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University of the Witwatersrand, Johannesburg

School of Accountancy

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 (Taxation).

E-Commerce and the taxation in South Africa of non–residents

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Abstract

Technological advancements have introduced new methods of operating and transacting between business and targeted markets. Electronic interaction by business with respective target markets has enabled business to transact from any location around the world, instantaneously delivering goods and services to markets globally. Although benefits have been derived by business, the impact of e-commerce on established income tax principles has raised concern to governments around the world, as e-commerce grows as a method of transacting with targeted markets (Hubbard: 2016).

Transacting in a digital environment has posed challenges to the taxation of residents and non-residents in South Africa which has resulted in the avoidance of income tax by taxpayers in countries of operation. Losses in tax revenue resulting from business conducted in e-commerce have been experienced (OECD, 2014a:5) by governments, as the application of income tax legislation is challenged by business operations in e-commerce (OECD, 2015:5). Transacting in a digital environment has provided business with the ability to operate in a market in the absence of physical premises established in that market, challenging income tax principles which rely on an association with a physical place or presence of an entity for taxation. This research report analyses the taxation of non-resident business operations in e-commerce in South Africa and the arising challenges due to e-commerce. An examination of the income tax legislation is performed to understand how tax is avoided by non-residents when operating in e-commerce. The possible solutions to address challenges posed to income tax by e-commerce will be examined as part of the research report.

Keywords: BEPS; double tax agreements; e-commerce; income tax; non-residents; resident; source; permanent establishment.

Declaration

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

Pumla Zondo
April 2017

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Chapter 1 - Introduction

1.1. Background

The collection of taxes is a priority for governments globally for the funding expenditure by government. As governments seek to collect taxes from taxpayers, the maximisation of profits through the reduction of expenses incurred and the taxes payable to revenue authorities remain a priority for companies. In attempts to reduce taxes payable to revenue authorities, various tax avoidance strategies have been adopted by companies which take advantage of income tax legislation which is no longer aligned to the operations of business.

Technological advancements have been made over the years which have resulted in the transformation of business operations and methods of transacting globally. The advancements made have resulted in the introduction of the internet, which has been integrated into communication, business, teaching and living (van Bruggen, 1998). Technological advancements made have resulted in a global economy, facilitating easier cross border transacting with targeted markets in various countries (Oguttu & van der Merwe, 2005:305). Noted as an important contributor to globalisation (Levitt, 1983), technology has enabled business to operate in various countries in the absence of physical premises or physical activity (Oguttu & Tladi, 2009:216) without an impact on the delivery of goods and services. The maintenance of a digital existence by business, in countries where targeted markets are located, has enabled transacting to occur electronically between business and targeted markets through electronic commerce (e-commerce).

The operation of business in a digital environment where the physical presence of a business in a market jurisdiction is not necessary for business activities to be conducted has however brought challenges to the systems of taxation applied in South Africa. The determination of a place of effective management, used in the classification of businesses as residents in South Africa for income tax purposes, has been affected by business operating in e-commerce as reliance is placed on the physical presence of a business in South Africa. Although the term of place of effective management is not defined in the Income Tax Act, paragraph 4 of Interpretation Note 6 issued by the South African Revenue Service (SARS) in 2015 interprets the term to be where the decisions that are necessary for the conduct of business activities are made, referring to a physical place.

Reliance is also placed on a connection of a business to a location within South Africa for non-residents in South Africa. A connection to a physical location within South Africa plays a role in the application of source rules contained in s 9 of the Income Tax Act and in interpreting source as established in case law. The application of treaty provisions such as the determination of a permanent establishment of a non-resident business, as found in Article 5 of double tax agreements between South Africa and various countries, also places reliance on the physical presence of business in South Africa. The dependence on a physical place for the taxation of non-residents in South Africa has resulted in income tax legislation that cannot be applied to business in e-commerce, due to the absence of physical premises in the country to enable the taxation of non-residents for income tax purposes.

Mismatches arising between income tax legislation and operations have resulted in the creation of opportunities for business to avoid income tax in the jurisdictions in which they operate. The ability to avoid taxation in countries of operation through a digital existence has enabled business to shift profits from high tax jurisdictions to low or no tax jurisdictions in a process known as base erosion and profit shifting (BEPS) (OECD, 2015a:5). BEPS activities which businesses have engaged in, have resulted in tax revenues lost by governments globally estimated at between 4% and 10% of corporate income tax revenues (OECD, 2015a:5), as businesses seek to gain a tax advantage in the countries in which they operate. While acting within the confines of legislation, businesses have taken advantage of gaps in income tax legislation and business operations resulting in the Organisation for Economic Co-operation and Development (OECD) launching the BEPS project in 2013, aimed at addressing issues of tax avoidance and aligning international tax rules to developments in the economy (OECD, 2015a:5).

Action plan aimed to address concerns around BEPS have been developed as part of the BEPS project. Taxation challenges arising from the digital economy within which e-commerce exists have been identified as a focus area for the BEPS project (Ault & Arnold, 2015:2). As a common platform for transacting for businesses and individuals, online sales have enjoyed growth rates above 20% in South Africa since the year 2000 (Hubbard, 2016), allowing for this method of transacting in business to gain popularity in South Africa. Providing business access to global markets (Chetcuri, 2002), opportunities for growth in customers and a platform for easier transacting with targeted markets in any location (Khurana, 2016), business operations have been transformed by e-commerce resulting in tangible products such as books, movies, music and software which were previously

purchased through retailers now available as digital products for consumption by targeted markets globally.

Various business models have arisen from e-commerce which have enabled businesses to operate partially or completely online to service consumers or other businesses, transforming sectors in the economy such as entertainment, transport, healthcare and retail (Choudhary, 2011). Business models arising from e-commerce have also enabled business to generate additional forms of revenue such as advertising revenue through websites in addition to the revenue from the sale of products or the rendering of services.

As an area of business enjoying growth, a consideration of the impact of e-commerce on business activities and taxation is important, to address any arising issues which may adversely affect tax revenues of governments due to the operation of business in a digital environment.

The residence basis of taxation is applied for income tax in South Africa, where income received by or accrued to South African residents is treated as gross income in terms of s 1 of the Income Tax Act 58 of 1962 (Income Tax Act). This income will be subject to taxation following the application of exemptions and deductions as allowed by provisions of the Income Tax Act. The jurisdiction to tax income relies on the establishment a connection between South Africa and the income received or accrued to a taxpayer (Oguttu & van der Merwe, 2005:306). As residents in South Africa are subject to income tax on their worldwide income (Stiglingh et.al, 2014a:59), little opportunity is provided to residents for the avoidance of income tax in South Africa. However, the operation of business in e-commerce provides challenges in classifying business as residents in South Africa. Challenges arise on aspects related to the incorporation or the management of business when operating in e-commerce (Oguttu & van der Merwe, 2005:309), where the incorporation of business can be chosen to be anywhere in the world (Oguttu & van der Merwe, 2005:310) and the determination of a place of effective management is challenged due to the absence of physical business presence in South Africa.

While business may be able to avoid classification as a resident in South Africa for income tax, resulting in the subsequent classification as a non-resident, the ability to operate within a jurisdiction in the absence of a physical presence also provides challenges to the taxation of non-residents in South Africa. The determination of the source of income that is received by

or accruing to a non-resident in South Africa for inclusion into a non-resident's gross income in terms of s 1 of the Income Tax Act and the application of treaty concepts such as permanent establishment as found in Article 5 of the OECD Model Tax Convention, on which South African double tax agreements are based, are challenged by business operating in e-commerce.

A source basis of taxation is applied for the taxation of non-residents in South Africa, where receipts and accruals derived from source within South Africa, in terms the definition of gross income found in s 1 of the Income Tax Act, are subject to income tax following deductions and exemptions applied (Stiglingh et.al, 2014: 70). The taxation of non-residents in South Africa for income tax incorporates the deemed source rules as contained in s 9 of the Income Tax Act, case law and the provision of double tax agreements such as permanent establishment (Stiglingh et.al, 2014: 70). Although the amounts earned by non-residents may be received from parties in South Africa, these amounts will be considered from a South African source when activities that generate income can be established along with the location of these activities in South Africa (Haupt, 2013:37). For business operating in e-commerce, the linking of business activities generating income to a physical place in South Africa is challenged due to the absence of physical premises from which business operates from in the country.

The avoidance of income tax by business appears to be enabled by characteristics of business in e-commerce such as mobility, anonymity and the provision of digital products. While businesses may be classified as a resident in another country, possibly leading to profits earned by the business being subject to taxation in the country of residence, businesses may seek classification as resident in jurisdictions which offer favourable tax rate to enable tax advantage to be gained. It therefore appears that income tax is avoided by non-residents that operate in e-commerce, as transactions are conducted in the absence of physical presence in South Africa resulting in difficulties in the application of income tax legislation which relies on a connection to a location for taxation rights (Olivier & Honiball, 2011:9).

