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2019

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Mochusi, Thabang Felicity Mmatone. (2019). An analysis of tax challenges arising due to digitalisation in South Africa. University of the Witwatersrand, https://hdl.handle.net/10539/29835

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SCHOOL OF ACCOUNTANCY

AN ANALYSIS OF TAX CHALLENGES ARISING DUE TO DIGITALISATION IN SOUTH AFRICA

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Degree: Master of Commerce (Specialising in Taxation)

Submission date: March 2019

A research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce in Taxation

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at 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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THABANG MOCHUSI

MARCH 2019

ABSTRACT

Since e-commerce started, a lot of studies on its taxability and possible solutions have been done with the aim of enforcing compliance to protect governments from eroding tax bases. The traditional way of doing business is rapidly changing and companies are using e-commerce to trade with each other. Goods and services are exchanged digitally using the internet and various software without physical presence in the state which the goods and services are being provided. As a result, the current traditional tax rules do not effectively address the issue of digitalised business models. At present the enforceability of relevant tax legislation to cater for digitalisation remains a challenge in South Africa and globally. Hence, the focus of this study is to critically analyse the challenges which are brought about by digitalisation to South African tax and recommendations on how the tax rules can be modified to effectively address taxation of digital transactions.

It has been reviewed and found that the greatest challenge that relate to fourth industry revolution from a tax perspective is the enforceability of the relevant tax legislation that was amended to make provision for digital transactions by South Africa. On the other hand, digitalisation also brought with its tremendous opportunities from an enforcement perspective as information can now be collated and linked in order to identify and detect evasion or avoidance with the use of specialised software which tax authorities can use. The research gives details of these main challenges and recommendations to tax policy makers.

Key words: Digitalisation, E-Commerce, Permanent Establishment, Source Rules, Tax Jurisdiction, Market Jurisdiction, Resident, Non-Resident, Value Creation, Double Tax Agreement; OECD, Base Erosion and Profit Shifting

ACKNOWLEDGEMENT

I thank God for giving me strength and ability to complete this journey. It would not have been possible without His grace and mercy. To God be the Glory.

I would also like to extend a big appreciation to my employer South African Revenue Service for awarding me the opportunity and support to complete this Masters' Programme. A special thanks to Tebogo Mathosa for his helpful advice and support given during my research.

To my supervisor, Roy Blumenthal, thank you for your invaluable guidance.

A special thanks to my mother, Nthibe Mochusi and all my siblings Kennedy, Nixon, Keamogetswe and Kedibone. Thank you for your love and support. I appreciate every role that each one of you has played in supporting me on this journey.

To my partner, Percy Manzini, thank you for being my pillar and your consistent support.

DEDICATION

This study is dedicated to my late beloved father, Allen Ramatsane Mochusi, who taught me the importance, value and power of education. I have promised to continue studying and making him proud, I hope I have fulfilled that promise. I wish he was still alive to share my success with me. Thank you for your many sacrifices and encouragement.

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LIST OF ACRONYMS

BEPS	Base Erosion and Profit Shifting
DTA	Diverted Profits Tax
EU	European Union
FTA	French Tax Authority
ICT	Information and Communication Technology
IP	Intellectual Property
IMF	International Monetary Fund
MNE	Multi National Enterprise
MTA	Model Tax Convention
MTC	Model Tax Conversion
ITA	Income Tax Act
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
PwC	Price Waterhouse Coopers
SA	South Africa
SAICA	South African Institute of Chartered Accountants
SARS	South African Revenue Services
3-D	Three dimension
TFDE	Task Force on Digital Economy
UK	United Kingdom
VAT	Value Added Tax

CHAPTER 1: INTRODUCTION

1.1 Introduction and background of the study

Digitalisation has not only radically transformed the aspects of everyday lives, but also the organization and functions of the economy and society itself (PwC, 2016). Its impact has also been observed in relation to international tax rules and other aspects of the tax system (European Commission, 2014). This changing environment has brought many challenges to tax policymakers, creating the need for redesigning policies in such a way that support economic growth (Drath & Horch, 2014). More specifically, digitalisation has changed methods of communication and interaction among people and society (De Swart & Oberholzer, 2016). This has affected and raised several issues in other areas, including jobs and skills, privacy and security, education, health and policy.

Considering all these technological changes, digitalisation has come with a platform that fosters stronger tax avoidance and evasion giving rise to behavioural responses to taxation such as through more aggressive tax planning (OECD, 2013). The emergence of fourth industrial revolution, brought several disruptive technologies, which has become a major challenge from a tax enforcement perspective due to its exceptional pace of development; complex business structuring and the opportunities it affords to taxpayers to either evade or avoid tax (Olivier & Honniball, 2013). Hence, the focus of this study was to critically analyse these challenges posed by digitalisation to taxation matters in the Republic of South Africa with the intention of establishing solutions that ensures the South African government can harness the tax opportunities.

In this chapter, the background, problem statement, research objectives, research questions, research methodology, limitations and chapter overview are outlined and discussed.

Long before the Organisation for Economic Co-operation and Development (OECD), released its 2013 Base Erosion and Profit Shifting (BEPS) Action Plan 1 on the challenges of the digital economy, concerns had been raised over the last two decades about global computer-based communications that cut across territorial

borders, creating a realm of human activity that undermines the feasibility and legitimacy of laws based on geographic boundaries (Davis Tax Committee, 2014:1). Technology brought new devices and machines that transformed relationships and markets (Jeffery, 2014). In addition, connectivity became increasingly ubiquitous and an enormous amount of data is now generated by constantly connected users and devices (Cockfield, 2013). Apart from bringing changes, digitalisation has been playing a central role in fostering innovation. Several emerging technologies, including the internet of things, digital crypto-currencies, the sharing economy, three dimensions (3-D) printing, advanced robotics and open government data have been introduced and entered the mainstream economy (OECD, 2015:365).

According to OECD (2015:257), the digital economy is characterised by an unparalleled reliance on intangibles, the massive use of data and the widespread adoption of multi-sided business models. The exponential and rapid pace at which technology has developed since the inception of the fourth industrial revolution has brought with its additional challenges and complications to traditional business structures and traditional tax rules (PwC, 2016). The fourth industry is defined by Steyn (2015) as the developing and current environment in which disruptive trends and technologies such as artificial intelligence, robotics, virtual reality, and internet of things are changing the way people work and live.

Digitalisation has thus enabled businesses and individuals to create value in a virtual environment. Some enterprises can now be extensively involved in the economic life of a jurisdiction with little or no taxable presence (Cockfield, 2013). The creation of advantages through technological usage has evolved at an exponential pace and most traditional products and services are moving into a sphere of service delivery which can be delivered digitally and globally (Olivier & Honniball, 2013). As a result, tax authorities have been forced, on a global scale, to identify the value that is created by digital and virtual businesses, determine how the value is taxed, where the value is taxed and how legislation is amended and enforced.

Digitalisation has thus exacerbated base erosion and profit shifting issues and a series of broader tax challenges identified as data, nexus and characterisation (OECD, 2015). Digitalisation has also enabled the use of aggressive tax structuring which leads to either the evasion or avoidance of tax. This is a global challenge which the OECD is seeking to address through a task force focusing solely on tax

challenges arising from digitalisation. Weaknesses in the current tax rules has created opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activity takes place and value is created (OECD, 2018). The highly mobile nature of e-commerce and the ability of residents to establish offshore companies has also led to tax driven migration of businesses to low tax jurisdictions (Buys & Cronje, 2004:301).

According to Cockfield (2013), digitalisation has come with non-standard work with technologies such as blockchain, and crypto-currencies, posing new risks and affecting tax revenue and compliance. These challenges chiefly relate to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries. The problem is that in South Africa, the current legislation is not adequate in establishing tax rules for digital transactions, prompting this study to critically examine the challenges in taxing digital businesses.

1.2 Research question

The primary research question is:

What are the various tax challenges and possible solutions in applying tax laws to digital transactions in South Africa?

1.2.1 Sub-research questions

The secondary research questions are as follows:

i) What are the various tax challenges brought about by digitalisation in South Africa?
ii) Does the Income Tax Act effectively address the taxation of digital transactions in South Africa?
iii) What measures can be adopted by South Africa to effectively tax digital transactions from a direct tax perspective?

1.3 Research methodology

The research was qualitative in nature. The sources that was analysed include journal articles, case law, dissertations, reports, South African income tax legislation, OECD guidelines, Australia, New Zealand, Canada and the United Kingdom (UK) tax systems that possess more advanced tax systems than South Africa. South African tax laws are mainly adopted from the European Union (EU) hence the relevance of comparison with European countries. This assisted in answering the research questions of this study that is to establish the main challenges that digitalisation brings to the South African tax systems.

The main research objectives were achieved by performing a literature study to understand the current PE rules and challenges with digitalisation in South Africa and drawing up remedies that can be employed to improve the tax systems with regards to digital businesses.

