enterprise both legally and economically; and

b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

The OECD (2014) states in paragraph 5 of Article 5 of the OECD Tax Model (2014) that an independent agent is an agent that is firstly, both legally and economically independent and secondly, one that acts in the ordinary course of their own business. If the agent's commercial activities are subject to detailed instructions or comprehensive control by the principal, it is unlikely that the agent would be legally independent. Furthermore, should the entrepreneurial risk of the transaction be shared by both the agent and the principal, it is unlikely that the agent would be economically independent. This enquiry is a factual one which must be supported by both the substance and form of the arrangement. If an agent is able to solicit and negotiate all the elements and terms and conditions of a contract on behalf of its principal (and such terms and conditions are binding on the principal), even if the actual signature (i.e. conclusion) of the contract takes place in the home country of the company, a permanent establishment would still be created. The actions of the contracting parties must therefore be considered. Huston and Williams state that an agent will be considered independent if his activities do not give rise to a permanent establishment in terms of Paragraph 5 of Article 5 of the OECD Tax Model.

Skaar, (1991) states that the substance of the authority exercised must be given more weight than the actual form of the authority. The authority that the dependent agent exercises in the foreign jurisdiction must be evaluated against the economic backdrop or reality of the transaction. If the conclusion of a business contract (i.e. the signing of the contract) is merely a rubber stamp following the negotiation phase, it could be argued that the major part of the

business activities is performed in the foreign jurisdiction, i.e. the country where the contract is negotiated. However to the extent that the negotiation of a contract is subject to genuine subsequent approval by the principal, such negotiation rights would be insufficient to establish a permanent establishment. Thus, to the extent that the principal has the power to reject the agent's business arrangements, the mere negotiation of the contract would not constitute a permanent establishment. The final element that must be satisfied is whether the dependent agent habitually exercises its authority to conclude the contracts. The activities must have a certain degree of permanence and/or frequency, i.e. the authority to conclude contracts must be exercised repeatedly and should be more than merely transitory or in isolated cases. Habitually or frequently exercised activities could result in the creation of a permanent establishment.

2.10 Business profits

As mentioned above, the result of a permanent establishment is that any business profits earned by that permanent establishment will be subject to tax in the country in which the permanent establishment exists. Therefore, once all exclusions have been taken into account, the remaining business profits need to be attributed to the permanent establishment and taxed in the country which has earned the taxing right on such profits. If the enterprise carries on business through a permanent establishment in the source state, the profits attributable to the permanent establishment will be taxed in that state. In some cases, Article 7(2) of the OECD Tax Model requires these entities to be treated as if they are independent entities and consideration must be given to the functions performed, the risks assumed and the assets used when calculating the business profits earned by that entity in that state. Accordingly, the profits need to be attributed on an arm's length basis.

Honiball and Olivier (2008: 90) report that the UN Tax Model Commentary defines business profits to include the following:

[i]ncome from any trade or business, including income derived from an enterprise from the performance of personal services and from the rental of tangible personal services.

Honiball and Olivier (2008) go on to indicate that business profits are those profits separate from the other income types dealt with in the treaties.

The 2010 Report on the Attribution of Profits to Permanent Establishments by the OECD (2010: 25) indicates that when attributing the profits of a permanent establishment it is important to determine assets owned and risks assumed. It states that:

Article 7(2) requires the permanent establishment to be treated as if it were a separate and independent enterprise, performing its own functions, assuming its own risk and owning or using assets on its own. It is therefore necessary under the arm's length principle of Article 7 to develop a mechanism for attributing risks, economic ownership of assets and capital to the hypothetically separate and independent PE.

2.11 BRICS countries and the concept of a permanent establishment

As mentioned, it would be impossible within the scope of the present thesis to refer to each and every country's treatment of the concept of a permanent establishment in order to consider each country's domestic legislation and treaty agreements. In order to obtain a sample of countries and their treatment of a permanent establishment, the countries that have been selected are emerging economies, namely Brazil, Russia, India, China and South Africa, also known as the BRICS. The reason for considering the selected countries for a detailed analysis is to note how these countries practically deal with the concept of permanent establishment. South Africa has not always formed part of this association and it was previously known as the BRIC. South Africa only became a member in 2010. The BRICS member countries are all, aside from Russia, known as developing or newly industrialized countries which can be distinguished by their rapidly growing economies.

2.11.1 Brazil

Sonia Zapata (2012) writes about the permanent establishment principles in Brazil in a topical analysis and about the changes that the Brazilian legislation has recently undergone. An example of this is the introduction of the taxing of income on a worldwide basis. Further amendments include the introduction of transfer pricing legislation and the anti-avoidance rules, which allow tax authorities in Brazil to disregard a transaction that has been motivated merely on the premise of tax avoidance. Brazilian tax legislation does not currently have a definition of a permanent establishment. However, it has been found, according to Zapata (2012) that discussions are currently taking place in order to introduce such a definition. What is important, however, is that the only means of creating a permanent establishment and hence a taxing right

in Brazil for a non-Brazilian resident is where that non-resident creates a taxable presence in Brazil. A taxable presence is a presence which is created by a permanent establishment; hence, that country has a right to tax the profits earned by that permanent establishment. Article 398 of the Income Tax Regulations (1996) states that the income earned by a non-resident company derived from the importation of goods to be sold in Brazil which is carried out by representatives, will be taxable in Brazil. This will, however, depend on whether the representative is acting on behalf of the non-resident enterprise in Brazil. Article 126(3) of Law 5,172/1996 states that an entity that is not a legal entity of Brazil will be subject to taxation locally if it constitutes a business or professional unit. Brazilian legislation does not define a business unit. Zapata (2010) reports that it constitutes a minimal structure that could be compared to a fixed place of business. There is, however, no literature or case law that could be relied on in order to obtain an understanding of the concept (Zapata 2010).

With regard to the treaties in place between Brazil and other contracting states, Brazil has a number of treaties in place. In these tax treaties, Brazil adopts the definition of a permanent establishment as is set out in Article 5 of the OECD Model (2009:26). The rules applicable therefore include the existence of a fixed place of business through which the business of an enterprise is wholly or partly carried on. As set out in the OECD Model (2009), the treaties in place with Brazil stipulate the specific inclusions as to what constitutes the fixed place of business. These include a place of management, branch, office, factory, workshop, mine, quarry or other place of extraction of natural resources. According to Zapata (2012), some treaties, for example, with Japan, Paraguay, Ukraine and the Philippines include a warehouse in this list of specific inclusions. However, other treaties specify that a place used solely for storage, display or delivery of goods or merchandise that belongs to the enterprise will not constitute a permanent establishment. The treaty concluded with China is the only treaty in force with Brazil that is based on the UN Model. For this reason, a factory is specifically included.

As mentioned above, Brazil's treaty network is mainly based on the OECD Tax Model. Therefore, when considering the rules pertaining to agency arrangements, Articles 5(5) and 5(6) of the OECD Tax Model are considered. Zapata (2012) states that the treaty with Japan, however, specifically states that a dependent agent will not create a permanent establishment even if he has the authority to conclude contracts on behalf of the foreign entity. However, if he habitually maintains the stock of goods and merchandise from which he regularly delivers such

goods or merchandise on behalf of the foreign enterprise, a permanent establishment is deemed to have arisen from such actions.

2.11.2 Russia

Oleg Konnov (Konnov, 2012) writes about the Russian domestic laws applicable to a permanent establishment. Konnov (2012) states that irrespective of the fact that Russia is not an OECD member country, the OECD Model is used as a guideline in terms of the drafting of treaties with other contracting states. The OECD Model and Commentary are also used when interpreting local Russian legislation. The Russian tax authorities actually refer to the OECD Commentary as supporting guidance. The permanent establishment principle therefore is an existing concept of the Russian domestic legislation. The Russian laws do not, however, have regard to a place of business, but rather to the use of the place of business. A home office is also not regarded as a place of business as the employee is not under the control of an employer.

When considering the concept of a permanent establishment under local Russian legislation, the concept is specifically defined in the Russian Tax Code (Konnov, 2012). The definition therefore mirrors that of the OECD, stating that it constitutes a fixed place of business (including a construction site) and a dependent agent arrangement.

According to Konnov (2012), the Russian tax laws recognise that the activities that are regarded as auxiliary or preparatory will not create a permanent establishment. The legislation pertaining to a permanent establishment is divided into a positive list and a negative list. The positive list is the inclusions in the definition of a permanent establishment and the negative list is that of the exclusions. Although these positive and negative lists are not considered further in this study, this aspect has been found to be similar to that of the OECD rules where the specific inclusions and exclusions are spelled out. With regard to timing, there is no specification as to what the minimum requirement is in order for a construction site to constitute a permanent establishment. However, Konnov (2012) notes that there are detailed rules surrounding the effects of a construction site on the creation of a permanent establishment. The mere fact that a Russian resident is controlled by a foreign employer does not give rise to a taxing right in Russia.

2.11.3 India

Metha (2012) deals extensively with issues relating to the Indian domestic tax legislation, the application of treaties between India and other contracting states and the rules relating to Indian permanent establishments. The author notes that Indian tax legislation has been found to contain a definition of permanent establishment. However, the main purpose of including this definition in the Indian tax legislation is the application of the transfer pricing rules applicable under the domestic legislation in India. This definition, though specific to transfer pricing, includes a fixed place of business through which the business of the enterprise is wholly or partly carried on. Domestic legislation, however, only includes a fixed place of business including an installation, office branch, etc. The service permanent establishment and dependent agent are not included in the domestic legislation.

In the Advanced Ruling by the Authority for Advanced Rulings (AAR) in the case of *Real Resourcing Ltd* (2010) 322 ITR 558 the basic rule of a permanent establishment, as stated in Article 5(1) of the UN Model, was discussed. *Real Resourcing* was a United Kingdom incorporated company that was tax resident in the United Kingdom. *Real Resourcing* was contracted to provide the following services:

- recruitment services: where *Real Resourcing* would place a candidate with an Indian company and receive payments for such services from the Indian company; and
- referral services: where *Real Resourcing* would refer potential Indian clients to a third party (also based in India) for which *Real Resourcing* would be paid an amount from the third party.

According to Mehta (2012) the judgement in the case of *Real Resourcing* then states that this type of service would not constitute a permanent establishment in India and therefore no business profits would be taxed in India. Under the regulations contained in the treaty between India and the United Kingdom, it is set out that the provisions relating to fees for services would not create a permanent establishment in India. This meant that the Indian clients of *Real Resourcing* would not be liable to pay tax on the income earned. The Indian tax authorities, on the other hand, contested this and noted that *Real Resourcing* would have an office in a specific location in India which is indicative of the existence of a permanent establishment under the India – United Kingdom treaty. *Real Resourcing* responded by showing that the office would only be a virtual office as the office would not actually have a physical existence and therefore

no presence. The AAR ruled in favour of *Real Resourcing* that they did not have a permanent establishment in India.