The operation of business activities in a digital environment appears to aid business in the avoidance of income tax in South Africa, due to income tax legislation that is no longer aligned to the operations of business. Business operating in e-commerce, although having

transformed business operations, has provided challenges to the application of income tax legislation in South Africa. The taxation of residents and non-residents is challenged by business in e-commerce due to the reliance placed by income tax legislation and treaty provisions on physical location of a business, enabling business to adopt tax avoidance techniques in attempts to reduce taxation payable to revenue authorities. Whether a conscious adoption of tax avoidance techniques by business or a resulting factor due to the inherent features of e-commerce, the ability of business in e-commerce to avoid income tax in South Africa requires consideration and analysis.

The purpose of this research is to examine the South African income tax framework and the treaty provisions applied for the taxation of business operating in e-commerce, specifically those related to non-residents. The examination of the basis of taxation applied for income tax will be to ascertain the appropriateness of the taxation frameworks to a digital business environment that is evolving and gaining popularity globally. The research will examine challenges that are posed to taxation by a digital business environment while seeking possible solutions to resolve taxation issues encountered related to business transacting in the e-commerce environment.

1.2. The Research Problem

1.2.1. Statement of the problem

Technology has transformed business around the world through e-commerce, changing methods of transacting. The transformation of business as a result of e-commerce has posed various challenges to the taxation of business, which have enabled the avoidance of income tax by business. The objective of the research report will be to determine how taxation has been impacted in South Africa from an income tax perspective as a result of non-residents in e-commerce. The proposed research report will aim to determine how the resulting challenges associated with non-residents in e-commerce can be overcome.

1.2.2. The Sub-Problems

a) The first sub-problem will be to determine what constitutes e-commerce.

b) The second sub-problem relates to determining what are the income tax provisions applicable to non-residents in South Africa and are these applicable to the non-residents in e-commerce.
c) The third sub-problem will be to determine if current treaty rules, such as the application of the concept permanent establishment, are appropriate to address taxation of profits arising from e-commerce.
d) The fourth sub-problem will be to determine what challenges exist in the taxation of business profits which arise from non-resident business e-commerce in South Africa.
e) The fifth sub-problem focuses on determining the possible solutions available to address the challenges associated with the taxation of non-resident business in e-commerce.

1.3. Research Methodology

The research conducted is qualitative in nature following an interpretive approach examining and analysing the available information on the research topic. Observations are made as part of the research report to determine the facts and views held with regards to the topic and to assist in making an opinion regarding the research topic.

The research will entail the use and analysis of the following resources in the exploration of the research topic:

- The Income Tax Act of 1962;
- Case law;
- Textbooks;
- Published articles in journals and the internet

1.4. Scope and Limitations

The research will focus on the taxation of non-residents in South Africa operating in an e-commerce environment from an income tax perspective. An analytical approach will be followed, examining available information pertaining to the research topic. The examination of the information available will be performed to seek an understanding of the research topic to allow for recommendations and conclusions to be made in relation to the topic.

A comparative analysis in this research will be limited to the comparison of the income tax treatment of non-residents in the e-commerce environment in Australia, India, Spain and the United Kingdom. These countries have been chosen for analysis as various actions have

been taken in these countries to address business in e-commerce and the related income tax implications. The analysis of the responses taken in these countries will be analysed in attempts to identify solutions that can be applied to the South African tax environment.

1.5. Chapter outline of the research

The following is a chapter outline of the research report:

Chapter 1 – Introduction

An introduction of the research topic of taxation in an e-commerce environment will be performed as part of the first chapter. The first chapter will introduce the research topic and the methodology that has been applied in conducting the research. The objectives of the research, the research problem and the related sub-problems will also be established in this chapter.

Chapter 2 – E-commerce in South Africa

The second chapter discusses e-commerce in South African business. A discussion of what constitutes e-commerce will form part of the chapter including a discussion of the prevalence of e-commerce in South Africa. The operations, products and services that are offered in e-commerce are discussed in this chapter including a discussion of the business models arising from e-commerce. The objective of this chapter is to provide an understanding of the e-commerce business environment in which taxpayers operate.

Chapter 3 – Taxation in South Africa

The South African system of taxation for the purposes of income tax is analysed in the third chapter. The residence and source basis of taxation applied for income tax purposes are analysed as part of the chapter, focussing on the source basis of taxation applied to non-residents in South Africa. The application of the source basis of taxation is examined to determine the applicability of the basis of taxation in an e-commerce environment.

Chapter 4 – Permanent Establishment

A consideration of transactions occurring with non-resident business is done as part of the fourth chapter. The effect of double tax agreements that have been entered into and the provisions of these agreements are examined as part of the chapter. This chapter will discuss the concept of permanent establishment which is relied on in the taxation of non-residents in South Africa. The chapter examines the effect of business in e-commerce on permanent establishment and challenges encountered to permanent establishment due to e-commerce. The chapter aims to determine if permanent establishment can still be applied to non-resident business in e-commerce.

Chapter 5 – Challenges posed by e-commerce on the taxation of non-residents

Tax avoidance strategies adopted by business such as the avoidance of a permanent establishment by a non-resident, establishing group structures allowing for profits earned to be moved from South Africa to low or no tax jurisdictions and avoiding withholding taxes due to double tax agreements will be discussed as part of this chapter to analyse how companies in the e-commerce environment have been able to avoid income tax leading to base erosion and profit shifting. The challenges associated with the taxation of business operating in an e-commerce business will be discussed with reference to the OECD's *Action 1 – Addressing the Tax Challenges of the Digital Economy.*

Chapter 6 – Solutions to address challenges associated with the taxation of non-residents in e-commerce.

Solutions aimed to address challenges which are posed to the taxation of non-residents in e-commerce will discussed as part of this chapter. This discussion will attempt to analyse possible solutions for consideration to address challenges posed by e-commerce to income tax. Responses to threats of base erosion and profit shifting as a result of business in e-commerce have been adopted by countries such as Australia, India, Spain and the United Kingdom. This chapter will analyse the responses adopted in these countries and the recommendations to address the challenges posed to income tax by the OECD, to assess the suitability of the responses for application or consideration into South African income tax.

Chapter 7– Conclusion

Following an examination of e-commerce and the taxation of e-commerce transactions of non-residents, this chapter will conclude on whether the source basis applied in South Africa is sufficient to apply to business in e-commerce for income tax purposes. The chapter will also conclude on the application of permanent establishment in taxing non-residents in e-commerce in South Africa.

2. Chapter 2 – Electronic Commerce

2.1. Introduction

Technological advancements have transformed business operations over the years, enabling easier transacting and communication with stakeholders globally. The advancements made technology have resulted in the introduction of a new environment in which business operates in the performance of business activities.

Globalisation, a process where the world has become interconnected due to increased trade and cultural exchanges (Mitchell,2013), has resulted in business operating as part of a global economy rather than existing in isolation within a country in the provision of goods and services to targeted markets (Levitt, 1983). Noted as a powerful force in driving the world to commonality, technology has played an important role in the process of globalisation (Levitt, 1983). Technological advancements made have introduced the internet in business, transforming business models and operations through the facilitation of easier communication between transacting parties. Initially limited to a small portion of the global population, access to the internet has grown considerably from an estimated 1% of the global population in 1995 with internet access, to an estimated 40% of the global population with internet access in 2016 according to *Internet Live Stats*. Local access to the internet has also experienced growth, from an estimated 5.3% of the South African population with access to the internet in 2000 to 52% of the population accessing the internet in 2016 according to *Internet Live Stats.* The growth in internet access over the last two decades can be attributed to improvements in technology and the spread of Information and Communications Technology (ICT) (Li, 2014:7). The growth enjoyed in internet access has resulted in the integration of the internet into communication, business, teaching and living (van Bruggen, 1998).

This chapter will discuss e-commerce, with the aim of understanding what constitutes e-commerce. The business activities undertaken in e-commerce will form part of the discussion to obtain an understanding of the operations of business and how revenues are generated in e-commerce. In order to provide an understanding of the business environment of e-commerce, this chapter will also discuss the prevalence of e-commerce globally and in South Africa.

2.2. What is e-commerce?

E-commerce has introduced business to a new environment in which operations can be conducted. E-commerce has been described as:

'commercial activities which are carried out by electronic means that enable trade without the confines of geographical boundaries.' (Oguttu & Tladi, 2009:216).

The *Green Paper on Electronic Commerce for South Africa* defines e-commerce as:

'The use of electronic networks to exchange information, products, services and payments for commercial and communication purposes between individuals (consumers) and business, between businesses themselves, between individuals themselves, within government or between public and government and, last between business and government' (Department of Communications, 2000:16).