1.4 Limitations

Taking into consideration the complexity and the broad scope of tax challenges arising from the digital economy, the research paper was limited to direct tax with specific emphasis on the PE nexus on digital activities.

There is no global consensus on how digitalised business models create value, therefore the value creation process was analysed in detail. The focus was on the approaches currently recommended as measures to tax digital transactions.

1.5 Chapters overview

The dissertation is structured under the following chapters:

Chapter 1- Introduction

In this chapter the background to the study is outlined and the problem statement is explained to set out the foundation to the study. The research questions are outlined,

and the research methodology is set out on how secondary data was gathered. The significance of the study, limitations, and structure of the dissertation is also outlined.

Chapter 2 – The digital economy and overview of the South African legislation framework

This chapter aimed at exploring and analysing the legal framework available in South Africa in addressing taxation of digital transactions. The chapter addressed the following:

- Income Tax Act 58 of 1962 (the Income Tax Act) and how it incorporates digital transactions;
- Direct tax issues; South Africa has not yet introduced direct tax legislation to taxing digital business models, and this is discussed in detail with comparisons to other developed countries.

Chapter 3 - Tax challenges and BEPS in the digital economy

In this chapter, the main tax challenges facing South Africa as a result of digital transactions are identified, explained and analysed. The main focus is the impact on digitalisation on direct taxes. A further analysis is done to understand how the current permanent establishment rules are affected by digitalisation. The Permanent Establishment (PE) definition does not address how digital business models can possibly create a PE in the source jurisdiction and how these digital transactions should be taxed from a direct tax perspective in South Africa. The analysis covers the developments within the digital economy and its taxation effect using the OECD reports and European tax systems. This chapter documents the BEPS issues presented by digitalisation and various challenges faced by tax authorities with regards to the taxation of digital transactions. The BEPS issues faced by South Africa is analysed with reference to European tax systems and guidelines of the OECD.

Chapter 4 - Current remedies to address the tax challenges arising out of digitalisation

The chapter analyses the current and proposed remedies to addressing tax challenges brought about by digitalisation. The OECD recommendations on how to tackle broader direct tax issues arising from digitalisation is discussed. The chapter also discusses South Africa's position in expanding the permanent establishment rules in order to address the issue of 'artificial avoidance of a permanent establishment status'. The measures that can be adopted by South Africa to effectively manage tax digital transactions from a direct tax perspective are also discussed.

Chapter 5 Conclusion

This chapter brings the main conclusions based on the analysis in the previous chapter. The potential recommendations to the tax authorities on how to improve taxation with digitalisation are outlined including areas of further studies.

1.6 Conclusion

In this chapter the background and problem statement of the digitalisation taxing challenges facing South Africa was introduced and outlined. The research objectives, research questions and brief research methodology guiding the study were also outlined. The chapter ended with a description of the limitations and an outline of the research report. The next chapter provides the literature study on the background of the digital economy and the overview of the South African tax framework.

CHAPTER 2 – THE DIGITAL ECONOMY AND AN OVERVIEW OF THE SOUTH AFRICAN LEGISLATION FRAMEWORK

2.1 Introduction

In this chapter the literature study on the background of digital economy is given to reveal the nature of the resultant tax challenges. In addition, the South African tax legislation that relates to digital transactions is discussed with focus on Income tax and direct tax issues that relate to direct tax legislation.

2.2 Background of digital economy

There is no agreed definition of the digital economy but according to the International Monetary Fund (IMF), 'the "digital economy" is sometimes defined narrowly as online platforms, and activities that owe their existence to such platforms, yet, in a broad sense, all activities that use digitised data are part of the digital economy, in modern economies and the entire economy (Hadzhieva, 2019). The OECD has defined the digital economy as a transformative process, brought about by advances in Information and Communication Technology (ICT) which has made technology cheaper and more powerful, changing in business processes and bolstering innovation across all sectors of the economy, including traditional industries (OECD, 2015:124). The difficulty in defining the digital economy is due to the ever-changing technologies of the ICT.

The effects of the digital economy on business models and activities has brought major challenges for the international tax systems, as the main rules for allocating taxing rights amongst States were established in the early 1920's and have not been adapted to the new dynamics of the economy and its global reach (Basu, 2013). In a digitalised platform, a taxpayer in one jurisdiction can buy goods and services in another jurisdiction over the internet without any physical involvement. These transactions can occur between any two parties that have access to the internet, regardless of their location around the globe, thereby transcending territorial boundaries. (Azam, 2013)

Although one cannot clearly define the boundaries of the digital economy, the transactions in the digital economy can be categorised as follows: ‘electronic services, supply over the internet of services other than electronic services and supply of goods ordered online’ (European Commission, 2016). 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 avoidance (Basu, 2013).

The ability of tax authorities to collect tax is dependent on the identification, location, verification of taxpayers and their corresponding taxable transactions (Basu, 2013). If a transaction is unidentifiable and the taxpayer unknown, it is likely to result in double non-taxation by both the residence and source state. Concerns had been raised over the last two decades about global computer-based communications that cut across territorial borders, creating a realm of human activity that undermines the feasibility and legitimacy of laws based on geographic boundaries (Valente, 2010). This is especially so with regard to transactions that are conducted electronically through e-commerce over the internet, which ignoring international boundaries, since “place” has little meaning in the networked world (Switzer & Switzer, 2014) E-commerce has been described as the wide array of commercial activities carried out by electronic means that enable trade without the confines of geographical boundaries (Basu, 2013).

The rise of the digital economy has posed a unique threat to the working of the traditional rules governing allocation of taxing rights between source and resident countries (Valente, 2010). The OECD has also over the years shown particular concern about the challenges that e-commerce poses to taxation, in particular about the challenges to the tax treaty rules for taxing business profits, which apply to the PE concept as a basic nexus/threshold rule for determining whether or not a country has taxing rights with respect to the business profits of a non-resident taxpayer (Davis Tax Committee, 2014).

The integration of national economies and markets has increased substantially in recent years due to advances in technology, putting a strain on the international tax rules, which were designed more than a century ago (OECD, 2015:3). Weaknesses in the current tax rules has created opportunities for BEPS, requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.

2.3 Key features of the digital economy

There are several features that are increasingly prominent in the digital economy and which are potentially relevant from a tax perspective. These key features have been summarised by De Bruyn (2016) as follows:

2.3.1 Mobility

The mobility of intangibles, users and business functions, is a result of the ever-decreasing need for a physical presence with local personnel as well as the flexibility to choose the location of the required resources, such as servers. Due to the mobility of the digital economy it is difficult to determine where value is added and where the source of the income is situated. Included with mobility is also the flexibility in many cases to choose the location of the company servers and business resources.

2.3.2 Reliance on data

The digital economy relies heavily on data, and the use of personal data individuals which can be utilised for advertising purposes, or to target service offerings. This data is often vital for businesses conducting targeted marketing and services offerings custom designed for specific jurisdictions and may be valuable in the value chain of certain Multi National Enterprises (MNEs). Many tax authorities have been challenged with the question of whether there should be a value attached to data and how to value such data.

2.3.3 Multi-sided business models

In a multi-sided business model, multiple groups of persons interact through an intermediary or platform and the decisions of each group affect the other groups. For example, an operating system is more valuable to end users if more developers write software for it, and valuable to software developers if more potential software purchasers use the operating system. Accordingly, the value of profits of an enterprise is often dependant on or attributable to the value of another enterprise.

2.3.4 Monopoly or oligopoly

A few players may have a dominant position in a short time in an immature market, due to the network effects combined with low incremental costs. This dominant position may be enhanced where a patent or Intellectual Property (IP) grants one business the exclusive power to exploit a specific innovation.

2.3.5 Volatility

The digital economy has low barriers to entry, with internet available without large start-up costs, the market has miniaturised, leading to high volatility. One business may be dominant for a short time, before another business puts forward a better value proposal or a more sustainable business model, with few companies managing to secure long term success.

2.4 Business models in a digital platform

The following are the types of business models which exists in the digital economy (OECD, 2015):

2.4.1 E-commerce

E-commerce is the sale of goods and services conducted over a computer network. E-commerce can be used either to facilitate the ordering of goods or services that are then delivered through conventional channels or to order and deliver goods or services completely electronically.

2.4.2 App stores

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 his/her device.

2.4.3 Online advertising

Online advertising uses the Internet as a medium to target and deliver marketing messages to customers. Online advertising involves a number of players, including web publishers, who agree to integrate advertisements into their online content in exchange for compensation, advertisers, who produce advertisements to be displayed in the web publisher's content and advertising network intermediaries, who connect web publishers with advertisers seeking to reach an online audience.

2.4.4 Cloud computing

entails provision of standardised, configurable, on-demand online computer services, which can include computing, storage, software, and data management, using shared physical and virtual resources. Because the service is provided online using the provider's hardware, users can typically access the service using various types of devices wherever they are located, provided they have a suitable Internet connection.

2.4.5 Participative networked platforms

It is an intermediary that enables users to collaborate and contribute to developing, extending, rating, commenting on and distributing user-created content.

