The Challenges of Taxing Profits Attributed to Permanent Establishments: A South African Perspective

ANET WANYANA OGUTTU*
University of South Africa

1 Introduction

When countries enter into a tax treaty, the treaty lays down the rules for the taxation of income by the two countries. Tax treaties are usually signed on the basis of a particular model and they generally follow the provisions of the prescriptive articles in the latter.1 It is a principle of international tax treaties that the profits of an enterprise of a contracting state are taxable only in that state, unless the enterprise carries on business in the other contracting through a permanent establishment (‘a PE’) situated therein. Even if a PE exists, only the profits attributable to the PE are taxable.2 Thus, the significance of a PE is that it gives the country in which it is situated (the source country) the right to tax its income, even though the PE has no separate legal existence.3

The approach recommended by the Organisation for Economic Co-operation and Development (OECD)4 for attributing profits to PEs requires that a PE be treated as a separate legal entity and that transfer

---

1 In principle, there are three models for drafting double taxation agreements, which have been developed over time. Firstly, there is the Model Tax Convention on Income and Capital, published by the Organisation for Economic Co-operation and Development (‘OECD’). This model was prepared by developed countries of the world and embodies rules and proposals by capital-exporting countries. Then there is the United Nations Model Double Taxation Convention. This Model has been drafted between developed and developing countries and it attempts to reflect the interests of developing countries. Lastly, there is the United States Model, which is followed by most treaties that the USA has signed with other countries, including South Africa. See Lynette Olivier & Michael Honiball International Tax: A South African Perspective 4 ed (2008) at 7; Radhakishan Rawal The Taxation of Permanent Establishments: An International Perspective 2 ed (2006) at 1.

2 Article 7(1) of the OECD Model Tax Convention on Income and on Capital: Condensed Version (July 2008).

3 As clarified further on in the article, a PE is an unincorporated business (for instance, a branch). It is not a separate legal entity; therefore, its property and activities are considered to be for its foreign parent company, which is liable for tax on the income of the PE. By contrast with a PE, a subsidiary company is a separate legal entity distinct from its parent company. Thus a subsidiary is taxable in the country where it is incorporated. See Arvid A Skaaa Permanent Establishment: Erosion of a Tax Treaty Principle (1991) at 1.

pricing rules applied to separate legal entities be applied to the PE. Of course, this gives rise to conflicts in the application of the domestic tax laws of some countries. This article sets out the workings of the OECD profit attribution rules, the criticisms of these rules and the challenges of applying these rules from a South African perspective. The article also sets out the views of some commentators on how these challenges can be resolved, and finally offers a recommendation for resolving the problem from a South African perspective.

2 The Definition of the PE Concept, Its Role in International Tax Law and How PEs are Taxed

Before discussing the issues pointed out above, it is important that the relevance of the OECD in this respect should briefly be explained. The OECD is an international organisation established in 1961 to contribute to economic development and growth in its member countries. Through its publication on topics such as taxation, it encourages dialogue and consensus that can encourage economic development and change in the market economy. Though its primary focus is on member countries, its additional goals of contributing to the expansion of world trade and the development of the world economy affect non-members as well. The OECD Model Tax Convention and its Commentary on the articles in the Model Convention are not legally binding. However, when countries sign a tax treaty that is based on the OECD Model Convention, the terms of that treaty are legally binding on those countries. In interpreting the terms of tax treaties (which are internationally classified as international agreements), customary international law interpretation rules have to be applied. These include the Vienna Convention on the Law of Tax Treaties, a codification of customary international law that is applied internationally to interpret treaties. Its art 32 provides that supplementary means of interpretation (which include the Commentary on the OECD Model Convention) can be taken into account in interpreting the terms of the treaty.

The PE concept is defined in art 5(1) of the OECD Model Tax Convention as ‘a fixed place of business through which the business of an enterprise is wholly or partly carried on’. In terms of this definition, the place of business has to be fixed in a geographical sense and permanent in duration. Article 5(2) sets out as the examples of PEs a place of management, a branch, an office, a

---

5 Explained below.
6 OECD ‘History of the OECD’ op cit note 4.
7 Klaus Vogel Klaus Vogel on Double Taxation Conventions: a Commentary to the OECD-, UN-, and US Model Conventions for the Avoidance of Double Taxation on Income and Capital, with Particular Reference to German Treaty Practice 3 ed (1997) in the Introduction in par 28. In South Africa, s 233 of the Constitution of South Africa, 1996, states that ‘when interpreting legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law’.
8 23 May 1969.
9 Olivier & Honiball op cit note 1 at 33.
10 Paragraph 2 of the Commentary to art 5 of the OECD Model Convention.
factory, a workshop, a mine, an oil or gas well, a quarry or any place of extraction of natural resources. Apart from a fixed place PE, a taxpayer is deemed to have a PE in a country if it has a ‘dependent agent’ in the country that habitually exercises authority to conclude contacts on behalf of the taxpayer. Both the ‘fixed place of business’ PE and the ‘dependent agent’ PE are modified by the exceptions in art 5(4) for preparatory and auxiliary activities. If a fixed place of business is used solely for such activities or if a dependent agent’s activities are limited to concluding contacts regarding such matters, then a PE is deemed not to exist, the rationale being that such preparatory and auxiliary activities ‘are so remote from the actual realisation of profits that it is difficult to allocate any profits’ to the PE in question.

The PE concept developed in the nineteenth century under German domestic law to prevent double taxation by Prussian municipalities. In 1927, the League of Nations adopted the PE concept in its first draft convention on double taxation, which included examples of PEs such as branches, factories and agencies and offices. These rules were included in the League of Nations’ first Model Tax Convention in 1943. The PE rules as promulgated by the League of Nations were embodied in the first report of the OECD, which was issued in 1958 and subsequently included in the OECD Draft Taxation Convention on Income and Capital that was succeeded by the 1977 Model Tax Convention. This has been maintained in the successive OECD Model Tax Conventions.

Article 7(1) of the OECD Model Tax Convention, which lays down the basic rule for taxation of PEs, states:

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

Thus, in the absence of a PE, the business profits derived in the source country by a non-resident are exempt from tax there and are taxable only in the country of residence. Once a PE is established in the source country, that country not only acquires the right to tax the business profits attributable to

\[\text{CHALLENGES OF TAXING PROFITS TO PERMANENT ESTABLISHMENTS} \ 775\]

---

11 Article 5(5) of the OECD Model Tax Convention. A ‘dependent agent’ is generally one that is subject to the principal’s detailed instruction and comprehensive control, and normally bears little or no business risk from its own activities. This is contrasted with an ‘independent agent’ that is legally and economically autonomous of its principal. Independent agents generally have non-exclusive relationships with more than one principal. Independent agents are not considered permanent establishments and, absent other factors, do not subject their principal’s business profits to taxation in the host country. Although subsidiary companies are separate legal entities, some countries (eg, the USA) have taken the approach of finding that a PE exists where a subsidiary is in fact a dependent agent PE. See Martin B Tittle ‘Permanent Establishment in the United States: A View Through Article V of the US – Canada Tax Treaty (2007) at 53. See also Jean Pierre Le Gall ‘Can a Subsidiary Be a Permanent Establishment of its Foreign Parent?’ (2007) 60 Tax LR 179; Annet Wanyana Oguttu & Sebo Tladi ‘E-commerce: A Critique on the Determination of a “Permanent Establishment” for Income Tax Purposes from a South African Perspective’ 2009 Stellenbosch LR 74 at 76.


13 See generally Skaar op cit note 3 at 72-96; Oguttu & Tladi op cit note 11 at 76.
the PE but also its right to tax takes precedence over the residence country’s right to tax those profits. The residence country becomes obliged either to exempt the business profits attributable to the PE in the source country or to provide a credit for the source country tax.\textsuperscript{14}

So the PE concept plays two important roles in international tax law. First, the concept is used as a threshold that must be satisfied in order for a country to tax a non-resident on business profits derived from sources in that country. Secondly, the concept also plays a role in allocating tax revenues from cross-border business transactions between the country in which the income is derived and the country in which the owners of the business are residents.\textsuperscript{15}

These two roles are clearly set out in the following extract from par 1 of the Commentary on art 7:

\begin{quote}
'When an enterprise of a Contracting State carries on business in the other Contracting State, the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise; the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should be taxed.'
\end{quote}

Here I will concentrate on the rules used in determining the answer to the second question, which in practice is usually more important than the first one but receives less attention in the literature. Since the entire profits of enterprise cannot be in the source country but only the profits attributable to the PE, this requires a determination of the amount that should be taxed as arising from the activities of the PE.