2.11.4 China

This section discusses the concept ‘permanent establishments’ in the People’s Republic of China. Eichelberger (2011) notes that with regard to Chinese domestic legislation it has been found that domestic Chinese legislation provides very little guidance as to what constitutes a permanent establishment. Chinese domestic legislation sets out the key concept as Guo Shui Fa. Where the loopholes in the legislation have been identified from a domestic perspective, the Articles in the OECD Tax Model are referred to for clarification (Eichelberger, 2011). It has been found that although China is not a member of the OECD, the Model is referred to and relied on from a domestic legislative perspective. This legislation for example, has similarities to the guidance provided in the OECD Model. China has, however, through the Ministry of Finance, posed challenges to the OECD Model which shows that the Model is not reliable for China when interpreting issues relating to a permanent establishment. It has been found by Eichelberger (2011) however, that this is a result of the misunderstandings and lack of uniformity in China about the concept of a permanent establishment.

Eichelberger (2011) points out that the term permanent establishment does not actually exist under Chinese domestic legislation. However, domestic laws indicate a similar concept, known as the establishment or place. This concept is used to determine whether income earned from a source within China will give China a taxing right over this income earned.

2.11.5 South Africa

South Africa is not a member of the OECD. Nevertheless, it has been found that South African domestic legislation refers to the OECD guidelines specifically when defining a permanent establishment. The OECD Model is typically used in South Africa as a guideline from a transfer pricing perspective. South Africa has, in its treaties in force with other contracting states, included some clauses applicable to the UN Model Convention. Article 5(1) defines the permanent establishment principle to mean a fixed place of business through which the business of the enterprise is wholly or partly carried on. The only treaty that defines a permanent establishment in a manner different to this is the treaty in force between South Africa and Zambia. This treaty defines a permanent establishment to include a branch, depot, management,

factory, farm, mine, quarry or other fixed place of business including any place of natural resources subject to exploitation. Article 5(2) of the remaining treaties, other than the one in force between South Africa and Zambia, specifically includes a place of management, a branch, an office, a factory, a workshop and a mine, an oil and gas well, a quarry or any other place of extraction of natural resources. The treaties between South Africa and Algeria, Egypt, Uganda, Belarus, Indonesia, Pakistan, Ukraine and Nigeria include in Article 5(2) a sales store or any premises used as a sales outlet. The treaties in place between South Africa and Australia, Ethiopia, Israel and Romania include a farm, plantation or any other place of agricultural related activities as a permanent establishment. The treaty in force between South Africa and Namibia goes as far as including a guest farm in the definition of a permanent establishment.

A service permanent establishment is also included in most treaties in force with South Africa. The treaties in place with South Africa exclude certain activities from constituting a permanent establishment. These are based on Article 5(4) of the OECD Model, setting out a list of activities that have been deemed not to give rise to a permanent establishment. These exclusions have also been adapted by certain treaties in different ways. For example, Honiball (2012) states that the treaty in place between South Africa and Hungary also provides that a permanent establishment shall not be created by:

- A building site or construction, installation or assembly project carried on by an enterprise of a contracting state in connection with the delivery of materials, machinery or equipment from that state to the other state; and
- The sale of goods or merchandise belonging to the enterprise displayed at an occasional temporary fair or exhibition after the closing of the said fair or exhibition.

Honiball (2012) states that under the domestic legislation a permanent establishment is not a means of taxing a non-resident. As there is no specific definition for the term under the domestic rules, there are no specific exclusions under domestic laws in South Africa.

According to Honiball (2012) with regard to the arrangements in place with agents, under domestic South African tax legislation, there are no specific rules pertaining to the agency rules. However, as the income that arises from a South African source will be subject to tax in South Africa on the part of the non-resident, an agent or representative that may create this income sourced from South Africa, the income will be taxed in South Africa. With regard to these arrangements relative to the treaties in place, Articles 5(5) and 5(6) of the OECD Model are

followed when considering the position with agents, namely dependent or independent agents. Again, it has been found that the dependent agent is one that concludes contracts on behalf of the non-resident and habitually exercises this authority to do so. Again, it has been found that although an agent is seen to be as independent, if he or she carries out their responsibilities as the agent wholly for the non-resident, this could be regarded as an indication of a dependent agency arrangement. Article 5(6) of the OECD Model specifically states that an enterprise will be deemed not to have a dependent agent when the activities that are carried out for the enterprise in the other contracting state are as a broker, general commission agent or any other agent with independent status. The treaties with South Africa, Egypt, Iran, Malta, Namibia, Thailand and Uganda state that when these activities are carried out by an agent, and are devoted wholly or mainly to the non-resident, that this independent agent will be regarded as a dependent agent and therefore create a taxing right in South Africa for the non-resident (Honiball, 2012).

2.12. Conclusion

This chapter has considered all the fundamentals that constitute the concept of a permanent establishment as it currently stands, including developments of the concept that have taken place to date. Each of the elements has been discussed, including a place of business that is fixed and through which the business is carried on. The specific inclusions and exclusions have also been discussed. The tests that apply to the determination of the existence of a permanent establishment have also been considered, including the geographical or location test, the duration test, business connection test, as well as the concept of agency. It is now clear that the concept and how to apply it in order to determine which country the business profits are to be attributed to is a complex matter. It has been found, however, that each case should be determined on its own facts and that a subjective approach is to be followed. Although these theories can be debated from every perspective, they merely form the basis or guidelines from which the definition of a permanent establishment has evolved. Both the OECD Tax Model and the UN Tax Model provide the necessary assistance in drafting domestic legislation on this topic.

From the sample of countries discussed in this chapter, it is clear that although both the UN Tax Model and the OECD Tax Model are used as a guideline when drafting the treaties that these countries have in place with other Contracting States as well as domestic legislation, there are

many variations applied in this regard. Although the basic principles are all specifically applied, specific inclusions and exclusions are added to certain treaties. These variances may be based on experiences of the contracting states or an element that is specific to a certain country that specifically requires special mention of an inclusion or exclusion. The ability of a treaty to be tailored to suit the contracting states is evident from the research findings outlined in this chapter. Although concepts have been adapted to meet the specific needs of contracting states, inclusions and exclusions have been specified depending on the needs of contracting states, there is no specific mention on the concept of e-commerce other than what is contained in the OECD Tax Model Commentary.

A permanent establishment has been discussed above to illustrate the effects of having a physical presence in a country through which a business is conducted. If the location, duration and business connection tests are all satisfied, this can create a permanent establishment for an entity in a country which will have a taxing right over the profits earned by that entity. This can be contrasted with the lack of physical presence that e-commerce presents in concepts such as webpages and clouds. In addition, the alternative method of creating a permanent establishment is through a dependent agent. This agent can be economically and legally dependent on the entity and therefore create a taxing right over profits in the territory in which the dependent agent operates. This too needs to be considered further when applying the concept of dependent agent to e-commerce. The reason is that an Internet Service Provider for example could represent the entity as a dependent agent therefore creating a taxing right over profits. It is therefore clear that when considering whether a permanent establishment exists, the concept of e-commerce adds a whole new dimension to the concept. The concept of e-commerce has therefore been included in the OECD Model Tax commentary (2014) as a discussion point. E-commerce is discussed in more detail below in Chapter 3. There are many authors who have expressed their views on the concept of e-commerce and these have been discussed in more detail in chapter 3 and 4.

Chapter 3 – E-commerce and a permanent establishment

3.1. Introduction

After considering the methods that are available as a means to create a permanent establishment for an enterprise in a multi-national environment, e-commerce adds a further dimension to the potential existence of a permanent establishment. As discussed in the previous chapter, the first test that is applied to determine whether a permanent establishment exists is that of a fixed place of business. E-commerce allows for business to be carried on without a tangible fixed place of business. The geographical nexus is no longer required in the virtual world that presents itself when considering the existence of a permanent establishment. The OECD Tax Model Commentary (OECD: 2014) provides a commentary on Article 5 that specifically deals with the implications attendant upon e-commerce and a permanent establishment.

The OECD Tax Model Commentary on Article 5, as mentioned above, concludes that the principles of a permanent establishment are sufficiently adaptable to the current environment and the challenges that are posed. This elasticity of the concept of a permanent establishment is demonstrated in the previous two chapters, where it was shown that a concept that is interpreted in a particular manner can also be adapted to suit the relevant environment by adding specific inclusions and specific exclusions. This could also be indicated by the flexibility of the current permanent establishment principles and the ability of the concept to be adapted to a modern environment. From a reading of the additional commentary contained in Article 5 of the Model Tax Commentary (OECD: 2014), it is clear that the OECD is demonstrating that the principles of a permanent establishment can be adapted to fit in with a modern society that poses the challenges of e-commerce.

In 1999, the Commission on Taxation, with the Business and Industry Advisory Committee (BIAC) to the OECD, pointed out that the OECD employs the necessary techniques to adapt to the existing principles pertaining to tax and the interaction between these principles and e-commerce. BIAC (1999) also indicated in the article that this adaptation should be built on the fact that a business has certain needs in order to operate in an ever changing market and that the legislation should mirror this flexibility in order to retain compliance from a business.

According to Frieden (2000), the largest commercial growth in e-commerce has been the impact of the internet and intranet on the functioning of a business. Frieden (2000: 464) uses an example to illustrate this:

Inventory controls are maintained online and automated ordering systems used by one business unit or related entity to order parts or materials from another related entity are becoming the norm in many industries.

Frieden illustrates in this example that files for example are being stored in a virtual space. The use of the internet as a means of carrying on a business, has led the question of physical presence in a virtual world where there are no tangible boundaries and no geographical connections. Despite this problem, Hoffart (2007) stated that the OECD believed that the definition of a permanent establishment could be adapted to this environment.

The OECD has taken the lead in providing commentary on the concept of e-commerce. This chapter will, therefore, explore the commentary and guidelines provided by the OECD. Specific attention is given to the impact of certain e-commerce equipment and data, and whether the use of these facilities gives rise to the existence of a permanent establishment. This analysis of e-commerce equipment includes a discussion on the ability of an Internet Service Provider, a server and a web page to each create a permanent establishment. The concept of agency is also considered as the possibility exists that a multi-national enterprise no longer requires an agent or a representative to carry out the business of the enterprise in a particular jurisdiction as e-commerce allows this to be carried out on behalf of the enterprise. What will happen to an enterprise in a country where the permanent establishment principles are based on dependent agents creating a taxing right in that jurisdiction? Should the agency requirement be removed from the concept of permanent establishment? Further consideration is given to this possibility in this chapter. When considering the questions raised on both the existence of a fixed base and a dependent agent in a virtual environment, it has been found that the best place to start is the source of the income earned and the residency of the income earner.