The above definitions highlight the features, the participants and the method of transacting involved in e-commerce. In summarising the above definitions, e-commerce is transacting with business, consumers and governments electronically in the provision of goods and services.

2.3. Features of e-commerce

ICT has transformed methods of conducting business globally (Ault & Arnold, 2015:19). The transformation of business operations and transacting can be attributed to the following features in e-commerce:

a) Cross border transacting

E-commerce has enabled the operation of business electronically, providing a virtual environment in which business exists (Chetcuti, 2002). As captured in the definition of e-commerce, business can trade internationally without the confines of geographical borders, which may serve as a barrier to entry into a market located in a country. The electronic conclusion of transactions along with the delivery of goods and services sometimes occurring digitally, has removed the importance of establishing physical premises for business, as a necessary component of transacting with target markets (Choudhary, 2011:33). The operation of business in a virtual environment has provided business with opportunities to access a global market for the goods and services offered whilst allowing for a saving of costs associated with the establishment of business in locations where target markets for goods and services offered are located (Khurana, 2016).

The pre-digital era necessitated business operating in a jurisdiction, where targeted markets are located, to establish premises from which a business can operate from. Costs related to the importation of goods to be sold and complying with foreign legislation of a market would be incurred as part of cross border transacting (Khurana, 2016).

b) Disintermediation

The operation of business in the digital environment of e-commerce has removed the necessity for physical premises to be established in areas where target markets are located and has resulted in less reliance on human intervention in conducting business activities as business activities are conducted through a website (Choudhary, 2011:38). The operation of business in a market would involve the use of intermediaries such as agents for the sale of goods, research, marketing and advertising of goods offered by business which would be carried out from business premises in locations where markets were located. These functions are now conducted through the website of the business (Chetcuti, 2002).

c) Anonymity

Transacting in e-commerce has resulted in limited interaction between parties to transactions that are concluded electronically (Chetcuti, 2002). Transacting in an electronic environment has enabled business operations to be established anywhere in the world, without affecting the delivery of goods and services to target markets located in South Africa. The ability to conduct business from any location in the world however, does not reflect the activity of business in the economy of the country where target markets are located. The identification of business in e-commerce may be limited to the internet address of the business revealing only the name of the business and the party responsible for the maintenance of the business website and no relationship may exist between a customer and the computer equipment used in the facilitation of the transactions (Choudhary, 2011:34).

2.4. Benefits of e-commerce

The operation of business in a digital environment have enabled the instantaneous delivery of goods and services and provided convenience in transacting (Khurana, 2016). The operation of business in e-commerce has enabled benefits to be derived by business such as (Khurana, 2016):

a) Lower costs of operation

Business functions have become centralised in e-commerce, where the establishment of business operations in each location serviced is no longer necessary and transacting is performed electronically (Khurana, 2016). The centralisation of business operations have enabled business to derive savings on the cost of operations that would have been incurred if business functions were conducted from multiple physical locations where targeted markets are located (Khurana, 2016).

b) Additional revenue streams for business

Transacting in a digital environment has enabled business to expand on additional forms of revenue earned by business (Khurana, 2016). Business activities are conducted from a website, where a platform is provided for the advertising of goods and services for a targeted market. Revenue streams derived by business are not limited to the product offering of a business but additional revenues arise from the use of data collected from the use of business websites which are sold to third parties for customised advertising to the user (Khurana, 2016).

c) Location of products and comparability

An appealing attribute of e-commerce relates to the ability to locate goods and services from suppliers globally, allowing for a comparison of the goods offered by business from a central location of a website, saving businesses and consumers' time and costs in locating desired goods and services (Khurana, 2016).

d) Availability for business

While traditional business models are reliant on operating times that have been established by business, e-commerce offers a service that is *'always open for business'* (Khurana, 2016), allowing transacting to be performed at any time and the delivery of goods and services occurring instantaneously.

2.5. Business models in e-commerce.

E-commerce has transformed business globally, enabling transacting across borders with ease (Khurana, 2016). Arising from e-commerce are two business platforms which supply products and services to targeted markets, namely (OECD, 2014a:74):

- Offline e-commerce, which offers tangible products, where the ordering of goods and services is facilitated online and the delivery thereof is performed through conventional channels; and
- Direct or online e-commerce, which offer intangible products where transacting is performed online.

E-commerce transactions occurring between businesses and consumers and between consumers have resulted in various business models arising from e-commerce such as:

a) Business to business (B2B) e-commerce

Accounting for a large portion of e-commerce is B2B model which is estimated to be 90% of e-commerce (Li, 2014:10). This model focuses on the transactions which are conducted with other businesses where the products sold by business are sold to other businesses and to provide support to business operations (OECD, 2014a:74). The B2B e-commerce model consists of online versions of businesses that have existed such as trading stores and the businesses providing services (Li, 2014:10).

b) Business to consumer (B2C)

Focusing on interactions between business and consumers, the B2C e-commerce model involves transacting with consumers who are usually end users of products and services which are offered by business (OECD, 2014a:75). The product and service offering in this model of e-commerce includes (OECD, 2014a:75):

- The sale of tangible products to consumers online with the delivery of the tangible products occurring at a physical location, adopting the features of offline e-commerce; and
- The sale of digitised products and services where business is conducted with online vendors.

The B2C model includes online versions of traditional retailers, service providers for information and research purposes, digital content providers of news and videos, transaction brokers and social media (Li, 2014:11).

c) Consumer to consumer (C2C)

The C2C model arises from transactions between consumers, where individuals act as intermediaries in transaction for the sale or rental of assets (OECD, 2014a:75). Information relating to the assets to be sold or rented is published on a website and transactions are facilitated through the website.

Through the various models that exist in e-commerce, e-commerce has shown growth since the year 2000, enjoying growth rates above 20% in South Africa (Hubbard, 2016). Estimated at 1% of total retail sales in South Africa, e-commerce retail sales have been estimated at a value of R9billion (Hubbard, 2016). As the process of globalisation continues, e-commerce sales in South Africa are expected to enjoy growth with the potential to grow to make up 10% of the total retail sales (Hubbard, 2016), therefore forming a larger component in the South African economy. Improvements in information and communications technology are considered as drivers of growth to e-commerce around the world. Decreasing costs in hardware and software have enabled greater numbers of people access to technology and internet used for e-commerce (Li, 2014:5).

2.6. Activities in e-commerce

E-commerce has transformed the landscape of business operation globally. Common activities which are engaged in between parties in e-commerce are in shopping, entertainment, healthcare and personal finance (Choudhary, 2011:37). Goods and services that are offered through e-commerce include broadcasting media such as news, videos and various entertainment platforms for consumption using internet applications (Li, 2014:11). E-commerce has resulted in the digitisation of products such as books, movies, music and software which were previously only offered by business in tangible formats (Li, 2014:21).

In retail, websites developed are used by business to supplement or replace paper catalogues which were commonly used in the pre-digital era for product offering of businesses (Choudhary, 2011:37).

Software has also become available for purchase and instantaneous digital download by users. Online information such as research and information portals have become available through e-commerce, where users can obtain required information for use, for free or for a fee that may be charged by the business (Choudhary, 2011:37).Research portals, search

engines and social media portals have enabled the generation of business activities through these digital tools such as offering platforms for advertising to users of these applications, the gathering and subsequent sale of information of users of internet applications and the offer of subscription revenues (Li, 2014:11). Various services of professional services such as marketing and legal services are also provided through e-commerce (Choudhary, 2011:37).

The integration of technology with business activities has transformed business, enabling benefits to be derived by business from e-commerce. As e-commerce continues to grow and evolve, changing the landscape of business, a consideration of the impact of e-commerce on taxation is necessary in order to determine if income tax legislation can still be applied to a transformed business environment.

Chapter 3 - Taxation in South Africa

3.1. Introduction

Providing an unlimited scope for market penetration through operation in a borderless environment (Choudhary, 2011:38), e-commerce has provided business with opportunities for growth in operations and revenues.

Technology has enabled business to overcome limitations associated with the operation of business activities only through physical stores established in areas where target markets are located (Khurana, 2016). Access to targeted markets offered by e-commerce have enabled foreign businesses to transact in South Africa with ease, as costs of establishing physical premises in the country from which to operate from are removed. Income tax legislation was however developed in a pre-digital era, where reliance was placed on the establishment of physical premises in the country to enable transacting with local markets. As technology integrates with business operations, enabling business activities to be conducted in absence of physical premises, the impact of e-commerce on income tax legislation requires consideration.