3 The Approach Recommended by the OECD for Attributing Profits to PEs

There are basically two methods that are advocated internationally for attributing profits to PEs: the ‘direct method’ and the ‘indirect method’.\textsuperscript{16} Under the ‘direct method’ (‘separate accounting method’), the attributable profits of the PE are those which it ‘might be expected to make’ if it were a distinct and separate enterprise for tax purposes. This legal fiction of the PE as a separate enterprise usually requires various notional adjustments to arrive at an independently determined arm’s length profit.\textsuperscript{17} It is argued, though, that the strict use of the arm’s length approach could lead to deductions that have not occurred and also to income that has not been earned by the enterprise as a whole.\textsuperscript{18}

Under the ‘indirect method’, the total profits of the enterprise are allocated to the PE under some apportionment formula. Although the use of the

\textsuperscript{14} Articles 23A and 23B of the OECD Model Tax Convention.
\textsuperscript{15} Arnold op cit note 12 at 14-20; Oguttu & Tladi op cit note 11 at 74.
\textsuperscript{16} Roy Rohatgi Basic International Taxation (2002) at 530.
\textsuperscript{17} Ibid; Gerhard Krali ‘Profit and Loss Attribution Between Head Office and Permanent Establishment in Different Jurisdictions: The German Tax Administration’s Point of View Critically Analysed’ (2001) 41 European Taxation 82 at 84.
\textsuperscript{18} Rohatgi op cit note 16 at 530. The ‘arm’s length’ approach is discussed in more detail further on in this article.
formulary apportionment approach is simpler to apply, it may not reflect the true allocation of the profits under the arm’s length standard. Tax authorities would need to access the tax information relating to whole enterprises to determine the taxable profits.19

The OECD applies the ‘direct’ or ‘separate entity’ approach.20 The question of what criteria should be used in attributing profits to PE, and of how to allocate profits from transactions between associated enterprises, has had to be dealt with in different OECD Model Tax Conventions even dating back to the work of the League of Nations in the 1920s and its successor, the Organisation for European Economic Cooperation (‘OEEC’), later reorganised and renamed as the OECD.21 The solutions adopted have generally conformed to a standard pattern.22 However, over the years, the OECD noted that there has been considerable variation in the domestic laws of OECD member countries regarding the taxation of PEs and that there was no consensus among these countries about the interpretation of art 7 which could lead to double taxation of income.23 Over the years the OECD Committee on Fiscal Affairs has therefore spent time and effort trying to ensure a more consistent interpretation and application of the profit attribution rules in art 7.24 For instance, a report that addressed this question in respect to banks was published in 1984 entitled ‘The Taxation of Multinational Banking Enterprises’, in ‘Transfer Pricing and Multinational Enterprises: Three Taxation Issues’. With further uncertainty in the determination of profits attributable to PEs in 1993, the OECD issued a report on the ‘Attribution of Income to Permanent Establishments’.25 Then, in 1994, the OECD released its Report on the Transfer Pricing Guidelines, which was adopted in 1995.26 This report indicated that further work would address the application of the transfer pricing guidelines to PEs. In 2001, a Working Hypothesis was developed as to the preferred approach for attributing profits to a PE under art 7.27 This approach built upon earlier developments on the OECD Commentary on art 7 as reflected in previous versions of the OECD Model Tax Convention and the Transfer Pricing Guidelines.28 Then the OECD issued a discussion draft with the aim of...

---

19 Kraft op cit note 17 at 83; Rohatgi op cit note 16 at 530. ‘Formulary apportionment’ is discussed in more detail further on in this article.

20 Article 7(2) of the OECD Model Convention, discussed below.


22 Paragraph 2 of the Commentary on art 7.

23 Paragraph 5 of the Commentary on art 7; see also Skaar op cit note 3 at 3.


27 Ibid.
creating some consensus amongst its member states on these issues.\textsuperscript{29} This culminated in a report issued in 2006 on the attribution of profits to permanent establishments,\textsuperscript{30} The final report in this respect was issued in 2008, and led to a revised art 7 of the OECD Model Convention in the 2008 version.\textsuperscript{31} It is important to note that the above-mentioned Report is divided into four parts. Part I deals with the attribution of profits to PEs in general; Part II deals with PEs of business operating in the financial sector (banks); Part III deals with PEs of enterprises carrying on global trading; and then Part IV deals with PEs of enterprises carrying on insurance activities.\textsuperscript{32} This article deals with Part I, which relates to PEs in general.

Article 7(2) of the OECD Model Convention sets out the central OECD directive on which the allocation of profits to a PE is to be based. This article reads as follows:

‘Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other contracting State through a permanent establishment situated therein, there shall in each contacting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.’

In effect the profits to be attributed to a PE are those which that PE would have earned if instead of dealing with its head office, it had dealings with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market.\textsuperscript{33} In other words, the PE is treated as if it were an affiliate company, and the income taxable in the source country is determined by estimating, through a series of assumptions, the amount of income that the PE would have earned if indeed it were an independent corporation.\textsuperscript{34}

The OECD recommends that ‘transfer pricing’\textsuperscript{35} rules applicable to transfers between related persons be used to attribute income to a PE. This requires that the ‘arm’s length’ principle be applied in determining the profits attributable to the PE. The ‘arm’s length’ principle, as set out in art 9(1) of OECD Model Tax Convention, provides that when conditions are made between two associated enterprises in their commercial or financial relations...
which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. It is important to note that although art 7 does not specifically use the term ‘arm’s length’, the language of art 7(2) incorporates the arm’s length standard for the purposes of determining the profits attributed to the PE. Paragraph 14 of the OECD Commentary on art 7 refers to the arm’s length principle in art 9. It should be noted that traditionally, the arm’s length standard is used to prevent transfer pricing where related parties supply good or services to each other at a non-arm’s length price. This is often the case with subsidiaries in a multinational group of companies trading in various jurisdictions.

The OECD approach also requires that in determining an arm’s length price, the Transfer Pricing Guidelines must be applied by analogy to the PE. These Guidelines set out the methods that the OECD recommends for countries to use in order to arrive at an arm’s length price. These methods fall under two categories: the ‘traditional transactional’ methods and the ‘profit based’ methods. Under the ‘traditional transactional’ methods fall methods such as the ‘comparable uncontrolled price’ method (‘CUP’), the ‘resale price’ method (‘RP’), and the ‘cost plus’ method (‘CP’). Under the ‘profit

---

36 A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related or connected person. It is usually contrasted with a market price, which is the price set in the marketplace for transfers of goods and services between unrelated persons where each party strives to get the utmost possible benefit from the transaction. Transfer prices are usually not negotiated in a free, open market and so they may deviate from prices agreed upon by non-related trading partners in comparable transactions under the same circumstances. See John P Warner ‘Taxing Interbranch Dealings: Application of Separate Taxpayer Arm’s Length Principles to Inbound Interbranch Distribution Dealings’ (2002) 31 Tax Management International Journal 155; Arnold & McIntyre op cit note 34 at 55; Hay, Horner & Owens op cit note 35 at 424; Marius van Blerck ‘Transfer Pricing and Thin Capitalization: The Basics’ (1995) 8 SA Tax Review 44.


38 Paragraph 18 of the Commentary on art 7(2).


40 OECD Transfer Pricing Guidelines op cit note 26 in par 87 at 336.

41 The ‘comparable uncontrolled price’ (‘CUP’) method is the primary pricing method. This method requires a direct comparison to be drawn between the price charged for a specific product in a controlled transaction and the price charged for a closely comparable product in an uncontrolled transaction in comparable circumstances. The CUP method is the method most preferred because it is the most direct and reliable way to apply the arm’s length principle. See the OECD Transfer Pricing Guidelines op cit note 26 in par 92 at 337. See also Guillermo Campos ‘Transfer Pricing of Major Trading Nations’ (1996) Bulletin for International Fiscal Documentation 212 at 217.

42 Where there are no comparable sales, the ‘resale price’ method is used. This method is based on the price at which a product that has been purchased from a connected enterprise is resold to an independent enterprise. The resale price is then reduced by an appropriate gross margin, to cover the reseller’s operating costs, so as to provide an appropriate profit having taken into consideration the functions performed, assets used and risks assumed by the reseller. The balance is then regarded as the arm’s length price. See the OECD Transfer Pricing Guidelines op cit note 26 in par 85 at 338; Campos op cit note 41 at 217; Hay, Horner & Owens op cit note 35 in par 66 at 432.

43 The ‘cost plus’ method requires an estimation of an arm’s length consideration by adding an appropriate mark-up to the costs incurred by the supplier of goods or services in a controlled transaction. This mark-up should provide for an appropriate profit to the supplier, in the light of the
based’ methods fall and the ‘transactional net margin’ method (‘TNMM’)
and the ‘profit split’ method.45 Generally, all these methods are based on
measuring a multinational’s pricing strategies against a benchmark of the
pricing strategies of independent entities in uncontrolled transactions.46

In determining the profits attributable to a PE, a two-step analysis is
required. First, a functional and factual analysis must be conducted in
accordance with the Transfer Pricing Guidelines, in order to identify the
economically significant activities and responsibilities undertaken by the PE.
This would require a hypothesis of the PE and the remainder of the enterprise
as if they were associated enterprises, each undertaking functions, owning
and/or using assets, assuming risks, and entering into ‘dealings’ with each
other and transactions with other related and unrelated enterprises.47 Under
the second step, the remuneration of any ‘dealings’ between the hypothesised
enterprise is determined by applying by analogy the art 9 transfer pricing tools
(as articulated in the Guidelines for separate enterprises) by reference to the
functions performed, assets used and risks assumed by the hypothesised
enterprise.48

It is worth noting, however, that in attributing profits to a PE, the
application of the arm’s length principle is qualified in certain respects. For
instance, par 16 of the Commentary on art 7(2) provides that the trading
accounts of the PE can be used by the taxation authorities concerned to
ascertain the profit properly attributable to the PE. Further, such accounts
should form the starting point for any processes of adjustment required to
produce the amount of attributable profits.49 As to what extent accounting
records should be relied upon when they are based on agreements between the
head office and its PE, the OECD is of the view that generally such internal
agreements cannot qualify as legally binding contracts, but this rule is
qualified. Paragraph 19 of the Commentary on art 7(2) notes that

to the extent that the trading accounts of the foreign head office and the permanent
establishments are both prepared symmetrically on the basis of such agreements and that those

---

44 The ‘transactional net margin method’ (‘TNMM’) examines the net profit margin that a taxpayer
realises from a controlled transaction, relative to an appropriate base of, eg, costs, sales or assets. The
profit level indicator of the tested party is compared to the profit level indicators of comparable
independent parties. See Campos op cit note 41 at 218.

45 Under the ‘profit split’ method, first the combined profit is identified and split between the connected
parties in a controlled transaction. The profit is split by economically approximating the division of profits
that would have been anticipated and reflected in an agreement made at arm’s length. See the OECD
Transfer Pricing Guidelines op cit note 26 in par 131 at 346; Campos op cit note 41 at 217; Hay, Horner &
Owens op cit note 35 in par 82 at 435.