2.4.6 High speed trading

uses technology like algorithms to trade securities at high speed. Because trades are conducted entirely electronically, high frequency trading generally does not require personnel in the country where the infrastructure used to make trades is located.

2.4.7 Online payment services

Paying for online transactions traditionally required providing financial information such as banking details to a vendor. The Online payment service providers provide a secure way to enable payments online without requiring the parties to the transaction to share financial information with each other. Each of these models is unique in the kind of service rendered. For example, an e-commerce platform is a distribution model where sellers list products and buyers can purchase them. Social networks connect users who exchange information. Multi-sided platforms, such as Uber and

Airbnb, connect buyers and sellers of a service based on location, and then there are companies, such as Netflix, that provide on-demand content. (OECD, 2015)

With regards to the above listed digital business models, the main tax challenges in the digital economy stem from this decreasing relevance of a physical presence in the market of the customers, the increasing importance and mobility of intangibles and the high degree of integration of the value chain (Olbert, & Spengel, 2017).

Due to the complexity of these digital business models, revenue authorities worldwide experience a challenge of understanding and agreeing on how value is created and how taxing rights should be allocated amongst jurisdictions. Each digital business models operates in its own unique way, as a result, value is also generated differently. The common feature that they have is that they all rely on servers, software, intangibles and user data, it is therefore important to understand how each of these tools contribute to value creation.

The unique nature of these digital business models helps digital companies to engage in BEPS practices. Revenue lost through the digital economy is a growing concern by governments internationally that lose substantial corporate tax revenue because of arrangements implemented by multinational enterprises which shift profits to low tax jurisdictions, thus eroding the taxable base (Davis Tax Committee, 2014).

Digitalized businesses present a special challenge for tax not only because of the intricate contribution of intangibles but also because no consensus exists yet on the contribution of inputs critical to revenue generation, such as user participation and data generation (Olbert, & Spengel, 2017).

In 2013, the OECD launched a BEPS project consisting of 15 action plans targeting the gaps and mismatches in the international tax system that facilitated the shifting of profits by multinational enterprises away from where the underlying economic activity and value creation took place (OECD, 2015). The 15- point action plan was

intended to tackle BEPS and structured around three key pillars, which were (OECD, 2019):

- Improving coherence in the domestic rules that affect cross-border activities;
- Reinforcing substance requirements to ensure alignment of taxation with the location of economic activity and value creation; and
- Enhancing transparency and certainty for businesses and governments.

The tax challenges of the digitalisation of the economy were identified as one of the main areas of focus of the BEPS action plan leading to the 2015 BEPS Action Plan 1 Report. The work to address the tax challenges presented by digital economy was carried out under Action 1 of the BEPS project by establishing a task force on digital economy ("TFDE") which issued a final report in 2015.

The Action 1 Report found that, as a result of the pervasive nature of digitalisation, it would be difficult, if not impossible, to ring-fence the "digital economy" from the rest of the economy for tax purposes. In other words, countries agreed that there was no such thing as a "digital economy", but rather that the economy itself had become digitalised and that this trend was likely to continue (OECD, 2015).

The report further noted that, beyond BEPS, the digitalisation of the economy raised several broader tax challenges chiefly relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated amongst countries. These challenges are discussed in detail in chapter 3 of this report.

2.5 Overview of the South African tax framework

As very early as 1994, the Katz Commission Report into Taxation ("the Katz Commission") was charged with the task of reviewing the tax system in South Africa to consider the impact of e-commerce on the tax system (SAICA, 2000). The Katz Commission noted that the way goods and services can be contracted for, advertised and even delivered via electronic means, can lead to the erosion of South

Africa's tax base (Davis Tax Committee, 2014). The Commission further noted that, e-commerce was a global problem and that South Africa would respond to it when the world economies began formalising policies on addressing international trade over the internet (SAICA, 2000). Since then, e-commerce has grown in South African as many transactions are being concluded online using the internet and technologies available.

In devising an e-commerce policy for South Africa, a green/white paper process was developed with the intention of coming up with legislation on e-commerce. This culminated into the Green Paper on E-commerce released in 2000 which pointed out that the legal framework in South Africa was insufficient to deal with e-commerce issues (Davis Tax Committee, 2014).

In 2002, South Africa enacted the Electronic Communications and Transactions Act to provide for the facilitation and regulation of electronic communications and transactions (Electronic Communications and Transactions Act 25, 2002). This Act contains certain provisions which, if complied with and effectively enforced, may alleviate some of the identification problems posed by e-commerce (Olivier & Honniball, 2013). Overall, the Act does not provide for taxation issues in respect of e-commerce transactions (Wassermann & Bornman, 2018).

In 2013, the Minister of Finance announced in his budget that a tax review will be set up to address among other things, the concerns about BEPS, with a big focus on corporate income tax (Davis Tax Committee, 2014).

Income tax principles are traditionally based on the existence of a physical presence in an area of jurisdiction before tax can be imposed or levied.

2.5.1 South African Tax system

Income tax in South Africa is governed by the Income Tax Act No. 58 of 1962("ITA"), where normal tax is levied in terms of section 5 of the ITA on the taxable income of a taxpayer in a year of assessment.

Prior to 1 January 2001, South Africa used the source-based tax system. Under the source-based system, taxpayers were only taxed on the income sourced or deemed to be sourced from South Africa. In January 2001, South Africa moved away from

the source-based tax system to a residence-based tax system. Under a residence basis of taxation or a worldwide basis of taxation, the connecting factor between the country and the income is the person who receives the income or to whom it has accrued (Olivier & Honniball, 2013). Residents are taxed on their worldwide income irrespective of where the income is sourced from. Motivating the change to a residence-based system of taxation in South Africa was the need (SARS,2000):

- To establish a 'sound footing' for the income tax system and to protect the South African tax base from exploitation;
- To align the South African tax system with international tax principles;
- To relax exchange control and ensure an increased involvement of South African companies offshore; and
- To cater for the taxation of e-commerce

The source-based tax system has not been completely abolished but it is being used to tax income generated by non-residents in South Africa subject to the provisions of any double tax agreement ("tax treaty/treaties") which might exist between South African and the other jurisdiction.

Under the residence-based tax system in South Africa (SA), to determine if an income stream derived by a non-resident is taxable, a two-pronged approach is adopted. Firstly, determine whether the income in question is "sourced" in SA. Sources of income streams are defined in section 9 of the ITA local legislation with reference to specific income streams, which would not include most income streams from digital activities. In accordance with the source provisions under section 9, it is usually required that the non-resident must conduct some activity or carry out its business through a physical place of business before income can be deemed to be sourced from South Africa and potentially be taxable in the Republic.

The source rules as contained in section 9 do not address electronic transactions or income generated from digitalised business models. Thus, common law needs to be considered. Much of common law predates the digital economy. The common law source rules rely on the principle of originating cause. The common law guidelines developed by the South African courts to determine whether the source of income may be located in South Africa do not also take into account the complexities of the digital economy (Davis Tax Committee, 2014).

Secondly, if the non-resident resides in a country with which SA has a tax treaty with, it must be established whether such a treaty allocates taxing rights to SA to eliminate double taxation whereby both the Source and the Residence State tax the same income twice.

The South African National Treasury has issued a draft proposal to define electronic services in section 1(1) of Value Added Tax (VAT) Act which will come into effect in April 2019. The proposal defines electronic services as (National Treasury, Government Notice, 2018):

any services supplied by means of an electronic agent, electronic communication or the internet for any consideration, other than-:

(a) educational services supplied from a place in an export country and regulated by an educational authority in terms of the laws of that export country; or
(b) telecommunications services; or
(c) services supplied from a place in an export country by a company that is not a resident of the Republic to a company that is a resident of the Republic if—
(i) both those companies form part of the same group of companies; and
(ii) the company that is not a resident of the Republic itself supplies those services exclusively for the purposes of consumption of those services by the company that is a resident of the Republic.

This proposal follows the requirement, which was introduced in the VAT Act on 1 June 2014, for suppliers of foreign electronic services to register as VAT vendors subject to specific categories in the VAT Act. The current legislation was narrow and lists electronic services as specific categories including non-regulated educational services, games and games of chance, internet-based auction services, e-books, music and subscription services to websites and web applications. The new definition of e-services is intended to broaden the VAT scope to include all services that are electronically supplied.

The ITA doesn't address electronic services specifically and applies section 9 read with the provisions of the tax treaty to determine if an income is generated from a source based in South Africa.

Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a permanent establishment ("PE") to which the profits are attributable (OECD, 2015). To an extent that a PE has not been created, the income generated by a non-resident is taxed in accordance with Article 7 "business profits" article of the relevant treaty.

Article 7 of the OECD Model Tax Convention (MTC) gives the primary taxing right to the profits of an enterprise to the Residence State of that enterprise, unless if the enterprise carried on a business in the source state through a PE in that state. In this case, the profits will be subject to tax in the source state where the PE is located. The allocation of taxing rights is based on the premise that any State other than the State of residence can tax business income only when there is a taxable presence in its territory and to the extent that there are profits attributable to that PE.

