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POSSIBLE SOLUTIONS TO THE CHALLENGES POSED BY E-COMMERCE ON THE PERMANENT ESTABLISHMENT CONCEPT- A SOUTH AFRICAN PERSPECTIVE

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

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TABLE OF CONTENTS

ABSTRACT

Electronic commerce ('e-commerce') is an essential part of the modern world that people live in. It involves cross border business transactions operating simultaneously. Where a business operates in two different jurisdictions at the same time, it faces challenges when determining to what extent, it becomes liable for taxation in either or both jurisdictions.[1]

The objective of this research is to examine the evolution of the concept of permanent establishment, the manner in which e-commerce affects this concept, and explores possible mechanisms of imposing tax on cross-border e-commerce transactions.

It commences with an analysis of the application of the South African tax jurisdiction over residents and non-residents, in order to establish the extent of its jurisdiction over cross border transactions. It then proceed to provide a perspective on the functioning of e-commerce and the challenges it posed to the current South African taxation system.

The research findings indicate that the current Organization for Economic Cooperation and Development ('OECD') concept of permanent establishment does not accommodate for the taxation of e-commerce transactions. It concludes with recommendations which can be used by the South African revenue authorities to ensure efficient tax collection on e-commerce transactions.

Keywords: Challenges Posed by E-Commerce, Double Taxation Treaty, E-Commerce, Model Tax Convention, Permanent Establishment, Resident, Place of Effective Management, Tax Jurisdiction, Virtual Permanent Establishment, Source Rules, Withholding Taxes.

[1] *AB LLC and BD Holdings LLC v Commissioner of SARS (13276) 2015 ZATC 2,* page 1

ABBREVIATIONS AND ACRONYMS

Abbreviation	**Meaning**
BEPS	Base Erosion Profit Shifting
B2B	Business-to-business
B2C	Business-to-consumer
B2G	Business-to-government
C2C	Consumer-to-consumer
CD	Compact Disk
CFA	Committee on Fiscal Affairs
DTT	Double Taxation Treaty
DTC	Davis Tax Committee
E-commerce	Electronic Commerce
G-20	Group of twenty
ibid	*ibid* short for the Latin *ibidem.* It means same source as last time (previous note).
ISP	Internet Service Provider
the ITA	Income Tax Act 58 of 1962
MTC	Model Tax Convention
OECD	Organisation for Economic Co-operation and Development
POEM	Place of effective management

SARS	South African Revenue Service
TAG	Technical Advisory Group
UK	United Kingdom
USA	United States of America
VAT	Value Added Tax
www	World wide web

CHAPTER 1– INTRODUCTION

1.1 Background

This research approaches the subject of taxing international electronic commerce (‘e-commerce’) by examining the South African existing income tax principles which were drafted in an era before e-commerce, and how these principles apply to the ever-increasing trend of trading over the Internet. To appreciate the complex challenges that e-commerce presents to tax principles, a solid understanding of the basics of the Internet is required.

The research report provides an overview of the way the South African taxation system on foreign transactions works. Furthermore, this study addresses the permanent establishment concept, and detailed explanation of how and what happens when e-commerce transactions are conducted.

Due to the popularity of e-commerce, businesses have increased rapidly,[2] as a result, there remain several key issues that are unresolved such as taxation of e-commerce transactions.[3] Whilst these issues present problems for taxing authorities and administrators, they also present opportunities for legitimate tax planning. By this, businesses can reduce their tax payments in some or all countries in which they operate.[4]

Against this background, this research attempts to examine the impact of the internet and e-commerce on the established taxation principles between South Africa and other countries, and the ability of the existing source and residency tax regimes to cope with the new realities.

The concepts of 'source of income’[5] and ‘tax resident'[6] will be addressed in detail– as they are the cornerstone of international tax principles, primarily used to determine whether income is taxable in a particular country. As no geographical

[2] Smith, C. 2017.
[3] Carnaghan, C and Klassen, K. 2003, page 1
[4] *ibid*
[5] Stiglingh M. *et al* .2018, page 754
[6] Stiglingh M. *et al* .2018, page 33

boundaries exist in cyberspace, this results in the concepts of source of income and tax residence becoming difficult to apply. Determining the residence of a company may prove difficult when the company decision makers (board of directors) are situated in different countries. Decision making, between the company's directors, such as the sitting of board meetings, may significantly take place electronically. As a result, it thus becomes difficult to determine a company's place of effective management.[7]

With the global nature of e-commerce, non-taxation is likely to result with electronic transactions.[8] Traditionally, the concept of 'permanent establishment' required some physical presence in the country seeking to impose tax.[9] Today, however, it is no longer necessary to have a physical place of business in a country to sell products or services in that country. This phenomenon has raised a discussion on whether the traditional concept of permanent establishment remains workable or if a change is indeed necessary. [10] Traditionally, countries have developed different rules for different types of income.[11]

For example, the rules for determining the right to tax income from services may be different from the rules for determining the right to tax royalties. Similarly, the rules for determining the right to tax income from sales may be different from the rules for taxing interest.[12] Such distinctions become challenging in the light of e-commerce. As e-commerce facilitates cross-border trade, particularly for businesses who may have 'web' subsidiaries, transfer pricing issues will occur more frequently and advances in communication technology may be more complex.[13] The concluding chapter of this research builds upon the foregoing chapters and draws upon the findings and conclusions of the preceding materials and related sources.

[7] South African Revenue Service. 2015, Interpretation Note 6, page 4
[8] Azam, R. 2012, page 653
[9] Olivier, L and Honiball, M. 201, page 336
[10] OECD Centre for Tax Policy. 2017, page 14
[11] Doernberg, R. *et al*. 2001. page 163
[12] *ibid*
[13] Naicker, K. 2003, page 3

1.2 Research Problem

1.2.1 The Statement of the Problem

The fundamental requirement posed by the current permanent establishment concept is the 'geographical, fixed, physical location' requirement.[14] Due to this requirement, it is extremely difficult for tax authorities to tax non-resident e-commerce transactions. The absence of a geographical location will not give rise to a tax presence. As a result, if a non-resident is conducting e-commerce business in South Africa, the South African Revenue Service ('SARS') will not be able to impose tax on that foreign entity.

The objective of this research is to identify possible solutions to the challenges which governments, particularly the South African government, face on the taxation of e-commerce transactions. The main challenges posed by transactions conducted over the internet is that they transcend international boundaries and have no 'geographical, fixed, physical location', which makes it difficult for tax jurisdictions to impose taxes on a transaction.

1.2.2 Sub-problems

- What is a permanent establishment?
- How has the concept of permanent establishment evolved over the years to its current state?
- What is e-commerce?
- Can an e-commerce transaction create a permanent establishment?
- What are the challenges faced by the South African government with regards to the taxation of e-commerce transactions?
- What are the possible solutions to the taxation of e-commerce transactions?

[14] Olivier, L and Honiball, M. 2011, page 340

1.3 Research methodology

The methodology used to conduct this research is the qualitative methodology. This is accomplished by an analysis of available literature on the problem. The study relies on the primary and secondary sources of information. The information was obtained from:

- books;
- case law;
- dissertations and theses;
- government publications;
- hypothetical case study;
- journal articles;
- legislation; and
- other internet sites;

A critical analysis of certain documentary evidence has been used to reach a result and suggest probable changes to the current tax legislation.

1.4 Scope and limitations

The focus of this research will be limited to the concept of a permanent establishment in the context of taxation of e-commerce transactions and the challenges the South African government faces in taxing e-commerce transactions. It thus will not look at Value-Added Tax ('VAT') and Transfer Pricing.

1.5 Chapter outline

1.5.1 Chapter 1 – Introduction

- The background to the research report;
- Research problem;
- Research Methodology;
- Scope and Limitations;
- Chapter overview.

1.5.2 Chapter 2 – Tax Jurisdiction: source of income and tax resident

In this chapter the meaning of tax jurisdiction will be analysed, particularly from a South African perspective. South Africa's right to tax income of non-residents is dependent on whether the activities that generated the income took place in South Africa.[15] Therefore, this chapter aims to establish where a taxing right originates.[16]

1.5.3 Chapter 3 – Evolution of the Permanent Establishment

This chapter explores the evolution of the concept of the permanent establishment, from its historic[17] concept to its current definition.[18] Different types of tax conventions are referred to[19] and the changing nature of the definition of the concept of the permanent is discussed.[20]

1.5.4 Chapter 4 – E-Commerce

For one to understand taxation of e-commerce transactions, it is important to know what e-commerce is. This chapter aims to give perspective on what is e-commerce and how it fits in the corporate environment.[21]

1.5.5 Chapter 5 – Taxation of e-commerce transactions

This chapter explains how e-commerce transactions are taxed.[22] This chapter will address:

- Effects of e-commerce on the South African tax legislation;[23]
- Tax Jurisdiction of cross border e-commerce transactions;[24]

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[15] Haupt, P. 2017, page 31
[16] Stiglingh, M. *et al* 2018, page 34
[17] Vogel, K. 1991, page 271
[18] OECD. 2014, page 26
[19] Schaffner, J. 2013, page 49
[20] Vogel, K. 1991, page 282
[21] Papadopoulos, S and Snail, S. 2012, page 42
[22] Du Plessis B *et al*
[23] Oguttu, A.W *et al.* 2009, page 213
[24] Papadopoulos, S and Snail, S. 2012, page 106

- Whether e-commerce activities can constitute a PE;[25]
- Hypothetical case study.[26]

1.5.6 Chapter 6 – Cross border tax challenges on the taxation of e-commerce transactions

In this chapter, the research report documents challenges faced by governments on the taxation of e-commerce transections.[27]

1.5.7 Chapter 7 – Recommendations to the taxation of e-commerce transactions

This chapter looks at possible solutions which can be adopted by the South African government to tax e-commerce transactions[28]. These include and are not limited to:

- Economic presence test;
- New source rules;[29]
- Withholding tax on digital services.[30]
- Virtual permanent establishment;[31]

1.5.8 Chapter 8 – Summary and conclusions

This chapter draws conclusions from the study and makes recommendations.

[25] IBFD, 2015
[26] Ademi, P. 2014, page 25
[27] OECD Base Erosion and Profit Shifting. 2015, page 98
[28] Pinto, D 2003, page 35
[29] *ibid*
[30] OECD Centre for Tax Policy. 2017, page 54
[31] Santoso, M. 2017. Page 268

CHAPTER 2 – TAX JURISDICTION

2.1. Introduction

When a country's residents transact offshore with residents of another tax jurisdiction, two taxation systems are likely to be involved in the taxation of the transaction. From a global perspective, countries need to maintain orderly tax regimes to promote international trade. There is a need for accepted rules and conventions limiting a country's rights to tax its own residents operating or investing abroad, or residents of other countries doing so in their jurisdiction. Two mainstream principles which have developed for this kind of 'international taxation' are respectively the *source* and the *residence* principles.[32] Where these exist in different jurisdictions, there is the potential for double taxation which is precluded either through unilateral legislation or bilaterally by a network of double taxation treaties ('DTT') which seeks to remove certain potential conflicts and to eliminate the danger of taxing the same income twice.[33]

Income or profits which result from international activities such as cross-border investment may be taxed where the income is earned (the source country), or where the person who receives it is normally based (the country of residence). Residence taxation of income is based on the principle that people and firms should contribute towards the public services provided for them by the country where they live, on all their income wherever it comes from. Source taxation is justified by the view that the country which provides the opportunity to generate income or profits should have the right to tax it.[34]

South Africa taxes its residents on a world-wide income basis and non-residents on a source basis, that is income from a South African source.

[32] Saunders, R. 2014.
[33] South Africa National Treasury 5th Report. 2015, page 1
[34] Yonah, R. 2005.

2.2 Residency

Since 2001 South Africa has taxed its residents based on the fact that they live in South Africa. This particular taxation system is called a residence based system of taxation. The basis of this system is that there is a legally relevant nexus between the state and the citizens, and that relevant nexus is the effect of residency. Most of the world has a residency based taxation system.[35]

Before 2001 South Africa applied a source based taxation system. In essence, amounts were only subject to tax (in South Africa) if they were from a South Africa source or deemed South African source. The residence of a taxpayer was by and large irrelevant. The source basis of tax was replaced by a residence basis for years of assessment commencing on or after 1 January 2001. The residence taxation system entails that South Africa residents are taxable on their worldwide income, regardless of the source of that income.[36] Non-residents are however taxed on their source of income in South Africa, this will be discussed under 2.3.

2.2.1 Meaning of 'residence'

A person's residence is determined in terms of the definition of resident in section 1 of the Income Tax Act ("the Act").[37] Section 1 of the Act defines resident for both natural persons and juristic persons.

A natural person is a resident if the person meets the ordinarily resident test or the physical presence test.[38]

If a person does not meet either of the tests then, that person will be regarded as a non-resident. For the purpose of this research, residency rules will be limited to juristic persons (companies) only.

[35] South Africa National Treasury 5th Report. 2015, page 1
[36] Haupt, P. 2018, page 25
[37] Stiglingh, M. 2018, page 33
[38] Income Tax Act Section 1

In the case of any person other than a natural person, that person will be regarded as a South African resident if the person is incorporated, established, formed, or has its place of effective management in South Africa.[39] A detailed discussion follows below in 2.2.2.

2.2.2 Residence of juristic persons- place of effective management

The concept of place of effective management ('POEM') is relevant in determining whether a company could be considered to be South African resident for income tax purposes.

As indicated above, the term 'resident' is defined in section 1(1) of the Act. For a company, paragraph *(b)* of the definition includes any company that is either incorporated in South Africa or has its POEM in South Africa.[40]

A South African incorporated company will not be considered to be a non-resident simply because its POEM is outside South Africa. To be clear, if accompany is incorporated in South Africa but has its POEM outside South Africa, the default point of departure in terms of South African domestic tax law, is still that the company is South Africa resident.

A company will not be considered a South African resident if it is deemed to be exclusively resident of another country in terms of a double tax treaty (DTT). For a South African-incorporated company, this would be in a situation where:

- that company is also considered to be a tax resident in another country;
- by virtue of the residence rules in the domestic tax law of that other country (so the company is therefore potentially dual-resident);
- there exists a DTT between South Africa and that other country; and
- in terms of the so called residence tie-breaker in that DTT.

[39] Haupt, P. 2018, page 30
[40] Haupt, P. 2018, page 30

The relevance of POEM is that a company's POEM is the most common example of a DTT residence tie-break. The company must first be considered to be tax-resident under the domestic law of that country, before the POEM tie-break becomes relevant.

The term 'effective management' is not defined in the ITA. As such, an entity's POEM in the context of establishing corporate residence is a factual matter which needs to be determined with reference to all facts and circumstances, in light of its ordinary meaning and in accordance with the common law rules regarding interpretation. Historically, South African authorities and judges have always been cognisant of, and influenced by, international pronouncements on tax matters –more so in relation to cross border taxation.

Internationally, the primary guidance on POEM comes from the OECD. In the OECD's Model Tax Convention ('MTC'), the concept of POEM serves as the standard residence tie-breaker.