The ability to levy and collect taxes is a priority for governments globally, to enable to governments to deliver services to those that are in the country. The South African income tax system will be examined as part of this chapter, to understand the principles that are applied for the purposes of income tax. A consideration of the changes to business resulting from e-commerce will be made, to determine if the changes arising from e-commerce affect income tax legislation and the principles applied. An examination of the source basis of taxation will also be performed as part of the chapter, to determine the applicability of this basis for the taxation of non-residents operating in e-commerce.

3.2. South African Income Tax

Income tax in South Africa is governed by the Income Tax Act, where normal tax is levied in terms of s 5 of the Income Tax Act on the taxable income of a taxpayer in a year of assessment. The determination of taxable income on which normal tax is levied commences with the determination of a taxpayer's gross income in term of s 1 of the Income Tax Act, on which applicable exemptions and deductions as pert he Income Tax Act are applied.

The gross income of a taxpayer is defined in s 1 of the Income Tax Act as:

(i)' 'in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

(ii) in the case of any person other than a resident, the total amount in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic.'

The definition of gross income brings into the ambit of income tax legislation the treatment of residents and non-residents for the purposes of income tax in South Africa, namely the residence basis and the source basis of taxation.

3.2.1. Residence-basis of taxation

A residence-based system of taxation has been applied in South Africa since 1 January 2001, following the previous application of the source-basis of taxation for income tax purposes (Stiglingh et.al, 2014: 59). 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;
- To cater for the taxation of e-commerce.

The global economy created that has resulted from globalisation necessitated an alignment of the South African system of taxation to international tax principles, to aid in the protection of the South African tax base and to accommodate relaxed exchange control and increase trade. The last stated reason in the motivation for a change to the residence-basis of taxation is of interest for the purposes of this research report as this forms the topic of discussion for this chapter.

The application of the residence basis of taxation is justified by the rationale that residents can be called upon to contribute towards the cost of good order and government providing the resident with protection (National Treasury, n.d). Under the residence basis of taxation, residents are taxed on their worldwide receipts, regardless of the source of the income that is received by the resident (Stiglingh et al., 2014:59). The taxation of income accruing or received by the resident is dependent on a connection between South Africa and the income that is earned (Olivier & Honiball, 2011:19).

Although the residence basis of taxation has been adopted for income tax purposes, an element of the source basis of taxation is also applied for the taxation of non-residents in South Africa (Olivier & Honiball, 2011:19).

The classification of taxpayers as either residents or non-residents in South Africa is important for the purposes of income tax, as the classification determines the treatment applied in terms of income tax legislation.

The classification of a taxpayer as a resident is dependent on the fulfilment of the requirements contained in the definition of a resident in s 1 of the Income Tax Act.

a) Resident

The Income Tax Act defines a resident by distinguishing between natural persons and persons other than natural persons as:

(a) 'A natural person who is

(i) Ordinarily resident in the Republic; or

(ii) Not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic –

(aa) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each year of the five years of assessment preceding such year of assessment; and

(bb) for a period or periods exceeding 915 days in aggregate during those five years of assessment,

In which case that person will be a resident with effect from the first day of that relevant year of assessment'

In terms of the definition applied for natural persons, classification of a resident occurs through being ordinarily resident or through a test of physical presence in South Africa which will be discussed further as part of the chapter.

Ordinarily resident

The term ordinarily resident, as found in the definition of a resident, is a term that is not defined in the Income Tax Act. Guidance is therefore sought from case law on the interpretation of the term and establishing meaning to the term (Stiglingh et.al, 2014:61). Interpretation as provided in various cases provides guidance on the principles to be applied

in determining whether a person is ordinarily resident in South Africa for income tax purposes.

In interpreting ordinary residence, a degree of continuity within a place by a person is considered (Stiglingh,2014:61).

The case of *Cohen v CIR* (1946 AD) at (371) assists in the interpretation of the term considering ordinary residence as a place where a person would return to from their wanderings.

Interpretation Note 3 issued by SARS in 2002 provides further guidance in determining whether a person is ordinarily resident in South Africa. Paragraph 3 of the Interpretation Note highlights that a physical presence of a natural person in South Africa is not the only determining factor in the determination of ordinary residence. Factors related to a fixed and settled place of residence, the habits of life, places of personal interest and business, the location of belongings and nationality are considered. The interpretation note relies on the following in determining ordinary residence:

- A person's intention to become ordinary resident in the country; and
- The steps taken to indicate the intention of a person being resident in the country.

From the above, the test for ordinary residence in South Africa can be considered to be subjective in nature (National Treasury, n.d) as the various tests consider the intentions of the individual rather than basing the determination of residence on factual information as does the physical presence test (Olivier & Honiball 2011:12).

Physical presence

The physical presence test applied is based on the duration of time that is spent by an individual in South Africa for classification as a resident (Stiglingh et.al, 2014: 61). The physical presence test requires the fulfilment of a number of days spent by an individual in South Africa in order for an individual to be classified as a resident of South Africa for the purposes of income tax.

For natural persons transacting in an e-commerce, affected e-commerce business models would include consumer to consumer models where individuals are participants in transactions. As e-commerce allows consumers to digitally exist in a market rather than maintaining a physical presence, activities can be conducted by individuals from any location in the world (Oguttu & van der Merwe, 2005: 308). Although existing and conducting activities over the internet and maintaining an online presence, a complete existence by an individual online is not possible and certain day-to-day activities performed by an individual require a link to a physical location in a country. Linking a person to a physical location may therefore assist in establishing the residence of an individual (Oguttu & van der Merwe, 2005:308).

Non-natural persons

The definition of a resident in the Income Tax Act also covers juristic persons such as companies and trusts. For juristic persons, a resident is defined as:

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

From the definition above, the residence of a juristic person is based on two factors, i.e. the incorporation, establishment or formation of a company or the determination of a place of effective management of a company in South Africa. These factors used in the classification of juristic persons as residents will be discussed as part of the chapter.

The incorporation, establishment or formation of entities is considered to be a technical aspect which is verifiable through the Registrar of Companies (Oguttu & van der Merwe, 2005:310). These aspects however are not indicative of the place where the business activities of an entity may be taking place (Oguttu & van der Merwe, 2005:310). The technical aspects related to the incorporation or formation of a company are open to manipulation, where companies may select any location for the registration of a business especially when motivated by favourable tax rates provided by some countries around the world while no economic activities are conducted in that country (Oguttu & van der Merwe 2005:310).

The classification of a juristic person as a resident in South Africa, in terms of the s 1 definition of resident, also results from the consideration of the place of effective

management of a business being in the country. The place of effective management applies the principle of substance over form in the determination of residence and is used around the world in double tax agreements to resolve matters of dual residence that are encountered (Van der Merwe, 2006: 122).

The concept of place of effective management brought into double tax agreements through Article 4 of the OECD Model Tax Convention on Income and Capital, on which South African double tax agreements are based, where a juristic person is deemed to be a resident of a country only if the juristic person has a place of effective management in that country (OECD, 2010:88). The place of effective management is considered by the OECD to be where '*key management and commercial decisions necessary for the conduct of the entity's business are in substance made'* (OECD, 2010:88).

Guidance is also provided by *Interpretation Note 6* issued in 2015 by SARS. The place of effective management, as detailed in paragraph 4 of the interpretation note, is where the key management and commercial decisions which are necessary for business activities are made in substance (SARS, 2015).

For business in e-commerce, classification as a resident is challenging as the first requirement relating to the technical aspects of residence appear to be avoidable. Entities can be registered anywhere in the world while business activities are conducted in locations differing from places of business registration. The choice of registration of a business may be motivated by tax advantages offered by jurisdictions with lower tax rates (Oguttu & van der Merwe, 2005:311) and the digital existence of business results in the elimination of a physical presence in South Africa which may result in the failure to meet requirements for classification as a resident.

The application of the concept of a place of effective management for a business in classification as a resident appears to enable the avoidance of classification of business as a resident, as the place of effective management relies on the physical location of a business which a business in e-commerce may not have in the country of operation. As business transacts electronically with targeted markets, business maintains a digital existence in the country, enabling the existence of business in cyberspace rather than at a physical location

in the country of operation. The lack of a physical presence in a jurisdiction in which business operates, with residence of the business in a location which may yield tax advantages, allows for decision making to be made from various locations around the world and the execution of business strategy may also be at various locations resulting in difficulties being encountered in the determination of where decision making is made when it is done at various locations around the world (Oguttu & van der Merwe, 2005:311).

Failing to meet the requirements as stated above for a natural or juristic person as a resident in South Africa for the purposes of income tax, will result in classification as a non-resident in the country. Classification as a non-resident also arises from the exclusions to the definition of a resident in s 1 of the Income Tax Act, where persons deemed to be residents of another country for the purposes of applying any agreement entered into between South Africa and the person's country of residence for the avoidance of double taxation are excluded from consideration as a resident.