Section 1 of the ITA defines a PE according to Article 5 of the Model Tax Convention on Income and Capital of the Organisation for Economic Co-operation and Development. Section 108(1) of the ITA read with section 23 of the Constitution provide inter alia that as soon as a treaty is ratified and has been published in the Government Gazette, its provisions are effective as if they had been incorporated in the ITA (Oguttu & Tladi, 2009).

2.5.2 Definition of a Permanent Establishment

The PE is defined in Article 5 of the OECD MTC as follows:

1. The term permanent establishment ("PE") means a fixed place of business through which the business of an enterprise is wholly or partially carried on.
2. The term "permanent establishment" includes especially:
   a) a place of management;
   b) a branch;
   c) an office;
   d) a factory;
   e) a workshop, and
   f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resource.
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than 12 months.
4. Notwithstanding the preceding provision of this article, the term "permanent establishment" shall be deemed not to include:
   a) The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
   b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
   c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
   d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
   e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) The maintenance of fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise , unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business , would not make this fixed place of business a permanent establishment under the provision of that paragraph.
6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.
7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

According to the PE definition quoted above, for a non-resident to be considered to have established a PE in another jurisdiction, there must be a distinct place which can be regarded as a place of business with a certain degree of permanence. It emerges from the above that the current PE concept requires a physical or representative presence as the nexus for source countries to tax profits of a foreign company. Whether or not a foreign company has a fixed place of business in the source country is dependent on several factors such as the character of income, the duration of the activities, and the right to use a location (Basu, 2013). This is commonly referred to as a geographical and duration test, in order for the permanence requirement to be met. The geographical location has to be at the disposal of the non-resident for a certain period, either six or twelve months in order for a PE to be deemed to exist. The underlying idea is that the source country is empowered to tax the business profits of a foreign company that is integrated into the economic life of the source country (Cockfield, 2013). Similarly, the purpose of the current PE threshold is to define when a foreign company can be said to have a sufficient nexus with the source country to justify source-based taxation (Palil & Mustapa, 2011). Such a nexus to tax is determined by whether a foreign company conducts income-producing business activities through some degree of physical presence, either in the form of labour or property, in the source country (Jones & Basu, 2012). To the extent that a foreign company is carrying out income generating activities in the source state, a PE will be established which brings the foreign company into the tax net of the source state.

Alternatively, there must be a dependent agent that habitually exercises a right to conclude contracts in the source state on behalf of a non-resident. The PE definition and the current legal framework is difficult to apply to digitalised business models as a physical location of where the income is sourced is required for a PE to be created. The dependent agent PE rules are also based on the physical location of where the dependent agent is habitually concluding and signing contracts on behalf of the non-resident for a PE to be considered to exist.

In relation to the digital business models, it is difficult to establish the place of business and where value is created as there is no physical presence in the country that the goods and services are being provided. Services and goods provided in a digital platform do not require a PE to carry out business in the market country and as a result can generate significant profits there without creating a taxable presence. Contracts with customers are also concluded online, it is therefore a challenge to establish the source of where the services and income originate from.

Due to the rapid changes brought about by e-commerce, the 1998 OECD report clarified how some aspects of e-commerce should be addressed.
As far as the OECD is concerned, the steps in reinterpreting the PE notion started in1998 at the Ottawa Ministerial Conference on Electronic Commerce, where the member countries reached to an agreement regarding the principles that should guide the development of rules in international tax matters for the electronic commerce (Cockfield, 2003). Such principles are as follows:

- Neutrality: According to this principle, tax rules applicable to electronic commerce and conventional commerce should be neutral and the taxpayers in alike situations performing comparable transactions should be taxed in similar ways.

- Efficiency: Costs for both the taxpayers and the tax authorities should be diminished as far as possible.

- Certainty and Simplicity: The tax rules should be clear and simple to understand for the taxpayers to anticipate the tax consequences in advance of a transaction.

- Effectiveness and Fairness: The tax liability should be fair and accrued in the proper time and the potential tax avoidance should be reduced while keeping neutralizing measures proportionate to the risks involved.

- Flexibility: The tax rules should be flexible and dynamic to follow technological and commercial developments.

Considering these principles and the rapidly expansion of the electronic commerce, in 2003 the OECD included in the Commentary on Article 5 of the OECD MTC the possibility to treat servers as PEs, rather than web pages, if substantial activities are performed through them.

Paragraph 42 was consequently added on article 5 of the commentary with recommendations on the challenges e-commerce poses to the PE concept. The following observations were made:

An internet website, which is a combination of software and electronic data, does not itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" … as far as the software and data constituting that website is concerned. On the other hand, the server on which the website is stored, and through which is accessible is a piece of equipment having a physical location may thus constitute a "fixed place of business" of the enterprise that operates that server.

The distinction between a website and the server on which a website is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the website. For example, it is common for the website through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the website, these contracts typically do not result in the server and its location being at the disposal of the enterprise…., even if the enterprise has been able to determine that its website should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the website is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. If the enterprise carrying on a business through a website has the server at its own disposal, for example it owns(or leases) and operates the server on which the website is stored and used, the place where the server is located could constitute a permanent establishment of that enterprise if the other requirements of the Article are met.

This commentary essentially states that a server could constitute a PE as its geographical location can be identified and if it is at the disposal of the enterprise. This is exclusive of the activities which are deemed to be preparatory or auxiliary in

nature. As it is discussed above, it is generally accepted that a website does not create a PE. A server can be a fixed place of business.

Although a server on which a company's website is stored can constitute and is accessible, for the purpose of article 5, a fixed place of business of the foreign company that operates that server; a website, which is a combination of software and electronic data, does not have a location that can constitute a "place of business" because there is no "facility such as premises or, in certain instances, machinery and equipment' as far as the software and data constituting that website is concerned (OECD, 2015).

International tax expert Dale Pinto has written extensively on why a server PE is inadequate to deal with the threats posed by the digital economy by convincingly arguing that the location of the infrastructure such as a server is an unsatisfactory and unstable basis for attributing nexus to tax (Charlet & Buydens, 2012).

According to Cockfield (2013), the location of a server is inadequately related to the location of essential economic activities comprising production and consumption of information. Technology has become so advanced, the location of a server can be easily moved between different countries and server programs can be moved almost immediately from one server to another server in a different country (Deloitte, 2016). Basu (2013) further argues that a server could be easily and frequently moved between different servers in different countries, and mirror sites could be set up to direct customers to different servers.

If a server is in one jurisdiction for a duration of less than a year, it may not be deemed to constitute a PE. The traditional PE rules considers the geographical and duration of activities for a place of business to be deemed to exist. This poses a difficulty of allocating taxing right to the jurisdictions where the servers are located, each jurisdiction may claim the right to tax the income on the basis that the server is in its jurisdiction and as a result, a physical presence test is met.

As it is prevalent from the overview above, for a non-resident to be taxed in South Africa, a physical location is required for a PE to be created. The only exception whereby a fixed place of business is not required is when a business of an enterprise is carried out through a dependent agent as defined in article 5(4) of the OECD MTC or the activities being carried out are deemed to be preparatory or auxiliary in nature.

This is a challenge as the digital services are mobile in nature and are not provided from a physical location, but they are transmitted over the internet. In dealing with cross-border transactions, traditional tax rules were designed to establish where the source is, and which jurisdiction should be allocated taxing rights in respect of that transaction. The borderless nature of digital transactions poses a difficulty in determining the source of the income as the economic activity is no longer preconditioned on physical presence. The traditional international tax rules are insufficient to deal with digitalised business models. Unlike in a traditional brick and mortar business where there are physical resources, the digital business models initiate and conclude transactions over the internet which bypasses the traditional existing tax rules. Domestic rules and international tax rules require physical presence in order to apply tax rules to a transaction.

The traditional international rules use the concept of a PE in addressing cross-border transactions. The PE as currently defined under article 5 of the OECD MTC requires fixed place of business to exist for taxing rights to be allocated. These PE rules do not take into consideration the digitalised business models which do not require a physical geographic location to carry out business.

International reforms efforts have added computer servers to the permanent establishment category in circumstances whereby the server performs integral functions associated with an international e-commerce (Cockfield, 2003). This was intended to address e-commerce transactions. The server PE also comes with its own issues as the location of a server can be easily moved between jurisdictions.

Although a server can create a PE in the market jurisdiction, it does not address the taxation of digitalised transactions which are provided over the internet or through a website as well as transactions generated through cloud computing. These transactions do not require a server to be setup in the source state where the customers are located to allow online purchasing of goods and services. This presents a big challenge for the revenue authorities to design tax rules which can efficiently address highly digitalised business models.