According to OECD's Commentary in its MTC, POEM: "is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made".[41]

Thus, a POEM enquiry needs to consider the company's overall business "as a whole" and, in considering the necessary commercial and management decisions, the enquiry would need also to appreciate which decisions are "key". Furthermore, the full reality of the decision making process must be understood in order to conclude on where "in substance" the decisions are made.

In this respect, the same part of the OECD's Commentary makes additional points that:

- relevant conditions should be assessed to determine the POEM; and
- a company can be managed in more than one place, however, it can only have one place of effective management at any one time.

[41] OECD MTC.2014, paragraph 24

In South Africa, there are two items of interpretive guidance on POEM, namely The Oceanic Trust case[42] and SARS Interpretation Note 6, both of which are supportive of the OECD position discussed earlier.

It is beyond the scope of this document to set out in detail the interpretive authorities referred to above, to summarise the position, the term ‘effective management’ means ‘real’, ‘true’ or ‘actual’ top level decision-making. It seems universally accepted that POEM should be interpreted to mean ‘the place where the key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made’.

2.2.3 Residency in terms of Double Taxation Treaty (‘DTT’)

A DTT is an agreement entered into between two countries to provide relief from double taxation and to prevent tax evasion by providing for the exchange of information between the countries which have entered into such agreement. A DTT overrides the provisions of the South African ITA.[43]

The definition of resident in a DTT provides that a person is not a resident if that person is deemed to be exclusively a resident of another country in terms of the DTT. This means that if a DTT between South Africa and another country is in place, one should first consider whether the taxpayer is deemed to be exclusively a resident of the other country under the DTT, before considering whether the person is a resident under the definition of ‘resident’.[44]

Article 4 of most DTTs provides the definition of a resident. This is for purposes where a resident might have dual residency i.e. residency in two countries. Article 4 usually states under which circumstances is a person considered to be resident in which state (either in the contracting state or the other state).[45]

[42] *The Oceanic Trust Co. Ltd N.O. v C:SARS, Western Cape High Court Case No.22556/09*
[43] Section 231 of the Constitution of the Republic of South Africa Act 108 of 1996, read with section 108 of the Income Tax Act 58 of 1962
[44] Stiglingh, M. 2018, page 29
[45] Voster, H. (2015)

Article 4(1) of the OECD MTC reads:

For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.[46]

In this regard, South African courts have accepted that the OECD Commentary[47] may be used in interpreting treaties, despite South Africa not being an OECD member state. This principle was confirmed in *SIR v Downing, 37 SATC 249*. In this case, the court upheld the *dicta* of the lower court that South Africa was bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on concepts utilised in the OECD MTC, as South Africa had adopted that Model for its DTTs. Furthermore, the South African courts will apply customary international rules and practice as confirmed by section 231 of the Constitution of the Republic of South Africa 1996, to the extent that they do not conflict with the constitution.

Non-residents receiving income from a South African source should determine whether a DTT exists between South Africa and the country in which they are resident and whether relief for taxation on their income is provided for in the DTT.[48]

2.3 Source

The alternative to residence based taxation system is the source based taxation system. The source principle of taxation entitles a country to tax income

[46] OECD MTC. 2014, page 26
[47] OECD MTC. 2014, page 85
[48] *Ibid*

originating in that country. In essence, the country which the income is derived from has the right to tax.[49]

Although South Africa taxes its residents on the basis that they reside in South Africa, taxpayers who are non-residents will be taxed as an exception if their income is sourced in South Africa. As discussed above, if a company is not incorporated, established, formed or has its place of effective management in South Africa it will be seen as not resident in South Africa.

The source of income is relevant for various reasons. Persons who are not resident in South Africa are only subject to tax on income which is from a South African source. South Africa is party to a number of DTTs with other countries. As mentioned above, a DTT is an agreement between two countries aimed at regulating the taxation of income which is earned in one country and subject to tax in another country. The principle objective of the DTT is to prevent double taxation. In resolving tax conflicts, treaties often use the source of income as the basis of provisions contained in the treaty. The application of the DTT therefore often requires the identification of the source of income.[50]

Section 9 of the ITA sets out the rules relating to determining the source of income. In the event that an income item is not specifically set out in the section, then common law rules including determination of the "originating cause" of the income are applied in determining the source of the income.[51]

Non-residents are subject to South Africa income tax on revenue from business profits[52] when the following two requirements are met:

- The revenue must be from a South African source; and
- In case the case of a company, the company can claim treaty protection, if it has a permanent establishment in South Africa and the business profits concerned must be attributable to that permanent establishment.

[49] Pinto. D. 2007, page 285
[50] Haupt. P. 2018, page 32
[51] *Ibid*
[52] Income Tax Act, Section 9 (2)

The determination of source is also relevant in the application of South Africa's DTTs which often provide that, if both the state of the taxpayer's residence and the state of the source of income are permitted to tax a particular amount of income, the state of residence should provide fiscal relief in respect of tax paid in the state of source.[53]

The South African rules on when income is considered to be South African-source can be categorised into two groups, namely:

a. General principles from case law
b. Specific source legislation

<u>General source principles</u>

The broader over-arching principles relating to the interpretation of "source within South Africa" has been derived by the South African judiciary. These general principles must also be applied to cover certain income-types, such as income for services rendered, rental income and general business income that are not expressly dealt with in the source legislation.

South Africa's general source principles apply not only where the income type is clearly not covered by the legislated rules in section 9 of the ITA, for example, section 9 of the ITA does not deal with services income, but also where the income-types cannot be categorised into specific amounts to be dealt with in section 9 of the ITA.[54]

The South African case law, generally accepted definition of source was laid down by Judge Watermeyer, C.J. in the *Lever Bros* case, where he said:

"*the source of receipts, received as income, is not the quarter whence they come, but <u>the originating cause</u> of their being received as income, and that this originating cause is <u>the work which the taxpayer does to earn them, the quid pro quo which he gives in return</u> for which he receives them. The work which he does*

[53] Stiglingh, M. *et al.* 2018, page 762
[54] Stiglingh, M. *et al.* 2018, page 756

may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these." [55]

Ordinarily it is not difficult to determine and locate the originating cause of income. However, the various court decisions show that difficult cases may arise. As a result, it is a very difficult to extract general principles from these cases, because the courts have frequently pointed out that it is dangerous to generalise when determining source and each case will have to be decided on its own facts.

A major difficulty arises when the originating cause is a combination of factors. However, the courts have held that where there are a number of causal factors, it is appropriate to weigh up these factors in order to determine the "*dominant or main*" cause of the receipt, as was stated in the *Essential Sterolin* case.[56] In addition, the court held that it was of fundamental importance that, at the time the agreement was entered into, the business operations from which the taxpayer derived income, were conducted primarily outside South Africa.

In the *Transvaal Hide case* it was held that where a taxpayer's profit-earning activities have been carried on partly in one place and partly in another place, it is necessary to consider the entirety of the activities and to determine whether those carried out in one place or those in the other played the greater part in earning the income. [57]

As a general principle, income is not apportioned if it is located partly within and partly outside South Africa. It might be possible to apportion the source of income where the income can clearly be split between separate originating causes. However, where a person has contracted to perform services in a given

[55] *CIR v Lever Bros & Unilever Ltd* 1946 AD 441, 14 SATC
[56] *Essential Sterolin Products (Pty) Ltd v CIR 1993 (4) SA 859 (A)*
[57] *Transvaal Associated Hide and Skin Merchants v Collector of Income Tax*

country and has minor duties, which are purely incidental and subsidiary, to be performed in another country, no such apportionment should be made and *none* of the income is regarded as having its source in the latter country. This non-apportionment principle was emphasised in the case of *Shein.*[58]

Although the Tax Court has authorised the apportionment of the source of income derived from services, in the case of ITC 77, it is doubtful whether the courts will readily resort to the apportionment of a particular amount of income according to the various sources from which it may have been derived. Regard must rather be had to the dominant or main source of such income; the source may therefore lie in the country in which the main activities may have taken place.[59]

In the case of *Epstein* case*,* Schreiner JA in his dissenting judgment stated that it is irrelevant where the taxpayer's general business is carried on, or where his principal place of business is. What is relevant and possibly crucial is where he carries on the business from which the income in question is derived and where the business profits are realised.[60]

Specific source legislation

Specific income-types are found section 9 of the ITA which specifically defines the source. This covers income-types such as interest, royalties, sale of moveable goods, and several others.

As suggested above, several arguments exist on the topic of source of income. However, the appropriate principles and arguments are also dependent upon the type or category of income. This is especially true for income types that are specifically addressed in section 9 of the ITA[61]

[58] *COT (SR) v Shein 1958 (3) SA (FC), 22 SATC 12*
[59] *ITC 77 (1927) 3 SATC 72 at 73 - 74*
[60] *CIR v Epstein 1954 (3) SA 689 (A), 19 SATC 221*
[61] Income Tax Act – Section 9

However, where a composite contract does not specifically assign amounts to each particular element of the contract, the entire contract income should be regarded as having been derived from the principal or dominant cause.[62]

In terms of the ITA, non-resident companies are subject to a South African income tax at a rate of 28%, if they derive income from a South African source, subject to DTT relief. If the non-resident is tax resident in a treaty country, South Africa will generally only tax business profits if attributable to that non-resident's permanent establishment in South Africa. In most cases, this means that the *permanent establishment* enquiry (under the DTT) only becomes necessary after the question of "source" under South African domestic law has been considered.

2.4 Permanent Establishment

The permanent establishment nexus shall be discussed further in chapter 5. In a nutshell, a permanent establishment is a fixed place of business through which the enterprise's business is wholly or partially carried on.[63]

The source country has the right to tax the business profits attributable to a branch of a foreign company, defined as a permanent establishment. In exchange, the source country agrees to apply no, or a low tax at source described as a `withholding' tax, on payments to residents of the other country.. Thus, the main effect of the tax treaties is to reduce source-based taxation in favour of residence-based taxation of passive income, sometimes referred to as income from capital. The degree to which this is done depends on each treaty. Capital-exporting (richer) countries prefer the OECD model treaty, which is more favourable to residence, while capital-importing (developing) countries tend to favour the United Nations ('UN') model treaty, which is more favourable to source.[64]

[62] *Ibid*
[63] Haupt, P. 2018, page 37
[64] Yonah, R. 2005.

2.5 Conclusion

The South African model of taxation is primarily residence based in that persons and companies who are resident in South Africa are taxed in the Republic on their worldwide income. There is, however, an element of the source principle retained in respect of non-residents who are taxed on income generated within or deemed to be generated within the country. Notably, the application of the source principle is contained in DTT concluded between South Africa and other jurisdictions as a means to allocate a portion of business profits to each jurisdiction that generates that portion of the income.

The reason why section 9 of the ITA makes reference to permanent establishment is to align the South African source rules with the various DTT which South Africa has with other countries.[65] The following chapter addresses the evolution of the permeant establishment concept and its importance to the South African taxation system.

[65] Haupt, P. 2018, page 36

CHAPTER 3 – EVOLUTION OF PERMANENT ESTABLISHMENT

3.1 Introduction

It is necessary to understand the history and evolution of the permanent establishment concept in order to review its current state. In this chapter the research report will look at the how the concept of permanent establishment has evolved over the years and the importance of the OECD definition of permanent establishment for South African tax purposes.

3.2 Types of Model Tax Conventions

The concept of permanent establishment is the most important subject in the treaty based international fiscal law. The most popular and mostly used model conventions are the OECD, UN and United States of America ('USA') model conventions. These model conventions, use the permanent establishment concept as the main instrument to establish taxing jurisdiction over cross-border business activities.

Olivier and Honiball opine that with the USA included, some other countries, like the Netherlands, have developed their own MTCs which they use as a basis for treaty negotiations. Although not commonly known, South Africa also has a MTC which it uses as basis for its treaty negotiations alongside with the Southern African Development Community Tax Convention and the OECD MTC.[66]

3.3 History of Permanent Establishment in Model Conventions

The permanent establishment principle can be traced back to the 1800s, when countries in Europe initially discussed mutual DTTs to manage the tax conduct of cross-border commercial activities. The phrase 'permanent establishment' traces as far as the 19th century from a German use through the term *Betriebsstrātte,* which was first used in the tax law of Prussia in 1855 as one of many other terms

[66] Olivier, L. and Honiball, M. 2011. page, 272

such as agency and place of management. From 1864 the phase has been used in the current tax sense.[67]

The contemporary version of the permanent establishment concept came post-World War I when European states were worried that international double taxation was preventing international trade. Equally, post-World War I in the North American continent, the Canadian tax authorities attempted imposing taxes on mail orders that were incoming from a USA firm, although the USA firm advertised its products in Canada exclusively. USA was adamant that it should have the sole taxing right of those earnings. This event thus created potential double taxation of the same commercial activities.[68]

Due to the growing concern of the requirement to prevent double taxation between the municipalities in Germany and Prussia. civic guidelines in Eastern Prussia indicated that 'a trader with a fixed place of business' in a municipality could be taxed in that municipality, even if the trader lived in another municipality. The concept required the existence of a fixed physical location and the intention of carrying on a business activity at such physical location.[69]

On 12 April 1927, the first preliminary draft convention was published in London by the Extended Committee of Technical Experts. This draft's purpose was to cover real taxes and personal taxes. In conjunction with this draft other drafts were also prepared on judicial assistance in the area of tax collection.