As a non-resident in South Africa, the source basis of taxation is applied for the purposes of income tax (Haupt, 2013:31).

3.2.2. Source basis of taxation

The source basis of taxation is applied for the taxation of non-residents in South Africa, where income accruing to or received by a non-resident from a source in or deemed to be in South Africa is taxed for income tax purposes following the application of deductions and exemptions as allowed by the Income Tax Act (Stiglingh et.al, 2014:70). The source basis of taxation is reliant on a connection between the income accruing or received by a person and South Africa (Honiball & Olivier, 2011:9). The application of the source basis of taxation is motivated by the rationale that taxpayers should contribute to the costs of infrastructure and running the country, which have enabled the generation of income (Honiball & Olivier, 2011:11).

The term source is not defined in the Income Tax Act therefore, guidance is sought from case law in the determination of the meaning of the term for the purposes of income tax. The general approach in the determination of source is that source is not a legal concept but something considered as a real source of income as decided in the case of *Rhodesia Metals Ltd v COT* (1938 AD) at 379.

The generation of income that is received by or that accrues to a non-resident may be as a result of multiple activities that are engaged in by a taxpayer. The case of *CIR v Black* (1957 AD) at 393 guides the determination of the source of income when there are multiple activities involved in the generation of income, requiring that dominant activities that are associated with the generation of income be established which will enable the determination of the source of income that is earned. If the dominant activities determined can be linked to South Africa, then the source of the income is in South Africa.

The authoritative case relating to the determination of the source of income, following a consideration of specific source rules that are contained in s 9 of the Income Tax Act, is the case of *CIR v Lever Bros* (1946 AD) at 10, where it is learnt that two factors are to be established in determining of the source of income namely, the activities which give rise to income, known as the *'originating cause'* (Haupt, 2013:37) and determining the location of the originating cause that has been identified (Haupt, 2013:37).

In determining the originating cause as required from the case, a consideration of activities ranging from physical activities to the exercise of intellectual abilities is required to identify activities responsible for the generation of income that is earned. Once an originating cause has been established, the location of these activities must be determined (Haupt, 2013:37).

In considering e-commerce, the application of principles of determining the source of income earned by non-residents, appears to be challenging due to an absence of a physical presence in the country of a non-resident business in e-commerce. The absence of a physical presence in the country in which a non-resident operates however is not an entirely new concept that has been brought on by e-commerce. Business in the pre-digital era have utilised methods of communication such as post, telephone and fax for transacting with markets, however e-commerce in its facilitation of easier communication has exacerbated the challenge faced in the taxation of non-resident business in e-commerce (OECD, 2014a:104).

The application of the principles of source is challenged as follows when applied to non-residents transacting in e-commerce:

a) Originating cause

E-commerce transactions may consist of various activities ranging from the initiation of a sale by a customer, the marketing of the product or service offered by the business and the

facilitation of a sales transaction through a website that has been developed and is hosted through a server. These activities that result in the sale or provision of a service may all be in different locations around the world (Pinto, 1999:232). As a non-resident supplier of products or services, transacting may be done with parties that are in South Africa, however there exists a challenge in identifying the activities generating the income arising from transacting with parties in South Africa, due to the various functions involved in the generation of the transaction.

The multiple activities involved in the facilitation of a transaction in e-commerce, also make the identification of a dominant activity in the transaction as guided by the *CIR v Black* case challenging.

b) Location of the originating cause

E-commerce has provided business with the ability to generate income without a substantial reliance on the infrastructure of the country, as business is conducted through communication lines (Oguttu & Van der Merwe, 2005: 314). E-commerce transactions have resulted in services being available over the internet which have generated income for non-residents. It may be possible to determine dominant activities which give rise to income that is earned by a non-resident, however as activities are conducted electronically in e-commerce the location of these activities may be challenging as the activities exist in cyberspace (Oguttu & Van der Merwe, 2005:314).

The rendering of services has also become available over the internet. For services that are rendered online, the activities giving rise to income that is generated may be the services rendered by the service provider. The location of the service income that is generated is however difficult to determine, as questions arise relating to whether the location of the services rendered is where the service is produced or whether the income has been generated where the benefit has been derived.

3.3. Principles of Taxation

The building of an effective system of taxation relies on broad principles which should be maintained by governments in taxing taxpayers in the country. Characteristics that ensure an effective system of taxation include (du Plessis & Viljoen n.d):

- **Jurisdiction to tax**

The jurisdiction to tax is the authority and control in the territory over which taxation authority is exercised (du Plessis & Viljoen n.d). The jurisdiction to tax is generally confined to geographical territory which is generally a geographical location (du Plessis & Viljoen, n.d). However, business in e-commerce operates in some markets in the absence of physical premises or a presence in the country where targeted markets are located. When business operates in a digital environment, the determination of a geographical location to associate the activities in e-commerce to enable a country to acquire the rights to the taxation of profits arising is challenged due to a lack of physical presence in locations where targeted markets are located.

- **Identification of the taxpayer**

Identifying a taxpayer who can be taxed plays an important role in the establishment of an effective tax system. One of the features of e-commerce is the anonymous nature of the environment that results from the lack of face-to-face interaction between parties to a transaction (Choudhary, 2011:38), leading to difficulties in identifying the business through information that is contained on the business website and the registration of the website.

- **Mechanisms to collect taxes**

The collection of taxes levied is important in a tax system to enable a government to fulfil its mandate of providing goods and services. The anonymous nature of the e-commerce environment however, challenges efforts involved in the collection of taxes when a taxpayer cannot be identified (du Plessis & Viljoen, n.d).

The development of a system of taxation should encompass the following principles whether applied to traditional business models or business in e-commerce (OECD, 2000: 225).

- Neutrality – where taxation should not differ between conventional and electronic forms of commerce.
- Efficiency - where the costs associated with compliance for taxpayer and the administrative costs for tax authorities should be minimised.
- Certainty – where tax rules applied in the system of taxation are simple to understand, to enable an anticipation of arising tax consequences in transactions
- Effective and fairness – where the system of tax produces correct amounts of tax at the correct times.

- Flexibility – where tax systems are up to date with developments in technology and business

The above principles of taxation however are affected by business operating in e-commerce. The lack of a physical presence in the country where markets are located appears to enable the avoidance of income tax in the country, as reliance is placed on the physical presence of non-resident business in South Africa, in establishing the source of income, the establishment of activities giving rise to the income received or accruing to non-residents and establishing a location of the activities responsible for the generation of income.

The costs of compliance with income tax legislation increase in business environment where products are digital in nature, as challenges in the application of legislation become difficult (Choudhary, 2011:39).

E-commerce also appears to affect the effectiveness and fairness principles of taxation. Business in e-commerce with its ability to avoid income tax as non-residents results in identical businesses that have adopted a traditional business model or those that are classified as residents in South Africa being subjected to income tax and thus bearing the burden of taxation as non-residents enjoy the benefits of avoiding taxation in South Africa and sometimes being subjected to significantly lower rates of taxation or no tax incurred.

The flexibility of the income tax system has also been affected as income tax legislation and principle applied to the source basis of taxation have not kept up with the evolution of technology and business as the legislation is still based on business models developed in a pre-digital era.

Considering the South African income tax system, it appears the income tax principles related to the taxation of business operating in e-commerce are not suitable for application in a digital environment, as reliance is placed on the association with physical premises being in South Africa. The unsuitability of income tax legislation to the taxation of business in e-commerce is largely due to the dependence of legislation on a physical presence in the country of a business which is absent in e-commerce. The avoidance of income tax by non-residents in South Africa therefore appears to be possible as reliance is placed on tangible aspects related to location.

As non-residents transact with the South African market, transactions conducted in e-commerce take on an international character. The international character that is assumed by transactions concluded is attributed to existence of business in a virtual environment that facilitates cross border transacting (Khurana, 2016). In a digital environment as provided by business in e-commerce, the source basis of taxation is challenged by the absence of physical presence of business in the country. As international transactions are facilitated through e-commerce, the implications of international transactions and the effect of e-commerce on international tax principles such as permanent establishment need to be considered.

Chapter 4 - Permanent Establishment

4.1. Introduction

Parties involved in transactions that are facilitated through e-commerce consist of non-resident suppliers of goods and services to a South African market, where the suppliers may be residents of countries where a residence basis of taxation is applied for the purposes of income tax. In transactions of an international nature, possibilities of double taxation arise, when a non-resident transacting with a South African market is taxed on the source basis of taxation in South Africa on the profits derived from the South African market and is also taxed on worldwide income in their country of residence (Haupt,2013:486).