This chapter considers the concept of source and residency, as most countries base their taxation on either one of these factors according to Haupt (2014). What is important from the perspective of e-commerce is that these factors form the basis of determining where a taxing right exists and therefore could possibly provide a solution to the current problem of allocating income earned in a virtual environment. This chapter then considers the many suggested definitions of e-

commerce in lieu of a formal definition. The debate around the definition leads to the exploration of further concepts such as e-business (this concept is explored further in section 4.3 below).

3.2. Source and residency

With regard to the concept of e-commerce, the OECD Tax Model Commentary in 1997 recognised the source rules as an area for debate when considering the challenges that may be posed by the internet. The OECD comments on the abilities of the member countries to push profits offshore by using the internet as a means of conducting their business. This would be achieved by ensuring that the source of the income was from a source with a lower tax rate than the source where the profits were actually earned. The OECD identifies the application of the source rules as a means of containing this spread of income in order to be subjected to a lower tax rate.

It is evident from the above that the source rules need further consideration for the purposes of this chapter. The source rules determine the source country from which income is earned. South Africa in particular contemplates the source of income already in the definition of gross income (as defined in chapter 2 above) in section 1 of the Income Tax Act. The Income Tax Act does not define source but the concept has been explored in a number of leading cases. In the case of *CIR v Lever Bros and Unilever Ltd* (1946 AD 441) (14 SATC 1), the general principles of source were outlined (1946: 457):

[T]he word ‘source’, when used as it is in this Act in order to symbolise the origin of ‘gross income’ received by a taxpayer, is also a metaphorical expression and the sense in which it is used in the Act must be determined.

As indicated in Chapter 2 above, the location test is the first test that is applied when determining whether a permanent establishment and hence a taxing right exists. Since the focus of this study is partly on the concept of a virtual permanent establishment, consideration is given to the location of a source. This poses a challenge as a virtual environment does not specifically lend itself to a particular source. In turning attention back to the case of Lever Brothers, the court stated (1946: 451) that when determining the location of the source of income the following should be considered:

Turning now to the problem of locating a source of income it is obvious that a taxpayer's activities, which are the originating cause of a particular receipt, need not all occur in the same place and may even occur in different countries and, consequently, after the activities which are the source of the particular 'gross income' have been identified the problem of locating them may present considerable difficulties, and it may be necessary to come to the conclusion that the 'source' of a particular receipt is located partly in one country and partly in another... Such a state of affairs may lead to the conclusion that the whole of a receipt, or part of it, or none of it is taxable as income from a source within the Union according to the particular circumstances of the case, but I am not aware of any decision which has laid down clearly what would be the governing consideration in such a case.

Although source has not specifically been defined under the South African income tax legislation, court decisions have based the interpretation on the need for an originating cause. Treaties in place between contracting states specifically state that the taxing right will rest with a country in which the income arose. Therefore, the source of the income is a determining factor. The courts indicated the importance of the concept of source when consideration was given to income arising from two sources. This was the decision in the case of *CIR v Epstein* 1954 3 SA 689 (A) (19 SATC 221), where the question of the source of profits derived by the taxpayer, who carried on business in South Africa as an agent for foreign firms was dealt with. The court held (1954: 233) that the apportionment of profit needed to take place between the partners:

In taxing the respondent, the Legislature looks at his activities and ascertains whether those activities were exercised within the Union; if they were, then he is taxable in respect of any profits resulting from such activities. It may be said that when there is a partnership the members of which carry on their business activities in two different countries, the income of the partnership is derived from two sources and that when one of the partners carries on his business activities in the Union his income from the partnership is derived from a source within the Union while the income of the other partner is derived from a source in a foreign country. For the income which the partner, who carries on his business activities in the Union, receives is the quid pro quo for the services he renders in the Union to the partnership.

Based on the above, it is clear that the concept of source is important when discussing e-commerce. When determining the source of income earned from a virtual environment, it is not easy to establish whether the source is in one particular state, or to apportion that income to many sources. Pinto (2006: 266) states the following:

Although source-based taxation remains theoretically valid in today's globalized world, the way source is defined under the permanent establishment threshold needs to be reconceptualised in light of the changes brought about by globalization and the related developments in electronic commerce.

Before the concept of e-commerce is explored in further detail, the concept of residency has been found to be prevalent in the domestic legislation of many countries. South Africa, for example, bases its taxation system on the fact that the worldwide income earned by a resident of South Africa will be taxable in South Africa.

The concept of resident is dealt with in the OECD Tax Model in Article 4 (OECD, 2014: 77). The OECD Tax Model Commentary states that the concept of resident of a Contracting State has various functions and is pertinent in three circumstances:

- a) in determining a convention's personal scope of application;
- b) in solving cases where double taxation arises in consequences of double residence and
- c) in solving cases where double taxation arises as a consequence of taxation in the state or residence and in the state of source or situs.

As is the case with determining the source of income, the ability to determine the residency of an income earner has also been blurred by the increased use of the internet to conduct business operations. E-commerce therefore makes the determination of source and residency of an entity complicated. With regard to internet-based transactions and the problem of determining source and residency, the Katz Commission Report into Taxation (1994: 53) states following:

The Commission received much evidence regarding a not-too-distant future where international trade investment will increasingly become a function of global electronic communication such as through the Internet. There is no doubt that these developments

will greatly impact on some of the basic tenets of international taxation as they exist today.

Following from the above, it is clear that the tests of source and residency are seen as the initial stepping stones when determining the taxing right of a country over profits earned in that particular jurisdiction. The internet and e-commerce have blurred the ease of determination of a taxing right. As stated above, the concepts that were always relied on and returned to as the initial stepping stones are now being questioned and it is being suggested that these basic ideas may need to be revisited. As mentioned above, the concept of e-commerce has not specifically been defined. However, many authors have provided their views on what the concept entails. In the next section, the concept e-commerce will be explored.

3.3. Considering the concept of e-commerce

Although not formally defined, different authors have expressed their views on what e-commerce entails. As mentioned above, the OECD (2014) defines e-commerce as the performance of business activities through electronic information and communication technologies and/or the sale of electronic products. As the OECD Tax Model is relied on by so many countries, the definition of e-commerce provided by the OECD can perhaps be concluded to be the definition holding the most influence. However, further consideration should be given to the many influential authors that have stipulated in their views how the concept should be defined.

Chetcuti (2002), for example, states that e-commerce comprises the electronic sale by online stores of downloadable 'soft merchandise' such as music, e-books, e-newsletters, photos and video recordings, software and documents, the electronic ordering of tangible products, online securities transactions as well as the provision of financial or other services. Chetcuti (2002) states that it also includes the subscription to and use of an Internet Service Provider or an online service provider, and has also been held to cover electronic data interchange, electronic fund transfers and all credit and debit card activity. Sprague (2001) defines the term narrowly, and refers only to electronic commercial transactions where an order is placed by means of electronic transfer and goods or services are delivered in tangible or electronic (digitized) form.

The principles of e-commerce are now being applied to everyday business operations. The development of these principles has been ongoing over the last few years since the introduction

of the concept. Below are some comments on the development of the concept by various authors including Sprague, Kruppens, Frieden, Turban, Graham and Heiselmann and Chetcuti.

Sprague (2001) states that because a geographical border is easily crossed when performing activities for a multi-national entity this raises questions pertaining to international taxes. E-commerce has resulted in these types of questions being raised. Sprague indicates that these issues warrant attention in order to ensure that tax risks and potential exposures identified are attended to.

Kruppens (2012) discusses concepts of globalisation, specialisation and centralisation and how these concepts, if supported by technological advancement can become the drivers of a business as well as the models developed by a business. Kruppens (2012) refers to the economy without the dot-com bubble to be outdated. He suggests that e-commerce is the new way to conduct a business. Kruppens discusses the pace at which these developments came about and notes that the developments in the e-commerce world have taken place at a pace far less than expected. Kruppens (2012) notes that at present, almost all entities utilise e-commerce as a means of doing business. Multi-national enterprises have expanded since the 1990s even though not to the extent that was expected or predicted by Kruppens. Kruppens (2012) has noted that the latest key Internet offering is cloud computing, where service providers offer a scalable, abstracted infrastructure for data storage, applications hosting and related services to customers, often billed by consumption.

The increase of the information technology industry is also a contributing factor to the availability and ever expanding network of e-commerce. Frieden (2000) notes that the outcome of the information age is that there is an expansion particularly in goods and services being able to be provided electronically. Frieden goes on to note that industries involved in telecommunications, television, cable and radio particularly have benefitted from e-commerce. Frieden (2000: 20-22) refers to this as the global expansion of remote selling.

This journey through cyber space has led to some drastic changes that have, along the way, increased the ease of doing business from anywhere in the world. It seems that no place is unreachable if the internet allows you to travel there. An enterprise that is not multi-national seems to be a thing of the past and having an Internet Service Provider with a web site in all countries has become extremely simple. For example, a small shop in South Africa, selling clothes from a boutique could set up a web page where persons in Germany could access the

web page and peruse through the clothes in an on-line catalogue as if they were walking through the boutique in South Africa. This effortless carrying on of a business can be termed electronic business (e-business) and is directly linked to e-commerce.

Turban (2011) states that e-business is sometimes used interchangeably with e-commerce. E-commerce constitutes the narrower definition of buying, selling, transferring or exchange of products and services, between businesses, groups and/or individuals using the internet, and intranets. It is an essential activity of business today. E-business covers a broader definition and includes e-commerce, customer relations management, and business partnerships, e-learning and conducting electronic transactions within an organization.

If an internet transaction taking place as part of e-business is isolated, keeping in mind the concept of permanent establishment when entering this virtual environment, there are certain stages that could lead to the existence of a permanent establishment. Graham and Heiselmann (1998) identify these stages as firstly, the online presence which is, simply put, the virtual storefront. As this first stage is the marketing phase, it will not have a significant impact as far as the virtual environment goes. The second phase is that of integrated online business. As this is also a development stage, the online business is then integrated with the entities' processes and formalities. This phase can thereafter be extended to the advanced online business, which according to Graham and Heiselmann (1998) is a more integrated and technologically advanced capability of the online storefront. This phase utilises the workflow and intensifies the internal processes such as warehouses and call centres etc. which leads to a more costs efficient manner of conducting a business. The final stage is identified as the full electronic phase which includes the full integration of an electronic system.

It has been found from the above that the presence of e-commerce can be divided into stages. The stages begin with the initial minimal involvement where only marketing services are being performed. The second stage involves a more integrated business where more operations are run directly from e-commerce related aids. Thirdly, there is more integration where the actual business is involved with e-commerce and the benefits thereof. Finally, there is the stage of full reliance on e-commerce. Although all four stages are identified by Graham and Heiselmann (1998) above, none of these phases lends itself one aspect that avoids complete dependence on e-commerce in order to trade.