In 1928 the League of Nations published a Model Convention for the Prevention of Double Taxation. This convention regulated the right of source and residence states to tax recipients of the income only when the concept of permanent establishment was established.[70]

In the League of Nations Model Convention, the permanent establishment Article 5 provided that income from 'any industrial, commercial and agricultural

[67] Jones, J. et al. 2006, page 233
[68] Cockfield, J. 2003, page 2
[69] Chaffey, A. 2014, page 13
[70] Chaffey, A. 2014, page 14

undertaking and from any other trades or professions shall be taxable in the State in which the permanent establishments are situated'. The economic events were considered according to various aspects. Establishments which were permanent were:

- real centres of management;
- branches; mines and oilfields;
- factories and workshops;
- agencies; and
- warehouses, offices, and depots.[71]

In 1929 the League of Nations further published a report in which set out criteria as to when an agent constituted a permanent establishment. The report determined that, when a foreign enterprise regularly conducts business in another country via an agent in that country, and such agent is entitled to act on behalf of the business, the foreign enterprise will be considered as having a permanent establishment in that country.[72] In 1933 the League of Nations compiled the draft definition of a permanent establishment together with the principle of residence-based taxation.[73]

The Organisation for European Economic Cooperation ('OEEC') (predecessor of the OECD), in March 1956 adopted a resolution to establish a fiscal committee for the 'Studying of questions relating to double taxation and other fiscal questions of a similar technical nature'. Five years post the adoption of the fiscal committee, on September 1961 the OEEC changed its name to the Organisation for Economic Co-operation and Development (OECD) and in 1971 the Fiscal Committee was renamed the Committee on Fiscal Affairs ('CFA'). The CFA consists of senior government officials, who are generally responsible for fiscal policy in their respective countries.[74]

[71] Cockfield, A. J. 2003, page 2
[72] *Ibid*
[73] *Ibid*
[74] Russo, R. 2005, page 12

CFA published the first draft double taxation convention on income and capital in 1963 (‘the 1963 draft’). This draft was revisited in 1977 and the revised Model Double Taxation Convention on Income and on Capital was published in 1977 (‘the 1977 Model’). As tax is not static and has to keep up with the ever changing form in which business is done, the Model is updated on a regular basis. In the past the OECD MTC has not been updated that regularly, it was only updated in 1973, 1977 and 1992. However, recently it has been updated more regularly in 1994, 1995, 1997, 2000, 2003, 2005, 2008 and 2010.[75] Olivier and Honiball emphasise the view of Russo that, 12 regular updates reflect the rapid changes in the global economy and environment.[76]

The present OECD model (condensed version) was approved on 21 November 2017. This research will focus on the 15 July 2014 version as the topic at hand was not amended extensively and majority of the research took place during the 2017 version.[77]

The substance of the taxation treaty structure is the widespread network of tax treaties that has evolved since the work of the League of Nations in the 1920s. The OECD presumed a principal role in leading the tax treaty system after the disbandment of the League of Nations and its replacement by the UN. The OECD's drive for guiding the tax treaty system is the OECD Model and Commentary, together with reports on specific topics. The tax treaties of the member countries of the OECD are based on the OECD model which is the epicentre of the tax treaty system. ‘*As countries vigorously protect their sovereignty and jurisdiction to tax, the implementation of the OECD Model and Commentary in the tax treaties of both OECD and non-OECD countries is a considerable achievement*.’[78]

[75] Olivier, L. and Honiball, M. 2011, page 270
[76] *Ibid*
[77] Kobetsky, M. 2011, page 106
[78] Kobetsky, M. 2011, page 152

3.4 The concept of a permanent establishment

The important aspect of the concept of a permanent establishment is to regulate the right of a contracting state to tax the profits of a non-resident entity which derived its source of income from that contracting state. Therefore, applying an appropriate tax policy is very important to grant taxing rights either to the source contracting state or the resident contracting state. [79]

Professor Lüdicke alludes that, the concept of permanent establishment has been used for a very long time in tax treaties. It reflects the supply-based theory. A permanent establishment in the source state is the decisive prerequisite for that state to tax profits of an enterprise of another contracting state.[80]

Apparently, in the past the fundamentally supply-demand theory required the mere use of the market in the other country. This would already justify taxation in the source state, even without any physical presence. It was not considered a proper basis for the allocation of taxing rights regarding business profits by either the OECD or the UN Model.[81]

Kumar believes the concept of a permanent establishment, significantly requires the business profits of an entity in one Contracting State to be taxable in the other Contracting State. However, this notion is only applicable if the entity maintains a permanent establishment in the former Contracting State and to the extent that the profits made by the entity are attributable to the permanent establishment.[82]

It is also worth noting that besides the theoretical notion, the practical aspects played an important role in defining the concept of permanent establishment. In essence, the legal concept of a permanent establishment involves an agreement between the source state and the resident state that is a DTT. The concept effectively represents the minimum threshold level of activities required to be carried on in the source state.[83]

[79] Steenkamp, L. 2014, page 539
[80] Lüdicke, J. 2004, page 190
[81] OECD Center for Tax Policy. 2012
[82] Kumar,R. 2013
[83] *Ibid*

This concept is fundamentally one of the most important concepts in international taxation. The existence of a permanent establishment or otherwise, would in most cases determine the exposure to domestic tax liability in the country of source. It is, therefore, imperative to understand the concept fully before embarking on the structuring of activities in another jurisdiction. Attribution of profits to a permanent establishment has also been one of the major issues both for taxpayer as well as Contracting States.[84]

As indicated above, the permanent establishment concept is the keystone of the existing tax treaty rules that govern the allocation of taxing rights over the business profits that non-resident entities derive from a country. Almost all existing tax treaties include a definition of that concept based on Article 5 of the OECD MTC.[85]

3.5 Definition of Permanent Establishment

Section 1 of the South African Income Tax Act ("the Act") provides that:
"permanent establishment" means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development…"[86]

As indicated above, the courts in South Africa have accepted that the OECD MTC and its Commentary may be used in interpreting treaties irrespective of South Africa not being an OECD member State. This principle was confirmed in the case *Secretary for Inland Revenue v Downing, 37 SATC 249*. In this aforesaid case, the court held that South Africa was bound to take cognisance of the guidelines for interpretation issued by the OECD as South Africa had adopted the OECD Model for its DTTs.[87]

[84] Kumar,R. 2013
[85] Sasseville, J. 2012
[86] Income Tax Act- Section 1
[87] Olivier, L. & Honiball, M. (2011) 311

Furthermore, the South African courts will apply customary international law rules and practice as confirmed by our courts and by section 231 of the Constitution of the Republic of South Africa, to the extent that they do not conflict with the Constitution.[88]

It was held in a popular Indian case *CIT v Visbakbapatnum Port Trust the Andhra Pradesh High Court* that:
"The words 'Permanent Establishment' postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another, which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country onto the soil of another country."[89]

The OECD MTC Article 5 defines permanent establishment and it gives an indication on whether a permanent establishment exists at the country in question. Even though the OECD MTC has been revised several times, due to necessity of time and development in international transaction, there still remains problems in the interpretations of the Article.[90]

In Article 5(1), the OECD MTC defines a 'permanent establishment' generally as: "*…a fixed place of business through which the business of the enterprise is wholly or partially carried on*."[91]

The following three different features may be identified in the definition of permanent establishment, as defined by the OECD MTC:

- a place of business;
- which is fixed;
- it is required that the business of the enterprise is carried on through this fixed place of business.[92]

[88] Constitution of the Republic of South Africa 108 of 1996 – Section 231
[89] Commissioner Of IncomeTax v Visakhapatnam Port Trust
[90] Stiglingh, M. *et al*. 2018. page 772
[91] OECD. 2014, page 26
[92] Olivier, L. & Honiball, M. 2011, page 335

Vogel emphasises that the main definition of permanent establishment is contained in the paragraph one, and that a permanent establishment is a fixed place of business through which the business of an enterprise is wholly of partly carried on. Vogel further explains that paragraph two of the definition of permanent establishment gives an illustration of the phrase ‘fixed place of business’ by listing facilities which constitute a permanent establishment. The third paragraph gives specifics to the phrase permanent establishment in relation to building sites, construction or projects. Paragraph four enlists exclusions of what does not constitute a permanent establishment. The fifth paragraph of the definition, stipulates that an enterprise’s agent constitutes a permanent establishment of the enterprise he represents. Paragraph six gives clarity to the notion that the business activities of an agent of an independent status do not constitute a permanent establishment of the enterprise which he represents. The last paragraph of the definition contains a rule which stipulates that the mere fact that one enterprise controls another does not make the second enterprise a permanent establishment of the former.[93]

In terms of the definition of permanent establishment in Article 5 of the OECD MTC, there is a pre-requisite that there must be either a physical presence in the Contracting State concerned or there must be some sort of presence.[94]

The OECD’s Commentary to Article 5 states that:
“the term ‘place of business’ covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or otherwise at the disposal of the enterprise.”[95]

[93] Vogel, K. 1991, page 281
[94] Steenkamp, L. 2014, page 542
[95] OECD. 2014, page 95

For a place of business to constitute a permanent establishment, the enterprise must carry on its business wholly or partly through it. In terms of the OECD MTC Commentary, the activity of an enterprise does not need to be of a productive character. The activities are also not required to be uninterrupted. However, operations must be carried out on a regular basis.[96]

Further, certain fixed places of business are excluded from constituting a permanent establishment where for example, the activities carried out by a company are of a purely preparatory or auxiliary character to the company's business.[97]

Distinction is drawn in the OECD Commentary between employees of a company who have limited responsibility with regards to the work performed in a particular country and employees that have a wider responsibility. An example of employees which have a limited responsibility would include, the provision of employees by a lessor after the installation of equipment to operate such equipment under the instruction of the lessee. On the other hand an example of employees that have wider responsibilities includes, a participation by employees in decision making regarding the work for which the equipment is used under the responsibility and control of the lessor. [98]

In terms of Article 5(3) of the OECD MTC, a building site, construction site and installation project will only be regarded as a permanent establishment if it has lasted for more than 12 months.

Agency permanent establishment can be created where an agent is regarded as a:

- "dependent agent";
- who has the authority to conclude contracts on behalf of the enterprise and who habitually exercises such authority in the source country.

[96] Steenkamp, L. 2014, page 543
[97] OECD. 2014, page 103
[98] OECD. 2014, page 107

An agent that is dependent, but who does not have the authority to conclude contracts on behalf of an enterprise will therefore not usually give rise to an Agency permanent establishment as both these factors need to be proven to exist.[99]

The OECD's Commentary to Article 5 states that:
"Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State"[100]

As such, a person will not constitute a permanent establishment of a company on whose behalf he acts if:

- the person is independent of the enterprise both legally and economically; and
- the person acts in the ordinary course of his business when acting on behalf of the enterprise.[101]

Factors which must be considered in deciding whether an individual or company acts as a dependent or independent agent include:

- The degree of freedom he/she has enter into contracts on behalf of the enterprise, for example, operating under detailed instructions and control indicate a dependent status;
- The entrepreneurial risk borne by the agent (if the risk is borne by the agent, if the agent acts independently).

It follows that in the event that the commercial activities of a person for a particular company are subject to detailed instructions or to significant control by the company, such person cannot be regarded as independent of the company. Similarly, if all the risk associated with the commercial activities of a person is borne by the company; such individual cannot be regarded as being independent of the company.[102]

[99] OECD. 2014, page 108
[100] OECD. 2014, page 109
[101] *ibid*
[102] OECD. 2014, page 110

A permanent establishment exists if the minimum threshold required for a country to tax non-residents' business profits derived from sources in that jurisdiction where they are carrying on business. A permanent establishment is often referred to as the legal fiction by way of which a state can widen its capacity to tax over a foreign non-resident entity where no other connection to the territory of the state is provided. Essentially, the permanent establishment definition determines the right of a contracting state to tax the profits of an enterprise of another contracting state. Thus, according to Article 7 of the OECD MTC, a country my not tax business profits of an enterprise unless that enterprise has a permanent establishment in that State.[103]

Profits attributable to a permanent establishment, in the state of source are either exempt in state of residence or the state of residence allows credit of taxes paid by the permanent establishment on such profits. To this extent, the taxing jurisdiction by the state of residence is said to be transferred to the state of source, where a person needs to file his return of income and comply with domestic laws.[104]

3.6 South African permanent establishment case

A recent decision made by the South African Tax Court is one of South Africa's first disputes on the concept of permanent establishment. In the case *AB LLC and BD Holdings LLC v The Commissioner of SARS*,[105] the Tax Court had to determine whether AB LLC and BD Holdings LLC had created a permanent establishment in South Africa, and as a result thereof, was liable for tax in South Africa.[106]

The facts relating to the two US tax resident aviation companies were the same, it was agreed that they would be treated as a single appellant for the purposes of

[103] Castro, L. 2012, page 130
[104] OECD Center for Tax Policy. 2012, page 20
[105] *AB LLC and BD Holdings LLC v Commissioner of the South African Revenue Service (13276) 2015 ZATC 2*
[106] Croome, B. 2015

the tax appeal. Therefore, the two companies were referred to as the same person throughout the judgement.

Between February 2007 and May 2008, the US resident entity availed seventeen of its employees to come to South Africa as and when required by the South African client. Three of the US entity employees formed a core of the project team and at least one of them was present all the time in South Africa, i.e. they were present on a rotational basis for three weeks at a time. In the 2007 calendar year, the employees were in South Africa for a period exceeding 183 days. The US entity's employees were allocated space at the South African client's premises where there were provided exclusive use of a boardroom. The US entity's employees had access to these premises on week days and during working hours only. These employees did not spend all their time in the boardroom but were required to work in other areas, for example, meeting with employees in other divisions. All this work took place within the same geographical premises.[107]

The Court had to consider the provisions of the DTT concluded by South Africa and the US. The focus of this case was on a specific inclusion in the US-South Africa DTT for consulting services rendered over an extended period which was in excess of the 183 days rule.[108]

The Court held that the US advisory firm's extended presence in South Africa, to deliver consulting services to a South African client, constituted a permanent establishment in South Africa.

The Court found in favour of SARS. The case also considered the more general question of whether the premises of a service provider's client can represent a "fixed place of business" (and thus a permanent establishment) of that service provider. In this case the Court found that the client's boardroom does in fact constitute a South African permanent establishment of the US entity's consultants.[109]

[107] Mazansky, E. 2015, page 494
[108] *AB LLC and BD Holdings LLC v Commissioner of the South African Revenue Service (13276) 2015 ZATC 2*
[109] Mazansky, E. 2015, page 495

3.7 E-Commerce inclusion in the permanent establishment concept

The concept of permanent establishment has evolved throughout the years until recently in the year 2000 with the inclusion of e-commerce to the OECD MTC Commentary was inserted. To assist persons in understanding how e-commerce fits in the permanent establishment definition, one issue which is specifically addressed in the OECD MTC Commentary on Article 5 is the extent to which e-commerce may result in a permanent establishment. This is extensively addressed in paragraphs 42.1 to 42.10 of the OECD MTC Commentary on Article 5.[110]

Due to the lack of consensus among the worldwide taxing authorities concerning what constitutes a permanent establishment in the context of e-commerce (and its exploding growth as a source of revenue for enterprises worldwide), countries are taking inconsistent positions on whether the e-commerce transactions conducted from one location of a website in a country can constitute a permanent establishment, increasing the risk of double taxation. Some writers have argued that the mere maintenance of a website on a server located in a taxing jurisdiction satisfies the requirements for a permanent establishment.[111] A detailed analysis of what constitutes e-commerce will be discussed in Chapter 4, followed by the taxation of e-commerce transactions in Chapter 5.

3.8 Conclusion

The current permanent establishment concept still includes the principles developed in the 1920s by the League of Nations, despite the effects of globalization. These principles were developed in a world economy in which international trade was in tangible items and international communication was slow. Over the years the permanent establishment concept has evolved but the element of a fixed place of business has not changed. Although more recently, the

[110]OECD. 2014, page 112
[111] Schaffner, J. 2013, page 65

e-commerce element is showing a significant business attraction, however, it brings about confusion in the tax environment, and this will be discussed in subsequent chapters.