The application of the combination between the residence and source basis of taxation for income tax can result in conflicts which lead to taxpayers being taxed twice on profits that they have earned when transacting internationally (Haupt, 2013:488). In seeking relief from double taxation, double tax agreements have been entered into with various countries to assist in relieving or eliminating double taxation which may arise from international transactions (Haupt, 2013:489). The double tax agreements in place, aim to assist in the determination of a country's right to tax income arising in international transactions (Haupt, 2013:483) and to provide relief from double taxation (Haupt, 2013: 489). These double tax agreements are incorporated into the Income Tax Act in terms of s 108(1) which is read with s 231 of the Constitution, where the agreements entered into are effected into income tax legislation as soon as the agreements are published in the Government Gazette (Oguttu & Tladi, 2009:214). Many of South Africa's double tax agreements which are entered into are based on the provisions of the OECD Model Tax Convention (Haupt,2013:491). As the provisions of the South African double tax agreements are based on the articles to OECD Model Tax Convention, provisions of the OECD Model Tax Convention are therefore substituted for provisions contained in the South African double tax agreements.

In the taxation of non-resident business profits arising in South Africa, the provisions of double tax agreements in place, such as permanent establishment, are important in the determination of a country's right to tax the profits which arise. Non-resident business profits arising in South Africa will be subjected to income tax in the country when the business profits can be attributed to a permanent establishment in South Africa, in terms of Article 7 of the OECD Model Tax Convention. Possibilities of double taxation occur, in instances where

no agreements have been entered into with the non-resident's country of residence, a risk which the double tax agreements aim to mitigate with the conclusion of the agreements. The determination of a permanent establishment plays an important role in the taxation of non-resident business profits acting as a source rule that subjects profits of a non-resident attributable to a permanent establishment in South Africa, to income tax in South Africa (Olivier & Honiball, 2011:322).

The concept of permanent establishment used in double tax agreements with various countries will be discussed as part of this chapter to understand the concept applied to the taxation of non-resident businesses. Business operating in e-commerce will also be considered as part of this chapter, to examine the applicability of the concept to a digital environment. The interaction of this concept with South African legislation will also be discussed to form a conclusion on the relevance of permanent establishment for business in e-commerce.

4.2. Permanent Establishment

Permanent establishment is used in treaty rules to determine a country's right to the taxation of business profits of a non-resident (OECD, 2005:7). The Income Tax Act defines a permanent establishment in s1 as:

'a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development.'

The Income Tax Act refers to Article 5 of the OECD Model Tax Convention, which further defines a permanent establishment as:

'a fixed place of business through which the business of an enterprise is wholly or partly carried on.'

Although South Africa is not a member of the OECD, the double tax agreements drafted between South Africa and various countries are based on the articles of the OECD Model Tax Convention.

The concept of permanent establishment has been incorporated into South African tax legislation in paragraph 2(1)(b)(ii) of the Eighth Schedule to the Income Tax Act, where a non-resident is subjected capital gains tax in the event of a disposal of assets which are attributable to a permanent establishment and in transfer pricing provisions contained in s 31

Income Tax Act, in the attribution of profits of a permanent establishment (Olivier & Honiball, 2011:337).

In considering the definition of permanent establishment in Article 5 of the OECD Model Tax Convention, the following characteristics of non-resident business are required to be present in order for a permanent establishment to exist:

a) A fixed place of business

Under both the OECD and United Nations model tax conventions, the existence of a permanent establishment is dependent on the physical presence of a business in a host country, acting as a source state (Olivier & Honiball, 2011:336).

Any premises, installations or facilities which are at the disposal of a business and used for conducting business activities by an enterprise are considered to be a place of business regardless of the ownership of the premises used (OECD, 2010:93).

The definition of a permanent establishment in terms of Article 5 of the OECD Model Tax Convention requires that the place of business be fixed, in order to qualify as a permanent establishment. Therefore, a degree of permanence that can be attached to a geographical location of the business is required consideration of a place of business as fixed (Olivier & Honiball, 2011:337). The place of business is required exist at a specific location with a degree of permanence (Olivier & Honiball, 2011: 338). Temporary interruptions in activities conducted by business do not result in a permanent establishment ceasing to exist, however it is required that there be activities taking place regularly over extended periods for a fixed place of business to exist. A place of business that is temporary in nature is therefore excluded from consideration as a fixed place of business (Olivier & Honiball, 2011:339).

Specific inclusions to permanent establishment such as places of management, offices, factories and workshops are considered in terms of Article 5(2) of the OECD Model Tax Convention.

Some places of business with a degree of permanence are specifically excluded from being considered as a permanent establishment in terms of Article 5(4). These exclusions relate to:

a) *'The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to an 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 the goods or merchandise or of collecting information, for the enterprise;*
e) *The maintenance of a fixed place of business solely for the carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;*
f) *The maintenance of a 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.'*

Exclusion of the above from classification as a permanent establishment is due to these places considered as incidental and supplementary in nature (Olivier & Honiball, 2011:341).

b) Business is carried on

A second requirement in the determination of a permanent establishment relates the requirement that business is carried on through the fixed place of business that has been determined (Olivier & Honiball, 2011:340). The business of an entity should be carried on whether wholly or partially through the fixed place of business that has been determined for classification of the business as a permanent establishment (Olivier & Honiball, 2011:340). The carrying on of a business however, does not translate to the physical presence of employees in a business and employees or individuals may not be necessary for business to be carried on (Olivier & Honiball, 2011:341).

The requirements for a permanent establishment in terms of paragraph 1 of Article 5, place reliance on linking a place of business to a tangible place such as premises or machinery

and equipment. Specific inclusions to permanent establishment in terms of Article 5(2) of the OECD Model Tax Convention also refer to physical places that can be linked to geographical locations. The reliance on physical premises of a business within the country for the determination of a permanent establishment however provides challenges in the application of the concept of permanent establishment when business maintains a digital existence in a jurisdiction as opposed to a physical presence within the country.

The concept of permanent establishment was developed in an era where the establishment of physical business premises was an integral component to conducting business activities (Choudhary, 2011:42). The concept as developed does not accommodate business that operates in the absence of physical premises, as does business in e-commerce. The ability to operate in jurisdictions without physical premises impacts on the applicability of the requirements for a permanent establishment and results in the exclusion of non-resident businesses operating in e-commerce South Africa from being considered as a permanent establishment. The nature of activities conducted in e-commerce may result in the translation of these activities as auxiliary function excluding the activities from consideration as a permanent establishment.

4.3. Permanent establishment in the e-commerce environment

The concept of permanent establishment was developed in a pre-digital era, however e-commerce and its effects have been considered in paragraph 42 of the commentary to Article 5.

Business in e-commerce is conducted through websites, servers and employing the services of internet service providers rather than through physical premises. Websites, servers and the services of internet service providers have become key components of business operations. The application of the concept of permanent establishment to e-commerce has been considered as follows (OECD, 2010:110):

a) Website

A website is a combination of software and electronic data and is not tangible in nature (OECD, 2010: 110). The intangible nature of a website, through which a business in e-commerce is operated, has resulted in contact between parties to a transaction being limited to interaction through a website with no physical interaction occurring between parties where digital goods and services are offered by a business (Chetcuri, 2002). As a website operates

in an electronic environment, rather than from a physical place, the absence of a physical location for a website results in the website failing to meet the requirements for a place of business as required for the determination of a permanent establishment (OECD, 2010:110). The website therefore is not considered as a permanent establishment (Choudhary, 2011:47). The ability to access and place orders through a website of a foreign supplier is also not considered to be sufficient to subject a foreign supplier to income tax in the country where its target market is located (Choudhary, 2011:47)

b) Computer equipment

A website is stored on computer equipment such as servers which are found at determinable geographical locations within a country. As the computer equipment is tangible in nature and is situated in a location which can be determined, the computer equipment may meet requirements for being fixed place of business if the computer equipment is located at a location of a sufficient period of time (OECD, 2010:111). In the determination of the existence of a permanent establishment through a server, the carrying on of business at the location of the server needs to be considered. The determination of whether business activities are carried on through the server however is recommended to be examined on a case-by-case basis (OECD, 2010:111). Where the e-commerce operations are carried on through computer equipment these activities may be considered to be preparatory or auxiliary in nature such as providing communication links, advertising, relaying information through servers for security or the supply and gathering of information, a permanent establishment cannot be considered to exist (OECD, 2010: 112). It is only when activities conducted through a server are essential and are core functions of an enterprise that the server used may constitute a fixed place of business and be considered to be a permanent establishment (OECD, 2010:112).

Computer equipment such as a server forming a permanent establishment is dependent on the nature of the business activities conducted by an enterprise (OECD,2010:112).

c) Internet Service Providers

The functions that are core to a business are dependent on the nature of the business. Functions may be considered to be core in one business while serving as auxiliary services in another business. The provision of services related to the hosting of websites is common in business, however internet service providers cannot constitute a permanent establishment or be deemed to be agents of a business conducting e-commerce activities as the internet

service provider merely offers a service to host a website and has no authority in the entering and conclusion of enterprise contracts (Chetcuti, 2002).