2.6 Conclusion

In this chapter the digital economy history and development were discussed highlighting how tax policies have lagged creating the taxation rules challenges

globally and in South Africa. The current South African tax framework was discussed highlighting the shortfalls of the Income Tax system and the complexities of application of the permanent establishment rule in relation to digital transactions. The next chapter gives a literature study on the tax challenges and BEPS in the digital economy in greater detail.

CHAPTER 3 - TAX CHALLENGES AND BEPS IN THE DIGITAL ECONOMY

3.1 Introduction

In this chapter the tax challenges facing South Africa and the issues of BEPS are discussed in detail to assist in answering the research questions of this study. The main tax challenges facing South Africa as a result of digital transactions are identified, explained and analysed. A further analysis is done to understand how the current permanent establishment rules are affected by digitalisation.

3.2 BEPS issues exacerbated by digitalisation

While the digital economy is an important driver of economic growth, it also presents challenges to the taxation system devised for traditional brick and mortar companies and cross-border sale of goods. Digitalisation has a wide range of implications for taxation, impacting tax policy and tax administration at both the domestic and international level, offering new tools and introducing new challenges. As a result, the tax policy implications of digitalisation have been at the centre of the recent global debate over whether the international tax rules continue to be “fit for purpose” in an increasingly changing environment (OECD, 2017).

Due to the virtual nature of business conducted by digital companies, tax loopholes are invariably created, making it difficult for tax authorities in the host country from collecting taxes from such companies. The mobility factor of the digital business models raises base erosion and profit shifting concerns in that business structures can be so arranged and shifted to low tax jurisdictions.

A digitalised business can carry on a business and create value in multiple jurisdictions without any physical presence in those jurisdictions. It is therefore a challenge to allocate value and taxing rights to those jurisdictions. A reliance on physical or representative presence raises questions as to whether the traditional rules on tax allocation continue to be an adequate mechanism to preserve the tax rights of the market country in a digital era, which relies excessively on digital technologies to carry on key business activities.

Due to the mobility nature of digital transactions, a taxable presence is difficult to be established which may result in tax losses in the source state. The ability to trade without the confines of geographical borders creates a world that undermines the legitimacy and feasibility of the tax laws that were created around the concept of the physical separation of countries (Cox, Rider & Sen, 2013).

The OECD identified the following as challenges that the digital economy poses to the international taxation system:

- Eliminating or reducing tax in the market country as the result of either avoiding a taxable presence or minimising the income in the market country. For cross-border online transactions that do not require a physical presence, a tax liability is usually not defined in domestic law. If the country of residence does not assume its taxing right, the respective income is effectively untaxed;
- In the case of a taxable presence, the income can be minimised by only allocating minimal functions, assets and risks or maximise deductions in the market country. This is considered problematic because the allocation of functions and assets is often tax motivated and functions and risks are not factually exercised; and
- The avoidance of withholding taxes and the elimination or reduction of tax in the intermediate country using specific contractual payments and the imposition of holding countries (Olbert, & Spengel, 2017).

Eliminating or reducing tax in the market country is usually done through two different scenarios, the first one is when the tax presence has been established, and profits are significantly reduced to minimise the tax liability in the market country. The second scenario is avoiding having a taxable presence in the market country by using various tax planning strategies (Noqueira, 2018).

Tax in a market jurisdiction can also be artificially avoided by fragmenting operations among multiple group entities in order to qualify for the exceptions to PE status for preparatory and auxiliary activities, or by otherwise ensuring that each location through which business is conducted falls below the PE threshold (OECD, 2015:185). These tax avoidance schemes are enabled by the misalignment in the rules between where the profits are taxed and where value is created.

Examples of digital economy structures that can be used to minimise the tax burden in market jurisdictions through contractual allocation of assets and risks include:

- Using a subsidiary or PE to perform marketing or technical support, or to maintain a mirrored server to enable faster customer access to the digital products sold by the group, with a principal company contractually bearing the risks and claiming ownership of intangibles generated by these activities; and
- In the case of businesses selling tangible products online, a local subsidiary or PE may maintain a warehouse and assist in fulfilment of orders. These subsidiaries or PEs will be taxable in their jurisdiction on the profits attributable to service they provide, but the amount may be limited. (Davis Tax Committee, 2015:40)

The challenges identified by the OECD above are not unique to South Africa. This is because South Africa's domestic source rules do not effectively address digital transactions. The existing international tax rules as contained in Article 5 of the double tax treaties which South Africa has entered still require physical presence to exist before a non-resident can be deemed to carry on a business in South Africa. Alternatively, the non-resident should be carrying out its business through a dependent agent which habitually concludes contracts with SA customers on behalf of that non-resident.

3.3 Broader tax challenges

According to the OECD (2017), the three broad challenges brought about by digitalisation which substantially overlap are:

- Nexus: The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business, combined with the increasing role of network effects generated by customer interactions, raise questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate;
- Data: The growth and sophistication of information technologies that have accompanied the digitalisation of the economy has permitted an increasing

number of companies to gather and use information across borders to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, and of how to characterise for tax purposes a person or entity's supply of data in a transaction; and

- Characterisation: The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models, particularly in relation to cloud computing (OECD, 2017).

  Traditionally tax authorities have imposed different types of tax regimes on different classes of cross-border income. The transmission of digital goods and services may not provide a clear indication as to what is being transferred, whether goods have been delivered, services performed or an intangible asset licensed (Cockfield, 2006).

These challenges raised by digitalisation, go beyond BEPS and chiefly relate to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries (OECD, 2018:18).

The current international tax rules presuppose a classical business enterprise with a physical location in order to establish a nexus between a payment and a location. Allocation of profits difficulty arises because digital business models are driven by high value intangibles which are often developed, maintained and exploited in another jurisdiction.

The digital economy also present administrative issues around identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers (OECD, 2015:270). Due to the anonymity of digitalisation, revenue authorities may not be able to know which activities are taking place in their jurisdictions as well as who the role players are to ensure compliance with their domestic rules. Even if the identity and role of the parties involved can be determined, it may be impossible to ascertain the extent of sales or other activities without information from the offshore seller (OECD, 2015:270). Due to the complexity of the digital economy, parties to the online transactions may be

known to the revenue authorities, however it is a challenge to measure the extent of services provided online in one jurisdiction and the value thereof.

The challenges discussed above presents a challenge of determining where value is created and how taxing rights should be allocated. The OECD (2014) aims to tax profits in line with value creation and economic activity.

3.4 The impact of digitalisation on permanent establishment rules

The impact of digitalisation on permanent establishment rules is discussed under the following headings:

3.4.1 Background of PE rules

The main objective of the concept of the definition of a permanent establishment in a treaty is to set out activities and a threshold which a non-resident enterprise should meet for the source state to have taxing rights to the income generated in its jurisdiction. The PE threshold creates certainty in that investors know when income derived from business activities in a foreign country will be subject to tax in that country (Olivier & Honniball, 2013).

E-commerce challenges the concept of a permanent establishment because it gives a company the potential ability to have digital presence in a country without having the burden of paying tax because of the lack of substantial nexus (Cadesky, Rinninsland & Lobo, 2014).

The traditional PE definition as explained in chapter 2 looks at a physical place of business to exist for a PE to be established. The goal of establishing a PE nexus is to ensure a solution able to preserve the taxing rights allocation in cross border business by conserving the sovereignty of the source state to tax business income derived from activities linked to territory and jurisdiction (Hongler & Piston, 2015).

Apart from requiring a substantial physical presence in the source state, the PE concept also considers a situation where activities of an enterprise are carried out in the source state by using a dependent agent. If a dependent agent is habitually concluding contracts on behalf of a non-resident, that non-resident would be deemed to have created a PE in the source state.

Digitalised business models allow cross border trade whereby non-resident taxpayers can derive substantial profits from transactions with customers located in another country without physical presence. Customers can just log into a website and purchase goods and services from the supplier and use the same platform to pay for the goods and services purchased without any human intervention.

A foreign company can provide virtual professional services to customers located in a market country, receive consideration and yet pay no income tax on profits so generated (Palil & Mustapa, 2011). With such developments, multinational companies with existing PEs may begin to shift part of their business operations from the PE in the source state to the internet in order to consolidate their operations and outsource non-essential functions to foreign affiliates (Oguttu & Tladi, 2009).

While the ability of a company to earn revenue from customers in a country without having a PE in that country is not unique to digital businesses, it is available at a greater scale in a digital economy than was previously the case (OECD, 2015:116). Digitalised business models have made it possible for multinationals to generate revenue in the other jurisdiction without physical presence and thus making it possible to avoid a taxable presence in the market jurisdiction. Under some circumstances, tax in the market jurisdiction can be artificially avoided by fragmenting operations among multiple group entities in order to qualify for the exceptions to PE status for preparatory and auxiliary activities, or by otherwise ensuring that each location which business is conducted falls below the PE threshold (OECD, 2015:185).