CHAPTER 4 – E- COMMERCE

4.1 Introduction

Improvements in technology regarding communications persist to make the world smaller. The technological improvements create a climate that is conductive to cross-border trade. E-commerce is linked with buying and selling online or conducting any business which involves transferring rights to use goods or services through computerised system. For one to understand the taxation of electronic transactions it is important to know what e-commerce is and how it functions. This chapter provides an overview of what is the internet made up of, and it gives a discussion on what e-commerce is. Furthermore, this chapter deliberates on the contribution of e-commerce to the digital, global economy and e-commerce as means to do business.[112]

4.2. Overview of how the internet functions

The international network, colloquially known as the internet, is an interconnected system of networks that connects computers worldwide through software called Transmission Control Protocol and Internet Protocol. [113]

The internet has two components, that is, the physical network and the logical network. The physical network comprises all physical mechanisms, which include the individual user, the computer, cables, routers and servers which enable computers to communicate information to each other. The logical network makes the abovementioned communication possible.[114]

The functionality of the internet involves information being transferred between a computer and server which is then carried out through terminals, routers, and

[112] Doernberg, R. *et al* .2011, page 34
[113] Papadopoulos, S. and Snail, S. 2012, page 2
[114] Naicker, K. 2003, page 10

domains. A server is an instance of a computer program that accepts and responds to requests made by another program, known as a client.

As indicated above, the internet is the physical infrastructure which consists of computers, fibre-optic cables, routers and servers which enables data to be shared. The World Wide Web ('www') is the data, which is made up of a significant number of documents, texts, visual images and audio clips. The server's work is to store the data and to make it available through Transmission Control Protocol and Internet Protocol, a software which connects computers around the world through the internet. This said data is navigated through a tool based on hypertext transfer protocol. Each form of data (for example, text or image) has a unique Universal Resource Locator which identifies their location in the internet infrastructure. Users access the required data by sending requests containing the Universal Resource Locator, to the server that stores the data. When the request is received by the server, the server prepares the data and sends the information back to the user.[115]

The internet is the only vehicle used for e-commerce to date. Since we now have an idea of what the internet is and how it functions, the research below expands on the concept of e-commerce.

4.3 What is e-commerce?

> "*Electronic commerce or e-commerce, as we colloquially refer to it, is a term for any type of business, or commercial transaction that involves the transfer of information across the internet. It covers a range of different types of businesses, from consumer based retail sites, to services between corporations. It is currently one of the most important aspects of the internet to emerge*"[116]

E-commerce has been defined as the ability to perform transactions involving the exchange of goods or services between two or more parties using electronic tools and techniques. A somewhat more descriptive and perhaps more useful definition of e-commerce refers to a wide array of commercial activities carried out using computers, including on-line trading of goods and services, electronic funds

[115] Papadopoulos, S. and Snail, S. 2012, page 3
[116] Dayana M.K. n.d.

transfers, on-line trading of financial instruments, electronic data exchanges between companies and electronic data exchanges within a company.[117]

Dayana reemphasises the notion by Greenstein and Ferman that e-commerce is the use of electronic transmission medium to engage in the exchange of products and services requiring transportation either physically or digitally from location to location.[118]

The Australian Taxation Office conducted an extensive research in 1997 and concluded that, e-commerce is the buying and selling of goods and services on the internet. Goods can be of a conventional kind, such as books or compact discs, where delivery is affected by conventional methods from a contract executed on the internet, or *digital* goods, where both the contract of sale and the delivery of goods is made via the internet.[119]

The South African Department of Communications agrees to the definition of e-commerce which was defined by the OECD in its Science and Technology study in 2011. OECD therefore defines e-commerce as follows:

"An e-commerce transaction is the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered by those methods, but the payment and the ultimate delivery of the goods or services do not have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organisations. To be included are orders made over the web, extranet or electronic data interchange. The type is defined by the method of placing the order. To be excluded are orders made by telephone calls, facsimile or manually typed e-mail." [120]

[117] Hellerstein, W. 2002, page 2
[118] Dayana M.K. n.d.
[119] Australian Taxation Office. 1997, page 8
[120] Department of Communications Review Report. 2013, page 85

4.4 How is e-commerce conducted?

E-commerce can be conducted by using the following ways:

- Electronic Interchange
- Electronic Mail
- Electronic Bulletin Boards
- Electronic Fund Transfer
- Other Network-based technologies[121]

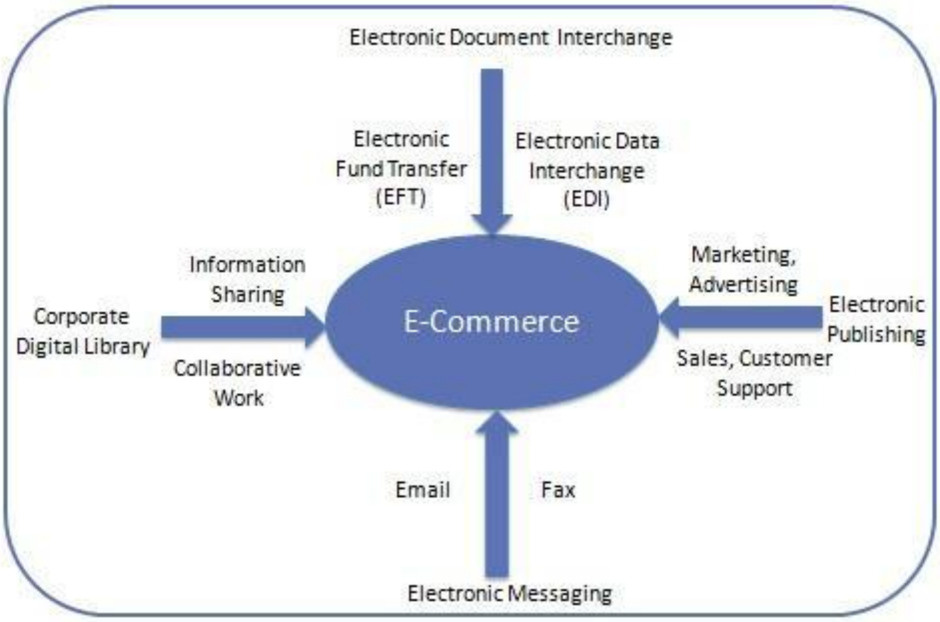

Fig 4.1[122]

Figure 4.1 depicts the effectiveness of e-commerce in a corporate environment.[123]

Multinational companies have been conducting *de facto* e-commerce for decades by networking their computing systems with those of business partners and clients. For instance, the banking industry uses Electronic Fund Transfer to transfer money between accounts. In addition, many other companies use Electronic Interchange, which enables business forms such as purchase orders and invoices to be processed, allowing companies to share information with customers, suppliers and business partners electronically.[124]

[121] Tutorials Point n.d, page 2
[122] Tutorials Point
[123] *Ibid*
[124] Deitel. 2004, page 137

As indicted in the definition of e-commerce above, e-commerce allows consumers to electronically exchange goods and services with no barriers of time or distance. E-commerce has expanded rapidly over the past years and is predicted to continue at this rate, or even accelerate. In the near future the boundaries between "conventional" and "electronic" commerce will become increasingly blurred as more and more businesses move sections of their operations onto the internet.[125]

4.5 How does e-commerce work? Who is involved in the e-commerce ecosystem?

The e-commerce ecosystem involves three key players, which is the buyer, the seller and the manufacturer. The buyer, is either an enterprise or an individual who wishes to purchase the goods and services. The seller is also either an enterprise or an individual who offers the goods and service. The seller can be a retailer selling directly to consumer or a wholesaler selling to both direct customers, who serves as the intermediary who sells to other retailers or businesses. Lastly the third player in the e-commerce ecosystem is the manufacturer, who can be an enterprise or an individual that produces the product or service offered. A manufacturer can sell to retailers, wholesalers, or directly to the consumer.[126]

Within the three key players involved in the e-commerce ecosystem, there are further four basic models which e-commerce comprises of, and they are business-to-business transactions (‘B2B’), business-to-consumer transactions (‘B2C’), consumer-to-consumer transactions (‘C2C’) and business-to-government (B2G). [127]

B2B consists of transactions in which a business sells products or services to another business. This form of transacting includes online varieties of traditional businesses in which a wholesaler buys packages of goods online, which it then sells to consumers from retail outlets. It can also include the provision of goods or

[125] *ibid*
[126] Department of Communications Review Report. 2013, page 87
[127] *ibid*

services to support other businesses, such as providing logistics services, warehousing, distribution and the outsourcing of support functions for e-commerce, such as web-hosting, security, and customer care solutions.[128]

The B2C model involves the supplying of products and services between business and end users. This model often referred to as a retail transaction models is among the earliest forms of e-commerce. A business following a B2C business model sells goods or services to companies or individuals who are outside the scope of their profession. B2C models may be found in different categories, including, online vendors with no physical stores or offline presence, or ‘click-and-mortar’ businesses that supplemented existing consumer-facing business with online sales.[129]

C2C involves the supplying of products and services between two consumers with the transaction usually completed by a third-party platform and payment system. An example of the C2C model is eBay where a person may auction off their goods to another interested individual. The C2C transactions are becoming more popular these days. Businesses involved in C2C e-commerce play the role of intermediaries, helping individual consumers to sell or rent their assets by publishing their information on websites. These businesses may or may not charge the consumer for these services, depending on their revenue model. This type of e-commerce comes in different forms such as auctions facilitated at a portal that allows online bidding on the items being sold, peer-to-peer systems allowing sharing of files between users, and classified advertisement portals which provide online marketplace that allows negotiation among buyers and sellers.[130]

B2G involves the provision of products and services between companies and the government. This business model encompasses topics such as public procurement, licensing procedures and any other government related operations. B2G particularly involves the rendering of services and information to the public using electronic means which allows government to deliver services to citizens

[128] OECD Base Erosion and Profit Shifting. 2014, page 25
[129] OECD Base Erosion and Profit Shifting. 2014, page 26
[130] Department of Communications Review Report. 2013, page 87

when they need them. B2G can also improve the quality of government services delivery.[131]

4.6 The growth of e-commerce

Although e-commerce is still minor in South Africa, it surprisingly has a large budget industry, worth approximately R28 billion annually. Statistics show that there are an estimated 17.1 million users who use e-commerce, which is roughly 31% of the South African population. These further indicate that each user spends an estimated R1 800 in a year on ecommerce purchases.[132]

The internet is changing the way business and trade is carried out, by moving it from a physical environment to one of a virtual environment. E-commerce has grown rapidly since users began to search more and more for services and goods sold on the www. Continuously rising internet penetration around the world will push further developments in the e-commerce arena as today's sales realised via the internet represent a significant portion of the overall commercial transactions.[133]

In recent times we even see the growth of internet access through smartphones and tablets which has caused an increase in the frequency of use of online services and the development of application stores (colloquially known as app stores), a type of digital distribution platform for software, often provided as a component of an operating system. App stores typically take the form of central retail platforms, accessible through the consumer's device, through which the consumer can browse, view information and reviews, purchase and automatically download and install the application on their device.[134]

The move towards the *new economy* has generated a lot of interest, and the present economic slowdown has served as a timely reality check when it comes

[131] *Ibid*
[132] QWERTY Digital. 2017, page 17
[133] Department of Communications Review Report. 2013, page 84
[134] OECD Base Erosion and Profit Shifting. 2014, page 28

to some of the more excited behaviour of internet consumers and sellers. Investments in information and communications technologies, connectivity and the growth of e-commerce have been the key elements of the expansion of e-business and the digital economy. These developments, along with policies to engage human capital, innovation and entrepreneurship, are creating the key platform for the *new economy* and thus create loopholes for mischief.[135]

4.7 Conclusion

We have seen in this chapter that the internet enables dealings such as ordering goods and services and payment thereof on line. This entails that many transactions that would have taken place over the internet are conducted more efficiently and at less expense. Furthermore, the Internet has expanded the reach of smaller businesses, enabling them to reach markets that would not have been possible to reach without its existence. As a result, the number of firms carrying out business transactions over the internet has increased dramatically over the last decade.[136]

For governments to manage or combat the supposed mischief which could arise due to e-commerce trade, governments are left with no choice but to enforce policies which regulate the usage and internet trade including taxation of such transactions. The following chapter, discusses the taxation of e-commerce transactions.

[135] *ibid*
[136] OECD Base Erosion and Profit Shifting. 2014, page 26

CHAPTER 5 – CAN AN E-COMMERCE TRANSACTION CONSTITUTE A PERMANENT ESTABLISHMENT

5.1 Introduction

In the previous chapters the research has explored the meanings of both e-commerce and permanent establishment. Focus will now be placed on how the two concepts are intertwined. This chapter will also look at how the two concepts are used globally and from a South African perspective.

5.2 Historical background of taxation of e-commerce

In the late 90s, the debate of whether internet transactions should be taxed at all was very controversial. Around 1998 the USA tax authority was of the view that e-commerce transactions should not be taxed at all. However, this view was changed in the year 2000 when the USA government supported the OECD in the co-ordination of international tax incentives. Concurrently, the OECD, the Australian Tax Office and the UK government developed the OECD's Ottawa Taxation Framework which contained the principles upon which e-commerce should be taxed. In its Green Paper on Electronic Commerce, South Africa incorporated the OECD's Ottawa Taxation Framework principles, however, no further legislative development has taken place since then.[137]

From as early as 1994, the Katz Commission (predecessor of the Davis Tax Committee) was tasked with studying the South African taxation system. Amongst other things, this Commission measured the impact of e-commerce on the South African tax system. The Commission reported that it received an indication that in the near future, international trade investment will gradually become a function of cross-border e-commerce through the internet. Undoubtedly so, the Commission also reported that these emerging developments will impact on some of the basic views of international taxation as they exist today.[138]

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[137] Papadopoulos, S. and Snail, S. 2012, page 103.
[138] Deloitte & Touche. 2000.