4.4. Features of e-commerce and the effect on permanent establishment

Several features of e-commerce affect the application of the concept of permanent establishment (Chetcuti, 2002) which will be discussed.

a) Virtual environment

E-commerce provides business with the ability to operate in a country without a physical presence. The presence of a business within a jurisdiction may be based on the hosting of a website on a server that is at a remote location (Chetcuti, 2002). As established in paragraph 42.2 of the commentary to Article 5 of the Model Tax Convention, a website does not result in a permanent establishment being formed and the location of the server through which the website is operated will also not result in a permanent establishment for the business that owns the website.

b) Disintermediation

To penetrate foreign markets, physical intermediaries were used by foreign business before the introduction of e-commerce. Advertising and marketing campaigns conducted by intermediaries would be operated through offices operating in the foreign market allowing for a permanent establishment (Chetcuri, 2002).

In e-commerce, functions related to sales, marketing and advertising which are components of the sale of products are conducted through websites of businesses (Chetcuti, 2002). The ability to conduct these functions through a website rather than utilising intermediaries enables the cost-savings for business in e-commerce (Khurana, 2016).

Human intermediaries which were relied on for the execution of transactions are also removed by the e-commerce environment, as functions once performed are automated, removing the need for presence in a source state which could constitute a permanent establishment, which results in the loss of tax revenues by the source state (Chetcuri, 2002).

c) Websites and servers

The intangible nature of a website has resulted in the exclusion of a website from being considered as a permanent establishment through paragraph 42.2 of the commentary to Article 5 of the OECD Model Tax Convention. A website of an e-commerce business consists of a combination of hardware and software where electronic data is stored and processed through servers that are in various locations around the world. Websites are intangible in nature and as such cannot constitute a place of business and therefore a permanent establishment (Chetcuti, 2002).

4.5. The attribution of business profits from a permanent establishment

Article 7 of the OECD model tax convention provides guidance on the attribution of profits arising from a permanent establishment in the determination of a country's right to tax business profits arising from international transactions.

Article 7(1) of the OECD model tax convention states that:

'Profits of an enterprise of a Contracting state shall be taxable only in that State unless the enterprise carries on business in the other Contracting State though a permanent establishment situated therein'

For the attribution of profits arising from a permanent establishment, an enterprise is needed which is the carrying on of any business by an entity (Olivier & Honiball, 2011:344).

Business profits which will be attributed are understood to include all income derived from carrying on an enterprise in the country and do not include items that are separately dealt with in other provisions of the treaty (Olivier & Honiball, 2011:344).

For the taxation of the profits arising, the attribution of the profits must be made as if the permanent establishment was separate from the main enterprise (Olivier & Honiball, 2011:344).

4.6. Effect of e-commerce on permanent establishment

The operation of business in e-commerce appears to provide challenges to the determination of a permanent establishment for the purposes of taxation. As permanent establishment was developed in a pre-digital era, the treaty concept is suited for business

operations where physical premises are established in the countries in which business operates.

The concept of permanent establishment in terms of Article 5 of the OECD Model Tax Convention appears to place reliance on tangible aspects of business such as business premises at determinable geographical location. Business in e-commerce however provides an environment where business is able to operate virtually in any market jurisdiction (Chetcuri, 2002), from any location in the world which providing challenges to the application of the treaty concept related to permanent establishment. Although e-commerce has been considered for the purposes of a permanent establishment, key components of business in e-commerce such as websites and server are still excluded from consideration as permanent establishment by paragraph 42 in the commentary to Article 5 of the OECD Model Tax Convention. In an evolving business environment, the concept of permanent establishment is still designed to cater for business model which were introduced before technological advancement.

Chapter 5 – challenges posed by e-commerce to taxation

5.1. Introduction

The operation of business in a virtual environment has enabled business to access targeted markets globally with ease (Khurana, 2016). While benefits have been derived from e-commerce by business and consumers, tax revenues have been lost by governments around the world as a result of the adoption of tax avoidance techniques by businesses which have enabled the shifting of profits earned from high tax jurisdictions to low tax jurisdictions (OECD, 2015a:5). The ability of non-resident businesses in e-commerce to avoid taxation in the countries in which they operate due to income tax legislation that cannot be applied to business in e-commerce and the resulting payment of taxes at low rates or the complete avoidance of taxes have posed challenges to the taxation of non-residents, especially those that operate in e-commerce.

This chapter will examine the challenges that are posed to the taxation of non-residents in e-commerce operating in South Africa, to obtain an understanding of how income tax is avoided by non-residents operating in South Africa and how the avoidance of tax has contributed to issues that are faced with BEPS. The impact of the tax avoidance techniques adopted by business operating in e-commerce will also be considered as part of the chapter.

5.2. Base Erosion and Profit Shifting

The maintenance of sustainable sources of revenues to fund government expenditure is a challenge that is faced by countries globally (Ault & Arnold, 2015:1). In considering the challenges that are posed to governments in maintaining revenues to fund government expenditure, the protection of a country's tax base is an important factor for governments (Ault & Arnold, 2015:1). In attempts to save on costs of taxation in the countries in which businesses operate, various tax avoidance strategies have been adopted by business which have enabled non-resident businesses to shift profits earned from high tax to low tax jurisdictions in a process that is known as BEPS (OECD, 2015a:5). These profit shifting activities adopted by businesses have resulted in revenue authorities losing tax revenues (OECD, 2015a:5). The loss in tax revenues experienced has become a concern to governments globally, as the losses can lead to underfunding of public investment which aims to promote economic growth in a country. (Oguttu, 2016:17).

Highlighted in the media with well-known global companies being exposed for profit shifting activities adopted, which have resulted in the payment of income tax at low rates or completely avoiding tax in countries of operation and in the country of residence, tax avoidance has become a topic of discussion globally (Ault & Arnold, 2015:1). In response to the adoption of tax avoidance practices by business in the jurisdictions in which they operate, the OECD initiated projects that are aimed at analysing and determining techniques adopted by business in attempts to reduce taxation payable in the jurisdictions in which business operates (Ault & Arnold, 2015:1).

The analysis of these profit shifting activities has resulted in the identification of areas which contribute to the expansion of BEPS which include (Ault & Arnold, 2015:2):

- Mismatches existing in entity and instrument characterisation, creating income that is taxed at artificially low rates or not taxed at all;
- The use of treaty concepts to limit taxing jurisdiction and to prevent the taxation of digital goods and services;
- The avoidance of tax using debt financing and intragroup financial structures;
- Transfer pricing aspects related to risk and intangibles which allow income to be taxed in countries other than the countries where value has been created;
- Ineffective anti-avoidance measures; and
- The availability of harmful preferential regimes.

The action plans developed by the OECD in 2013, following the identification of these contributing factors to the issue of BEPS, aim to address issues arising which are related to BEPS (Ault & Arnold, 2015:2). The action plans have been categorised to address transactions and arrangements where profits of business are taxed at artificially low rates or no taxation occurs due to the domestic laws that are in place and those to address disconnects between the economic activities of business and the assignment of taxation rights to a country for income that is earned (Ault & Arnold, 2015:3).

The protection of the South African income tax base is important to government as corporate income tax accounts for almost 20% of South Africa's total tax revenue with approximately R186, 6 billion in corporate income tax collected by the South African Revenue Service in the 2015 fiscal year (National Treasury & SARS, 2015: 130). The adoption of profit shifting activities has resulted in decreases in corporate tax revenues experienced, with revenue losses estimated at between 4% and 10% of global tax revenues (OECD, 2015a:5).

5.3. Tax avoidance techniques in e-commerce

The avoidance of income tax by businesses is achieved through the adoption of tax avoidance techniques, which result in businesses paying tax at low rates or completely avoiding taxation in areas in which they operate or in the country of residence. Residents, for the purposes of income tax in South Africa, are provided few opportunities for the avoidance of income tax due to the application of the residence basis of taxation (Davis Tax Committee, 2014:26), where residents are taxed on their worldwide income (Stiglingh et.al, 2014:59).

The avoidance of income tax by non-residents operating in e-commerce appears to be possible as a result of the source basis of taxation applied, where reliance is placed on the determination of a physical location within the country that can be associated with the income that earned by non-residents. The determination of source through the establishment of activities which give rise to income that is earned and the determination of dominant activities resulting in income earned by non-residents as established in *CIR v Lever Bros and Unilever Ltd* and *CIR v Black* respectively, place reliance on a physical location within the country.