46 SARS Practice Note No 7 op cit note 35 in pars 9.2.1–9.2.3.

47 Paragraph 18 of the Commentary on art 7(2); see also OECD 2006 Report on PEs op cit note 30 in
par 13.

48 Paragraph 18 of the Commentary on art 7(2).

49 For more on the working of this paragraph, see Rawal op cit note 1 at 72.
agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities.\textsuperscript{50}

The condition, however, is that the values of transactions or the methods of attributing profits or expenses in the books of the PE correspond exactly to those of the head office in terms of the national currency or functional currency in which the enterprise recorded its transactions.\textsuperscript{51}

Paragraph 21 of the Commentary on art 7(2) acknowledges that 'there may be a realisation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within a State’s territory is transferred to a permanent establishment or the head office of the same enterprise in another state'. This article allows the former state to tax profits deemed to arise in connection with such a transfer.

Paragraph 24 of the Commentary on art 7(2) emphasises the general principle that income is attributable to a PE only when it results from activities carried on by the enterprise through the permanent establishment. Thus, where goods or services are supplied by other parts of the enterprise operating outside the state where the PE is located, the profits arising from that supply do not result from the activities carried on through the PE and are not attributable to it.\textsuperscript{52}

Article 7(3) of the OECD Model Tax Convention provides that expenses incurred for the purpose of the PE should be allowed as a deduction. The article reads: 'In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere'.

Paragraph 27 of the Commentary on this article explains that in calculating the profits of a PE, allowance has to be made for expenses wherever incurred, that were incurred for the purposes of the PE. In effect, this provision is intended to ensure that the expenses of the PE are not disallowed because the expense is incurred outside the PE’s jurisdiction, or that the expenses are not incurred exclusively for the PE.\textsuperscript{53} The Commentary provides further that in some cases, 'it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account'. For example, in the case of administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment’s turnover (or gross profits) bears to that of enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into

\textsuperscript{50} Accounts are considered to be prepared symmetrically if the methods of attributing profits or expenses in the PE’s books correspond exactly to the methods of attribution in the books of the head office. See Russo 2004 op cit note 21 at 481.

\textsuperscript{51} Paragraph 19 of the Commentary on art 7(2).

\textsuperscript{52} Paragraph 25 of the Commentary on art 7(2).

\textsuperscript{53} See also OECD 2006 Report on PEs op cit note 30 in par 52.
account as incurred for the purpose of the PE should be the actual amount so incurred.

Paragraph 34 of the Commentary on art 7(3) acknowledges that it may be extremely difficult to allocate ‘ownership’ of intangible rights solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other part as though it were an independent enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. The Commentary notes that the services that the enterprise provides to third parties should be charged at an arm’s length consideration. However, for services, which are general in nature and are for the enterprise as a whole, for instance, the training of employees, the cost should be charged at actual cost without any mark-up. If the main activity of the PE is to provide services to other parts of the enterprise and such services provide real advantage to the enterprise and their cost represents a significant cost for the enterprise, then the PE should be remunerated at arm’s length consideration for such services.

As regards interest that arises from internal ‘loans’ between the head office and the PE, the Commentary generally provides that such internal ‘interest’ should be recognised. However, in the case of financial organisations like banks, interest on such internal borrowings should be considered. This is on the basis that for such organisations, lending is the normal course of business.

Before moving into the other paragraphs of art 7, it is worth pointing out that the reading of articles 7(2) and 7(3) could give the impression that the two articles conflict. Article 7(2) makes it clear that the PE and the enterprise are to be treated as independent entities and that the transactions between the two are required to be at arm’s length. However, this article also states that it is ‘subject to the provisions’ of art 7(3), which provides that in calculating the profits of a PE, deduction should be allowed for the expenses incurred in whichever country. In this respect, art 7(3) appears to imply that a deduction should be given for actual expenses as opposed to an arm’s length price. To reconcile these two articles, the OECD clarifies that there is no exception to the arm’s length principle in art 7(2) and that the purpose of art 7(3) is to ensure that the PE is allowed deductions for expenses, irrespective of the country in which they are incurred.

Article 7(4) of the OECD Model Tax Convention states:

‘Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the

---

54 For further explanation, see Rawal op cit note 1 at 101.
55 Paragraphs 35-6 of the Commentary on art 7(3).
56 Paragraph 41 of the Commentary on art 7(3).
57 Paragraph 42 of the Commentary on art 7(3).
58 Paragraphs 28 and 29 of the Commentary on art 7(3).
enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article."

Paragraph 52 of the Commentary to this article allows countries that customarily determine the profits attributable to a PE by reference to various apportionment formulas, to continue doing so. Clearly, this approach contradicts the OECD separate accounting approach. Nevertheless, the OECD acknowledges that the use of formulas might produce results that would differ from that which would be arrived at by a computation based on separate accounts.

Article 7(5) of the OECD Model Tax Convention states: ‘No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.’

Paragraph 57 of the Commentary on this article explains that this refers to a permanent establishment which, although carrying on other business, also carries on purchasing for its head office. In such a case, the profits of the PE shall not be increased by adding to them a notional figure for profits from purchasing, and any expenses that arise from the purchasing activities will not be deductible. If effect, the profits attributed to a PE are only those derived from assets used, risks assumed and activities performed by the PE.

Article 7(6) of the OECD Model Tax Convention states that ‘the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary’.

Paragraph 58 of the Commentary to this article explains that the method of allocation once used should not be changed merely because in a particular year some other method produced results that are more favourable. This rule is intended to provide some degree of certainty to enterprises of contracting states about the tax treatment that will be accorded to their PEs in the other contracting state.

Before moving on to the next aspect of this article, it is important to point out that in determining the profits attributable to a PE, the OECD explicitly rejects the ‘force of attraction’ principle that is applied in the United Nations Model Treaty. In terms of this principle, in addition to taxing a PE within its own jurisdiction, the United Nations Model Treaty explicitly includes the profits of the enterprise from transactions that are not directly carried on through the PE or connected to it. This is on condition that similar activities are pursued by the same enterprise through a fixed place of business within the source country. It is reasoned that the aim of the ‘force of attraction’ principle is to counteract the inefficiency of the arm’s length principle. For instance, it is argued that the ‘force of attraction’ principle is instrumental in preventing tax evasion or avoidance through artificial contracts or other

59 Paragraph 10 of the Commentary on art 7(1).
60 Article 7(1) of the UN Model Tax Convention.
business arrangements which should be allocated to the PE anyway.\textsuperscript{61} It is also reasoned that the ‘force of attraction’ principle may eliminate problems of proof in a situation where an enterprise may claim that a trade was organised by a PE, rather than the head office. The OECD is of the view, however, that in taxing the profits that a foreign enterprise derives from a particular country, tax authorities should look at the separate sources of profit that the enterprise derives in that country and should apply to each the PE test (subject to the possible application of other articles in the Model Tax Convention). The OECD reasons that this approach is simpler, efficient for tax administration and compliance, and in line with the complexities of the way business is carried on. A number of companies engage in a wide diversity of activities in various countries. Thus a company may set up a PE in a country to carry on its manufacturing activities whilst (for valid commercial reasons) a different part of the same company sells different goods in that country through independent agents. If the country in which the PE is situated taxed the profit element of each transaction carried on through such independent agents, with a view to aggregating that profit with the profit of the PE, this approach would interfere with ordinary commercial activities and would be contrary to the aims of the Convention.\textsuperscript{62}

4 Commentators’ Views on the OECD Approach

Various commentators have pointed out the drawbacks of applying the OECD arm’s length approach for attributing profits to a PE. Arnold and McIntyre\textsuperscript{63} note that serious conceptual and practical difficulties arise in applying the transfer pricing rules to PEs. Those rules were intended to apply to transactions between related persons (such as subsidiaries of a multinational company), not to branches which are not legal persons, and legally, transfers cannot take place between branches of the same corporation.\textsuperscript{64} Warner\textsuperscript{65} also notes that determining a reliable arm’s length result in respect of inter-branch transactions could be complicated in practice because any transfer of goods or risks of loss would not be accomplished through a legally recognisable transaction and formal ownership of relevant property would only reside in the name of the foreign corporation. The absence of separate legal limits on liability where a PE is not a separate legal entity may mean that there is no meaningful way of assigning risks to the different branches. This further implies that assets cannot be separately transferred or held in a way that has tax significance.\textsuperscript{66}

\textsuperscript{61} Prof Dr Irene JI Burgers & Giammarco Cottani (eds) The Taxation of Permanent Establishments (2007; loose-leaf) in par 4.1.2; Skaar op cit note 3 at 336; Rawal op cit note 1 at 35.
\textsuperscript{62} Paragraph 10 of the Commentary on art 7(1).
\textsuperscript{63} Arnold & McIntyre op cit note 34 at 74.
\textsuperscript{64} Ibid.
\textsuperscript{65} Warner op cit note 36 at 159.
\textsuperscript{66} Ibid.
Vincent points out that the arm’s length principle requires the matching of comparable transactions between non-arm’s length entities and arm’s length entities; however, the transactions of multinational enterprises are often not comparable to those of arm’s length parties. Modern multinational enterprises do not normally operate as if their single subsidiaries were separate enterprises; they often operate as a single unified enterprise managed from a central location by managers who are responsible for the enterprise as a whole. Because of these factors, Couzin notes that taxpayers, their advisers and tax authorities are left to reconstruct, from largely dissimilar transactions or entities, what parties at arm’s length would have done in similar circumstances. This task requires taxpayers to comply with diverse documentation requirements of their national tax authorities that are time-consuming and expensive. These problems are compounded when taxpayers have to treat PEs as fictitious separate legal entities.

Avi-Yonah and Clausing note that the separate accounting approach advocated by the OECD ‘is both complex and conceptually unsatisfactory’, given that the worldwide income of multinational enterprises is generated by interaction between affiliates across countries. Multinational enterprises exist in large part because these interactions generate more income than separate domestic firms interacting at arm’s length would generate. Thus, requiring these enterprises to allocate income to domestic tax bases is artificial and arbitrary. Furthermore, such income allocation creates opportunities for multinational enterprises to reduce worldwide tax burdens by shifting income to low-tax jurisdictions.