The current PE rules are not effective in assuring fair allocation of taxing rights on income derive from digitalised transactions. The physical presence and dependent agent requirements are inadequate in addressing taxation of digitalised business models in order to preserve the taxing rights of the market country. There are hindrances in identifying a “place of business” since the business activity is carried through the network and so tracking connection between an online transaction and a specific geographical location may be difficult (Valente, 2010). The reduced need for a physical presence in the source country due to digitalisation of business activities present several international tax-related policy challenges, particularly, in establishing nexus with a jurisdiction to tax business profits (OECD, 2014).

3.4.2 Dependent agent PEs

Multinational companies often use agents to finalise complex contracts or exploring new business opportunities (Oguttu & Tladi, 2009), in the digital era, these functions can now be easily done over the internet without human involvement. This presents a challenge in identifying a dependent agent PE as well at establishing where the functions are being carried and value created.

The judgement of a tax court case involving Google Ireland and the French Revenue authority is analysed below to demonstrate how conclusion of online contracts can escape the dependent PE threshold in the market country.

French Tax Authority (FTA) vs Google Ireland Limited (Google Ireland); (Deloitte, 2017)

In July 2017 the Paris Administrative Court issued a judgement in a case involving Google Ireland, in which it held that Google Ireland did not have a PE in France due to activities of its French sister company because the French entity lacked sufficient authority and autonomy and, therefore Google Ireland was not subject to tax French tax.

Background:

Google Ireland, an Irish subsidiary of Google Inc., provided online advertising services through Google website which was used by French business customers between the years 2005 and 2010.

Google France SARL (Google France), also a subsidiary of Google Inc. provided marketing advise and analysis and other assistance to Google Ireland with respect to its French sales activities under the terms of a “marketing and services agreement” between the two subsidiaries.

The intercompany agreement did not allow Google France’s employees or representatives to conclude sales of advertising services or other agreements or contracts on behalf of Google Ireland.

FTA took the position that, as a result of the assistance provided by Google France, under the intercompany agreement, Google Ireland performed the services for its French customers from a PE in France. The FTA based its arguments on documents discovered through a raid of Google France's offices, exchanges with the Irish and other tax authorities and among companies that transacted business with Google France. The FTA specifically relied on the following:

- Google France's employees were specifically mentioned in the customer agreements;
- Internal documents showed that Google France's employees were involved in discussions both before and after the agreements were, including order taking, billing management, debt recoveries, etc.;
- Google France hired a business legal counsel to advice with regards to the agreements;
- Google France made closing deals with customers in certain cases; and
- The switch routers and other connections used by Google France to access data essential to the services it provided to Google Ireland were in France.

The FTA assessed Google Ireland various taxes totalling over EUR 1.1 million for the period 2005 – 2010, based on its findings that Google Ireland sold AdWords services to French customers through the French PE.

Google Ireland appealed the assessments and the findings of a PE, of which the lower court ruled in favour of Google Ireland. The court held that:

- Although Google France is a sister company of Google Ireland, no PE of Google Ireland could exist under the French law or the French/Ireland DTA, because Google France's employees did not have the power to commit Google Ireland to third-party contracts under the intercompany agreement between the two subsidiaries.
- Google France's employees were involved only in pre-sale and post-sale activities.
- Google Ireland had to validate the deals electronically in Ireland before the agreements could be considered final.

- The price of the advertisements was not determined by the employees of Google France, but by an automatic bid system based on the number of clicks.

This judgement applies the literal meaning of a PE as detailed in article 5 of the France/Ireland DTA, a consideration is only given to the actual requirement of article 5(5) that, for a PE to be created, the dependent should be habitually negotiating and physically signing the contracts which binds the principal in the jurisdiction that the dependent agent is located. This is based on the premise of a traditional brick and mortar business which do not take the online conclusion of contracts. The business model adopted by Google enables it to enter into online contracts with its customers located in another jurisdiction without any of its personnel present in that jurisdiction to conclude and sign the contract. The DTA does not take into consideration any work done by Google France which influences the conclusion of the contract.

Paragraph 33 of the commentary to article 5 of the OECD MTC states the following:

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

This commentary contradicts the judgement as the tax court focused mainly on the physical signing of the contracts by the staff of Google France. The commentary explicitly states that the work done by the dependent agent which leads to conclusion of the contract may establish a PE in the source state. There is a view that the commentary is not law itself. This demonstrates the greatest challenge in applying PE rules to online contracts as it is difficult to consider the work done by the local agent which influenced the conclusion of the final contract entered by the customer and the non-resident service provider.

Action Plan 7 of the BEPS report noted that there are various strategies being used by Multinationals to avoid having a PE in the market State. The proposed amendments to the definition of a PE seek to address cases like the Google Ireland case under the work carried out by Action Plan 7 of the BEPS project termed "addressing artificial avoidance of a PE status".

One of the strategies is avoiding the application of article 5(5) by having the contracts which are substantially negotiated in a State but not concluded in that

State because they are finalised abroad, or the person that habitually exercises an authority to conclude contracts constitutes an “independent agent” to which the exceptions of article 5(6) applies even though it is closely related to the foreign enterprise on behalf of which it is acting (OECD, 2015).

As a matter of policy, where the activities that an intermediary exercises in a country that are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business (OECD, 2015).

3.4.3 Action Plan 7 of the BEPS project: Preventing the artificial avoidance of permanent establishment

The work done under Action Plan 7 was aimed at addressing BEPS by preventing the artificial avoidance of a PE status by multinationals in the market country through the replacement of subsidiaries that traditionally acted as distributors by commissionaire arrangements, exploitation of specific exceptions for preparatory and auxiliary activities and restriction of anti-fragmentation rules. A final Action Plan 7 report was issued in October 2015 and considered the key features of the digital economy in developing changes to the definition of PE to ensure that artificial arrangements cannot be used to circumvent the threshold of for exercising taxing rights (OECD, 2015).

3.4.4 Amendments to the PE definition in accordance with BEPS Action Plan 7

Anti-fragmentation rule, in the context of the digital economy, this means that where an online platform has warehousing delivery, merchandising and information collection activities of the company would constitute complementary functions that are part of a cohesive business operation (Bailleul-Mirabud & Pasquier, 2018). This is to ensure that activities which form part of the same value chain are not intentionally fragmented in order to avoid having a taxable presence in the market State.

Artificial avoidance of PE status through commissionaire arrangements: this is intended to address instances where agents play an active role in negotiating and

conclusion of contracts, but the actual signing of the contract is done by the principal without any material modification in another jurisdiction to avoid creating a dependent agent PE in the market State. The South African legislation does not provide for a commissionaire. The OECD defines commissionaire as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. The PE issues pertaining to commissionaire agency are of concern in South Africa regardless of the fact that South Africa in not a civil law country and the commissionaire agency concept is not applied as is especially where proxies are employed to escape the PE rules, which could pose a risk for South Africa (Davis Tax Committee, 2014).

The wording of Article 5(5) has been amended as follows:

> Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise, in doing so habitually concludes contracts, or habitually plays the principle role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:
> a) In the name of the enterprise, or
> b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
> c) For the provision of service by that enterprise.

The broadening of the dependent agent notion is to consider the work carried out by the dependent agent leading to the conclusion of a contract. This will assist revenue authorities to tackle, for example, online advertising pre-sale structures where such structure would habitually play the principal role leading to the routine conclusion of sales by the foreign company to customers in the other country without material modification of the terms and conditions on which customers offer to purchase advertising space (OECD, 2018a).

The focus is no longer on the agent's authority to sign and conclude contracts, but on the actual functions carried out by the agent leading to the conclusion of the contract. It is also no longer compulsory for a contract to be physically signed in the country where the agent is negotiating from, this means a dependent agent PE can be deemed to exist even in cases where the agent negotiates all the material aspects of the contract but the contract is signed by the principal who is located in a different country. All functions carried out by the agent are considered in concluding

whether the agent has created a PE on behalf of the principal or not. The new threshold rests in whether the agent habitually concludes contracts or plays a principle role in the conclusion of a contract. This addresses the issue of avoiding a PE status in the source state by having the principal to a contract concluding and signing the contract in a different jurisdiction whereas the important aspects of the contract are negotiated and concluded by an agent in the source state.

South Africa has reserved its right to amend the PE definition in order to address artificial avoidance of a PE through the use of certain agency arrangements. It is not clear why South Africa has taken a decision not to effect this change as this would address the loopholes in the current agency PE definition.

3.4.5 Multi-lateral Instrument

The Action Plan 7 report entails making changes to the provisions of Article 5 in the double tax treaties. As a result, countries that opted to implement the Action Plan 7 recommendations had to do so by signing a multi-lateral instrument ("MLI"). An MLI allows the modification of existing double tax treaties without requiring the jurisdictions to the "covered" tax treaty to engage and negotiate with each other.

3.5 Allocation of profits to a PE

After it has been established that a PE exists due to activities carried out in the source state, it is then required for profits to be allocated to that PE. Article 7 of the OECD MTC states that, profits to be attributed to a PE are the profits that the PE would have derived if it were a separate and independent enterprise performing the activities that cause it to be a PE. The concept of profit allocation requires aligning tax to where value is created.

