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UN Model Services Permanent Establishment: What you do – not where you do it

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Wednesday, August 12th, 2015

The services permanent establishment concept is perhaps the most noteworthy contribution to tax treaties provided by the UN model. The tax treaty concluded by South Africa and the United States in 1997, to replace the one terminated during the apartheid era, has provided an opportunity to consider thorny questions of services and permanent establishments. The South African Tax Court has recently been called on to interpret and apply provisions relating to the existence of both physical and services permanent establishments and temporal issues in the attribution of profits in AB LLC and BD Holdings LLC v SARS (13276) [2015] ZATC 2 (15 May 2015).

The facts were simple: two United States incorporated companies engaged in consulting services to airlines, agreed to provide certain strategic and financial advisory services to a South African based and operating company between February 2007 and May 2008. Three employees of the taxpayers provided the core work on the project and were each in South Africa, on a rotational basis, for three-weeks at a time. 17 employees came to South Africa as and when required. During 2007 the taxpayers' employees were in South Africa more than 183 days. The South African customer provided a room for the employees to work.

Services permanent establishment

Article 5(2)(k) of the South Africa- United States treaty refers to "the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned."

Readers may be perplexed as to how the existence of a service permanent establishment could be in dispute in such circumstances. The services PE language in this treaty, while following the language of the UN Model, is not found in a separate sub-article, in line with the UN Model, but, instead tacked onto article 5(2), the illustrative list. On this basis, the taxpayers contended that the provision of services for sufficient duration is only prima facie, a permanent establishment, and that a service permanent establishment only exists if requirements of article 5(1) for a physical PE are satisfied.

The Tax Court rejected this argument on the basis that while Article 5(2)(a) to (f), following the OECD Model, were merely illustrative of physical PE in article 5(1), that no such relationship

could be inferred in relation to services under article 5(2)(k) which it ruled was a self-standing provision. The court noted that articles 5(2)(a) – 5(2)(f)refer to a place of work, while article 5(2)(k) deals with a form of work.

The task of the court would have been made easier had it been referred to the decision of the Indian Income Tax Appeal Tribunal in Linklaters LLP v Income Tax Officer-International Taxation, Ward 1(1)(2), Mumbai ITA Nos 4896/Mum/03, 5085/Mum/03, (discussed in Schwarz in Tax Treaties, Chapter 7, para. 15-250). There, the Indian tribunal was faced with the identical issue under article 5(2)(k) of the 1993 India-United Kingdom treaty. It concluded that while art 5(2)(a) to (i) of the India-UK treaty were merely illustrative of the basic rule in art. 5(1), article 5(2)(k) was an extension of the basic rule and, therefore, constituted a freestanding category of permanent establishment as recognised by both the OECD and UN Model Conventions.

Physical permanent establishment

The Tax Court also found that there was a physical permanent establishment within article 5(1). It found that the taxpayers were, at all times, present in the room that had been made available during the tenure of the contract. It had exclusive use of this space for the entire duration of the contract. Vally J said at para 42: “To put it differently, it had at its disposal constant access to the boardroom during working hours. Access during nonworking hours was neither necessary nor requested. This flows directly from the fact that compliance with its obligations in terms of the contract required regular intensive interaction with employees of [the South African customer], which, it goes without saying, was most suitable during normal working hours.”

The court distinguished this case from the Canadian decision in The Queen v Dudney 2000 CanLII 14932 (FCA) (2000) D.T.C. 6169 on the basis that in Dudney, a sole individual providing services moved from one area to another at the customer’s premises. This conclusion, which strayed into a highly controversial issue, hotly debated, (See OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment), 19 October 2012, pp 5 to 8) is rather more doubtful. The facts found by the court are insufficient to address this issue satisfactorily. The finding that a service permanent establishment clearly existed gave full taxing rights to South Africa in any event.

Attribution of profits

The case raised an important temporal issue in the attribution of profits under article 7(1). In addition to income for services rendered in South Africa during its 2007 and 2008 years of assessment, when the permanent establishment existed, additional income in the form of a success fee was paid in 2009, when the milestone for that fee was achieved. There was no permanent establishment in 2009. It was, however, part of the income earned for the services provided during the 2007 and 2008 years and the court had no difficulty in finding that the success fee was “attributable to the permanent establishment”.

Penalties

The case is a severe warning of the risks for taxpayers who incorrectly conclude that they have no permanent establishment and therefore do not render a tax return or pay the related tax. In upholding penalties of 100% of the tax, the court was influenced by the fact that the taxpayer was an enterprise with global reach, operating in many foreign jurisdictions, and was not a novice in the area of tax liability.

Principles of treaty interpretation

It is a pity that the court did not take the opportunity to adopt the modern approach to treaty interpretation by reference to articles 31-32 of the Vienna Convention on the Law of Treaties, particularly in light of recent UK decisions that the Convention may be used to interpret treaties involving South Africa (Ben Nevis (Holdings) Ltd v HMRC [2013] EWCA Civ 578) and the United States (Anson v HMRC [2015] UKSC 44) who are not parties, on the basis that it is an accurate statement of customary international law (See my blog of 7 July 2015).

Although some customary principles of treaty interpretation are discussed and applied, their use is unsystematic and in some cases erroneous. There is no attempt to establish any hierarchy of principles, nor the interpretive value of particular sources, starting with the ordinary meaning of terms in context in light of the object and purpose of the treaty (article 31(1) VCLT). The extensive discussion on the ordinary meaning of the expression "includes especially" in article 5(2) would be put in a better context by a reference to article 32 VCLT, which permits the use of supplementary means of interpretation where the ordinary meaning is obscure or absurd. This is certainly such a case.

Better use of the model treaties, in particular the UN Model, the source of the services permanent establishment concept, would have brought the arguments to a swift conclusion. Indeed, this would be an ideal, precedent making, opportunity to refer to the Commentary to the UN Model as a supplementary means of interpretation. The history of the treaty would make it obvious that the service permanent establishment language was intended as an addition to the physical permanent establishment and not illustrative of it. Use of the VCLT as a roadmap to interpretation would have prevented and rendered unnecessary the reference to the "Technical Explanation" (presumably the standard US Treasury Technical Explanation) which would normally be rejected as being a unilateral statement unless it had been accepted by the other contracting state.

US LLCs
It was accepted in this case that US LLCs were entitled to treaty benefits. Whether this is the case may be questionable unless they have elected to be taxed as corporations in the US. See my blog of 7 July 2015 and *Anson* above.

I am indebted to Edlan Paul Jacobs in Johannesburg for drawing my attention to this decision.

This entry was posted on Wednesday, August 12th, 2015 at 3:11 pm and is filed under OECD, Permanent Establishments, Tax Treaties, United Nations
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