For the reasons set out above, Taylor points out that the OECD approach is ‘a cumbersome creation of stupefying complexity’ with ‘rules that lack coherence and often work at cross purposes’. Altshuler and Ackerman point out that observers testifying before the President’s Advisory Panel on the United States Federal Tax Reform found the OECD approach ‘deeply, deeply flawed’. Vann notes that most of the problems arise from the difficulties of applying the methods set out in the Transfer Pricing Guidelines that the

---

70 Avi-Yonah & Clausing op cit note 69 at 24.
73 Vann op cit note 68 at 68.
OECD recommends in order to arrive at an arm’s length price. I agree with these commentators.  

The OECD has acknowledged the practical difficulties of applying the transfer pricing rules to PEs. Yet the guidance that it offers on how to deal with these difficulties is often not very helpful. For instance, the OECD suggests that countries should rely on the books of account that taxpayers present to the tax authorities unless it appears that those books have been presented to facilitate tax avoidance. However, entries contained in these books may not be reliable when applying the arm’s length approach to intra-group arrangements since they are often completely under the control of the taxpayer. If a country offers a tax advantage to PEs operating within its borders, taxpayers are likely to claim the advantages in books of accounts of their PEs. 

With respect to the difficulties of attributing the profits from intangible property to a PE, the OECD suggests that intra-group royalties should not be deducted in computing the income of a PE. The OECD Commentary also proposes that the costs of developing intangible property should be allocated by formula among the parts of the corporation that use the property. However, the solution that the OECD offers in this respect is arguably inconsistent with the arm’s length approach. 

5 The Challenges of Applying the OECD Approach from a South African Perspective

For the purposes of South African income tax, a PE is defined in s 1 of the Income Tax Act, with reference to the definition of the concept in art 5 of the OECD Model Tax Convention. Although South Africa is not a member of the OECD, it was awarded observer status in the OECD in 2004. And, like most developing countries, most of South Africa’s treaties largely follow the OECD Model Tax Convention.

South Africa employs the residence basis of taxation as its main basis of taxation. Consequently, South African residents are taxable on their

---

76 Arnold & McIntyre op cit note 34 at 24.
77 Idem at 75.
78 Idem at 76.
79 Ibid; Russo 2004 op cit note 21 at 478.
80 Act 58 of 1962.
81 Olivier and Honiball op cit note 1 at 8; see K Huxham & P Haupt Notes on South African Income Tax (2009) at 341. There are 30 OECD member countries: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States. See OECD ‘OECD Member Countries’, available at http://www.oecd.org/document/58/0,2340,en_2649_201185_1889492_1_1_1_1,00.html (visited on 17 May 2007).
82 Olivier & Honiball op cit note 1 at 10.
83 From the years of assessment commencing 1 January 2001, the residence-based system of taxation was introduced in South Africa, ushered in by the Revenue Laws Amendment Act 59 of 2000 (‘the
worldwide income, subject to certain exceptions. Non-residents are subject to tax on a source basis of taxation, in that only income that has its source in South Africa is taxable. The source basis of taxation is also relevant with respect to PEs, in that, in a treaty context, a non-resident taxpayer may only be taxed on the business profits attributable to a PE in a source country.

It is important to note, however, that although tax treaties refer to the attribution of ‘profits’ to a PE, South Africa’s Income Tax Act does not refer to the taxation of ‘profits’; instead it refers to the notion of ‘taxable income’ as defined (on a net basis). Thus theoretically, the concept of ‘attributing profits’ as contained in double tax treaties does not accord with the way taxable income is determined in the Income Tax Act. Thus in a South African domestic tax context the better term would be the ‘attribution of income’ to a PE. However, for the purposes of keeping to the topic of this article, the term ‘attribution of profits’ as used in tax treaties will be used interchangeably with the term ‘taxable income’.

It should be noted that although South Africa’s tax treaties provide for the taxation of a PE’s profits that are derived from a South African source, the Income Tax Act does not contain rules that explicitly specify how the attribution of profits to PEs is to be effected. Neither is there any guidance for calculating profits attributable to a PE for the purposes of South African income tax charges. Section 5(2) of the Income Tax Act simply states that a non-resident company doing business in South Africa through a branch or agency is taxed on a source basis at a rate of 34 per cent. Although this section does not refer specifically to the term PE, it is assumed that the same rate will be applicable to PEs. It should be noted that even though a tax treaty may contain provisions that relate to the attribution of profits to PEs, a tax treaty cannot create tax liability; domestic law has to be referred to in order to determine the taxable income of a PE. The rules in the Income Tax Act that should be applied in order to determine the taxable income of a PE create various anomalies when applied in determining the taxable income of PEs according to the OECD approach. Most of these anomalies arise from the fact

---

84 Section 1 of the Income Tax Act defines the term ‘resident’ with respect to natural persons and persons other than natural persons. Natural persons are resident if they are ‘ordinarily resident in South Africa’, or if they are ‘physically present’ in South Africa in terms of the relevant physical presence test rules. Persons other than natural persons are resident if they are incorporated, established or formed, or if they have a ‘place of effective management’, in South Africa.

85 Note that the Income Tax Act does not define the term ‘source’. Case law has to be referred to determine the meaning of the term. In CIR v Lever Bros and Unilever Ltd 1946 AD 410, 14 SATC 1, it was held that the term ‘source’ requires determining the originating causes of income (what the taxpayer does to earn the quid pro quo) and then locating that originating cause. When activities are performed partly in South Africa and partly in another country, the source of income will be in the country where the main or dominate activities are carried out. See Transvaal Associated Hide and Skin Merchant v Collector of Income Tax, Botswana 29 SATC 97.


87 Idem at 556.

88 Oliver & Honiball op cit note 1 at 109.

that South African company law, as is the case in most countries, does not regard a branch as a legal entity separate from its foreign head office. This same position is upheld in South African income tax law. Consequently, transactions between a branch and its head office would generally have no income tax effect for domestic tax purposes.89

In order to determine the ‘taxable income’ of any taxpayer, the starting point is to determine the taxpayer’s ‘gross income’. With regard to non-residents, ‘gross income’ is defined as the total amount, in cash or otherwise received by or accrued to or in favour of such non-resident during the year or period of assessment from a source in the Republic or deemed to be in the Republic, excluding receipts or accruals of a capital nature but including the certain specific inclusions.90 From this provision it is clear that gross income would consists only of amounts received by or accruing to or in favour of a PE from a source within South Africa.91 In terms of the OECD approach, in determining the profits attributable to a PE, tax authorities are required to recognise notional transactions between the PE and its foreign head office.92 For instance, par 21 of the Commentary on art 7(2) recognises the transfer of assets or trading stock from the head office in one state to its PE situated in another state and allows the former state to tax profits deemed to arise in connection with such a transfer. However, in terms of South African domestic law, where goods or trading stock is transferred from a foreign head office to a PE, there is no change of ownership. In terms of the ‘gross income’ definition, an amount cannot be said to have been ‘received by or accrued to’ the PE. Neither can it be said that the amount is ‘in favour of’ the PE, because this phrase implies that the amount must be received by the PE for its own benefit (not in notional terms) as would be the case if it were a legal person. Thus no tax liability arises when there is no receipt or accrual of an amount, and hence it is submitted that the transfer of such stock will not give rise to a taxable event. Even s 22 of the Income Tax Act, which deals with the taxation of trading stock, does not envisage a tax charge on the transfer of stock from a parent company to a PE. Thus where under a tax treaty a determination has to be made of the profits attributable to the PE, there cannot be double taxation relief on such transfers. If a PE is regarded as an independent entity for tax treaty purposes, then the transfer of trading stock may arguably be seen as a fictitious sale of stock. However, it appears to be the practice of the South

89 Note that for South African VAT purposes, there are tax consequences with regard to transactions between a branch and its head office. See s 8(9) of the Value-Added Tax Act 89 of 1991.
90 Section 1 of the Income Tax Act.
91 After a PE’s ‘gross income’ has been determined, the next step is the deduction of all exemptions in order to determine the taxpayer’s ‘income’. This is followed by the deduction of all amounts allowable as deductions under the general deduction formula and the specific deductions provided for in the Act. The amount remaining represents a taxpayer’s ‘taxable income’.
92 Paragraph 14 of the Commentary on art 7(2).
African Revenue Service (SARS) to regard the PE as having acquired the stock transferred to it by the parent company at market value.93

In terms of par 2 of the Eighth Schedule to the Income Tax Act,94 a non-resident is subject to capital gains tax (CGT) on the disposal of any immovable property situated in the Republic or any interest or right in immovable property situated in the Republic.95 A non-resident is also liable for CGT on the disposal of any asset of a PE of the non-resident in the Republic.96 Paragraph 11(1) of the Eighth Schedule to the Income Tax Act defines a disposal of an asset as including ‘any transfer’. This implies a legal transfer that implicitly requires the existence of two legal entities and does not envisage a mere physical movement or relocation of an asset.97 Thus a PE in South Africa cannot be considered as having disposed of a capital asset upon its transfer to its parent company. It should also be noted that if South Africa charges an exit charge on the transfer, the foreign head office will not be able to claim unilateral tax credit relief, since for the purposes of unilateral tax credit the foreign head office must receive income but this would not be the case for this kind of transfer.98

In regard to determining the taxable income of a non-resident, the Income Tax Act allows deductions for losses and expenses incurred for trade purposes. With regard to non-residents, the general deduction formula set out in s 11(a) of the Act allows a deduction of expenditure and losses that are actually incurred in the Republic during the year of assessment, in the production of income for the purposes of the taxpayer’s trade that are not of a capital nature. However, art 7(3) of the OECD Model Tax Convention provides that PEs are allowed to deduct expenses incurred, whether in the state in which the PE is established or elsewhere. This is clearly in conflict with the Income Tax Act, which only allows non-residents to claim deductions for expenditures incurred in the Republic.