Chetcuti (2002) states that the primary characteristic of e-commerce is that it is conducted by electronic means. Therefore, the marketing of certain products or services of an enterprise can be carried out through the enterprise's website, a transaction can be made in real time and orders can be placed via interactive order forms whilst on line. Chetcuti further notes that the only traditional means of a transaction such as this one is the actual delivery of the product which even then, can come from a completely separate country which holds the stock for the enterprise. Alternatively, actual digital products purchased can be downloaded onto the customer's computer.

Sher (2000) notes that e-commerce allows for the transmission of data, images, voices and video information to take place in cyberspace by using the Internet. When applying the location test here, it is clear that certain equipment that is used to provide the internet as a service may have a specific location. Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated, many entities may run their e-commerce operations from that particular location indicating that the location may perhaps represent a virtual environment for each entity. According to the OECD Tax Model Commentary (OECD: 2014), in order to explore this potentially virtual environment further, a distinction is made between computer equipment versus data and software which is stored on that equipment. The OECD Tax Model Commentary illustrates an example of this distinction by way of an Internet website. The Internet website is considered to be a combination of software and data and is said to not constitute tangible property which therefore cannot have a location or a place of business. This mirrors the requirement of a permanent establishment which requires a tangible place of business. On the other hand, the server on which that software and data is stored will be considered to be an accessible piece of equipment which will constitute a place of business of the enterprise and subsequently a fixed location.

Where a business is carried on through an Internet Service Provider and a contract exists between the Internet Service Provider as the host and the enterprise using the Internet Service Provider, the enterprise will not have the server and the location at the disposal of the enterprise. According to the OECD Tax Model Commentary (OECD: 2014), in such circumstances, the enterprise also does not have a physical presence at that location. Equipment on the other hand, if fixed, will constitute a permanent establishment. However, where computer equipment is fixed at a said location for a certain period of time, and no personnel are required to be present to operate such equipment, this may also satisfy the requirements for a permanent establishment

(OECD :2014). The question therefore arises as to whether the equipment can be considered to be auxiliary or preparatory in nature to the business of the enterprise. The OECD Tax Model Commentary (OECD: 2014) states that such circumstances need to be examined on a case by case basis and more importantly, on the actual activity being carried on.

For example, a website that is serving the purpose of advertising will probably be considered to be auxiliary or preparatory in nature. An enterprise that has the core activity of providing an Internet service to users would be considered to be carrying out the essential part of their business and therefore cannot be considered to be auxiliary or preparatory in nature as this is the core business activity of the Internet Service Provider. The Internet Service Provider can also not constitute an agent of the enterprise and cannot therefore create a permanent establishment for the enterprise. An example of this is when a South African company makes use of an Internet Service Provider that is located in Australia. This mere use of the Internet Service Provider will not create a permanent establishment for the South African enterprise.

There are two main questions that arise when determining whether e-commerce products give rise to a permanent establishment. These questions stem from the 2 main questions being asked when considering if a permanent establishment exists. The first question is whether a website constitutes a permanent establishment or whether the server on which the website is hosted would constitute a permanent establishment. This question relates to the creation of a fixed place of business. The second question that arises is whether the Internet Service Provider is considered to be a dependant agent as the Internet Service Provider essentially puts the customer in contact with the internet. Each of these questions, although addressed above briefly, are considered and discussed below.

3.4. A website as a permanent establishment

Chetcuti (2002) defines websites as digital documents through which the purchaser can order his goods or services. Chetcuti goes on to state that a website or home page is therefore intangible and cannot be regarded as a place of business. A website therefore allows customers to interact with a business enterprise over the World Wide Web and it is made up of electronic data and software which is stored on a server.

According to the OECD Tax Model Commentary (2009: 97):

An Internet website, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a 'place of business' as there is no 'facility' such as premises or, in certain instances, machinery or equipment as far as the software and data constituting that website is concerned.

According to Strangio (2006) a web page is made up of digital and binary codes and although these codes may have a physical presence, the codes will only exist if paired with actual computer equipment. Owens (1997) considered the potential that a website, although without a tangible physical presence, may be considered to be a dependent agent that concludes contracts on behalf of the company whose website it is. Chetcuti, however, states that this agency requirement needs a human person to operate and therefore, unless the web site is considered to be intelligent agent software then this is not possible.

Therefore, it can be concluded that an enterprise that has only a website will not constitute the creation of a permanent establishment for that enterprise. The website and home page, however, will need to be hosted on a server. The next concept for consideration is a server.

3.5. A server as a permanent establishment

A server is defined by the OECD Tax Model (OECD: 2014) as automated equipment stored on an internet website and through which the website is accessible. A server therefore has a fixed location and can be regarded as a fixed place of business for the business that operates on that server. However, when an enterprise conducts its business through an Internet Service Provider, this will not result in a fixed place of business. If the enterprise owns or leases this server on which the website is stored, then this will result in the server being fixed in terms of location and as a result create a permanent establishment. Again, the server must be fixed in terms of location and duration and the activities carried out must not be auxiliary or preparatory to the business.

In summary, when applying the principles set out in the OECD Tax Model (2014), it can be suggested that for a server to constitute a permanent establishment, it has to meet the following requirements:

1. The server on which web site is hosted and its location have to be at the foreign enterprise's disposal – owned or leased and operated by the enterprise – not web hosting;
2. The server must be located in the taxing state – a “fixed place of business”;
3. Core business activities have to be performed through the server, as opposed to preparatory or auxiliary functions, without the need for human intervention.

If all three of these foundations are present and the activities being performed are not auxiliary or preparatory in nature but rather for the purpose of carrying out the core business of the enterprise, then a permanent establishment will be created by the server. In many cases, a server that hosts a website will be used merely for advertising purposes. This type of advertising will be considered to be auxiliary or preparatory in nature and therefore not part of the core business. This will not result in the existence of a permanent establishment.

Chetcuti (2002) adds to this by stating that the server will still require human intervention which will be involved in the actual extraction of the information from the server. Based on this, it has been found by the German Tax Court, in 2001 Case No. I R 86/01 in the case of Schleswig – Holstein that a server constituted a permanent establishment. The case involved a German enterprise that had a server in Switzerland to which a substantial amount of income was attributable. The Germany – Switzerland DTA, however, exempted this type of income from being taxed in Germany. The enquiry was therefore carried out as to whether this income was attributable to the server in Switzerland and whether this server constituted a permanent establishment, therefore creating a taxing right over that income in Switzerland. The court found that the server was set up on leased premises. The court found further that the server actually did not require human intervention as it was linked up to an automated operator. The server was set up in Switzerland and information was directed from the German company and automatically circulated to its Swiss customers. The court found that the income was not attributable to a permanent establishment in Switzerland as a result of the server not being regarded as a permanent establishment as no human intervention was required for the operation thereof. The income remained exempt under the Germany – Switzerland DTA.

It is clear therefore from the case above that human intervention can be indicative of linking a virtual environment to a tangible one. Although the server itself may not be regarded as a tangible environment to which income can be attributed, consideration is given to the human intervention that is required for the operation of such server. As set out in the case above, it is

clear that the automatic responses provided to the customers were not in fact the result of human intervention and therefore did not create a source to which the income could be attributed. After taking the above into account, consideration is given to an agency arrangement where human intervention is not required but where an Internet Service Provider acts as the agent.

3.6. An Internet Service Provider as a dependent agent

An Internet Service Provider provides connections to the internet to its clients for a fee (OECD: 2014). The question therefore arises as to whether the Internet Service Provider can constitute a dependent agent of the enterprise making use of that Internet Service Provider through the websites hosted on the server of the Internet Service Provider. The answer is simple. An agent needs to conclude contracts on behalf of the enterprise in order to constitute a dependent agent and therefore constitute a permanent establishment. The OECD Model (OECD: 2014) sets out that the Internet Service Provider will not be able to conclude contracts on behalf of the enterprise and therefore not be regarded as a dependent agent of the enterprise.

3.7. The taxation of e-commerce

Many authors have indicated their concern surrounding the effects of e-commerce and how the taxation thereof can be a relevant topic for discussion. Most discussions surrounding e-commerce and the taxation thereof have led to taxation based on the source rules. The source basis of taxation was discussed in more detail above. However, this concept can be discussed in further detail when considering the method of taxing income earned from e-business. The source basis of taxation is therefore very relevant when considering e-commerce. According to Honiball (2008), the rationale behind such a consideration is that taxpayers can be expected to share the cost of such infrastructure as they already do with the running of the country which enables the tax base of a country to earn income from these operations.

As has been established above, in order to constitute a permanent establishment two requirements need to be met. Simply put, there must be (i) a fixed place of business and (ii) a dependent agent that is concluding contracts on behalf of the enterprise. When considering e-commerce, it is clear that a website, server and an Internet Service Provider do not create a permanent establishment as there is no tangible presence. Furthermore, when considering whether the website, server or Internet Service Provider could constitute a dependent agent, it is

clear that this too requires human intervention. Keeping the above in mind, how would the operations carried out by means of e-commerce create a permanent establishment if these two simple requirements can under most circumstances not be met? The question is therefore asked whether the source basis of taxing activities relating to e-commerce would result in a justifiable taxation where there is no actual physical presence or dependent agent in respect of the e-commerce. However, there are still authors who express their views on the concept further. Skaar (1999) for example argues that even if an enterprise does not have a physical presence in that source country, it will still benefit from that source country's infrastructure that is in place and should therefore compensate the country for the use of such infrastructure.

Pinto (2006) notes that although a source-based taxation method would be viable in today's global environment, the permanent establishment principles would need to be revisited if such a mechanism of taxation was implemented. Sher (2000) stated that the OECD has submitted that applying the current international tax principles to a virtual world is nearly impossible as too many challenges would result when e-commerce enterprises trade with, a foreign country as opposed to trade in, a foreign country. Skaar (1999) on the other hand argues that as a permanent establishment is not merely a method of obtaining evidence of economic liability, it is not a justifiable reason for adopting a source-based method of taxation specifically for this purpose. Further, Cockfield (1999) states that should profits earned by multinational enterprise from their software functions be taxed separately, these profits attributable to the entity's source would need to be calculated as per each and every e-commerce line utilised in a single year of assessment, which would be cumbersome and this burden would rest on the taxpayer.

3.8. Cloud computing

As the demand for information technology in organisations increases, so does the cost to pay for such provision. Organisations are therefore looking to reduce these costs by entering into sub-contract arrangement with specific information technology enterprises to assist with these services. Cloud computing is the next innovation as far as sourcing an information technology function is concerned, and has recently been identified as the next feasible step for reducing the costs associated with information technology by creating a virtual environment in which data can be stored or backed-up.

The US National Institute of Standards and Technology (National Institute of Standards and Technology, 2011: 1) defines cloud computing as:

a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g. networks, servers, storage, applications, and services) that can be rapidly provisioned and released.