As much as studies have been conducted regarding the impact of e-commerce on the tax base, South Africa has over the years concluded several DTTs based on the OECD MTC, but none of these treaties specify how e-commerce transactions should be taxed.[139]

5.3 Tax jurisdiction of e-commerce transactions

The identification of countries that have jurisdiction or taxing rights on specific transactions has been a major problem posed by e-commerce. It is obvious that e-commerce requires business to be conducted without geographical borders. Du Plessis, B. and Viljoen, PA. emphasize that e-commerce takes place in cyberspace over the internet and it does not require any physical location. To tax e-commerce transactions in a specific jurisdiction, certain linking factors such as a permanent establishment need to be existing.[140]

To impose taxes on a cross-border transaction, international principles of income taxation require physical presence. A Contracting State's income tax system must indicate to who the tax applies to, and what income is subject to tax. As alluded in previous chapters, residence and source are the two most widely used connecting factors of international tax. Currently in practice, most governments will not assist other states in enforcing their tax claims. As a result, a country will be lucky in collecting taxes in the international context if it focuses its taxing rights on transactions connected with the country of source. The country of residence is regarded as the place with which a taxpayer has the closest personal links. The country of source is the country with which income has its closest economic connection. Like South Africa, most tax systems contain elements of both resident and source taxation.[141]

Due to the cyber nature of e-commerce, business transactions may affect the efficiency of both the residence and source taxation systems. Existing income

[139] Papadopoulos, S. and Snail, S. 2012, page 104
[140] du Plessis, B. and Viljoen, M, page 233
[141] du Plessis, B. and Viljoen, M, page 234

allocation between states, and consequently the allocation of tax revenues, may become distorted because of new technology and e-commerce. South Africa and many other African countries which import capital and skills offshore, normally have a source-based tax system on the non-residents. These countries are likely to experience an erosion of their tax bases if the application of existing tax legislation is not adapted to deal with e-commerce. Since e-commerce is not bound by any statutory or geographic boundaries, a source-based tax system has limitations in an e-commerce environment. [142]

These source-based taxation limitations are double-edged. First, it must be borne in mind that the true source of income has become hidden since the essentials of a transaction can be performed in different jurisdictions. For instance, a buyer can place an order for goods while based in one country and that order can be processed through a server in another country. To complicate matters, the payment of that order can be done in a third country, and delivery made from a fourth country. Given the above scenario, it thus becomes difficult to determine the source and dominant source under South African case law. The second limitation is that it has become economically viable to transfer value added elements of businesses out of the source jurisdiction. The value-added elements of the business are usually transferred to a low tax jurisdiction and thus give rise to taxation base erosion.[143]

5.4 The possibility of taxing e-commerce transactions

E-commerce is becoming increasingly popular and is gaining more importance. E-commerce also creates new challenges and opportunities for countries to raise tax revenue. This applies especially to cross-border e-commerce transactions. Over the last years, the OECD have studied the tax implications of e-commerce with respect to corporate income tax, withholding taxes and VAT. Due to that the OECD have published several reports on these tax topics.[144]

[142] *ibid*
[143] *Ibid*
[144] Department of Communications. 2000, page

The digital economy has given rise to many questions which relates to income taxation of e-commerce cross-border transactions. Cyberspace shadows the lines of cross-border jurisdiction, identity of taxpayer, and nature of goods or services sold, potentially creating issues such as double taxation, double non-taxation and tax evasion. These obstacles are harmful for both the corporate side and the revenue collection side. Companies are showing hesitation to take their business online due to unclear tax regulations as well as for the taxing authorities whose concern revolve around lack of clear taxation framework may result in shrinking tax base and therefore reduced fiscal revenue of a country. It is therefore becoming important that South Africa has a well-defined taxation policy in place which also takes into consideration the tax framework of its international trading associates.[145]

The increasing usage of the internet and e-commerce has called for the foundation of a new tax era. There is a significant change in the vital tax concepts which are used globally by different tax jurisdictions. Governments will have to speedily familiarize the application of existing tax principles on the e-commerce environment. Taxpayers, will also have to familiarize their tax planning strategies and consider the impact of a changing business environment on their global tax charge. Although e-commerce has solved the problems of physical location and distance as an obstacle to economic development, it has equally created a major problem to taxing authorities. Tax collection systems in force around the world require physical presence of a taxpayer in a jurisdiction as a prerequisite to having a taxable presence there. This premise potentially renders the application of these systems ineffective in an e-commerce environment. [146]

5.5 Can e-commerce transactions constitute a permanent establishment

In recent years, the permanent establishment tax concept has attracted a lot of attention because of the beginning of the internet and e-commerce era. Recapping what has been alluded to in the previous chapters, the internet is a network of

[145] Department of Communications. 2013, page 99 and page 100
[146] du Plessis, B. and Viljoen, M, page 235

networks linked by a common communication protocol, which allows and facilitates remote commercial activity. At times, the internet removes the necessity for traditional intermediaries such as branches of companies in a foreign tax jurisdiction that were used to allow cross-border transactions. Instead of a traditional store, computer servers can perform the functions which are performed by a traditional permanent establishment. For example, the software in the server is able to display a website on the internet, which then takes an order from a customer, at the same time accept payment, and deliver digital goods and services.[147]

According to Schaffner, in January 1999 the OECD's Committee on Fiscal Affairs set up a Technical Advisory Group ('TAG') which was to monitor the application of existing treaty norms for taxing business profits. TAG started its reporting by giving a list of various categories of business models which are enabled by internet related technologies. It stated that web-based systems assist in streamlining ordering, selling and payment systems for commodity suppliers. They reduce costs of manufacturing. Furthermore, the technologies improve delivery, such as the tracking system for the shipping of orders.[148] Bearing in mind that the historical permanent establishment represents a fixed physical presence within the source country that lasts for a significant period of time and performs integral aspects of a cross-border transaction.[149]

The starting point for TAG was the interpretation of the definition of a permanent establishment in the context of e-commerce which was contained in OECD's report: Taxation and electronic commerce- Implementation of the Ottawa taxation framework conditions.[150]

TAG found that, irrespective of being difficult to trace the location from which e-commerce transactions are performed, it is on the contrary, simple to identify a server which is based in a low-tax jurisdiction. This can be done through a division of business functions which are related to a business transaction between

[147] Cockfield, A.J. 2003, page 2
[148] Schaffner, J. 2013, page 80
[149] Cockfield, A.J. 2003, page 3
[150] Schaffner, J. 2013, page 81

separate servers and have websites hosted by the same internet service provider ('ISP'). Even though traditionally, the concept of permanent establishment was based on the physical presence requirement, with the evolution of e-commerce transactions, such traditional views of this concept have been tempered with, and equally the physical presence requirement has been left out in this specific type of business. The TAG Committee thus reached a conclusion, stating that a website cannot, in itself create a permanent establishment. [151]

OECD MTC Commentaries to Article 5 contain guiding principles as to whether or not a website, a webpage or a server can be regarded as a permanent establishment.[152] However, these guide lines are not clear enough to indicate the taxation of online services. Therefore, the question, whether online services can create a permanent establishment is still unanswered.

The e-commerce principle of the existence of a permanent establishment requires that a computer equipment such as a laptop should be treated in a different matter from the data and software stored on the device. As indicated in Chapter 4, a website is made up of data and software that exist in cyberspace and cannot be traced to a physical device. Traditionally, this entails that a website cannot be attached to a specific location to constitute a permanent establishment.[153]

Papadopoulos and Snail are of the view that a server on which the information is stored, and which provide access to such a website is normally a piece of equipment which can be traced to a physical place and thus qualifies as a permanent establishment.[154]

In practice, an e-commerce enterprise usually does not own its own server, however, it pays a fee to an ISP, which is a different enterprise that hosts the server and provides access to the website. According to the OECD MTC Commentaries, the mere hosting of a server does not amount to the establishment of a permanent establishment. However, if a business owns or leases and as a

[151] Schaffner, J. 2013, page 82
[152] Papadopoulos, S. and Snail, S. 2012, page 106
[153] *ibid*
[154] Papadopoulos, S. and Snail, S. 2012, page 107

result thereof operates its own server, the place where it is located will constitute a permanent establishment, provided that all the other requirements are met.[155]

An issue arises even when the server is moved, in which case the fixed nature of the server may be affected, or the tax jurisdictional link is lost. The e-commerce OECD MTC Commentary as it relates to a permanent establishment states that, the test is not whether the servers are capable of being moved, but whether the servers are actually moved. This is the problem which taxing authorities face when they must apply the guidelines in practice, because it would mean that they have to keep track of non-residents' computer equipment in their country.[156]

Furthermore, if the business has a server in a different country, the OECD MTC Commentary further requires that the business must be wholly or partially carry on business at the place where the server is located. Technically, when an ISP provides access to a website, only the ISP will have a sufficient link with the country where the server is located since it provides the business of internet access.

On the issue of the ISP being a possible agent of its client, the OECD MTC Commentary emphasises that the ISP will not usually be an agent with the authority to regularly enter into contracts in the name of its clients. This entails that the requirement of a dependent agent of Article 5 of the OECD MTC is not met and thus the ISP will not form a permanent establishment of its client. Another requirement that must be met for an ISP to constitute a permanent establishment is contained in Article 3 of the OECD MTC. Article 3 of the OECD MTC contains general definitions. In order for Article 5 to apply to a website, a website must be defined in Article 3 as a person. Since a website is not included in the definition of a person, an ISP can therefore not be said to form a permanent establishment.

According to Article 7 of the OECD MTC, the profits attributable to a permanent establishment of a business, must be taxed in the country where the permanent establishment is situated. The underlying question is how this attribution will be

155 Papadopoulos, S. and Snail, S. 2012, page 107
156 *ibid*

done specifically for e-commerce where the locations of the transactions are difficult to determine.[157]

5.6 Emphasis on internet elements which cannot constitute a permanent establishment

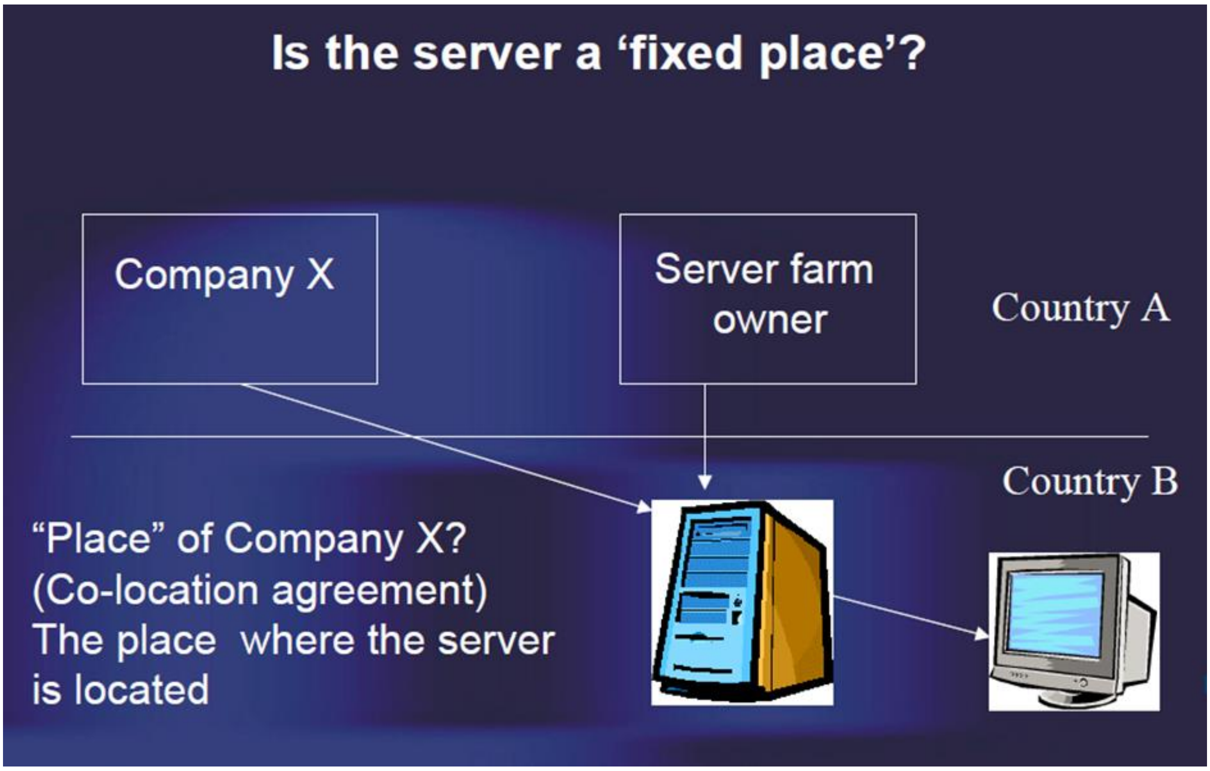

Fig 5.1[158]

As figure 5.1 depicts, although a server as such cannot be a permanent establishment itself, the place where it is deposited, may constitute a place of business. On the other hand, the existence of computer equipment at a fixed location in a certain state may itself give rise to a permanent establishment in that country. It is however important to distinguish between computer equipment that is in a certain country and the software used by that equipment.

[157] Papadopoulos, S. and Snail, S. 2012, page 107
[158] Vogelaar, P. 2001, slide 12

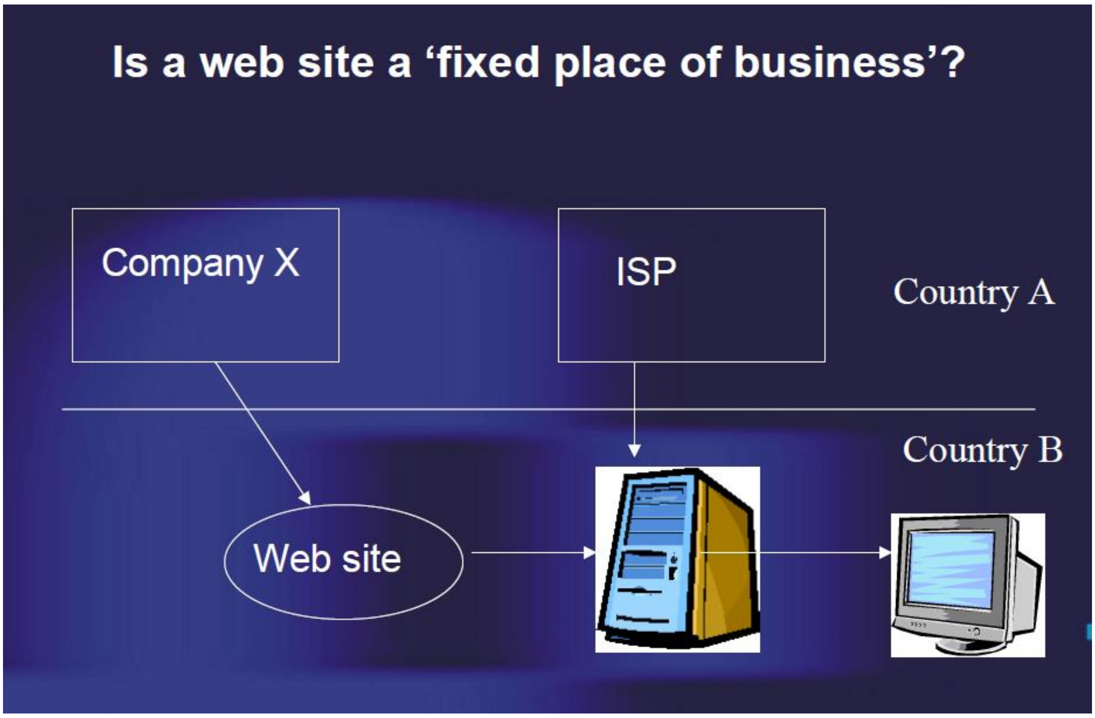

Fig 5.2[159]

Figure 5.2 *visualises the notion that a website would not have a fixed place of business and thus would not be considered a permanent establishment under the current definition. Irrespective of the consensus reached on the topic of non-qualification of websites as permanent establishment, disagreement has occurred when experts analyse the role of web servers as a sufficient physical manifestation of an enterprise that is the place of business for purposes of rendering applicable the concept of a permanent establishment. However, as expressed by the OECD MTC Commentary, the issue whether computer equipment at a given location constitutes a permanent establishment will depend on whether the functions performed through that equipment exceed the preparatory or auxiliary threshold, something that can only be decided on a case-by-case analysis*.[160]

An examination of the commentary to the permanent establishment Article of the OECD MTC is elaborated through a hypothetical case below under point 5.6.

[159] Vogelaar, P. 2001, slide 11
[160] Papadopoulos, S. and Snail, S. 2012, page 107

5.6 Hypothetical Case on e-commerce transaction

Some of the practical issues are emphasised by the hypothetical case below.