In terms of the OECD approach, when determining the profits attributable to a PE, tax authorities are required to recognise the deduction of notional expenses between the PE and its foreign head office.99 However, the denial of the deduction of notional expenses is a well-established principle in South African income tax law. Section 23(e) of the Income Tax Act prohibits a deduction for income carried to any reserve fund. In Anglo American

---

94 The Eighth Schedule to the Act contains rules for the determination of a person’s taxable capital gain or assessed capital loss for a year of assessment. In terms of s 26A of the Act, any taxable capital gain so determined must be included in a person’s taxable income for the relevant year of assessment. The amount of a person’s taxable capital gain for a year of assessment is therefore treated as a component of that person’s taxable income and subjected to normal tax at the relevant rates applying to that person.
97 Hattingh op cit note 93 at 293.
98 Ibid. In terms of par 12(2) of the Eighth Schedule to the Income Tax Act, where a person ceases to be a resident, that person will be deemed to have disposed of his assets (subject to specific exclusions) at market value. The tax arising from this disposal is often referred to as an ‘exit charge’.
99 Vincent op cit note 67 at 413.
Corporation of SA Ltd v Commissioner of Taxes, the then Rhodesian Appellate Division refused – despite a provision to the contrary in the double tax agreement between South Africa and Rhodesia – to accept that the head office and a branch were two separate entities. As a result, a notional loss resulting from the devaluation of the rand on an inter-branch loan could not give rise to a deduction. This case shows that although a tax treaty can provide which country has the right to tax income, the tax so imposed must be levied in accordance with domestic law. Even in the Canadian case of Cudd Pressure Control Inc v The Queen, the deduction of notional expenses was not accepted.

With respect to services, the OECD is of the view that where the main activity of the PE is to provide services to other parts of the enterprise and their cost represents a significant cost for the enterprise, then the PE should be remunerated at arm’s length consideration for such services. In South Africa, there is no provision in the Income Tax Act that requires a PE to be taxed on notional income for the provision of services to its foreign head office. However, SARS follows the practice of computing the income and expenses of the PE of a foreign head office on the basis of separate accounts; this accords generally with accepted South African accounting principles. Hattingh is of the view that this practice is questionable because it is based on a misinterpretation of the function and purpose of art 7(2) to 7(4) of the OECD Model Tax Convention. It should also be noted that in terms of the South African rules for determining the source of service income, case law has repeatedly held that the source of income from services is where the services are rendered. By implication, only the cost of services rendered in South Africa would be considered as actually incurred from a South African source and thus deductible.

With regard to intangibles, par 34 of the Commentary on art 7(3) acknowledges that it is difficult to allocate ‘ownership’ of intangible rights to only one part of the enterprise and for it to claim royalties from the other parts. It is thus recommended that the costs of creation of intangible rights be regarded as attributable to all parts of the enterprise. In South African tax law there is no provision that deals with notional income or deductions that arise from the use of intangibles between a PE and its foreign head office. SARS is of the view, however, that if there is a double taxation treaty in place between South Africa and the country where the head office is resident,

---

100 1975 (1) SA 973 (RAD).
101 Olivier & Homball op cit note 1 at 105. A similar conclusion was reached by the Canadian Tax Court in Cudd Pressure Control Inc v Her Majesty the Queen (1995) 95 DTC 5559 (TCC).
102 [1995] 2 CTC 2382 (TCC), as read from Vincent op cit note 58 at 413.
103 Paragraphs 35-7 of the Commentary on art 7(3).
104 Paragraph 6.4 of Practice Note 7 op cit note 35.
105 Hattingh op cit note 93 at 303.
106 Ibid.
107 ITC 396 10 SATC 87; Commissioner of Taxes v Shein 1958 (3) SA 14 (FC).
108 Anglo American Corporation of SA Ltd v Commissioner of Taxes supra note 100.
109 For further explanation, see Rawal op cit note 1 at 101.
transfer pricing provisions may be applied.\textsuperscript{110} Hattingh\textsuperscript{111} again suggests that this view is based on an incorrect understanding of arts 7(2) to 7(4) and art 9 of the OECD Model Tax Convention, because there is no basis in the Income Tax Act that enables SARS to deem a PE in South Africa as having earned notional royalty from the use of intangibles by its foreign head office. Thus there can be no notional royalty deductions or income and there is no case in South Africa where SARS deemed royalty income to accrue to a PE from a head office located in a tax treaty partner country.\textsuperscript{112}

Although the PE and its foreign head office are supposed to be treated as separate entities, this approach is qualified in that the OECD recognises ‘internal agreements’ between a foreign head office and the PE. In that respect, to the extent that the trading accounts of the head office and the PE are prepared symmetrically on the basis of such agreements, and to the extent that those agreements reflect the functions performed by the different parts of the enterprise, they should be accepted by tax authorities.\textsuperscript{113} This is the case with regard to internal ‘loans’ with ‘interest’ between a foreign head office and the PE, especially in the case of banks.\textsuperscript{114} In terms of South African domestic law, a company cannot transact with itself. Therefore, it is not possible for a loan agreement to exist legally between a foreign head office and its PE. Such a loan would not have been ‘actually incurred’ in terms of s 11(a) of the Income Tax Act.\textsuperscript{115} Thus while for accounting purposes the various branches of one enterprise may be credited or debited, such debts and credits do not constitute expenditure actually incurred for the purposes of domestic tax. Even for the purposes of double taxation relief, when determining the profits attributable to the foreign PE, there is no domestic tax provision enabling South Africa to take into account such notional interest payments.\textsuperscript{116} An example can be given of the Indian case of \textit{Mitsui Bank Ltd IAC (Bombay ITAT)},\textsuperscript{117} which can be of persuasive authority in South African courts. In this case, the taxpayer was a Japanese Bank that had established a PE (a branch and office) in India. The Indian PE had to pay certain funds to the head office. The taxpayer had claimed a deduction for interest on such balance payable to the head office. The Mumbai Tribunal, however, rejected the claim of the taxpayer on the basis that the Indian branch and the head office in Japan could not be treated as separate entities, and deductions could not be allowed to the branch in India for such notional interest.

Paragraph 27 of the Commentary to art 7(3) provides that in calculating the profits of a PE, it may be necessary in some cases to estimate or to calculate

\begin{itemize}
\item \textsuperscript{110} Paragraph 6.4 of SARS Practice Note 7 op cit note 35.
\item \textsuperscript{111} Hattingh op cit note 93 at 303.
\item \textsuperscript{112} Ibid.
\item \textsuperscript{113} Paragraph 19 of the Commentary on art 7(2).
\item \textsuperscript{114} Paragraph 41 of the Commentary on art 7(3).
\item \textsuperscript{115} Olivier & Honiball op cit note 1 at 105.
\item \textsuperscript{116} Hattingh op cit note 93 at 307.
\item \textsuperscript{117} 35 TTJ 426. See also \textit{Betts Hartley Huett and Company Ltd v CIT (Calcutta HC)} 116 ITR 425, and other cases as read in Rawal op cit note 1 at 80-2.
\end{itemize}
by conventional means the amount and expense to be taken into account. For
instance, in the case of administrative expenses incurred by the head office,
the OECD suggests that a proportionate part of those expenses could be
allotted to the PE based on the ratio that the PE’s turnover bears in relation to
that of enterprise as a whole. This approach is again in conflict with s 11(a)
of the Income Tax Act, which requires that a taxpayer can only deduct expenses
that are ‘actually incurred’. Thus, where an expense is not ‘actually incurred’
by the PE it cannot it be deductible for the purposes of South African income
tax.

It is a universally accepted principle of international tax law that a tax
treaty cannot impose tax, nor can it create taxing rights;\(^\text{118}\) instead, treaties
provide boundaries within which domestic tax provisions are enforceable. Tax
treaties ‘create an independent device to avoid double taxation, through
restriction of Contracting States’ tax claims, where there could be an
overlapping of these claims’\(^\text{119}\). Thus although a tax treaty can provide
guidance as to which country has the right to tax income, the tax so imposed
must still be levied in accordance with domestic law. Since treaties cannot
impose tax,\(^\text{120}\) it is to be doubted whether in a South African context a tax
treaty can create a tax liability where there is no accrual in terms of domestic
law, or whether a treaty can create a deductible expense in circumstances
where there is no actual expenditure in terms of domestic law.\(^\text{121}\) Oliver and
Honiball\(^\text{122}\) submit that a treaty cannot create a deduction by allocating profits
attributable to a South African PE, to the detriment of the South African fiscus
simply by allowing such a deduction. Domestic tax law must be applied to
determine how gross income and deductions will be allocated to the PE of a
foreign corporation, since domestic tax laws are generally not overridden by
the provisions of tax treaties.\(^\text{123}\)

Olivier and Honiball\(^\text{124}\) submit further that whether notional expenses are
deductible or what the correct profit allocation will depend on the
application of transfer pricing principles to the profit allocation or expense
deduction, both of which are simply methods to allocate the correct amount of
profits to the PE under the arm’s length principle. To date there have been no
South African court decisions on this issue.\(^\text{125}\) In South Africa, the transfer
pricing provisions are set out in s 31(2) of the Income Tax Act. In terms of this
section the Commissioner for SARS is empowered to adjust the consideration
for goods or services supplied in terms of an international agreement between
connected parties, if the actual price paid is either less or greater than the price

\(^{118}\) Russo 2004 op cit note 21 at 485; Olivier & Honiball op cit note 1 at 11.

\(^{119}\) See Eusebio González 'The Administrative Procedure for Determining Tax Liability' in: Andrea

\(^{120}\) Olivier & Honiball op cit note 1 at 11.

\(^{121}\) Ibid.

\(^{122}\) Idem at 110.

\(^{123}\) Arnold & McIntyre op cit note 29 at 77.

\(^{124}\) Oliver & Honiball op cit note 1 at 110.