The US National Institute of Standards and Technology (2011: 1) sets out the following essential characteristics:

- On demand self-service: a user need not rely on another's capability to access the cloud, the cloud is unique to the individual that uses it;
- Broad network access: The network is available from either a computer or a phone which makes access convenient;
- Resource pooling: the resources can be pooled together to serve multiple consumers with differing physical and virtual resources;
- Rapid elasticity: resources can be rapidly controlled; and
- Measure service.

Cloud computing is therefore a means of sourcing the information technology for an enterprise from this virtual space. The demand of the enterprise to access and use the information stored on the cloud will increase and decrease on a daily basis. However, the cost once installed will remain the same, and therefore decreasing the overall costs of a current information technology system. The cloud will contribute to flexibility and productivity of the enterprise utilising it. The problem arises in that the system is not a physical server from which organisations can source their information technology demands, but rather a hypothetical space in which the data is stored.

Moving to a virtual environment can, however, raise even more issues with regard to attributing the profits earned to the virtual space, as one cloud could be utilised by a multinational enterprise. Perhaps the cloud will be utilised by a multinational enterprise to store intellectual property to which the various entities of the multinational enterprise will have access? The question therefore arises as to which entity in the multinational enterprise should carry the costs of such cloud? Even more so, being accessible by all entities, the use of the intellectual property needs to still be governed by a right of use agreement. In many jurisdictions, foreign tax credits may only be claimed to the extent that foreign taxes paid are associated with foreign source

income. If for example, a Mauritius entity utilised a cloud that is sourced in South Africa for purposes of receiving income in South Africa, could this mean that this income should be taxed in South Africa and not in Mauritius as it is earned from a source within South Africa?

In many, if not most, cloud transactions, there will be no such transfer of property, and it is likely that the rules governing the taxation of service income would apply to the transaction. However, there may be circumstances where a right is transferred to a customer, in which case the cloud service provider will have to consider whether the income earned is treated as rental or royalty income (each of which involves the transfer of either a copyrighted article or an intangible property right). The correct classification of the underlying transaction is fundamental to the tax treatment.

From a transfer pricing perspective, it is essential to establish if it is a service, for example a technical service, or the provision of intellectual property, that has been provided and not a transfer of tangible property. This determination will significantly impact on the benchmarking analysis required to support the arm's length nature of the intra-group transaction. The OECD (2014) has addressed this issue in more detail in the Base Erosion and Profit Shifting Action Plan released in 2014. This will be discussed in further detail in Chapter 5 below. Another point to consider is the widely debated question whether the provision of a service should be charged for in terms of a royalty or licence fee, or rather in terms of an agreement for the provision of technical services. This would result in different charge methodologies that would be applicable. For example, a royalty would often be charged based on turnover or a similar indirect method, whereas a pure service would be charged based on the costs incurred by the services provided plus an arm's length profit mark-up.

The OECD Tax Model (OECD: 2014) states that for the avoidance of double taxation, a permanent establishment as a fixed place of business through which the business of an enterprise is wholly or partly carried on. As noted above, cloud computing allows the remote operation of many information technology processes. It is no surprise, especially when considering the fact that revenues can be earned remotely, that tax authorities worldwide are seeking to address any possible tax leakage. Since cloud computing is new territory for most tax authorities, taxpayers will need to have a detailed understanding of the transactions undertaken and how the value of the cloud business is distributed among the intellectual property, infrastructure and the personnel that support the business.

3.9. Conclusion

From the discussion in this chapter, it can reasonably be concluded that e-commerce is the catalyst for the further evolution of the permanent establishment principles. The concept of e-commerce is divided into three main components: a website, a server and an Internet Service Provider. What is important in determining whether a permanent establishment comes into existence as a result of e-commerce is that the standard tests that are usually applied need to be considered in more detail. This means that the existence of a tangible fixed place of business or a dependant agent cannot be considered to be appropriate tests when determining the existence of a permanent establishment through a web site, server or Internet Service Provider. The OECD (2014) has provided guidance in the Commentary and sets out three situations where a permanent establishment could be established in relation to e-commerce. The first of these comprises the existence of a server on which web site is hosted, with its location at the disposal of the foreign entity. Secondly, this server must be located in the taxing state, creating a fixed place of business. Finally, the core activities need to be carried on through the server, preventing any possibility of the server only supporting services that are auxiliary or preparatory in nature. The OECD may in future expand on the concept of e-commerce and its close relationship with the creation of a permanent establishment. It appears that it is possible to align the permanent establishment concept with a virtual environment.

In discussing the treatment of e-commerce and the taxation thereof, many authors have expressed their differing views on the concept. The next chapter sets out these ideas, opinions and views on the challenges that e-commerce poses for the existing concept of a permanent establishment.

Chapter 4 – The challenge of e-commerce and the effect on the concept of a permanent establishment

4.1. Introduction

After considering all the components of what makes up a permanent establishment, it becomes clear that this concept has evolved and been adapted over the years since its introduction. This elasticity of the principles of a permanent establishment are illustrated in the OECD Tax Model Commentary (OECD: 2014), where a specific section is dedicated to the taxation of e-commerce. As discussed in the previous chapter, consideration is given to the taxation of e-commerce from a web page, server and/or Internet Service Provider. Authors such as Skaar (1999), Kruppens (2012) and Cockfield have questioned whether the commentary provides enough detail in its analysis (to be discussed in this chapter). However, since the introduction of the OECD Tax Model Commentary on e-commerce further developments have taken place in the Information Technology sector, with the creation of a cloud, in which information and data can be stored being the latest development.

Authors such as Frieden (2000), Chetcuti (2002) and Hinnekens (2003) are of the opinion that the current principles set out by the OECD in the Commentary to the OECD Tax Model should be re-visited in order to incorporate a specific set of rules that should apply to the taxation of a virtual permanent establishment (to be discussed in this chapter). As pointed out above, the first step in determining the existence of a permanent establishment is the existence of a physical presence. As this is the core factor in determining the creation of a permanent establishment and, due to the complete absence in a virtual environment, it is submitted that the authors' concern is, to an extent, justified, particularly in the context of potential tax avoidance schemes.

Skaar (1999: 559-573) deals with the 'erosion of a tax treaty principle'. In this regard, the following extract is relevant, before commencing with the analysis of suggested solutions to the challenges affecting the permanent establishment principles:

Changes in communications and technology have created new industries where the performance of extensive and profitable business activities does not require substantial machinery or equipment, or establishment at one specific geographical point for a long period of time. The conclusion is that the effects of the permanent establishment concept

in international fiscal law have changed, in particular during the last few decades. Rather than protecting the tax base in the source state, the permanent establishment principle today has become instrumental in ensuring avoidance of source state taxation for some economically important business operations ... [and] the future is likely to prove that the permanent establishment principle has lost its force for new and mobile industries, whether tax treaties are renegotiated for this purpose or not.

Chapter 3 provided an analysis of the current principles applicable to e-commerce. Consideration was given to the OECD Tax Model Commentary and guidelines in this regard. The problems that are currently associated with the principles as they are applicable today are discussed in this chapter. This chapter also explores the solutions that have been suggested by various authors. With the core requirement of the existence of a permanent establishment being the physical presence or a fixed place of business and the absence of this requirement in the case of e-commerce, the concept of a virtual permanent establishment is addressed in this chapter. As a geographical border would normally allocate a taxing right to profits earned in a particular country, the line can no longer be drawn in terms of in which country the income arose in the case of the digital economy. As well as a borderless environment, human intervention is no longer required in order to operate from a particular jurisdiction. This chapter discusses these problems and then considers the suggested solution of reconceptualising the current principles of a permanent establishment. This re-conceptualisation includes the exploration of a virtual permanent establishment.

4.2. The present position

In 2003 the OECD considered the application of the existing permanent establishment principles to the rules surrounding the concept of e-commerce. A first draft on this issue was released for comment in October 1999. This was revised and reworked and released as a further draft on 3 March 2000. The changes were subsequently finalized by the Working Party No. 1 in September 2000 and approved by the Committee on Fiscal Affairs in December 2000. The OECD established five technical advisory groups consisting of representatives of business, OECD and non-OECD member countries. The groups dealt respectively with treaty characterizations of Internet payments, issues relating to business profits, consumption tax issues, technology, and data banking. Kruppens (2012) notes that new forms of taxes such as a bit tax, were rejected because they did not fit within the existing basic principles of international taxation.

Kruppens (2012) notes further that in February 2001, the TAG on monitoring the application of existing tax treaty norms for the taxation of business profits (the business profits Tax Advisory Group) published a Discussion Thesis on the Attribution of Profits to a Permanent Establishment Involved in Electronic Commerce Transactions. The intention of this document was to limit the comments to e-commerce operations. It was, however, not intended to evaluate the effectiveness of the current rules. The discussion thesis was aimed at analysing e-commerce operations based on the current rules.

According to Kruppens (2012), the starting point for the discussion was four situations in the area of e-commerce. Kruppens identifies the four situations, the first being as the stand alone computer server which in this case operates with no intervention of personnel. The second case is that where multiple servers exist and each of these servers is geared towards the same task. The third situation exists where personnel are present in the permanent establishment and provide services to maintain the server. The fourth situation contrasts the first situation where hardware and software is developed by personnel that are located in the permanent establishment. It is clear that the concept of permanent establishments is being revisited in its virtual environment form. The reliance on e-commerce has been divided into extreme cases where no human intervention is required to cases where equipment creates a direct connection to a permanent establishment and finally, where human intervention is still required for the functioning of the virtual environment.

Kruppens (2012) notes in a document published on 22 December 2000, and entitled *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the OECD Model Tax Convention on Article 5*, that the Tax Advisory Group reached a consensus (subject to some dissenting opinions of Portugal and Spain) that a website in itself cannot constitute a permanent establishment. A website is not considered to be a means through which a business is carried on. Furthermore, an Internet Service Provider is not considered to be a dependent agent of an enterprise and human intervention is not required for the existence of a permanent establishment. Kruppens (2012) also states that whether a permanent establishment is created by computer equipment is completely dependent on the functions being performed through the hardware. It is concluded that in these circumstances, each case needs to be judged on its own facts.

Kruppens (2012) goes on to identify three primary issues that arise as globally-operating companies increase. These include the following:

1. Accommodating and controlling all these new, increasingly virtual business models. While the usual bricks and mortar companies are easy to locate, e-commerce or e-business activities and technology-driven operations are more difficult to pin down in a given location. As the existing tax concepts are to a large extent dependent on physical presence (such as effective management, permanent establishment, etc.), it is obvious that there are doubts as to whether or not the traditional OECD tax rules can continue to apply in view of the changes.
2. The allocation of profits and losses to specific activities and locations, and in connection with this, the attribution of taxing authority to specific jurisdictions. If, for instance, intangibles play an important role in e-commerce, would it be justified, for example, for a tax authority to tax profit connected with intangibles at the level of the permanent establishment if the permanent establishment acts as a limited risk distributor? Then again, because there would be no business need to establish physical presence to do business in a given market, the head office operation could be situated in a tax haven.
3. New (supply chain of) e-products or e-services mean that the payments for these should be categorized correctly for tax purposes as well; for example, should a payment for a given transaction (e-product or e-service) be categorized as a royalty, a service fee or business profit?