With regards to digital business models, it is a challenge to understand how these models generate income which makes it difficult to quantify the profits to be allocated to the PE if there is any.

3.6 Value creation in the digital economy

The fundamental principle for taxation on cross-jurisdictional activities is that taxation should take place where value is created. Digitalisation has enabled multi-national enterprises to structure their companies in such a way as to separate income from the underlying economic activities (Cockfield, 2013). The OECD has incorporated actions 8-10 into its 2016 Transfer Pricing Guidelines to ensure that transfer pricing outcomes are aligned with value creation (OECD, 2017).

Due to its technological features and globalized nature, digital business models constitute prime examples of integrated global value chains and should thus be directly affected by the ongoing transfer pricing policy that aims at outcomes aligned with value creation (Olbert, & Spengel, 2017).

Companies in the digital economy are most likely to create a mismatch between the place where value is created and the place where their profits are being taxed. This is because digital businesses can operate from multiple jurisdictions and therefore the process value is created in a different way as compared to traditional brick and mortar business which operate from a physical location with business process which can easily be identified.

The digital business models therefore raise a question of how they create value; generate profits and how the market jurisdictions should impose tax on the value so created. In its 2018 Interim report (OECD, 2018) on tax challenges arising from digitalisation, the OECD did not provide a clear view of how these digital business models create value but instead highlighted issues to be considered in addressing the value creation concept.

3.7 Conclusion

This concludes that digitalisation exacerbate BEPS issues that broaden direct tax challenges. Issues of nexus, characterisation and data were discussed as they impact BEPS. The virtual nature of business conducted by digital companies was revealed to create tax loopholes that makes PE and tax collection difficult. The concepts of value creation, allocation of profits is discussed in relation to digital transactions and its tax implications with reference to best practise in developed

countries. The next chapter discusses the remedies available in addressing BEPS issues with digital transactions in South Africa.

CHAPTER 4 – REMEDIES TO ADDRESS BEPS IN THE DIGITAL ECONOMY

4.1 Introduction

In this chapter, the remedies to address BEPS in the digital economy are discussed. the current and proposed remedies to addressing tax challenges brought about by digitalisation. The OECD recommendations on how to tackle broader direct tax issues arising from digitalisation is discussed. The chapter also discusses South Africa's position in expanding the permanent establishment rules in order to address the issue of 'artificial avoidance of a permanent establishment status and measures that can be adopted by South Africa to effectively manage tax digital transactions from a direct tax perspective.

4.2 Summary of the OECD Interim Report

The OECD released an interim report in March 2018 addressing tax challenges arising from digitalisation. The report follows the Action 1 report of the BEPS project which highlighted the challenges presented by the digital economy. The report did not provide a solution on how tax should be levied on digital transactions. The report analysed the key features of the digital economy and explored the interim measures which countries may use in the interim to levy tax. However, a consensus has not been reached on how value is created by these models and how tax should be imposed. The interim report provided an in-depth analysis of the value creation across new and changing business models in the context of digitalisation and the tax challenges it presented.

The OECD is looking to tax digital business according to where value is created. It is therefore important to understand the various business models in the digital environment in order to establish how these can create value in every jurisdiction. Most jurisdictions are concerned by digital businesses that have a significant market presence, but little physical presence in the local jurisdiction in which they have business models which heavily rely on intangible property, data, user participation and network effects (OECD, 2018).

It is for this reason that some countries opted to adopt interim measures to address the tax challenges presented by the digitalised business models, while waiting for a global consensus to be reached by the year 2020. The OECD is expecting to issue a final report in the year 2020, which is expected to provide a global agreement on how value is created by the digital business models and how tax should be levied.

To tackle the broader direct tax issues raised by digitalisation, the TFDE analysed three options, namely:

- a new nexus rule in the form of a “significant economic presence” test,
- a withholding tax which could be applied to certain types of digital transactions, and
- an equalisation levy intended to address a disparity in tax treatment between foreign and domestic businesses where the foreign business had a enough economic presence in the jurisdiction. (OECD, 2018)

Since the release of the Action 1 Report, the lack of consensus in relation to these options has seen many countries around the world explore alternative measures for the taxation of highly digitalised businesses, generally by adopting new tax measures or changing the way they interpret existing laws and tax measures (OECD, 2018).

The countries which opted to adopt the interim measures were given an option to introduce any of the interim measures in their domestic laws provided the provisions of the relevant tax treaties are considered. It is worth noting that the OECD interim report did not recommend the early adoption of these interim measurers but merely presented them as an option for those countries which wanted to implement taxing measurers immediately.

4.3 Adjustment of the PE concept

The OECD is looking at amending the definition of a PE to address the issue of nexus in relation to digitalised business models. The work of the BEPS Action Plan 7 report has been considered in amending the definition of a PE as discussed in chapter 3. In summary, the dependent agent definition has been expanded to

consider the extent of activities being carried out in the market State which lead to conclusion of contracts.

An anti-fragmentation rule has been introduced which prevents splitting of activities to avoid having a taxable presence in the market state. Overall activities of an enterprise that are preparatory or auxiliary in nature could constitute a PE if those activities are essential to the business of that enterprise, i.e. they form part of the same business value chain.

The OECD also presented a new taxable nexus based on the concept of significant economic presence. In the absence of a taxable presence, according to the existing principles, such a significant economic presence could be based on different factors comprising of sales, the frequency of digital transactions and the number of users (Olbert, & Spengel, 2017). This approach contains several shortcomings, such as the required comparability of the significant presence with traditional business operations to find appropriate margins (Olbert, & Spengel, 2017).

The significant economic presence requirement allows the source state to tax when a non–resident enterprise establishes or realises a significant economic presence in its jurisdiction. This aims to address a situation whereby a digital multinational entity operates significant activities and the concept of a significant economic presence is part of the ongoing discussions at the OECD through the TFDE. The EU is one of the groups which are considering the significant economic presence in introducing measures to address taxing of digital business models.

Finding a new PE concept in the digital age is taking time. The OECD is looking at having a global consensus by the year 2020. To address the issue of digital business operating in a source state without having a PE as the traditional PE rules do not address the digital business, the concept of a virtual PE is being explored by other countries. The virtual PE proposes the taxing nexus for electronic commerce should be the continuous commercially significant conduit business activity rather than a physical fixed place of business. One possibility for making the PE concept work in the digital age is to create a jurisdictional sales threshold above which a taxpayer would be deemed to have a PE in that jurisdiction (Sapirie, 2018).

The virtual PE is aimed to address the issue of digitalised business models which have a virtual presence in the source jurisdiction based on the revenue generated

and marketing presence even though there is no physical presence in that country. Establishing a new PE nexus based on digital presence will reduce the existing bias in the tax treatment of cross-border digital and physical activities with a view to achieving a broader consistency between the two categories (Hongler & Piston, 2015).

4.4 Withholding taxes

In order to collect taxes from digital businesses in market countries, in the form of a final withholding tax or to enforce the nexus option, the OECD discussed the opportunities and issues of a withholding tax on digital transactions as an alternative to complicated profit allocation mechanism (Olbert & Spengel, 2017).

The implementation of withholding taxes on digital transactions would also be a valid approach to secure that income tax is levied in the market country (Valente, 2010). Such a withholding tax could be structured as final gross withholding tax on specific payment, and a back-up mechanism imposed to enforce the net-basis taxation (OECD, 2015).

4.5 Equalisation levy

An equalisation levy is intended to serve to tax a non-resident enterprise's significant presence in a country. It is however not a tax but a levy imposed on fees paid to a non-resident in respect of online services provided to a resident in the market jurisdiction. The equalisation levy is only applied in cases where it is determined that a non-resident enterprise has a significant economic presence (OECD, 2015). The concept of significant economic presence is not defined but it is still being discussed by TFDE at the OECD. Countries like India have unilaterally adopted the equalisation levy in their domestic legislation.

4.6 Measures adopted by various jurisdictions to address tax challenges arising from the digital economy

A few countries have begun to unilaterally enact measurers to tax the digital transaction until such time that a global consensus is reached. For the purpose of this research, the interim measures adopted by India, the EU and the United Kingdom is analysed as countries that have addressed tax issues arising out of digital economy decisively.

4.6.1 South Africa digital transactions tax measures

South Africa has not adopted any of the proposed interim measures. The Davis Tax Committee in its 2015 report on addressing tax challenges arising from the digital economy made the following recommendations that South Africa should await the final work of the OECD ‘s ongoing work on the PE threshold of the digital economy as the challenges faces are of an international nature. South Africa should not attempt to implement the unilateral measures which most European countries have adopted.

South African legislators should not implement unilateral measures which are attached to any technology as technology is continuously changing and by the time the provision is promulgated the technology in question might be obsolete. To enable South Africa to impose tax on non-resident suppliers of ecommerce goods and services to South African customers, new source rules that deal with the taxation of the digital economy need to be enacted. The rules should aim to clarify the characterisation of the typical income flows from digital transactions.