\(^{125}\) Ibid.
that would have been paid if the supply of the goods or services had been between independent parties dealing on an arm’s length basis.\textsuperscript{126} The adjustment is based on the conditions that would have existed between unconnected persons under comparable circumstances.\textsuperscript{127} This section is in line with the arm’s length principle set out in art 9(1) of the OECD Model Tax Convention. The Commissioner determines an arm’s length price by using one of the methods set out in SARS Practice Note 7.\textsuperscript{128} Although SARS Practice Notes or Interpretation Notes are not law,\textsuperscript{129} Practice Note 7 sets out the methods that have been developed in international practice for determining and appraising a taxpayer’s transfer prices. Although SARS has deviated in some respects from the OECD in the way it applies these methods,\textsuperscript{130} in general the working of these methods accords with the OECD Transfer Pricing Guidelines.\textsuperscript{131}

In terms of s 31(2), the arm’s length principle is applied if there is a supply of goods\textsuperscript{132} or services\textsuperscript{133} between:

\begin{itemize}
  \item \textit{Where any supply of goods or services has been effected—}
  \begin{itemize}
    \item [(a)] between—
    \begin{itemize}
      \item [(aa)] a resident; and
      \item [(bb)] any other person who is not a resident;
    \end{itemize}
    \item [(bb)] a person who is not a resident; and
    \item [(bb)] a permanent establishment in the Republic of any other person who is not a resident;
  \end{itemize}
  \item [(bb)] between those persons who are connected persons in relation to one another; and
  \item [(c)] at a price which is either—
  \begin{itemize}
    \item [(i)] less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm’s length (such price being the arm’s length price); or
    \item [(ii)] greater than the arm’s length price,
  \end{itemize}
  the Commissioner may, for the purposes of this Act in relation to either the acquiror or supplier, in the determination of the taxable income of either the acquiror or supplier, adjust the consideration in respect of the transaction to reflect an arm’s length price for the goods or services.
\end{itemize}

\textsuperscript{126} Section 31(2) of the Income Tax Act as amended by Revenue Laws Amendment Act 35 of 2007 reads:
\begin{quote}
  ‘Where any supply of goods or services has been effected—
  \begin{enumerate}
    \item [(a)] between—
    \begin{enumerate}
      \item [(aa)] a resident; and
      \item [(bb)] any other person who is not a resident;
    \end{enumerate}
    \item [(bb)] a person who is not a resident; and
    \item [(bb)] a permanent establishment in the Republic of any other person who is not a resident;
  \end{enumerate}
  \item [(b)] between those persons who are connected persons in relation to one another; and
  \item [(c)] at a price which is either—
  \begin{enumerate}
    \item [(i)] less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm’s length (such price being the arm’s length price); or
    \item [(ii)] greater than the arm’s length price,
  \end{enumerate}
  the Commissioner may, for the purposes of this Act in relation to either the acquiror or supplier, in the determination of the taxable income of either the acquiror or supplier, adjust the consideration in respect of the transaction to reflect an arm’s length price for the goods or services.’
\end{quote}

\textsuperscript{127} SARS Practice Note No 7 op cit note 35 in par 2.7. See also Susan C Borkowski ‘Transfer Pricing Documentation and Penalties: How Much is Enough?’ (2003) 29(2) International Tax Journal 1 at 3; Van Blerck op cit note 36 at 45.

\textsuperscript{128} SARS Practice Note No 7 op cit note 35 in pars 9.1.2-9.1.3.

\textsuperscript{129} ITC 1675, 62 SATC 219.

\textsuperscript{130} For a discussion of SARS’s deviation from the OECD Transfer Pricing Guidelines, see Oliver & Honiball op cit note 1 at 495-6.

\textsuperscript{131} OECD Transfer Pricing Guidelines op cit note 26.

\textsuperscript{132} The term ‘goods’ as used in s 31(1) includes any corporeal movable thing, fixed property and any real right in any such thing or fixed property.

\textsuperscript{133} The term ‘services’ is defined (s 31(1)) as including ‘anything done or to be done, including, without limiting the generality of the foregoing—
  \begin{enumerate}
    \item [(a)] the granting, assignment, cession or surrender of any right, benefit or privilege;
    \item [(b)] the making available of any facility or advantage;
    \item [(c)] the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee;
    \item [(d)] the performance of any work;
    \item [(e)] an agreement of insurance; or
    \item [(f)] the conferring of rights to or the use of incorporeal property’.
• a resident and a non-resident;
• a non-resident and a permanent establishment of another non-resident in the Republic;
• a South African resident and a permanent establishment of another South African resident outside the Republic; or
• connected persons.134

From the above, it is clear that the arm’s length principle cannot apply to ‘dealings’ between a PE and its foreign head office.135 However, if the transaction between the branch and the foreign head office relates to another transaction with a connected person,136 the transfer pricing provisions could come into play to the extent that an expense is allocated from the foreign head office to the branch, or vice versa. For example, if a foreign company makes an interest-bearing loan to the foreign head office of a South African company which is a connected person in relation to the lender and the proceeds of the loan are made available to the branch, then the South African transfer pricing provisions could apply to restrict the deductibility of the interest on the loan. The transfer pricing provisions could not apply if surplus funds of the foreign head office were made available to the branch at interest, because there would then be no transaction between two different persons as required by s 31(2).137 But SARS seems to follow the approach that where South Africa has concluded a double tax treaty, the profits which are attributed to a PE will be based on transfer pricing principles. This approach is set out in par 6.4 of SARS Practice Note 7 as follows:

‘Although the provisions of s 31 of the Act are applicable to persons, which are separate legal entities, the contents of this Practice Note will also apply to determine the arm’s length consideration for income tax purposes of cross-border transactions conducted by . . . a person’s Head Office with a branch of such person; or a person’s branch with another branch of such person, in the application of the tax treaties entered into by South Africa.’

However, SARS Practice Notes are not law and in a number of cases, it has been argued that SARS is not bound by its own Practice Notes and Interpretation Notes.138 Thus South Africa’s courts are not bound to follow SARS’s approach in Practice Note 7 in attributing profits to PEs in South Africa.

Alongside the transfer pricing provisions, South Africa also has ‘thin capitalisation’ provisions set out in s 31(3) of the Income Tax Act, which are used to prevent the tax avoidance that results when a company is financed by the use of unusual proportions of loan to equity capital in order to gain tax

134 Van Blerck op cit note 36 at 45.
135 Hattingh op cit note 93 at 293.
136 The term ‘connected person’, as used in s 31(2), is defined in s 1 of the Act. For a detailed explanation of this term, see David Meyerowitz Meyerowitz on Income Tax (2008) in par 12.23.
137 Note that even the ‘thin capitalisation’ provisions in s 31(3) of the Income Tax Act, which come into play when a non-resident grants financial assistance to a resident, cannot apply between a branch and its foreign head office.
138 ITC 1675, 62 SATC 219, supra note 129.
advantages. Section 31(3) gives the Commissioner for SARS the discretion to disallow excessive tax deductions for interest charges payable by South African tax residents to non-residents. However, this provision can be applied only in respect of interest payments from one connected person to another. It does not apply in respect to cross-border notional ‘interest flows’ between various parts of the same legal person.

Because of the anomalies of applying the OECD approach when attributing profits to PEs, the OECD recommends that countries should place emphasis on the accounting documents of the PE. However, this recommendation does not address most of the challenges. For instance, the OECD does not make it clear whether the deductible expenses attributed to a PE are to be determined under the domestic law of the host country. Thus, for most jurisdictions, including South Africa, the OECD does not provide much certainty about how to attribute profits to a PE. It is for this reason that commentators recommend that taxpayers apply for unilateral or other advance rulings from host countries, where such rulings are available. For instance, where countries sign an ‘advance pricing agreement’ (‘APA’), they can agree on the best transfer pricing method for determining the arm’s length price. However, APAs are not in use in South Africa, and SARS gives no reasons why APAs are not available to South African taxpayers. Section 76 of the Income Tax Act, which provides for the types of advance tax ruling that are available, specifically provides in s 76G(1)(a)(iii) that the Commissioner for SARS may not accept any application from a taxpayer for an advance tax ruling in respect to ‘the pricing of goods or services supplied by or rendered to a connected person in relation to the applicant’. This provision essentially excludes advance tax rulings with respect to transfer pricing. But it is not clear whether it is possible to apply for a ruling about the attribution of profits to a PE, the reason being that s 76G, which contains the list of exclusions, refusals and rejections in respect of which a ruling cannot be obtained, does not specifically exclude a ruling about the attribution of profits to a PE and merely excludes transfer pricing. Since a PE is not a connected person as defined in relation to the rest of the enterprise, it can be argued that a ruling about the attribution of profits to a PE is not one of the specific exclusions, despite


140 Olivier & Honiball op cit note 1 at 110.

141 Ibid.

142 An ‘advance pricing agreement’ (APA) is a binding written contract between a taxpayer and the revenue authority. Sometimes a foreign revenue authority may be included as a party to the agreement. In that case, it is referred to as a bilateral APA and it can be used in curbing double taxation of income. See Marc M Levey, Steve C Wrappe & Kerwin Chung ‘The Future of Transfer-Pricing Disputes: All Roads Lead to Competent Authority’ (1998) 27 Tax Management International Journal 379; see also Yitzhak Hadari ‘Resolution of International Transfer-Pricing Disputes’ (1998) 46(1) Canadian Tax Journal 29 at 47.

the fact that transfer pricing principles are involved.\textsuperscript{144} Since South Africa rejoined the international trading community after the apartheid era, there has been a lot of foreign investment in South Africa. In order to keep its international tax laws in line with international trends, I recommend that South Africa introduce APAs.\textsuperscript{145}

5 Analysis on How the Conflict between Tax Treaties and South Africa’s Domestic Provisions Can Be Resolved.

The above discussion has shown that there are conflicts between South African income tax law and the PE profit attribution rules in most of its tax treaties. In order to resolve these conflicts, it is necessary to investigate the status of tax treaties in South African law. Section 2 of the Constitution\textsuperscript{146} provides that the Constitution is the ‘supreme law of the land’. Thus, all South African law, which includes statute law, common law, international customary law and international law, is subject to the Constitution. Section 231(4) of the Constitution states:

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

In effect, an international agreement or treaty does not become part of domestic law until it is enacted into law by national legislation.\textsuperscript{147} There are three principal methods employed by the legislature to transform treaties into municipal law. First, the provisions of a treaty may be embodied in the text of an Act of Parliament; secondly, the treaty may be included as a schedule to a statute; and thirdly, an enabling Act of Parliament may give the executive the power to bring a treaty into effect in municipal law by means of proclamation or notice in the \textit{Government Gazette}.\textsuperscript{148}

Section 108(1) of the Income Tax Act read with s 231 of the Constitution\textsuperscript{149} provides, among other things, that the national executive of South Africa may enter into an agreement with the government of any other country to regulate the taxation of income, profits, gains and donations which may be taxable in both countries. As soon as the double tax agreement is ratified and has been published in the \textit{Government Gazette}, its provisions are effective as if they had been incorporated into the Income Tax Act.\textsuperscript{150} This implies that treaty

\textsuperscript{144} Olivier & Honiball op cit note 1 at 112.
\textsuperscript{145} See Oguttu op cit note 143 at 472.
\textsuperscript{146} See the \textit{Constitution of the Republic of South Africa}, 1996.
\textsuperscript{148} Dugard op cit note 147 at 61.
\textsuperscript{149} Op cit note 135.
provisions and any other provision in the Income Tax Act have equal status under South African law, even if the Income Tax Act contains a provision that is inconsistent with the treaty.\textsuperscript{151} Indeed, in a number of cases, although decided in a different context, it has been held that tax treaties do not have a special or privileged status under South African law.\textsuperscript{152} Thus, a court may not automatically assume that a treaty overrides domestic legislation.\textsuperscript{153}

From the above, it can thus be said that the Constitution sets out the procedure for the incorporation of treaties into the Income Tax Act, and the effect of s 231 of the Constitution, read together with s 108 of the Income Tax Act, is that a tax treaty has the same status as domestic tax law. But the Act does not provide a solution where there is a conflict between a treaty and a particular provision of the Income Tax Act.\textsuperscript{154} Where a tax treaty and domestic tax law conflict, the conflict must be interpreted.

Since tax treaties have the same status as any other provision in the Income Tax Act, the provisions of tax treaties have to be interpreted in terms of the normal rules regarding the interpretation of statutes in order to make sense of any conflicts.\textsuperscript{155} In \textit{ITC 1544}\textsuperscript{156} the following was held: ‘The terms of a double tax Convention on which statutory status has been conferred are to be considered as any other statutory provisions to determine the extent to which these conflict with the provisions of another statute and whether such provisions have been modified thereby.’\textsuperscript{157}

A rule of interpretation that is internationally accepted and could be relevant in resolving the above conflict is \textit{lex posterior derogat legi priori} (the ‘later in time’ rule). In terms of this rule, a statute that was promulgated last in time will prevail. The later statute is deemed to have impliedly repealed the earlier one.\textsuperscript{158} In applying this rule, a court would look at the respective dates that the treaties came into force and the date that domestic legislation was introduced. In respect to the use of this rule, the OECD\textsuperscript{159} explains:

‘If treaty obligations are considered as having – at most – the same rank as that of domestic law, they may, within some national legal systems be subject to the rule ‘\textit{lex posterior derogat legi priori}’ (i.e. later law overrides prior law). However, the situation is less simple to determine in practice since this principle applies only when inconsistencies arise between the new law and the prior law and it is well known that courts are reluctant to construe treaties as inconsistent with domestic law (and vice versa).’\textsuperscript{157}

\begin{itemize}
\item[\textsuperscript{151}] Olivier & Honiball op cit note 1 at 30.
\item[\textsuperscript{152}] \textit{Pan American World Airways Inc v SA Fire and Accident Insurance Co Ltd} 1965 (3) SA 150 (A); see also \textit{South Atlantic Islands Development Corporation Ltd v Buchan} 1971 (1) SA 234 (C).
\item[\textsuperscript{153}] Olivier & Honiball op cit note 1 at 30. ‘Treaty override’ refers to a situation where the domestic legislation of a state overrides provisions of either a single treaty or all treaties hitherto having had effect in that state. See OECD Report on Tax Treaty Override (2000) at 1.
\item[\textsuperscript{154}] Olivier & Honiball op cit note 1 at 30.
\item[\textsuperscript{155}] Ibid.
\item[\textsuperscript{156}] 54 SATC 456 at 460.
\item[\textsuperscript{157}] Olivier & Honiball op cit note 1 at 38 note that although this decision was made under the old Constitution, even under the current Constitution, where a treaty ranks equally with domestic law, this decision can still apply.
\item[\textsuperscript{158}] LM Du Plessis Re-interpretation of Statutes (2002) at 15; GE Devenish Interpretation of Statutes (1992) at 57; LC Steyn \textit{Uitleg van Wette} (1981) at 188.
\item[\textsuperscript{159}] OECD Report on Tax Treaty Override op cit note 153 at 8-9.
\end{itemize}
If a country does not grant special status to treaties and it applies the ‘lex posterior derogat legi priori’ rule, the provisions of a treaty may be overridden by domestic legislation subsequently enacted.\(^\text{160}\) South Africa does not grant special status to treaties and it applies the lex posterior derogat legi priori rule.\(^\text{161}\) One argument against applying the lex posterior derogat legi priori rule is that using domestic law to override a treaty provision creates problems as a treaty represents a binding contract between the two contracting states. It may thus be argued that domestic law cannot subsequently be enacted to override a treaty provision as such legislation may be in conflict with a state’s international obligations.\(^\text{162}\)

It is also worth noting that it is not clear what weight the courts will attach to the lex posterior derogat legi priori rule in the light of the other interpretation rules. For instance, there is the generalia specialibus non derogant rule that is applicable to the resolution of conflicts between general and special laws.\(^\text{163}\) In terms of this rule, a general statue should not be interpreted in such a way as to alter specific provisions of an earlier statute or of the common law.\(^\text{164}\) This rule may justify a departure from the lex posterior derogat legi priori rule.\(^\text{165}\) In *R v Gwantshu* it was held:  

> ‘When the legislature has given attention to a separate subject and made provision for it the presumption is that a subsequent general enactment is not intended to interfere with a special provision, unless it manifests that intention very clearly. . . . Where general words in a later Act are capable of reasonable and sensible application without extending them to subjects specifically dealt with by earlier legislation, that earlier and special legislation is not to be . . . altered . . . merely by force of such general words, without any indication of a particular intention to do so.’\(^\text{166}\)

In terms of the generalia specialibus non derogant rule, it could be said that a treaty entered into after the introduction of domestic legislation is a subsequent general enactment not intended to interfere with the specific domestic legislation.\(^\text{167}\) It could, however, be reasoned that as tax treaties are international agreements, they should be interpreted much more widely than domestic legislation. This may require taking international interpretation rules into consideration. This reasoning could influence the courts to apply the lex posterior derogat legi priori rule (discussed above) since it is an international interpretation rule for tax treaties as is evident in the above quotation from the OECD Report on treaty override.

Paragraph 2 of the OECD Commentary on art 7 states that the provisions of this article are not intended to ‘lay down a series of precise rules for dealing with every kind of problem that may arise’. When problems arise, states should attempt to find a solution by mutual consent or adopt a unilateral

---

\(^\text{160}\) Olivier & Honiball op cit note 1 at 40.
\(^\text{161}\) Idem at 41; Steyn op cit note 158 at 188.
\(^\text{162}\) Olivier & Honiball op cit note 1 at 41.
\(^\text{163}\) Du Plessis op cit note 158 at 41.
\(^\text{164}\) Devenish op cit note 158 at 280.
\(^\text{165}\) Olivier & Honiball at 41; Steyn at op cit note 158 at 188.
\(^\text{166}\) Du Plessis op cit note 158 at 41.
\(^\text{167}\) Devenish op cit note 158 at 280.
interpretation. In this regard, some countries, such as the United Kingdom, have sought to resolve the above conflict by incorporating the PE concept and the attribution principles into domestic law. Previously the United Kingdom sought to resolve these problems by making use of the terms ‘branch’ or ‘agency’ in its domestic law, and issued guidelines on the attribution of profits to a branch or agency. These guidelines essentially applied the OECD arm’s length principles even where no tax treaty applied. However, because of problems in defining a branch or agency and problems with attributing profits to such branch or agency, the United Kingdom opted to incorporate the PE concept into its domestic law. This approach is in line with Vann’s following recommendation:

‘A drafting issue for the domestic law is that the arm’s-length principle should be provided for both branches and subsidiaries. This is most easily done by using language similar to that found in tax treaties. Such an approach ensures that there is a basis in domestic law for making transfer pricing adjustments. In many countries, it is not clear whether tax treaties on their own would provide a sufficient basis for such adjustments, and, in any event, it is necessary to have the rules in the case of residents of countries with which there is no tax treaty in force. Using statutory language based on treaties has the added advantage of giving a clear signal that the country intends to follow international norms.’