The first point addressed by Kruppens above is the effect of a multi-national entity conducting a business from many jurisdictions. The challenge identified here is allocating this income earned by the entity to a specific source. This is illustrated by Kruppen's second point which notes that this income cannot actually be allocated to a specific source as the source is in fact intangible in some circumstances. The difficulty is satisfying the location test in order to determine whether a permanent establishment actually exists. What is concerning is the fact that in cases where a location cannot be determined, the income could be allocated to the wrong country and taxed incorrectly in that country. Do these profits remain un-taxed as they could not be allocated? Could this become the driving force for unallocated profits lending themselves to tax avoidance schemes? According to Sher (2000), if a server should constitute a permanent establishment, there is an increased possibility of tax avoidance schemes as tax planning and strategies could be the result of a server being strategically placed in a lower tax jurisdiction in order to yield minimal taxes payable on business profits earned in that jurisdiction.

Skaar (1991) points out that it becomes difficult to determine the location of a server if the server is moved from one location to another. Therefore, the creation of a permanent establishment may also be avoided by moving operations to a server in another country before the conditions of being fixed are satisfied. Pinto (2006) points out that mirror sites can, for example, be developed in order to direct a customer to a different server at any time depending on traffic, which could frustrate the attempts of a tax authority to establish a stable physical presence which would create a permanent establishment. However, Cockfield (2003) sets out that the reality is that the location of a server need not have any geographical connection to activities that add value and create income. Furthermore, according to Cockfield (2003), over and above location, e-commerce also makes it difficult to determine which activities are core and which are preparatory as functions can be split between servers.

When defining a permanent establishment, another aspect is what type of activities may qualify as auxiliary and preparatory. The OECD Model Tax Model Commentary (2014) sets out in Article 5 that these types of activities are considered to be a communications link – much like a telephone line – between suppliers and customers. Examples of this include advertising of goods or services; relaying information through a mirror server for security and efficiency purposes; gathering market data for the enterprise; and supplying information.

Kruppens (2012) notes that if the auxiliary or preparatory activities are in themselves an essential and significant part of the business activity, they would not be considered as being of an auxiliary or preparatory nature. It is also submitted that allocating profits that are attributable to a server or website may become an administrative nightmare. Such an exercise would not in fact be feasible. Cockfield (2003) states that the highly complex nature of computer codes would result in administrative difficulties.

4.3. Diagnosing the problem

Frieden (2000) is of the opinion that e-commerce and taxation are on a collision course. He states that the expansion of the internet has impacted on public finance structures and has allowed for an increase in these types of transactions. These increased transactions are identified as consumer to business transactions or business to business transactions. Frieden (2000) submits that this expansion and increase in transactions complicates multi-jurisdictional

transactions and as a result skews the understanding of what transactions create a taxing right and in what country.

Frieden (2000: 46-51) states that the internet is reshaping the world economy. He divides the chapter relating to the tax complexities of e-commerce into five categories which include the following:

1. Borderless commerce:

This concept illustrates the ease of doing business across borders and the difficulties associated with taxation of income earned from such actions.

2. Digital commerce:

Digital commerce relates to goods and services that are purchased and delivered by electronic or digital means.

3. The hollow corporation:

A hollow corporation is classified by Frieden as an entity that lacks core competencies, which allows businesses to relocate.

4. Real time commerce:

Transactions have been enhanced and become the normal method of completing transactions.

5. Changing business models:

Although new tax models have been developed, these will have to remain flexible as the technological age is rapidly and continuously evolving.

Owens (2001: 10) maintains that:

two forces will determine the outcome of whether new tax rules are necessary for the new age: globalisation and technological progress. We will be confronted with vibrant global economy with world trade increasingly dominated by e-commerce and new communication technologies.

According to Chetcuti (2002), the international tax communities have identified e-commerce as a challenge that is being posed to the current permanent establishment principles. Chetcuti (2002) also refers to this evolution of e-commerce as disintermediation. Disintermediation is divided into three phases according to Chetcuti (2002) which have been analysed and can be summarised as follows:

1. Removal of physical intermediaries and consolidation

Chetcuti (2002) states that traditionally, multinational entities would have attempted to enter a foreign market by setting up intermediaries within that foreign market. An example of this is illustrated as a marketing or advertising campaign that takes place via offices operating in that foreign jurisdiction. These physical intermediaries often constituted permanent establishments under tax treaties, which are regarded as a source base of taxation.

2. Removal of human intermediaries

Due to the technological advancement, computers can now perform tasks that were previously only subject to human control and therefore carried out by a dependent agent or employee.

3. Reintermediation and the 'cybermediary'

With the increase of business being carried out through virtual activity, and the ambiguity of transactions taking place via the internet, it becomes difficult to keep track of them.

Some authors, including Horner and Owens (1996: 516), see what they term as a new era from the development of E-commerce. Horner and Owens stressed that the speed, multiplicity, and decentralization of the cross border exchanges/transmissions involved put pressure on traditional concepts of taxation. Hinnekens (1997: 116) referred to this in an almost religious manner: stating that new age taxation does not happen to be new, and it is not just any tax change or tax reform. It very deeply needs and wants to be new because traditional principles and systems of taxation no longer adequately perform their role.

4.4. Re-conceptualisation of a permanent establishment

As a result of e-commerce, and considering the ease with which business operations can be re-located from a high tax jurisdiction to a tax haven, it is important to consider the need to revisit the concept of a permanent establishment. Where a business enterprise is situated in a high tax jurisdiction, and can easily be moved by applying the principles of e-commerce, for example relocating to a server in a low tax jurisdiction, this indicates the increased ability to embark on a scheme of tax avoidance. It has been illustrated in the discussion above that many authors are of

the opinion that the entire concept of a permanent establishment should be revisited. The term that has been allocated to these views is 're-conceptualisation'.

With borders becoming indeterminate and less human intervention being required in order to conduct business operations, perhaps it is time to revisit the current principles and adapt the current application of the concept of a permanent establishment. This re-conceptualisation is interlinked with the concept of a virtual permanent establishment. By reconceptualising the current application of the permanent establishment principles, new rules should be identified and applied to a virtual permanent establishment. This re-conceptualisation is important to ensure that a country that provides the infrastructure for e-commerce to function in that country should be compensated accordingly by having a taxing right over profits earned as a result of the availability of e-commerce in that country. But how have authors suggested that these rules be developed and from what existing concepts, when a physical presence is lacking?

Skaar (1999) identifies the solution to be the re-conceptualisation of the permanent establishment principle and to discard the current principles and develop new ones. To support this process, he suggested that source countries seek to include the principles of e-commerce in their DTAs and tax treaties in order to ensure that the treatment of e-commerce and the creation of a permanent establishment from the actions of e-commerce are correctly dealt with. Skaar (1999) is of the opinion that this would assist in the avoidance of confusion concerning which country has a taxing right over profits from the outset. This suggests that treaties be renegotiated by adding a separate clause indicating the rules that should be established and applied to specific transactions falling within the ambit of a virtual environment.

Hinnekens (2003) identified an approach which suggests a solution to the problems caused by e-commerce and similar concepts. Hinnekens terms this approach the virtual permanent establishment approach, and it is suggested that this method be applied in order to relax the permanent establishment principle by adopting a threshold for source-based taxation that is lower than that of a traditional permanent establishment. This relaxation of the principle is achieved by creating a tax nexus in source countries where there is no fixed place of business. This new nexus will represent a virtual connection to a permanent establishment which will be operating from one specific country. This suggestion by Hinnekens, if implemented, would see the introduction of a whole new concept, as opposed to branching off from the current permanent establishment principles as suggested by Skaar (1999). The question that arises at

this stage is whether the adoption of a current concept versus the introduction of a new concept would only address the complexities currently being experienced, as opposed to finding a long term functional solution which could be adapted in times of uncertainty going forward?

Skaar's position in this regard provides support for Hinnekens' proposed virtual permanent establishment approach, which identifies firstly a fictitious permanent establishment and secondly a source country to tax and then identifying a nexus with the fictitious permanent establishment. This concept of a virtual permanent establishment would be the result of, firstly, fewer requirements to qualify as a permanent establishment. This means a relaxation of the current rules for qualification, such as deleting the requirement for the existence of a fixed place of business in the foreign country in which the source of income is located. Secondly, to ensure that because only core business activities are taxed and not the auxiliary activities, that concrete guidelines are put in place in this case. This possible reconceptualising of source under the virtual permanent establishment approach may be a consideration to be kept in mind.

A further reconceptualising approach identified is that of the base-erosion approach which addresses two particular problems created by the effect of e-commerce on the principles of a permanent establishment. Doernberg (1998: 1013) notes these two concerns as follows:

First, electronic commerce importing countries are concerned that they may lose some of their existing tax base and/or will not be able to share in any new tax base generated by electronic commerce transactions. Second, taxpayers and governments are concerned about the likelihood of double taxation because of inconsistencies in the application of existing tax principles to income generated by electronic commerce.

This may create complications as some countries are not as advanced as others when it comes to technology and therefore, the removal of the need for a fixed base may open a door for investors from technologically advanced countries to erode the tax base of these countries by implementing sophisticated schemes in these countries.

Based on the above suggestions made by Skaar, Hinnekens and Doernberg, it is clear that the permanent establishment principles need to be reconceptualised in light of the changes brought about by globalization and the related developments in electronic commerce. Authors have identified many more methods of reconceptualising the permanent establishment principles and

these approaches all illustrate one thing in common: the need for the income earned in these countries to be correctly allocated to the taxing state. On the need to attribute profits correctly, Skaar (1999: 559 - 573) states the following:

Changes in communications and technology have created new industries where the performance of extensive and profitable business activities does not require substantial machinery or equipment, or establishment at one specific geographical point for a long period of time. The conclusion is that the effects of the permanent establishment concept in international fiscal law have changed, in particular during the last few decades. Rather than protecting the tax base in the source state, the permanent establishment principle today has become instrumental in ensuring avoidance of source state taxation for some economically important business operations ... [and] the future is likely to prove that the permanent establishment principle has lost its force for new and mobile industries, whether tax treaties are renegotiated for this purpose or not.

Owens (2001: 19) hypothesises that:

Two forces will determine the outcome of whether new tax rules are necessary for the new age: globalisation and technological progress. We will be confronted with a vibrant global economy with world trade increasingly dominated by e-commerce and new communication technologies.... Financial activity, services and investment will become increasingly footloose. Physical location will become less important than access to information.