Enterprise Lefatshe is incorporated and a tax resident of state Azania. Enterprise Lefatshe is in the business of providing software related services which constitute mainly of maintaining websites. The scenario implies that Enterprise Lefatshe would provide services to Enterprise Tokollo, a resident in country Batho. Enterprise Lefatshe does not have physical presence or employees in state Batho. These services which Enterprise Lefatshe would provide will be through internet networks. In essence, Enterprise Tokollo would be provided with services through a website arranged from Enterprise Lefatshe. The only link Enterprise Lefatshe has with state Batho is the agreement they have with an ISP which is situated in state Batho. This agreement enables them internet presence in state Batho. Another factor which links Enterprise Lefatshe with state Batho is the customer itself (client), which is Enterprise Tokollo, who is a tax resident of state Batho. In the event that the client and the independent contract with an ISP is sufficient to determine the presence of Enterprise Lefatshe in state Batho, then a permanent establishment is bound to exist. However, the possibility for the ISP to be located in a different jurisdiction is foreseen. As indicated in the figure 5.3, the ISP can be situated in either sate Bathor or state Sizwe (a different state), which will make it very difficult to locate where the ISP is situated.

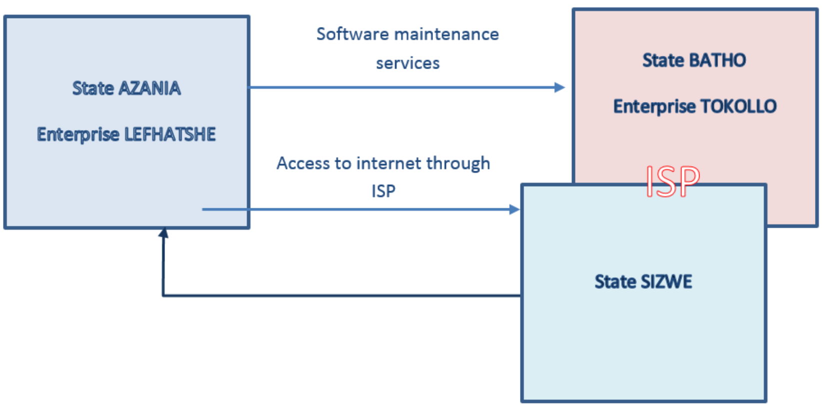

Fig 5.3

Who produced the income?

In terms of the hypothetical example above it could be stressed that Enterprise Lefatshe generates its income from state Batho, since its customer Enterprise Tokollo is in state Batho. The contrary may be apparent as well, as Enterprise Lefatshe is tax resident country Azania. In accordance with the actual interpretation of paragraphs 42 of the OECD MTC Commentary which relates to e-commerce, the OECD does not support the notion that a permanent establishment for Enterprise Lefatshe exist in state Batho.

Physical presence test

Technology has simplified business in a sense that the people who make decisions in a business can be reached digitally. These days, it is possible to conclude and sign contracts through specific software programs. Therefore, this technological advancement has made the human intervention unnecessary. These possibilities which are brought by technology raise questions of a different nature in international taxation environment. With the *new kid in the block* i.e. e-commerce, the question that may be raised is, how can the physical presence test be passed?

> Although a server may prima facie appear to fall within the traditional definition of a permanent establishment as contained in international tax treaties, the rapid developments in e-commerce contrasted with the relatively slow development of the traditional permanent establishment principle. This principle emphasises the need for a physical presence within the source country, have effectively hamstrung the ability of many jurisdictions from taxing the profits arising from online businesses.[161]

The physical existence requirement in the permanent establishment threshold, should be re-looked at in e-commerce, since it is possible for software to conduct specific functions and also replace the human presence.

[161] Young, N.J. 2012, page 57

5.7 Conclusion

The permanent establishment notion remains an important and core aspect of international taxation, however, it still raises several complex issues. Common difficulties include determining if there is a place of business. E-commerce creates difficulties in the identification and location of taxpayers, the identification and verification of taxable transactions and the ability to establish a link between taxpayers and their taxable transactions, thus creating opportunities for tax arbitrage.[162]

[162] Oguttu, A.W. and Tladi, S. 2009, page 80

CHAPTER 6 – CHALLENGES POSED BY E-COMMERCE IN THE PE ENVIRONMENT

6.1 Introduction

From as early as the using the telephone to order goods there have been challenges with running businesses electronically. Therefore, challenges which come with e-commerce are not new at all. There are two reasons for the significance of challenges posed by e-commerce transactions. The first reason is that cross-border transactions are quicker and simpler due to new technology. This aspect has made it difficult for tax authorities to identify, locate and value e-commerce transactions. The second reason is that the traditional stress of orders through mail business have now been overcome through new technology.[163] This chapter seeks to unfold the challenges faced by governments with taxing digital transactions and e-commerce.

6.2 Challenges created by e-commerce to the rule of law

Challenges which exist with traditional legislation include the nature of trade over the internet that does not have residence. *Residenceless* internet trade gives rise to hidden identities of potential taxpayers, the nature of the goods traded, the undetectable multi-territoriality of entities by governments and tax administration. The most fundamental challenge posed by e-commerce which tends to be overlooked is the very nature of e-commerce. It must be borne in mind that e-commerce includes all forms of commercial transactions which are done through the internet. This includes the likes of online banking, provision of internet and network, provision of online services such as online advice by professionals, the provision of digitised goods, the production of intellectual property and the traditional sale of goods and services.[164]

[163] du Plessis, B. and Viljoen, M, page 234
[164] Papadopoulos, S. and Snail, S. 2012, page 103.

The minimal use of traditional business, which are closely connected to the system which they occur, gives rise to revenue which is not included in the tax calculations of the taxpayer which then results in tax evasion. A practical example of this is the rise of intellectual property, whereby an online entity provides a free download of a digital product, this then promotes the brand of the of the entity and consequently the entity's value increases. It then becomes difficult to measure such an increase in value and the income tax or the gain on the increased value. Furthermore, the digital products which can be downloaded directly to a consumer's device also makes a complex web of international trade as they occur in cyberspace and not attributable to any location.[165]

E-commerce has afforded a primarily modern way of conducting commercial transactions. It is able to touch many economic and societal issues on various aspects of life including how the work is conducted, and the role of governments. The manner in which businesses do their work has vastly been changed by e-commerce. As discussed in the previous chapter it is evident that the traditional intermediaries have been minimised with direct purchases from the manufacturer. As a result, e-commerce has brought about new challenges in the global trade and economies. These new challenges such as taxation, include instances where governments want to increase taxes without altering the fiscal or digital choices. The changes and challenges which are brought by e-commerce require reassessments of the effectiveness of government policies and procedures, of which most were formed with a different view of business in mind.[166]

Since the internet overlooks international limitations, in the internet world, "place" has slight meaning. This creates a challenge in establishing cross-border customs for pinpointing a taxpayer's source of the income. The biggest fear which revenue authorities have is that e-commerce might alter the distribution of taxable activities and result in the tax bases of countries being eroded. With the given nature of e-commerce, first it is difficult to locate taxpayers involved in the transection, secondly, it is also not easy to identify and verify the taxable transactions and thirdly and to make matters worse tax authorities are not able to establish a link

[165] *ibid*
[166] OECD Centre for Tax Policy. 2004, page 15

between taxpayers and their taxable transactions, thus creating opportunities for tax practice of profiting from differences between the way transactions are treated for tax purposes. As a result, globally, governments are worried that they will not be awarded their due taxes which relate to e-commerce income.[167]

Challenges faced by governments across the world on the taxation of e-commerce transactions are real and the focus is on how to address them collectively and by way of ensuring international consensus. The allocation of taxing rights must be based on mutually agreed principles and common understanding of how these principles should be applied. In addition to the need for consensus between governments, a need for cooperation between governments and business must be identified. [168]

E-commerce affords pressures like those posed in the 1980s with the rise of the 'big box' stores. The goal of the 'big stores' was to crash community-based businesses and serve as the sole retail. These big stores would generally want tax reductions from communities in return of employing locals. On the contrary, local merchants have supported the local economies vastly. They did not just sell goods but bought supplies from other local shoppers such as using the services of local lawyers, doctors, plumbers and utilised the services of the local banks.
It is Jones and Basu's view that the 'big box' stores are colonisers in the modern day, by exploiting local businesses and taking resources from the communities without returning anything. There should be a significant amount of care for locals who are working to bring economic empowerment to their societies and who are bearing the burdens of tax.[169]

Jones and Basu believe e-commerce and internet businesses take the colonialism economic model of chain stores to another level. Traditional chain stores collect VAT, income taxes and hire local workers, instead internet businesses dodge most of these activities, which are important to the survival of communities and local economies.[170]

[167] Oguttu, A.W. and Tladi, S. 2009, page 218
[168] OECD Centre for Tax Policy. 2016
[169] Jones, R. and Basu, S. 2002, page 37
[170] Jones, R. and Basu, S. 2002, page 38

Revenue authorities can impose a tax on purchases made by residents however they cannot impose an obligation on the offshore vendors to collect the tax unless the vendor has a substantial presence in the state. Some authors have argued that tax revenues will in any event increase as productivity enhancements stimulated by e-commerce expands, the economy will raise, and all states' tax revenues will consequently increase. Indeed, it may also be argued on the contrary that non-neutral tax treatment of e-commerce transactions may reduce rather than expand the economy. If consumer transactions are taxed differently based on how commodities are obtained, efficiency losses are probable as well.[171]

6.4 Classification of e-commerce products challenge

Basu is of the view that the challenge of classifying e-commerce products has been a subject of attention for numerous years. When imposing a tax on a transaction, it is necessary to classify the object of a transaction. Transactions are often classified, for instance, as gross income or income from royalties, and the objects of the transactions are classified, as products or services. This discussion will focus on the classification of products and services. The circulation of information has traditionally depended on the distribution of the media. If the information has been affixed on a CD for instance, the information has thus been distributed in fixed form. These transactions have traditionally been taxed as transactions in goods, disregarding the fact that the real object of the transaction is the information contained in the physical CD. In such instances, the information product is an object that exists and can be observed in the corporeal world.[172]

The classification problems relating to e-commerce are mainly related to the principle of objectivity. An information product such as a music album, can either be distributed physically, in the form of a CD, or digitally over the internet. In terms of current taxation laws, the same information product will be taxed differently depending on how it is delivered. It is difficult to find ways to classify information

[171] *ibid*
[172] S, Basu. 2008, page 7

deliveries within the framework of current tax law, which at the same time satisfies fundamental taxation principles and considers the characteristics of information. As production and distribution move out from the physical into the networks, the problems grow more pressing. At the end of the day, the problem of objectivity can significantly harm the legitimacy of the tax systems by tax erosion. Taxation laws which tend to treat them as different products, will seem out of touch with the evolving world. Though, underlying these products there are additional essential assumptions which relates to tax law. These assumptions are acutely rooted in the history of tax law and its connection to trade. The argument which relates to the classification of digital products can contribute to the discussion of taxation of information by highlighting the fact that products in networks are not good nor are they services in a traditional sense. Information simply does not fit into tax law, because tax law is rooted in the production and distribution of physical products, and not services, still less information.[173]

Tax authorities will find it difficult to tax the profits generated by servers located within their borders because the location of the servers and the functions performed by software code within the servers are highly malleable. The OECD has also acknowledged that servers are highly mobile and flexible in nature. The United States Treasury Department has noted that, "*Computer servers can be located anywhere in the world and their users are indifferent to their location. It is possible that such a server, or similar equipment, is not a sufficiently significant element in the creation of certain types of income*." The location of a server can also be easily moved (without affecting the underlying transaction) between different countries. Servers can transfer their programs almost instantaneously to a server in a different jurisdiction if necessary. Mirror sites can for instance be established to direct customers to different servers depending on the level of traffic at any time. Actions such as these could frustrate the attempts of tax authorities to find a stable physical presence on which to base taxation under the permanent establishment concept. The finding of the existence of a permanent establishment concept may also be avoided by moving operations to a server in another country before the conditions of being "fixed" under the permanent establishment test are satisfied.[174]

With technological developments, central servers can be completely taken out of the transactional loop by peer-to-peer networking where users trade digital products without resorting to any centralised server location. In these circumstances, it may be difficult to assert that business is being conducted through a server owned or leased by the resident-based e-

[173] S, Basu. 2008, page 8
[174] Oguttu, A.W. and Tladi, S (2009).

commerce business. The emergence of such networking techniques may ultimately frustrate the focus on physical aspects of the network. It has also been noted that the location of a server often bears little relationship to the location of the essential economic activity that e-commerce comprises – the production and consumption of information. E-commerce makes it possible for functions to be disintegrated between servers, which practically makes it difficult to determine whether activities are core or preparatory in nature. These possibilities expose the vulnerabilities of trying to apply the permanent establishment principle to tax e-commerce transactions.[175]

6.3 OECD BEPS challenges on e-commerce

Base erosion and profit shifting ('BEPS') refers to tax planning strategies that takes advantage of gaps and mismatches in tax rules to make profits "disappear" for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid.