Unlike the position in the United Kingdom (where initially guidelines were issued on the attribution of profits to a branch or agency, and currently the PE principle and profit attribution rules have been adopted in domestic law), in South Africa no statutory measures are in place to resolve the problem, neither has SARS issued any guidelines to that effect. Instead, in some of South Africa’s newer tax treaties, an attempt has been made to deal with the problem of deemed accruals and deductions to or by a PE by incorporating specific provisions in this regard in art 7 of the relevant tax treaty. For example, in the treaty with Tunisia, art 7(3) provides specifically for ‘executive and general administrative expenses’ to be deducted wherever incurred. The article provides further that certain expenses, such as royalties and interest, may not be deducted at all. In accordance with the OECD Commentary, banking enterprises are distinguished and are specifically allowed to deduct interest. Article 7(3) contains similar provisions in respect of the accrual of income, where, once again, interest must be taken into consideration in determining the profits of the PE of a banking enterprise. It should, however, be noted that even though a tax treaty may contain specific and prescriptive provisions with regard to the calculation of the profits of a PE, these measures

---

168 Russo 2004 op cit note 21 at 472.
169 This was with effect from 1 January 2003. See UK Inland Revenue ‘Consultation on Branch Taxation’ (October 2002). Also referred to by Olivier & Honiball op cit note 1 at 163.
170 Olivier & Honiball op cit note 1 at 163.
171 The UK Inland Revenue also noted that the taxation of an overseas entity with a presence in the UK on profits attributable to its branch or agency was inconsistent with the international standard as well as with the treatment in terms of tax treaties that tax profits attributable to a PE. See UK Inland Revenue Report op cit note 169.
173 For example, in the Tunisia treaty, art 7(3) provides specifically for ‘executive and general administrative expenses’ to be deducted whenever incurred.
do not act like taxing provisions, nor are they deduction provisions. Based on their wording, these provisions simply allow a deduction. It remains the prerogative of the domestic legislature to legislate the particular deduction provision or the particular taxing provision. To date, there are no such provisions in South African domestic law.

It is submitted that even if countries come up with such unilateral statutory measures that ensure that OECD profit attribution rules can be applied domestically, this does not resolve the problems discussed above that countries face in applying the OECD arm’s length approach in attributing profits to PE.

6 The Alternative View to the OECD Approach on Attributing Profits to PEs.

Various commentators have suggested that instead of applying the separate accounting approach advocated by the OECD, a ‘formulary apportionment’ approach should be applied. In terms of this approach, tax liabilities should be based on a multinational enterprise’s global income, and the share that is taxed by the national jurisdictions should depend on the fraction of the enterprise’s economic activity that occurs in a particular country.

The main argument in favour of formulary apportionment is that it addresses the economic reality of multinational firms and that it provides a reasonable, administrable, and conceptually satisfying compromise that suits the nature of the global economy. By contrast, so it is argued, the main deficiency of the arm’s length principle is that the system artificially attempts to draw lines between aspects of an enterprise where no lines exist in reality. Multinational firms are becoming more highly integrated with each other’s operations located in different regions: it is often not possible to find comparable transactions with unrelated parties. Formulary apportionment, on the other hand, accepts the reality of firm integration and tries to come up with a workable solution that matches each jurisdiction with tax revenues related to the economic activity that takes place within the jurisdiction. Rawal notes that where a business is highly integrated and interconnected, the process of determining arm’s length profits on the assumption of independent entities and separate accounts is complicated and cumbersome. Developing a

---

174 Olivier & Honiball op cit note 1 at 110.
175 Ibid.
178 Cockfield op cit note 177 at 116.
179 Ibid.
180 Rawal op cit note 1 at 139. See also Arnold & McIntyre op cit note 34 at 80.
fixed formula for profits attribution is administratively more convenient and can solve the above difficulties.\(^{181}\)

Avi-Yonah and Clausing\(^{182}\) argue that formulary apportionment provides the advantage of eliminating the tax incentive to shift income to low-tax jurisdictions. Under this approach, business entities are taxed on the basis of their global tax exposure. This removes the incentive for locating operations in low-tax jurisdictions, thus reducing the tax-distorted decisions regarding the location of economic activity. Thus where multinational enterprises consider the tax advantages associated with operating in low-tax jurisdictions, these advantages will be based simply on the lower tax associated with their operation in such countries, rather than additional advantages that could be conferred because real operations in low-tax jurisdictions facilitate tax avoidance.\(^{183}\)

It is also argued that the formulary apportionment approach has the advantage of simplifying the international tax system because there would be no need to allocate income or expenses among countries, thus resulting in lighter compliance burdens for multinational enterprises.\(^{184}\)

Commentators have also pointed out that introducing the formulary apportionment approach would not be a far-fetched idea.\(^{185}\) Although the OECD rejects this method,\(^{186}\) art 7(4) of the Model Convention permits apportionment of total profits. The method is also recognised by some transfer pricing methods recommended by the OECD. For example, the TNMM and the profit split methods referred to above seem closer to formulary apportionment than to the arm’s length method.\(^{187}\) Couzin\(^{188}\) notes that many advance pricing agreements (APAs) that tax authorities enter into in order to resolve transfer pricing disputes are based on the profit split method, even though this method was relegated to methods of ‘last resort’ in the OECD’s Transfer Pricing Guidelines. While one can claim that the profit split method reflects the way in which unassociated enterprises would behave if similarly situated, the reality is that these solutions to intractable transfer pricing cases are an attempt to apportion the profits of an integrated enterprise among competing tax authorities on a fair and verifiable basis.\(^{189}\) In this regard, a number of commentators hold the view that there has to be some degree of convergence between the arm’s length methods and the formulary approach. Arnold and McDonnell\(^{190}\) note that the arm’s length principle and formulary

---

\(^{181}\) Avi-Yonah & Clausing op cit note 69 at 13.
\(^{182}\) Ibid.
\(^{183}\) Ibid.
\(^{184}\) Ibid.
\(^{185}\) Idem at 16.
\(^{186}\) OECD Transfer Pricing Guidelines op cit note 26 in par 3.66.
\(^{187}\) Arnold & McIntyre op cit note 34 at 80; Vincent op cit note 67 at 416.
\(^{188}\) Couzin op cit note 70 at 407.
\(^{189}\) Ibid.
apportionment should not be seen as polar extremes; rather, they should be viewed as part of a continuum of methods ranging from CUP to predetermined formulas.

The most common objection to formulary apportionment is that it requires countries to agree on a formula but such agreement is impossible.\(^{191}\) There could be arbitrary predetermined formulas that could make it difficult to apply, depending on the particular circumstances of each multinational enterprise. The method also relies heavily on access to foreign-based information. The amount of profits attributed to each member may also differ from the income shown on its books of account, even though they may be kept in good faith.\(^{192}\) Furthermore, the approach would intrude on countries’ tax sovereignty because countries would need to reach agreement on a set of common rules at the supranational level that would determine how much revenue each state would collect from cross-border transactions. By doing so, each state would have to cede fiscal sovereignty with respect to aspects of its international income tax laws.\(^{193}\) For instance, it is argued that the approach would require the harmonisation of corporate tax bases and possibly even tax rates.\(^{194}\) In addition, it is argued that formulas based on factors such as sales and wages do not provide a fair allocation of tax revenues and are open to manipulation.\(^{195}\) With respect to intangibles, it may be difficult to use formulary apportionment to determine the geographical location of income produced by intangible assets, thus making it difficult to determine which jurisdiction has the right to tax.\(^{196}\)

Despite these disadvantages, it is still argued that the formulary apportionment offers a means of resolving the problems discussed above. It is, for instance, suggested that not all nations have to agree on a formula for this approach to work. Couzin\(^{197}\) suggests that nations could follow the procedure of APAs that are usually bilateral, with the result that only the jurisdictions significantly involved with the particular enterprise agree on a certain formula for attributing profits to the PE. Formulary apportionment could be used to supplement rather than replace transactional transfer pricing. South Africa could, for instance, operate a formulary apportionment system if it concludes agreements with a few key trading partners, while continuing to rely on transactional arm’s length transfer pricing with others. This is what American federal states commonly do, and it is where Europe may be heading.\(^{198}\)

\(^{191}\) Arnold & McIntyre op cit note 34 at 80.
\(^{192}\) Ibid.
\(^{193}\) Cockfield op cit note 177 at 119.
\(^{195}\) Couzin op cit note 70 at 407; Vincent op cit note 67 at 415; Cockfield op cit note 177 at 118.
\(^{196}\) Couzin op cit note 70 at 408.
\(^{197}\) Ibid. Arnold & McIntyre op cit note 34 at 80 note that formulary apportionment is used by some jurisdictions, notably by the provinces of Canada and the states of the USA. It has been proposed for internal use within the North American Free Trade Agreement (NAFTA) and the European Union (EU).
Arnold and McIntyre\textsuperscript{199} note that ‘[g]iven its potential strength and the well-documented problems with the arm’s length standard, the formulary apportionment method is likely to continue to be an important part of the international tax scene’.

7 Conclusion and Recommendations

As discussed above, the OECD requires that the profits attributable to a PE be determined on the assumption that the PE is a ‘separate and distinct’ enterprise dealing independently with the remaining part of the corporation and that the arm’s length standard should be applied in attributing profits to PEs. This approach, however, poses conflicts in countries’ domestic income tax laws. To resolve these conflicts, some countries have incorporated the PE concept and related attribution principles into domestic law. This has not been done in South Africa; however, an attempt has been made to deal with the problem by incorporating specific profit attribution provisions in art 7 of some of South Africa’s newer tax treaties. It is submitted, though, that such provisions simply allow a deduction, but they do not resolve the conflict in the law. If the South African legislature fully supports the OECD approach, it is recommended that in order to resolve the conflict between PE profit attribution rules in tax treaties and the provisions of the Income Tax Act, a provision should be inserted into the Income Tax Act that explicitly provides that the arm’s length principle will be applied with respect to attributing profits to PEs.

As discussed above, this suggestion would not, however, alleviate the challenges of applying the arm’s length principle to PEs. It is therefore further recommended that South African parliamentarians and international tax-law policy makers actively participate in the international dialogues to resolve this problem. Pursuing formulary apportionment seems to be the way that the international community is heading. As discussed above, this could best be achieved at bilateral level, as is the case with APAs. It is regrettable, however, that South Africa is lagging behind the international trends towards introducing APAs. Internationally, there is a growing use of APAs\textsuperscript{200} and they are being used by many of South Africa’s trading partners in the developed world. If South Africa introduced APAs, this step could provide a platform for introducing the formulary apportionment approach with some of its trading partners, thus alleviating the problems caused by the arm’s length approach.

\textsuperscript{199} Arnold and McIntyre op cit note 34 at 80.

\textsuperscript{200} Li op cit note 190 at 607.