It is impossible to wait for all countries to develop to the extent of equal technological advancement while other countries develop at a rapid rate and as a result erode the tax base of less advanced countries, taking advantage of their lack of information technology. By removing concepts such as a fixed place of business this could lead to the creation of loopholes in the current application of the principle of the concept of a permanent establishment. Although physical presence is becoming less important, it is still necessary in the current environment which is not entirely virtual.

4.5. Conclusion

The OECD Tax Model (OECD: 2014) spells out certain rules that can be applied to e-commerce when determining the existence of a permanent establishment. It has, nevertheless, been shown in this chapter that various authors have the view that these rules can only assist to a certain extent and that these rules do not always provide a clear answer to the question of the creation of a permanent establishment. This chapter illustrates the concerns raised with regard to the elimination of borders and reduction of human intervention that e-commerce presents in the modern age. The increase in the pace of doing business has been fuelled by the ease with which business can be carried out.

When diagnosing the problem, Chetcuti (2012) identified the concept of disintermediation, which states that the principles of borderless economies and the lack of human intervention are having a direct impact on the current guidance given on determining the existence of a permanent establishment. Frieden (2000) talks of the five categories of e-commerce, stating that the entire way of conducting a business is being re-shaped by the effects of globalisation and technological advancement. After considering the arguments and suggestions of these authors, it is submitted that the most significant suggestion is that of the re-conceptualisation of the concept of a permanent establishment. Both Skaar (1999) and Hinnekens (2003) provide their views on the re-conceptualisation and Skaar particularly suggests that re-conceptualisation takes place in relation to the source rules that currently apply when allocating business profits to a permanent establishment. Doerenberg (1998), suggests that the concept needs to be considered further as tax erosion is taking place in certain territories and in other territories double taxation is occurring. Having considered all the suggestions, it would appear that the concept of a virtual permanent establishment should be considered as a potential solution to the problems posed by e-commerce.

Chapter 5 – Base Erosion and Profit Shifting

5.1 Introduction

In 2013, the OECD directed its attention at a concept known as Base Erosion and Profit Shifting (BEPS). The first publication was an action plan. The idea underlying the BEPS action plan is to combat erosion of a tax base by taxpayers shifting profits from certain territories in order to avoid taxation. Anti-avoidance rules have been in place for years, but the BEPS Action Plan introduces a global perspective. The BEPS Action Plan is aimed at combatting modern techniques employed to avoid tax (TP Weekly, 2014: 2).

The BEPS Action Plan (OECD, 2013: 10) states that the current situation is that:

the international co-operation has resulted in shared principles and a network of thousands of bilateral tax treaties that are based on common standards and that therefore generally result in the prevention of double taxation on profits from cross-border activities. Clarity and predictability are fundamental building blocks of economic growth. It is important to retain such clarity and predictability by building on this experience. At the same time, instances where the current rules give rise to results that generate concerns from a policy perspective should be tackled.

The publication of the BEPS Action Plan has been the focus of many tax role-players over the last year. The publication has come to the aid of tax authorities worldwide as it provides a greater basis for revenue collection. The BEPS Action Plan set out the proposed strategy to obtain co-operation of taxpayers globally and to combat the avoidance of tax in the form of profit shifting. The action plan has been implemented in order to facilitate the collection of taxes and reduce tax avoidance.

On the issue of e-commerce, TP Weekly (2014: 2) wrote that:

While the OECD is tackling base erosion and profit shifting (BEPS), with a strong focus on e-commerce, its project will still have an impact on non-OECD countries, whether they choose to implement its recommendations or not because of the OECD's monopoly on best practice.

Tejas Shah (2013: 1) wrote in his comment letter on the artificial strategies used to avoid permanent establishment in source jurisdictions that:

Considering the vital implications on tax liability including risk of potential tax litigations, taxpayers would have been trying to manage/ arrange their affairs in source jurisdiction (outside residence jurisdiction or in the jurisdiction other than which has lower rate of taxation) in such a way that such taxpayer will avoid having permanent establishment in such source jurisdiction.

The digital economy is said to be the driving force behind the development of the BEPS Action Plan and strategy to avoid schemes of profit shifting. It is clear that the BEPS Action Plan is aimed at restricting the use of profit-shifting schemes by setting rules applicable to the digital economy, when doing business on a global level.

5.2 The Content of the BEPS Action Plan

Chapter 1 of the Action Plan introduces the driving forces behind the identification by the OECD of the need for such an Action Plan in order to combat base erosion and profit shifting. According to the OECD (2013) the first of the driving forces is that of globalisation and how the economy has benefited to date from the ease of moving profits to a preferred tax jurisdiction, exploiting intellectual property and how technological developments have aided this process. The OECD (2013) states that the second driving force identified are international tax principles and how the BEPS Action Plan is aimed at applying these principles to avoid double taxation. Thirdly, the BEPS Action Plan (OECD: 2013) was put in place for purpose of multinational enterprise integration. These concerns are the driving force behind the decreased tax burden of multinational enterprises. The BEPS Action Plan (OECD: 2013) goes on to describe the results of such decreased tax burdens by stating that governments, and incidentally the economies, suffer from this erosion of the tax base. Individual taxpayers as well as businesses are harmed as an effect of this multi-national integration resulting from globalisation as shifting profits can directly influence the tax rate of a country either negatively or positively.

The BEPS Action Plan (OECD: 2013) identifies certain principles before it stipulates the action points. Although there are eight principles identified in the Action Plan, this thesis focuses on the principle relevant for the purposes of this research, being the development of the digital economy that poses a challenge for international taxation.

Before setting out the action of the BEPS Action Plan, the OECD illustrates the fundamental requirement for these actions to be implemented. These fundamental requirements are centred on the development of new standard of tax laws in order to ensure that all loop holes are closed. These are said to be the loop holes in the current laws that have allowed taxpayers to take advantage of the system (OECD, 2013: 13). The first action point (Action 1) centres on the digital economy. More specifically, the challenges of the digital economy

The OECD BEPS Action Plan (2013: 14) states the following on the challenge posed by the digital economy:

The digital economy is characterised by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes. At the same time, the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation is not per se an indicator of defects in the existing system. It is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent base erosion and profit shifting.

This specifically points out that there is a significant challenge posed by the digital economy. The attempts to combat the erosion of a tax base through the digital economy have been carried out with the purpose of utilising existing legislation. The concerns expressed specifically refer to the need to examine a company's presence in a jurisdiction other than its tax paying jurisdiction and the need to draw a nexus or connection between the place where income is earned and the country in which this income is taxed.

The OECD (2013: 15) identifies certain strategies in order to implement the action plan. These include the following (although the OECD specifically states that the list is not exhaustive):

- The ability of a company to have a significant digital presence in the economy of another country, without being liable for taxation due to the lack of nexus under current international tax principles;
- The attribution of value created from generation of marketable location-relevant data through the use of digital products and services;
- The characteristics of income derived from new business models; and
- The application of related source rules and how to ensure the effective collection of VAT/GST with respect to cross border supply of digital goods and services.

The OECD sets out the relevant steps of the Action Plan on how it intends to combat BEPS. The main aim of the first action (action point 1) of the Action Plan (OECD, 2013: 15) is to establish international coherence of corporate income tax. This illustrates the modern view that tax systems cannot be looked at in isolation and that globalisation has in fact blurred the borders of countries and their differing taxation rules. Although this thesis will not discuss the other action plans in detail, it is worth referring to Action number 7 which relates to the prevention of the artificial avoidance of permanent establishment status. According to the OECD (2013), what this Action is aimed at is to develop legislation as to no longer allow taxpayers to avoid the payment of tax through an artificial permanent establishment. For example, a company could create a presence by meeting the requirements to be considered a permanent establishment in a certain territory that has a low tax jurisdiction in order to be liable for tax at a much lower rate than what should be levied in the jurisdiction in which it is situated. The OECD (2013: 19) sets out the purpose of this action as follows:

Develop changes to the definition of permanent establishment to prevent the artificial avoidance of permanent establishment status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions.

This illustrates that the permanent establishment definition will be reconsidered in order to be in line with the principles of BEPS. The OECD BEPS Action Plan (OECD, 2013: 19) continues to state that:

Work on these issues will also address related profit attribution issues. A major issue is transfer pricing and the enforcement of the arm's length principle.

Although this thesis does not involve an extensive study of the concept of transfer pricing, it is important to set out some principles of transfer pricing. as this is indicative of profit allocation and therefore applicable to the rules pertaining to permanent establishments.

Domestic legislation does not always refer to transfer pricing rules. However, both the OECD Tax Model and the UN Tax Model provide guidelines for countries when allocating profits offshore. South Africa, for example, sets out in section 31 of the Income Tax Act that cross border transactions between connected parties need to be at arm's length. The legislation indicates that goods and services need to be transferred between connected parties under the terms and conditions of an agreement that would ordinarily be reflected in an agreement between unrelated parties.

A connected person is defined in the South African tax legislation under section 1 of the Income Tax Act. This definition is extended into section 31 of the Income Tax Act. The extensive definition includes connected persons in the form of natural persons, companies and trusts. With regard to companies, the definition includes all companies within the same group that are connected through a fifty percent or more shareholding. The definition also includes a shareholder in relation to a company from as little as a twenty percent shareholding where no other shareholder holds more than this percentage. This definition in the Income Tax Act therefore extends beyond a parent company and subsidiary but may also connect fellow subsidiaries and their shareholders, making the requirements for a group of companies significantly easy to be met.

Transfer pricing extends to the goods and services being transferred across borders to connected persons.

Services are comprehensively defined in section 31 of the Income Act as

anything done or to be done, including:

- the granting, assignment, cession or surrender of a right, benefit or privilege;
- the making available of any facility or advantage;
- the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee;
- the performance of any work;

- an agreement of insurance; or
- the conferring of rights to or to the use of incorporeal property.

It follows that companies no longer need an international agreement as formerly defined, but rather, a supply of services or goods between connected parties, one resident and the other not, to fall within the ambit of section 31 of the Income Tax Act.

The legislation sets out that the terms and conditions under which these goods and services are being transferred between connected persons should reflect the terms and conditions that are set out in an agreement between non-connected parties (section 31 of the Income tax Act). For example, Company X located in South Africa manufactures pharmaceutical products and then transports these products to a connected party in China for packaging who then on-sells the products into the market in India. The pricing of the products needs to be market related (i.e. what a third party would charge a non-connected party). However, transfer pricing looks at the value chain and each stage of the value chain as a step in a transaction. Each step should be monitored and reflect the same terms of an agreement as if being transferred to a non-connected party.