Group of twenty ('G20') together the OECD aims to discuss policy pertaining to the promotion of international financial stability. G20 is an international forum of governments and governors of central banks. The membership of the G20 consists of 19 individual countries and the European Union. The member countries include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, the Republic of Korea, the Russian Federation, Saudi Arabia, South Africa, Turkey, UK, USA , and as indicted above the European Union. To combat BEPS, the OECD created an Action Plan which was published in July 2013 with a view to closing gaps in existing international tax rules that allow corporate profits to "disappear" or be falsely shifted to jurisdictions with low or no taxes. The Action Plan was negotiated and drafted with the active participation of its member countries, and contains 15 separate Action Points.[176]

The OECD presented its Final Reports on each Action Point on 5 October 2015. The final package of BEPS measures includes issues like provision of minimum standards on country-by-country reporting, prevention of treaty shopping, measures to assist in curbing harmful tax practices, and effective mutual

[175]*Ibid*
[176] OECD BEPS- The tax challenges arising from digitalisation. 2018, page 3

agreement procedures, to ensure that the fight against double non-taxation does not result in double taxation.[177]

During the duration of BEPS, the OECD has labelled the tax challenges of the digital economy (e-commerce) as Action 1. It has been concluded that digital business models entail substantial opportunities for aggressive tax planning but also increase wider issues for the tax system. Even though the OECD illustrates some of the technological foundations digital era, it does not discuss or deliberate on the resultant consequences in detail. The latest BEPS report on the digital economy highlights how business models of multinational companies in the Information Technology or e-commerce sector are able to assist undesired outcomes in terms of low or no taxation. Options to address the tax challenges put forward by the OECD are character raised by mitigating BEPS risks and creating awareness of the tax challenges, rather than by confronting the long-term tax issues caused by digital business models. The work of the OECD has been accompanied by an extensive body of literature containing different reform proposals.[178]

Until recently in March 2017, the G20 members Finance Ministers mandated the OECD, through the Inclusive Framework on BEPS, to deliver an interim report on the implications of digitalisation for taxation by April 2018. This report is named Tax Challenges Arising from Digitalisation – Interim Report 2018 ('the Interim Report'), has now been agreed by the more than 110 members of the G20.[179]

Through the Task Force on the Digital Economy (TFDE), Interim Report 2018 considered the tax challenges raised by the digital economy. The 2015 BEPS Action 1 report noted that the digital economy is characterised by an unparalleled reliance on intangibles, the large usage of data, and the extensive implementation of multi-sided business models. The 2015 Action Plan further found that it would be not be easy, to ring-fence the digital economy. This report also highlighted ways in which digitalisation had worsened BEPS issues, but also noted that the

[177] *ibid*
[178] Olbert, M. and Spengel, C. 2017, page 11
[179] OECD. 2018.

proposed procedures under the other BEPS Actions were likely to have a substantial impact in this regard. [180]

Taxation of the digital economy is not an easy task for revenue authorities, the Interim Report discusses interim measures that some countries have indicated they would implement. Specifically, the Interim Report considers an interim measure in the form of an excise tax on the supply of certain e-services within their jurisdiction that would apply to the gross consideration paid for the supply of such e-services. Many countries have not conceded to these proposals as some countries are of the view that such measures will give rise to risks and adverse tax consequences. However, the Interim Report describes, the framework of design considerations, identified by countries in favour of introducing interim measures, which should be taken into account when considering introducing such measures.[181]

The Interim Report also noted that over and above BEPS, digitalisation raised a series of broader tax challenges, which it identified as data, nexus and characterisation. These challenges mainly refer to the issue of the allocation of taxing rights on income from offshore activities in the digital environment. While identifying a number of options to address these concerns, none were ultimately recommended. After the release of the OECD/G20 BEPS package it was agreed by countries to renew the mandate of the TFDE and continue to monitor developments in respect of digitalisation with a further report to be delivered by 2020 and with an interim report to be produced by the end of 2018.[182]

6.3 South Africa's input and challenges on the BEPS project to address challenges posed by the digital economy

In South Africa non-residents are only subject to tax on income derived from a source in South Africa. However, these firm source rules do not accommodate or provide for the treatment of e-commerce transactions. Therefore, non-residents

[180] OECD. 2018.
[181] OECD. 2018.
[182] OECD. 2018.

can significantly avoid paying tax in South Africa since the source of their income is not in South Africa. This thus crates one of the challenges which is posed by e-commerce to the South African fiscus.[183]

The South African Minister of Finance appointed the Davis Tax Committee's ('DTC') to review South Africa's taxation system in light of economic growth, employment, development and fiscal sustainability in July 2013. The DTC subsequently established a sub-committee to address concerns regarding 'BEPS'. The DTC BEPS Sub-committee focuses on BEPS's effects on the nation's tax base as identified by the OECD and G20. The report is up to date with the OECD's deliverables providing 7 of the 15 deliverables in accordance with the OECD's schedule.[184]

South Africa is not a member county of the OECD, however as indicated in previous chapters, it received its observer status in 2004. South Africa has since also became member of the OECD BEPS Committee. The OECD's recommendations are not legally binding to South Africa, however, the South African courts have recognised and applied the OECD Commentary. The interpretation of a DTT, read in conjunction with the Commentaries of the OECD MTC was addressed in the Special Tax Court in ITC 15032 (1990) 53 SATC 342. The court held that the DTT must be interpreted in accordance with the normal rules pertaining to the interpretation of contracts in South Africa. The court further held that, a treaty must be interpreted according to the common law rules pertaining to the interpretation of statutes as well as the OECD MTC Commentary. Since the OECD recommendations have become a globally accepted standard, and as a member of the G20 and the OECD BEPS Committee, it is important for South Africa to work together with the international community to come up with a holistic approach to property addresses the BEPS issues.[185]

[183] Camay, A. 2015
[184] Davis Tax Committee. 2016, page 1

[185] Davis Tax Committee. 2016, page 9

The DTC made recommendations which were in line with the OECD BEPS options. The OECD provided countries with options regarding the taxation for the digital economy and further left it open for countries to include, in their domestic law. In summary, these options include:

a. a new nexus in the form of a significant economic presence that would allow countries to tax activities in the digital economy;
b. a withholding tax on certain types of digital transactions; and
c. an equalisation levy.[186]

The new nexus in the form of a significant economic presence consists of various alternative tests. The OECD Final Report recommends a combination of a revenue-based factor together with a second indicator based on the digital presence of the entity through a local domain name, or the size of active users or information collected.[187]

The proposed withholding tax on certain digital types of digital transactions would operate on a gross basis at source and could be adopted either as a standalone measure, or alongside with the significant economic presence alternative.[188]

The equalisation levy alternative could be applied to digital transactions is intended to ensure tax neutrality in the country of the consumer and/or buyer between enterprises that provide goods or services digitally and enterprises that provide such goods or services by more traditional means.[189]

In light of the above, South Africa has not yet amended its taxation laws on direct taxes with regards to the taxation of e-commerce transections (or broadly speaking the taxation of the digital economy). According to Pricewaterhouse Coopers ('PwC'), South African companies are finding it difficult to compete with multinationals with the provision of digital goods and services and conducting general e-commerce transactions.[190]

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[186] Davis Tax Committee. 2016, page 3
[187] Dhuldhoya, V. 2018, page 8
[188] *ibid*
[189] *ibid*
[190] IT-Online. 2015.

PwC is of the view that South Africa's tax laws have not kept pace with the growth of the digital economy and changes in the way in which business is conducted. They indicate that the tax laws in South Africa were designed at a time when the current technology and business models were the work of science fiction and the ability of a company to conduct business in a country required a physical presence in the country.[191]

Charles de Wet the then head of Indirect Tax, PwC Africa, emphasised that people are living in an era of extraordinary digital intervention whereby multinationals in the digital economy that sell goods and services in the South African market and elsewhere do not have to comply with the same rules as local companies.[192]

De Wet explains that there have been plentiful reports regarding multinationals that pay little or no tax at all in the markets in which they generate profits such as South Arica. Over and above this situation being position unmanageable, it also distorts competition between companies, as well as placing the multinational at an advantage over South African businesses operating in the same market.[193]

Throughout this research it has been indicated that non-resident companies are only subject to tax in South Africa on income derived from a source in South Africa. However, these source rules were developed many years ago before the digital economy existed and do not take into account the way in which the modern economy operates. As a result, this gives a loophole for multinationals to avoid paying tax in South Africa because the source of their income is not in South Africa, notwithstanding that they operate in the local economy.[194]

Furthermore, multinationals are also blamed for repatriating profits made in one country by setting up structures in low-tax jurisdictions and shifting profits both from the markets in which they operate and those in which they do have a physical

[191] *ibid*
[192] *ibid*
[193] *ibid*
[194] *ibid*

presence to these low-tax jurisdictions. This manner of tax avoidance allows these multinationals a cost advantage over local businesses that are fully within the South African tax net and have to pay tax on the profits they make at comparatively high rates.[195]

Currently, South African resident companies are taxed at the rate of 28% on their worldwide income for corporate tax purposes. On the contrary, multinational companies selling digital goods and services escape paying corporate tax in South Africa. Kyle Mandy, PwC head of National Tax Technical, says that this is because the multinationals do not fall within the South African tax net, either because their income is not sourced in South Africa in accordance with the South African domestic rules, or because of relief provided by a double taxation agreement entered into between South Africa and the foreign country.[196]

In 2015 in his budget speech the South African Finance Minister announced that proposed changes would be made to the rules for the digital economy in line with the guidance issued by the OECD in its report on BEPS. The proposed changes which relates to e-commerce and taxation of the digital economy only relate to VAT.[197]

Although the discussion on VAT is beyond the scope of this research, however, it is important to note that on 21 February 2018, an amended draft regulation on electronic services for VAT was published in South Africa. The present regulation's definition of electronic services includes a specific list of services and only foreign suppliers of these services fall within the ambit of the South African VAT regime. The South African National Treasury aims to expand this definition. The proposed amendments are expected to come into effect on 1 October 2018.[198]

[195] *ibid*
[196] *ibid*
[197] IT-Online. 2015.
[198] EY Global Tax Alert. 2018, page 5

6.3 South Africa's challenges faced by public officials- Interview

What are the difficulties SA has experienced in general services from overseas companies having to pay taxes in South Africa?

What are the challenges faced by SA on the allocation of taxes

6.4 Conclusion

From this chapter, it can be concluded that the guidelines contained in the Commentaries of the OECD MTC which provide for the taxation of e-commerce transactions, cannot be relied on to tax the income of electronic transactions. In South Africa resident taxpayers are equally facing a challenge as they are waiting for the government to come up with possible solutions to tax non-residents who are conducting e-commerce businesses and thus deriving income from a South African source.

CHAPTER 7 – RECOMMENDATIONS ON TAXATION OF E-COMMERCE TRANSACTIONS

7.1 Introduction

Currently there is no legal framework which allows the South African revenue authorities to tax income that is resulting from e-commerce transactions between non-residents and South African residents. In essence, entities such as Google and Amazon are able to evade and avoid tax which is due in South Africa due to the fact that the originating cause of their income is not in South Africa, in terms of the South African source rules.[199]

This chapter seeks to explore four possible solutions which will assist the SARS to collect taxes from income on e-commerce transactions.

7.2 Economic presence test

Cockfield suggests that tax authorities must consider implementing an economic presence permanent establishment notion within model tax treaties. This permanent establishment concept would permit source countries to tax significant cross-border economic activity. An economic presence threshold will ensure that source countries are able to impose non-resident entities to their tax jurisdiction only if those non-residents conduct substantial business activities within their borders. The essence of the economic presence test is that it is intended to be a backstop to safeguard the source country income tax base.[200]

The suggested economic presence permanent establishment is aimed at upholding the traditional permanent establishment rationales. It would firstly make sure that source countries enjoy tax revenue from significant cross-border activities that takes place within their countries. This concept would therefore

[199] Davis Tax Committee. 2014, page 27
[200] Cockfield, A. J. 2003, page 408

encourage a balanced sharing of revenue between capital- exporting and capital-importing countries.[201]

The economic presence permanent establishment is a simple in conception and practice. Its rule is pragmatic in the sense that it inspires business certainty, as multinational firms would predict whether they would be subject to source country income tax jurisdiction. This proposed approach is aimed at catching the bigger firms which have substantial international trade. The focus will not be on smaller firms, such as start-up e-commerce firm, as they have less resources to comply with foreign income tax laws.[202]

The economic presence permanent establishment debatably characterises an important departure from traditional international tax principles, since a physical presence within a source state is no longer required to enable the source state to tax active business profits. On the other hand, an economic presence permanent establishment can be portrayed as just another step in the evolution of the permanent establishment principle.[203]

Cockfield is of the opinion that the economic presence permanent establishment represents an incremental step in the evolution of the permanent establishment principle than the current server permanent establishment. Cockfield alluded that he has argued that the server permanent establishment only represents a form of qualitative economic presence test because maintaining a server permanent establishment in a source country is elective, therefore tax authorities will focus more on what type of economic activity is taking place within each country where a server is located. Due to the fact that there is a significant amount of servers globally which form an important component of the internet infrastructure of the Internet, the server permanent establishment rule discourages tax authorities from asking companies what sort of a taxable presence exists within each country. The server permanent establishment does not uphold the traditional rationale for the

[201] Cockfield, A. J. 2003, page 410
[202] Cockfield, A. J. 2003, page 411
[203] Cockfield, A. J. 2003, page 411

permanent establishment because it leads to business uncertainty and will not effectively share tax revenue between residence and source countries.[204]

The economic presence permanent establishment is designed to allow source countries to tax active commercial taxable income, in the same way as profits are taxed when an entertainer or sports person generates them through a short presence within the source country. This proposal allows countries to maintain their worldwide taxation systems whereby they can choose to add any difference between the foreign tax liability (which gives rise to a foreign tax credit). The economic presence permanent establishment is aimed at offering a neutral tax treatment between e-commerce and traditional commerce. These two forms of conducting business would be governed by the same rule.[205]

In its Final Report on Action 1 (Address the Tax Challenges of the Digital Economy), the OECD also proposed a significant economic presence permanent establishment, which suggest that a non-resident taxpayer would be taxable in the source state when the taxpayer established. The factors that would determine a significant economic presence would be revenue factors and factors that offer an insight into the continued interaction of a non-resident taxpayer with the economy of a source state by way of digital earnings.[206]

The motivation of the suggested a significant economic presence permanent establishment comes from the fact that, multinational entities are able to undertake substantial activities within the economic environment of a certain state without having any physical presence in that country and as a result they are not subject to tax in that country in absence of a permanent establishment. The economic presence test would mitigate this difficulty by taking into account the income arising within a country and the digital events. This concept would consequently modify existing permanent establishment concept.[207]

[204] Cockfield, A. J. 2003, page 411
[205] Cockfield, A. J. 2003, page 411
[206] Cockfield, A. J. 2003, page 411
[207] *ibid*

The application of economic presence permanent establishment suggest that the taxable income or revenue factors should be based on the revenue made from digital transactions within a country by a non-resident company, with the sales being made remotely through a website. This concept also proposes that a revenue threshold be established so that the non-resident company is not burdened with compliance obligations. Furthermore, another requirement is that countries are required to implement very strong tax administrative measures. As a result, developments would have to be made to trace and the trades made remotely within a particular country by the foreign enterprise.[208]

Essentially this kind of a revenue factor should be joint with digital factors. An example of a digital factor would include an existence of a local domain name that is equivalent to a local digital address, in a particular country which belongs to a non-resident company. Further, if a non-resident company offered local payment options when a customer has made an online purchase that could be considered to be a digital factor as well, since that transection would provide evidence of the integration into the business environment of that country.

In addition to the above mentioned factions, user-based factors should also be considered. These could include the amount of contracts concluded digitally with customers that are resident in a country of ‘source’ or the volume of data which is collected from customers and internet users that are resident in a country.
A combination of such factors may possibly offer perception into the economic presence of a non-resident company in a source state, which could contribute towards ensuring taxation of the non-resident company there. [209]

The economic presence permanent establishment concept is very similar to the traditional permanent establishment test, since it also requires the existence of certain local features, such as a local domain name, a local website as well user-based factors that take into consideration contracts concluded with local customers. Meaning, that there would appear to be some form of a threshold.[210]

[208] *ibid*
[209] Dhuldhoya, V. 2018, page 413
[210] Dhuldhoya, V. 2018, page 413

7.3 New source rules

It is evident that many revenue authorities do not have suitable resources to audit multinational companies. As a result, an economic presence permanent establishment may be difficult for these revenue authorities to enforce. Therefore, alternatives to the economic presence permanent establishment test would be new domestic source rules or withholding taxes domestically on e-commerce transactions.[211]

It has been over a century since the formation of the permanent establishment notion. However, the current concept is still largely similar to the ancient concept and continues to play a significant role in the allocation of taxing rights between source states and residence states. The fundamental reasoning of the concept is that, if a company has considerably participated in the economic environment of the source state, that company it should be taxed on the profits arising from those activities.[212]

Research suggests that it may not be suitable to change the current threshold of the concept of a permanent establishment in its entirety. This threshold, in the view of addressing international double taxation, is imperative, as it provides a measure of certainty for foreign taxpayers and for revenue authorities. It is therefore suggested that countries should create a new source taxation criterion or threshold.