Rules should be enacted that require non-resident companies with South African sourced income to submit income tax returns even if they do not have a PE in South Africa. This will ensure that such non-residents are included in the tax system. South Africa’s source rules need to be aligned to accounting mechanisms and should not rely heavily on tax law to attempt to reconcile and determine a tax liability; and the ITA should be amended to provide that the Electronic Communication and

Transactions Act be taken in to account in identifying and detecting potential PEs. These recommendations by the Davis Tax Committee have not yet been implemented at the time that this research paper is written.

4.6.2 India digital transactions tax measures

India introduced an equalisation levy in its domestic legislation in 2016, to address the direct tax challenges arising from the digital economy. The equalisation levy is charged at a rate of 6% of the amount of consideration, for any specified service receivable by a person being a non-resident from, a person resident in India and carrying on business or profession; or a non-resident having a permanent establishment in India (Mehda, 2016)

The equalisation levy applies to online advertisements and any provision for digital advertising space facilities/ services for the purpose of online advertisement. The tax base is the value of the covered transactions, not the income generated by them. It is therefore a gross based tax or equivalently a turnover tax limited to revenue from online advertisement services supplied by non-residents (OECD, 2018).

4.6.3 United Kingdom digital transactions tax measures

The diverted profits tax (DPT) is aimed to ensure that the profits taxed in the UK fully reflect the economic activities in the UK and to counter profit shifting (HM Revenue & Customs, 2018: 3). The DPT is levied at a rate of 25% of the diverted profits. The focus is on non-resident companies that have entered into artificial arrangements to avoid a UK permanent establishment and circumvent the transfer pricing rules (OECD, 2018).

4.6.4 EU digital transactions tax measures

The new concept of virtual or digital PE and its treatment is creating a challenge on a global scale, the EU published two proposals to address this challenge (EU Report, 2018):

4.6.4.1 Digital Service Tax

A single rate of tax at 3% to be levied on revenues which apply to digital service providers with an annual worldwide revenue exceeding 750 million euros and an annual taxable revenue in the EU exceeding 50 million euros. This is designed as an interim measure to be implemented until the second comprehensive measure on significant digital presence is implemented. The digital service tax is aimed to apply with effect from 1 January 2020.

4.6.4.2 Significant digital presence

Under this approach, a new taxable nexus would be introduced to address the situation of digital businesses operating across the border in case of a non-physical commercial presence. Pursuant to the proposal, a digital presence exists through which a business is wholly or partly carried on.

A significant digital presence shall be characterised in an EU member State by a business consisting wholly or partly of the supply of digital services. Digital services are defined as any services which are delivered over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention and impossible to ensure in the absence of information technology (Gabbai & Ross, 2018). One or more of the following conditions should be met:

- The proportion of the total revenue resulting from the supply of digital services in that member State exceed 7 million euros;
- The number of users of one or more of the digital services located in that member State exceed 100 thousand euros; and
- The number of business contracts for the supply of digital services that are concluded by users located in that member State exceed 3 thousand euros.

Because the international tax system does not take account of the digital nature of many modern business models and practices, the OECD and the Commission assert that a misalignment exists in the current system between the country or countries in which the profits are taxed and the country or countries where the value is created. The significant digital presence directive seeks to resolve this misalignment.

4.6.5 Latest developments by the OECD

The OECD has since issued a policy note in January 2019, in its attempt to find a global consensus in addressing the tax challenges arising from the digital economy. The report identifies two pillars which are being explored and which could form the basis of a global, consensus-based solution. The first pillar will focus on how the existing rules that divide up the right to tax the income of multinational entities among jurisdictions, including traditional transfer-pricing rules and the arm's length principle, could be modified to take into account the changes that digitalisation has brought to the world economy (OECD, 2019). The process will be done by assessing the nexus rules and how profit allocation should be done. The OECD has agreed to explore the different concepts, including changes to the permanent establishment threshold, such as the concept of significant economic presence and significant digital presence as well as special treaty rules.

The second pillar aims to resolve remaining BEPS issues and will explore two sets of interlocking rules designed to give jurisdictions a remedy in cases where income is subject to no or only very low taxation (OECD, 2019). The OECD agreed to explore the basis taxing rights that would strengthen the ability of jurisdictions to tax profits where the other jurisdictions with taxing rights applies a low effective rate of tax on those profits. This will address cases where multinational entities structure their operations in a manner that a significant part of their profits are effectively shifted to jurisdictions with no or very low tax rate. Two inter-related rules are being considered which are, an income inclusion rule and a tax on base eroding payments (OECD, 2019).

4.7 Conclusion

This chapter discussed and highlighted the various remedies to address BEPS in digital transactions in various tax jurisdictions. South Africa has not implemented any measures. However, developed countries such as India and bodies such as OECD have interim measures that include levy tax on digital transactions, new nexus rules to guide the significant presence test, a digital transaction withholding tax, an

equalisation levy, virtual PE rules. The UK has introduced the diverted profits tax aimed to ensure that the profits taxed in the UK cover all revenues including digital ones, derived out of economic activities within the UK .In the EU the significant digital presence and a digital tax levy are propositions currently in place to curb tax evasion and avoidance in digital transactions. The next chapters provide the conclusion and recommendations.

CHAPTER 5-CONCLUSIONS

5.1 Conclusions

The research question of this thesis was to analyse what the various tax and possible solutions in applying tax laws to digital transactions in South Africa are. The thesis further assessed the effectiveness of the current direct tax legislation to address tax challenges arising from digitalisation with specific focus on PE rules.

Based on the analysis done in chapters two, three and four of this research, the following conclusions have been drawn:

- It is evident that the traditional international tax rules which South Africa also applies to cross border transactions are outdated and inefficient in addressing tax challenges arising from the digital economy.
- The physical presence requirement for determining nexus is ineffective in the digital economy as transactions are concluded online without being physically present in the market jurisdiction. As a result, digitalised transactions can easily escape tax in South Africa and the resident State. This essentially means South Africa as it also applies to all market jurisdictions are potentially losing out on revenue generated by these digitalised business models.
- South Africa has not adopted the new Article 5(5) which addresses avoidance of a dependent agent PE by an agent negotiating material aspect of a contract in South Africa, but the contract physically signed by the principal in another jurisdiction. The new article 5(5) deems a PE to exist in the market jurisdiction by considering the work done by the agent and not just the mere signing of the contract. It is submitted that South Africa to consider its position on this Article.
- Most developed countries, the EU and the UK have unilaterally adopted interim measures to tax the digital economy.
- The Davis Tax Committee report recommended for South Africa to wait for a global consensus to be reached as opposed to adopting interim measures to address tax challenges arising from the digital economy. The OECD is expected to issue a final report on taxation of the digital economy by the year 2020. South Africa has no interim measure in place to tax digitalised transactions from a direct tax perspective. Companies such as

Google and Amazon have a significant presence in South Africa as the key players in the online advertising platform. They are popularly used in the country and generate significant profits which are presently not subject to tax in South Africa. The current PE rules do not deem digitalised business models to have a PE as they operate without a physical presence and they do not have servers physically present in the country which could establish a PE on their behalf.

- The concept of a significant economic presence is ideal to address these types of business models.
- It is not clear whether the significant economic presence will be incorporated in the existing PE definition or whether a new provision will be introduced in the OECD MTC and effectively in the double tax agreements. However, it is prevalent that a virtual presence exists, and traditional rules need to be amended to be relevant in the digitalised economy.
- More work is still required on the profit allocation rules. Once a nexus has been established, profits must be fairly allocated to the market jurisdiction. It is therefore important to have clear rules to guide countries in this regard.
- Although South Africa does not have direct tax rules to address digitalised transactions, it is participating in the international forums aimed at arriving at addressing the challenges arising from the digital economy. As stated in the Davis Tax Committee report stated that South Africa has not taken a policy decision, but is rather waiting for a global consensus on the application of direct taxes to digital transactions.

5.2 Recommendations

It is recommended South Africa embark on the following actions to address taxation on digital products:

- Introduction of modern tax rules to address cross border transactions arising from the digital economy.
- Expansion of the source rules in the domestic legislation to cater for income sourced through digital transactions.

- Introduction of tax legislation that recognises virtual presence of digital transactions to capture revenue on digitalised business models by considering the notion of significant economic digital presence.
- Adoption of the new article 5(5) which deems a PE to exist in the market jurisdiction through consideration of work done by the agent and not just the mere signing of the contract. This addresses avoidance of a dependent agent PE by an agent negotiating material aspect of a contract in South Africa, but the contract physically signed by the principal in another jurisdiction.
- There is a need for South Africa to unilaterally adopt interim measures to tax the digital economy until the time that a global consensus is reached on taxing the digital economy. An equalisation levy seems to be the best option as it does not pose a risk of double taxation. It is a levy and not a tax levied on income derived by non-residents from digital services provided to residents.

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