Transfer pricing analyses each stage of this value chain and determines what value is added at each step of the transaction. This essentially ensures that no value is stripped from a particular country when the goods or services are passed through that country in the value chain from manufacture of raw materials to sale of final product. Transfer pricing therefore ensures that no profits are shifted to another country. In essence, this means that the transfer pricing values could to be imputed into all facets of virtual permanent establishments in order to ensure that the virtual world is not stripping or shifting profits from a country that is or is not entitled to these profits. In the example used in the paragraph above, transfer pricing in the virtual world would mean that the goods do not actually pass into the Chinese border but value is added from a virtual environment. This would result in profits that would have rightfully been earned by China in the value chain being excluded from the attribution of these profits. A significantly higher profit can be earned from the bigger trough of profits for the countries remaining in the value chain, i.e. South Africa and India. By implementing transfer pricing rules in all territories, this could enforce the necessity to look at each stage of a transaction as if it were a third party transaction and thereby assist by ensuring that no stage of the transaction goes undetected in terms of attributing value to these stages of the transaction.

As set out above, BEPS is closely considering, as part of Action Point 7, that the allocation of profits be considered in more detail. Action Point 7 sets out that:

In many instances, the existing transfer pricing rules, based on the arm's length principle, effectively and efficiently allocate the income of multinationals among taxing jurisdictions. In other instances, however, multinationals have been able to use and/or misapply those rules to separate income from the economic activities that produce that income and to shift it into low-tax environments. This most often results from transfers of intangibles and other mobile assets for less than full value.

In an article written by PriceWaterhouseCoopers (PWC), on the issues faced by the digital economy, it is stated that the action plan, with specific reference to Action Point 1, is aimed at solving the issues created by the digital economy. The article (2014: 1) states that:

The report focuses on the fragmentation of international business models, aided by developments in technology, as being the key tax area to address, identifying the specific remedies to be considered by the other BEPS workstreams – specifically, ... ; artificial avoidance of permanent establishment (PE); and transfer pricing measures.

The article (2014: 2), however, challenges the methods being considered to be employed in order to solve the trials posed on taxing the profits earned in accordance with the aid of the digital economy. One of these methods being considered is the taxation of the data. However, the article criticizes this as there is a difference in views as to whether data has value or not. The article states further that considering the taxation of data as it is transferred from one jurisdiction to another could result in a whole new set of rules being implemented when it comes to taxation. It is suggested that (2014: 2)

What lies behind it seems to be an attempt to find a way to tax the monetisation of business activities where that monetisation comes from someone other than the apparent consumer.

Could the way to solve this be the implementation of transfer pricing rules? Perhaps the cloud in cloud computing becomes a step in the value chain when allocating profits? But how would one allocate these profits to a jurisdiction? Would the allocation of profits under the transfer pricing

rules be limited to the extent that profits are allocated to an actual jurisdiction (including a permanent establishment)?

The PWC Article concludes on the issue as follows (2014: 3)

Overall, a sensible approach, expressed most clearly by the business and industry advisory committee (BIAC), suggests waiting to see what the other working parties recommend and whether there are any residual issues which need to be dealt with. At that point it would be sensible to debate other tax approaches.

In December 2013, following the publication of the BEPS Action Plan, the OECD requested comments on an approach to addressing the tax challenges of the digital economy. Included in this, the OECD requested that taxpayers set out any models that have been impacted by the digital economy that were not previously affected in the non-digital economy.

5.3 Conclusion

The OECD's BEPS report has sparked new questions on the concept of a permanent establishment and, more specifically, the allocation of profits to a permanent establishment when it comes to a multi-national enterprise that is conducting business through e-commerce. The adaptation to e-commerce and the need to consider the digital economy has therefore become a discussion point for legislative purposes by being introduced by the OECD as an action point in the BEPS report. Since the introduction of the OECD's BEPS report, parties have shown a new interest in the current environment and the challenges posed by the digital economy. The solution has, however, not yet been determined. Nevertheless, the BEPS action plan poses potential ideas towards finding a solution to the effect of globalisation on e-commerce. More importantly, the Action Plan is encouraging both revenue authorities and taxpayers alike to work towards finding a solution to the tax avoidance that is currently taking place across blurred borders. The intention of the BEPS action plan is therefore to work towards finding a solution to the erosion of a tax base of a country or profits derived from that jurisdiction. The OECD is therefore indicating that the profit shifting has become their focus in order to stabilise the effect of a growing digital economy.

The Action Plan suggests the application of transfer pricing rules in order to ensure that profits are clearly attributed and attributed fairly in accordance to the contribution to the value chain.

Not all countries have transfer pricing rules, however, and the application of these principles to all transactions would ensure that all points in the value chain are rewarded and that this reward is directly attributable to the value added in each step of a transaction. The BEPS Action Plan may be suggesting that transfer pricing is the answer in ensuring that base erosion and profit shifting is controlled by revenue authorities.

Chapter 6 - Conclusion

The main goal of this research was to consider the possibility of aligning the concept of a permanent establishment with e-commerce. Both the concepts of permanent establishment and e-commerce have been considered in detail in chapter 2 and 3 respectively. It is important to discuss these concepts in relation to each other. This is important as, together with the rapid increase in the phenomenon of globalisation, the ease of carrying on a business from anywhere in the world has created an urgent need to review current permanent establishment provisions in both domestic legislation and Double Tax Agreements. Tax authorities need to ensure that taxing rights over profits (even if attributable to a virtual or non-tangible environment) should be rightfully allocated to the appropriate country. The reason for this is that, as discussed in chapter 3, the digital revolution has increased the ability to carry on a business from anywhere in the world and has led to the ability of an entity to strategically place an enterprise's foreign operations in a low tax jurisdiction.

Chapter 1 has provided an overview of how a taxing right is determined, i.e. income should be attributed to the country where the source of the income is located. The source of income may, however, be at the location of a permanent establishment of an entity. Based on the UN Tax Model, the OECD Tax Model as well as DTAs, the concept of a permanent establishment can be applied and taxing rights accordingly exercised. This chapter however introduced the concept of e-commerce and illustrated how this concept has blurred tangible boundaries, when it comes to allocating profits.

Chapter 2 provided a detailed breakdown of what is included in and specifically excluded from what constitutes a permanent establishment. It can be concluded, therefore, that the permanent establishment concept will exist in two specific situations. The first situation where an entity has a fixed place of business in a country. The existence of a fixed place of business will result in the income that is earned from these operations being attributed to the country in which the source of this fixed base is located. When aligning this concept of fixed base with the concept of e-commerce as has been discussed in chapter 3, this paper has concluded that the OECD provides the necessary guidance, both in the OECD Tax Model and the BEPS Action Plan. These documents note that a website will not constitute a permanent establishment. On the other hand, chapter 3 also confirms that a server and an Internet Service Provider will not create a permanent establishment. Should there be a degree of human intervention, however, this could

result in the creation of a permanent establishment. This human intervention alludes to the second requirement for the existence of a permanent establishment as set out in chapter 2.

A further requirement for the creation of a permanent establishment is a dependant agent. It has been discussed how an agent will be considered to be dependent on the entity. These actions of dependence on the entity will result in the income being earned being taxable in that country through the existence of a permanent establishment. Unless specifically excluded from the permanent establishment concept, actions being performed towards the core activity (and not auxiliary or preparatory) of the business will result in a taxing right being created in that country.

Following the initial consideration of a fixed base and dependent agents, three tests can be applied. As discussed, a physical presence that creates a geographical nexus is the core requirement that is said to lead to the creation of a permanent establishment, should a business be carried out from that physical place. The requirement of time, i.e. the duration of that presence, is also a contributing factor to the creation of a permanent establishment. Dependent agents carrying out the core business of an enterprise on behalf of that enterprise in a foreign jurisdiction, is also a determining factor. E-commerce creates a situation that calls into question these three determining factors.

When considering the three tests, together with the concept of e-commerce, firstly, the physical presence is no longer required to carry out business operations by means of e-commerce. Secondly, the duration requirement can easily be avoided by moving virtual operations from one server or Internet Service Provider with ease to another jurisdiction on a frequent basis to avoid the duration required under the current rules to create a permanent establishment. Thirdly, the necessity for human intervention is limited by e-commerce. Rules developed for a traditional economy may therefore be seen to be inappropriate for a virtual economy.

Multi-national organisations doing business by means of e-commerce is a contributing factor to increasing tax avoidance. E-commerce introduced the ability to carry out operations with limited human intervention and coupled with the ease of doing business in any economy that is not hindered by a border, distorts the determination of the taxing right by a jurisdiction.

Chapter 4 considers the ongoing question as to e-business and how technology, combined with new business models, would frustrate tax authorities all over the world in obtaining their fair

share of tax. The main justification for the continuous questioning is because e-business is by its nature not confined to physical boundaries. The US government issued a discussion thesis in which the Department of the Treasury (1997: 148) stressed that:

a major substantive issue raised by these new technologies is identifying the country or countries that have the jurisdiction to tax such income. It was considered necessary to clarify how existing concepts such as residence and source apply to persons engaged in e-business transactions. In addition, the US government held that the classification of income arising from transactions in digitalized information had to be clarified: is such income a royalty, a service fee or a profit from a sale of goods?

Together with Owens, many others recognised a new era in which there would be less room for traditional business models, outdated tax rules and principles. Horner and Owens (in Owens, 1996: 516) make the point that

the speed, multiplicity, and decentralization of the cross border exchanges/transmissions involved put pressure on traditional concepts of taxation.

The constant evolution of the concept of a permanent establishment has led to adaptable principles which provide for each case to be judged on its own facts. The principles therefore provide a guideline rather than a set of rules. This flexibility is illustrated in this thesis, which sets out the rules applicable in a limited number of countries in relation to their domestic legislation as well as the current double tax treaties in place. Certain clauses have been added and removed in order to be most optimally suited to the particular contracting state's requirements. As set out in chapter 4, a number of authors have questioned these principles and concluded that the concept of a permanent establishment requires re-conceptualisation in order to provide for e-permanent establishments in a virtual environment.

Finally, in chapter 5, it has been shown that various authors have contended that the continuous search for the formula that will provide the solution as to what needs to be amended, changed, re-visited and reconceptualised with regard to a permanent establishment in an e-commerce world leads to yet more questions. The OECD BEPS Action Plan is explored in Chapter 5. This action plan is the latest indication of the need to further consider the digital economy. It is possible that the solution is not itself attainable due to the rapid changes taking place on a

continuous basis. Once a solution is found, further developments may create the need for further amendments, like chasing a moving object.

The OECD's recent BEPS Action Plan and various articles that have commented on the Action Plan indicates problem that is under ongoing consideration. Transfer pricing rules may be the answer to ensuring that profits are allocated to an actual source and that virtual environments will need to be traced back to their source in order to be taxed accordingly. The OECD has made it clear that it has a strategy to implement the BEPS Action Plan in order to ensure that profits are allocated and taxed accordingly to put an end to any avoidance schemes that make use of artificial permanent establishments.

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