The amendments which have been made to the OECD MTC Commentary on Article 5 regarding e-commerce in terms of taxing the profits of digital activities still adhered to the requirement of physical presence. These amendments gave clarity that a server could essentially constitute a fixed place of business in terms of Article 5(1) of the OECD MTC. However, the amendments also clarified that a website cannot constitute a permanent establishment, since a website is not a tangible thing, but, a combination of data and software codes.

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[211] Cockfield, A. J. 2003, page 413
[212] Dhuldhoya, V. 2018, page 413

In the near future some technological trends my further impact countries, goods may be provided through Cloud-based services, paintings may be done though 3D Printing services and payments could be made through virtual currencies. Business models based on these advances may or may not fall within the scope of taxation under the current rules. It is therefore important for countries to alter their source rules by inserting taxation of digital businesses in their source rules to make room for these technological advancements. The OECD should also come about with a policy choice that will assist countries in providing a new clause in its MTC that would enable the source state the taxation of digital business activities. To date, the OECD has not made a policy change, although little insight is offered by the Final Report on Action 1.

It is understood that the digital economy challenges which South Africa faces are of an international nature and it is turs recommended that South Africa adopts the OECD recommendations. That being said the OECD recommends that countries should adopt new source rules.[213] It is imperative for South Africa's lawmakers to note that technology is constantly changing. Consequently, it is necessary for South Africa to adapt e-commerce legislation that accommodate the technological changes which are brought about by e-commerce. Therefore, new source rules that deal with the taxation of the digital economy and e-commerce have to be legislated. [214]

The South African source rules under section 9 of the Income Tax Act have to be re-looked at and has to accommodate rules that cover profits resulting from the supply of digital goods and services derived from a source in South Africa. The proposed source rules must be based on principle similar to the royalty principle. The proposed digital or e-commerce inclusive source rules could provide that digital services be sourced where the recipient who pays for the digital goods or services is resident at the time the supply of the services is made.

The proposed new source rules for non-resident suppliers of goods and services via e-commerce to South African customers should also cover the circumstances

[213] Davis Tax Committee. 2016. page 4
[214] Davis Tax Committee. 2016. page 5

where physical goods and services are rendered in South Africa and for which payment is made electronically to a non-resident. This would establish the foundation for South Africa to tax non-residents on such goods and services. However, this will be subject to the application of any DTT which South Arica has concluded with another country and the revised nexus rules contained in that DTT.

In order for the proposed source rules to function accordingly and assist SARS to achieve its collection mandate, certain rules should also be enacted that require non-resident companies with South African sourced income to submit income tax returns even if these companies do not have a permanent establishment in South Africa. This would ensure that such non-residents are included in the tax system. In order to make sure that these non-residents register with SARS, a system should be created that enforces a requirement on a resident that transacts with a non-resident to withhold tax on any payment to a non-resident otherwise they would suffer penalties.[215]

> "From a policy perspective, it is also important to create a level playing field so that South African companies dealing with digital goods and services are able to compete with the likes of Google. This is what prompted the concerns of Kalahari's e-books complaints. It should be noted that it is not in the interest of countries like Germany or the USA to allow the expansion of the permanent establishment concept to grant source states a wider scope to tax profits of digital businesses, since this would simply reduce the profits of the German or USA digital companies which may be taxed in the home state as the residence state would be required to give foreign tax credits in respect of such source tax. [Emphasis made]."[216]

7.4 Withholding tax

In its Final Report on Action 1, the OECD proposed that countries should consider the alternative of a withholding tax on digital transactions. This withholding tax on digital services could be applied to payments made with regards to goods or services purchased online from non-resident companies. As a result, the withholding tax would operate as a final withholding tax. This withholding tax could be applied on a net basis to assist on the application of the economic presence permanent establishment.[217]

[215] Davis Tax Committee. 2016. *Second Interim Report on Base Erosion and Profit Shifting (BEPS) in South Africa- Summary of DTC Report on Action 1: Address The Tax Challenges Of The Digital Economy* page 5
[216] *ibid*
[217] Dhuldhoya, V. 2018, page 16

In South Africa, the withholding tax mechanism in is not something new. Generally, withholding tax, in the context of income derived by a non-resident in South Africa, is a mechanism by which the resident taxpayer will withhold the tax from the purchase price paid to the non-resident and pay it over to SARS. The non-resident will then be required to submit records to the tax authorities in South Africa to claim any amounts which may be owing to it.[218]

Currently South Africa only levies a withholding tax under the following scenarios, with the tax rates indicated being subject to DTT relief:

a. Dividends - 20%[219]
b. Royalties - 15%[220]
c. Entertainers and sportspersons - 15%[221]
d. Interest - 15% [222]
e. Payments to non-residents on the disposal of immovable property and interests in immovable property in SA - rate varies between 7%-15%.

It can be assumed that the mechanisms of these withholding taxes could be referred to with the proposed withholding tax on e-commerce. In order to clear uncertainties, the proposed withholding taxes on e-commerce transactions scope must be well defined. With this system, customers would be required to withhold the tax when purchasing online. In order for the withholding tax tool to function well on e-commerce transactions, the following should be applied by the South African resident customer:

a. the customer responsible for withholding must have access to information about the covered transactions;
b. the customer responsible for withholding must know when the tax will apply and;
c. the customer responsible for withholding must be reasonably expected to comply with the obligation to withhold applicable taxes.[223]

[218] Young, N.J. 2012, page 78
[219] Section 64G of the Income Tax Act
[220] Section 49B of the Income Tax Act
[221] Section 47B of the Income Tax Act
[222] Section 50B of the Income Tax Act
[223] Dhuldhoya, V. 2018, page 16

The undisclosed nature of e-commerce can make it difficult to levy a withholding tax on e-commerce. Firstly, to impose such a withholding tax, the South African resident taxpayer (in other words the purchaser), must be identified. Secondly, the South African resident purchaser must be the one who will withhold the required taxable amount and pay it to SARS on behalf of the non-resident seller. As indicated in the previous chapters the South African Green Paper on E-commerce recommended, that it was necessary to come up with ways of identifying parties on websites. Due to this particular Green Paper, in 2002, the Electronic Communications and Transactions Act was enacted. The Electronic Communications and Transactions Act contains provisions which, if complied with and efficiently enforced, could relieve some of the identification problems posed by e-commerce. For example, section 23 of this Act requires users or customers to disclose the time and place of communication, despatch, and receipt of information. Both sections 24 and 25 deal with the attribution of data messages to the originator. Section 38 provides that the authentication of the products or services of service providers. Sections 27 and 30 contain provisions relating to cryptography so as to ensure the authenticity, integrity and reliability of Internet data. Sections 42 and 43 require the display of information about the supplier of electronic goods and services on the website. Sections 80 and 81 deal with the appointment of cyber inspectors who have the power to inspect any website activity and information.[224]

Should South Africa introduce the proposed e-commerce withholding tax, it is recommended that a section which provides that the provisions of the Electronic Communications and Transactions Act would be relied on to identify the parities to the transaction and in order to ensure the collection of the withholding tax should be inserted in the Income Tax Act.[225]

7.5 Virtual Permanent Establishment

Professor Luc Hinnekens has advocated and emphasised on the necessity of the virtual permanent establishment concept. The potential creation of a virtual permanent establishment in model tax treaties seeks to grant country of source the right to tax cross-border revenues as long as the non-resident entity conducted continuous and commercially significant business activity within the source country.[226]

In his studies, Professor Skaar supports the proposal of Professor Hinnekens that the suggested virtual permanent establishment tax nexus would operate as a “fiction” by allowing the source country to have jurisdiction on the basis of a virtual permanent establishment.[227]

[224] Young, N.J. 2012, page 78
[225] Oguttu, A.W. and Tladi, S.2009
[226] Pinto, D. 2003, page 191
[227] Pinto, D. 2006, page 276

Hinnekens' proposal comprises of a twofold test that is a facts and circumstances test. The first part of the test requires that there should be a lower threshold for a permanent establishment which is intended to apply to e-commerce transactions which is achieved by removing the requirement of *a fixed place of business* in the source state under the current permanent establishment definition. The second part of the test entails that the main business activities will be subject to tax in the source country whereas the ancillary activities will not be subject to tax, similar to the current exclusion under Article 5(4) of the OECD MTC.[228]

The virtual permanent establishment principle has its basis in the removal of the requirement of a physical, fixed place of business in the source country. This entails removing what is generally considered to be the largest hurdle in applying the traditional source principles in the context of electronic commerce.[229] According to Pinto, in order to implement the virtual permanent establishment concept, the current definition which is found in Article 5 of the OECD MTC has to be revised.[230]

In 2015 Hogeler and Pistone proposed the following wording for the definition of a permanent establishment for e-commerce:

> If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place, storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBT, CNY, CHF, etc.) per annum.[231]

Later in October 2017 in their research document on Adapting Current International Taxation to New Business Models, Brauner and Pistone recommended the following wording for the proposed amendment of the definition of permanent establishment which is includes e-commerce transections:

[228] Pinto, D. 2006, page 276
[229] Young, N,J. 2012 page 64
[230] Pinto, D. 2003, page 195
[231] Santoso, M.R. 2017, page 276

> The fixed place of business shall be deemed to exist also when the enterprise carries out business in the other Contracting State without a physical presence on the territory of such State. This situation includes cases in which the enterprise regularly concludes contracts with users in such Contracting State for an amount that exceeds XXX in a given year.[232]

Even if a mechanism could be developed whereby business profits could be attributed to a virtual permanent establishment, it would only be feasible where *active* business profits exist, as the difficulties in implementing such a system would prove to be practically challenging in the case of passive business profits.[233] Some writers suggest that for a taxpayer whose sales exceeds $500,000 in a certain country in any given calendar year that taxpayer would be deemed to have a permanent establishment in that country and taxed on profits attributable to those sales.[234]

In its first research report on Action 1: *Address The Tax Challenges of The Digital Economy*, the Davis Tax Committee indicted that that countries like France, have also considered the concept of virtual permanent establishment. As France is a member of the OECD, it thus follows the OECD principles on e-commerce. If there is an entity in France operating a company's server, that server itself would not constitute a permanent establishment. This theoretical concept has caused a concern to tax authorities. There is an increasing disconnect between the theoretical position on permanent establishment and the conduct of the tax authorities in France. Recently, the French revenue authorities, have raided the premises of Google and Amazon with the expectation to find information about business activity that would justify the determination of a permanent establishment in France. If the French revenue authorities decide that a company has a permanent establishment in France and it determines that the company was engaging in undisclosed business, the company could be liable to heavy penalties on the tax that the undisclosed business is deemed to have avoided. On 19 January 2013 the French Finance Ministry published the Colin-Collin report (preceding the OECD Base Erosion and Profit Shifting Interim Report: *Addressing the Tax Challenges of the Digital Economy, Action 1*). This report proposed a new tax (commonly referred to as a Google tax) on database collection and the

[232] Brauner, Y. and Pistone, P. 2017, page 684
[233] *Ibid*
[234] Santoso, M.R. 2017, page 277

attribution of profits to a virtual permanent establishment based on the notion that data provided by Web users who shop online must be regarded as a source of revenue to digital companies. The French government contemplated altering the definition of permanent establishment to accommodate for the digital economy. In essence, a permanent establishment would be defined as the provision of services in a country using information which would have been uploaded by the consumer voluntarily, and systematic monitoring of online users in that country. French proposals to enact the Google tax were however stopped because of lobbying pressure and investors started disinvesting in France[235]

Having said the above, the fact remains that some countries have already introduced unilateral national measures in taxing e-commerce transactions. For instance, India has introduced a 6% levy on gross consideration for B2B digital advertising services. Italy on the other hand, has introduced a voluntary ruling procedure for digital businesses. This ruling procedure allows digital businesses to agree in advance with allocated to their Italian activities. If a business does not take up the opportunity, they face an increased risk of an Italian tax audit.[236]

A number of OECD member states and non-member states fear that in the absence of OECD progress in this area, unilateral measures such as the ones taken by India and Italy will continue to spread. It is therefore important for the OECD to look into this issue as a matter of urgency[237].

7.6 Conclusion

It is found that there are at least four possible options which South Africa can consider in order to address challenges which are currently posed by e-commerce to the South African tax base. The provisions of the Electronic Communications and Transactions Act which relate to e-commerce transactions should be closely aligned to the Income Tax Act. From the above, it is evident that countries like Italy have considered taxing e-commerce transactions which have some sort of economic presence the country.

[235] Davis Tax Committee (2015) Recommendations
[236] Accountancy-Europe. 2017.
[237] Accountancy-Europe. 2017.

CHAPTER 8 – CONCLUSION

Countries impose taxes on companies based on both source and residence principles. In general, if it is established that a company is a resident of a country, that country may fix a legal right to tax that company's income..

From time in memorial, the concept of permanent establishment has been a mostly relied upon concept when countries tax multinational companies which transact with offshore companies. Difficulties arose when companies' business evolved from the traditional physical presence system to a more technologically advanced e-commerce system. By that, a form of tax base erosion emerged through the difficulty or impossibility of taxing e-commerce transactions.

Over the years, countries across the world, through the assistance of organisations like the OECD have forged forth to find ways of taxing cross-border e-commerce transactions however no resolution was met or solution found. It became more difficult to find a solution as the OECD Commentary states that a website does not itself involve any tangible property, and thus cannot constitute a permanent establishment.

Legal writers had various views on taxation of cross-border e-commerce transactions. This research recommends four possible solutions which the South African government can consider and possibly lobby G20 members and OECD members to incorporate any of the four in the OECD MTC.

The fist recommended solution is the economic presence test. This test permits the source country to tax the non-resident company on significant e-commerce transactions which are conducted in the source country. This test however upholds the traditional permanent establishment rationales.

Secondly the research suggest that South Africa should alter its source rules, by adding an e-commerce subsection in section 9 which covers taxation of profits resulting from the trade of digital products. This entails that the digital services are sourced where the payer is resident.

The third solution which the research recommends is withholding taxes on e-commerce transactions. This taxation mechanism will function similarly to the dividends, royalties and interest withholding tax systems in South Africa. Its provisions would however require that the Income Tax Act and Electronic Communications and Transactions Act be synchronised.

The forth and most suitable proposed solution is the virtual permanent establishment, which suggests that there will not be any physical presence requirement on the permanent establishment, however for a state to be granted the taxing right there has to be some sort of digital presence.

From the research conducted, one can conclude that the OECD recommendations on taxation of business profits on the location of the servers as permeant establishments in a country of source, are an insufficient and improper basis for attributing a tax link for e-commerce purposes. The most viable manner for solving this problem is by introducing a global economic presence test or formulating new source rules for South Africa, or levying withholding tax on e-commerce transactions or implementing virtual permanent establishments in the OECD MTC.

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