Provisions of double tax agreements in place between South Africa and various countries, used in the determination of a country's right to tax profits arising from transactions between non-residents and South Africa also place reliance on a physical location of business in the determination of the existence of a permanent establishment in terms of Article 5 of South African double tax agreements. For non-residents operating in e-commerce, the avoidance of income tax in South Africa appears possible, due to difficulties in the application of the source basis of taxation and treaty concepts such as the concept of permanent establishment.

Characteristics of e-commerce, such as the ability to operate in within a country in the absence of a physical presence, have enabled the avoidance of income tax by non-resident businesses, enabling the adoption of techniques to avoid income tax through the structuring of business activities as follows (OECD, 2014a:182):

- **Avoidance by online retailers**

A multinational enterprise selling physical and digital products using an online platform may transact with target markets located in South Africa or anywhere in the world. The

multinational enterprise transacting in the e-commerce platform is to be a non-resident for the purposes of income tax. In transacting with a target market, the products of the multinational entity may be displayed on the multinationals website developed to facilitate the sale of goods. The sale of products by the non-resident entity, may involve various activities ranging from the placement of orders by customers to the delivery of products ordered to customers.

In instances where products are sold through a website by non-resident business, group structures may be established which enable the avoidance of income tax in the jurisdictions in which the non-resident businesses operate, in the following ways (OECD,2014a:182):

- **Delivery of products ordered by a customer**

In transacting with an online retailer of goods, a customer located anywhere in the world may place orders for products that are offered through the non-resident supplier's website. An online retailer may sell physical or digital goods to its customers. Physical goods purchased by the customer from the supplier may be delivered by using a courier service or where digital goods are purchased, the goods will be made available for download from the non-resident's website. To provide after sales support to customers in respect of physical goods sold and to co-ordinate logistical functions related to the delivery of the physical goods to the customer, a subsidiary may be established by the multinational entity in locations where customers are located. A warehouse may be established in the same country as the subsidiary which will be operated by the subsidiary for the delivery of physical goods ordered by customers.

- **Procurement**

For the delivery of physical goods ordered via the multinational entity's website, a part of the multinational's group of companies may include a company responsible for the procurement of the goods to be sold to customers. The company that is responsible for the procurement of the goods may be established at a remote location, differing from the location of the multinational entity and the location of the subsidiary tasked with the logistical and support functions. The establishment of the procurement function in that location may be for purposes of centralisation and cost savings that may be derived from operating in a particular area. The legal ownership of goods purchased rests with the company responsible for procurement and goods purchased are transferred to the subsidiary responsible for warehousing and logistics for preparation of delivery of these products to customers. Upon

the transfer of the goods, the warehousing function is invoiced to recover the cost of the goods and a mark-up is added.

- **Intangibles associated with the website**

As transactions are concluded through the non-resident's website, the development of the business website may be performed by employees of the non-resident business. The operation of the business website may incorporate the collection of data relating to the customers that make use of the website, to enable the customisation of customer preferences based on the activity of the customer on the website. Information collected using the website by the non-resident results in the creation of an intangible asset, such as data collected from customers using the website that may be used for the purposes of selling on to third parties or used in the promotion of additional goods and services offered by the business.

The structuring of the activities of a multinational entity involves various functions such as the development of the website, procurement, the development and management of intangible assets such as data collected and the sales transaction to the customer (OECD, 2014a:183). These functions may be located in different countries around the world, rather than functions being in a single location, providing the multinational entity with opportunities for the avoidance of income tax (OECD, 2014a:183).

In transactions involving a multinational entity transacting with customers online, income tax can avoided by the non-resident business in e-commerce in a number of ways, raising BEPS concerns such as (OECD, 2014a:101):

- An elimination or reduction of tax;
- Low or no withholding taxes;
- Low or no taxation for the recipient of the income; or
- No current taxation of profits at the level of the ultimate parent company.

5.3.1. Elimination or reduction of tax in South Africa

Non-resident companies may transact with customers via digital means, using a website or a mobile device (Khurana, 2016). The operation of business activities in e-commerce has thus resulted in the ability of business to operate from any location, without a reliance placed on

the physical location of business operations within a country where customers are located, for the delivery of goods to customers (Khurana, 2016). The ability to operate within a market in the absence of physical premises has enabled business to eliminate or reduce the tax that is payable through the shifting of profits earned by business (OECD, 2014a:101). The avoidance of tax within a jurisdiction has been achieved through the establishment of group structures or through the maximisation of deductions therefore decreasing the taxable income on which the applicable tax rate will be applied (OECD, 2014a:101).

Income tax is reduced or eliminated in the following ways by businesses which operate in e-commerce (OECD, 2014a:102):

a) The avoidance of a taxable presence

Reliance is placed on the physical presence of a business in determining whether income received or accruing to a non-resident is from a source in South Africa, for inclusion into the non-resident business' gross income in terms of the s 1 definition of gross income in the Income Tax Act. In considering the provisions of double tax agreements which are entered into with various countries, physical presence of a business in a country also plays an important role in the determination of the existence of a permanent establishment, in terms of Article 5 of South African double tax agreements with various countries. For business operating in e-commerce, a link to a physical place within the country where targeted markets are located cannot be established due to the virtual environment in which business operates in (Chetcuri, 2002). Business processes over the years have placed less reliance on human intervention, as automated processes conduct duties previously conducted by employees of the business and automated processes can be conducted from any location in the world with no necessary requirement for activities to be in the same location as the markets that are serviced (OECD, 2014a:102).

The operation of a business in the absence of a physical presence in the country is however not a new concept that is introduced by e-commerce (OECD, 2014a:104). Various methods of communication, such as fax, mail and telephone, have been previously been utilised by non-resident businesses to transact with markets located within a jurisdiction, where a non-resident business had no physical presence (OECD, 2014a:104). E-commerce however, has enabled the operation of business in a market jurisdiction without a physical presence to be faster and easier (OECD, 2014a:102).

BEPS issues arise when the avoidance of a taxable presence by a business is accompanied by the adoption of strategies which are motivated by possibilities of eliminating taxation in

the non-resident's country of residence and in the source country, which would result in income earned by a non-resident business not being taxed in both the country of residence or in the country where it operates (OECD, 2014a:102).

In considering the provisions of the OECD Model Tax Convention, on which South African double tax agreements are based, the profits of a non-resident arising from South Africa will be taxable in South Africa if business is carried on through a permanent establishment in South Africa in terms of Article 7 of the double tax agreements. In considering group structures that may be established by online retailers where activities of the retailer are in various locations, although a subsidiary may be established in South Africa, the subsidiary's function is limited to the after sales support and the co-ordination of the delivery of goods to the customers of the non -resident retailer in the event of a tangible product being sold. The support and delivery functions of the subsidiary however may be considered not to be a core function of the non-resident online retailer, classifying the functions to be auxiliary in nature and therefore not a permanent establishment, in terms of Article 5(4) of the double tax agreements which are entered into between South Africa and the non-resident's country of residence. The subsidiary established also does not have the authority to conclude contracts, in the country of operation, on behalf of the non-resident retailer, therefore a dependent agent permanent establishment, in terms of Article 5(5) cannot be created for the non-resident retailer.

b) The minimisation of income that is allocable to functions, assets and risks in market jurisdictions.

The presence of a significant market in a country where business activities are conducted by a multinational entity may necessitate the establishment of a subsidiary in the country where the non-resident's target markets are located (OECD, 2014a:102). Where a multinational entity is transacting with a market in South Africa, a subsidiary may be incorporated in South Africa, allowing for classification as a resident based on incorporation in terms of the definition of a resident in s 1 of the Income Tax Act allowing for taxation on all income earned. A branch of the multinational entity may be formed in South Africa, where the activities of the multinational may be carried out. These functions carried out by the branch may be considered to be functions considered to be core functions of the business, allowing for classification of the business as a permanent establishment for the application of Article 5 in double tax agreements between South Africa and the non-residents country of residence.

The presence of a permanent establishment in South Africa may still present non-resident companies with opportunities for the avoidance or reduction in income tax levied. Activities within a group of companies however, may be structured to enable the minimisation of taxable income of the permanent establishment that exists. The minimisation of the taxable income may arise from the allocation of functions of a multinational entity, where the permanent establishment may be charged for services rendered by the parent company and these costs charged may be high or costs may be borne on behalf of the multinational entity, which do not relate to the permanent establishment, to enable a reduction of taxable income through deductions claimed. These activities or functions allocated to the permanent establishment may not be reflective of the actual conduct of entities in the group (OECD, 2014a:103).

c) Maximisation of deductions in the market jurisdiction

The avoidance of income tax in a jurisdiction of operation, where a permanent establishment has been formed, can be achieved through the maximisation of deductions such as interest, royalties and service fees (OECD, 2014a:104). The maximisation of deductions is done in attempts to reduce the taxable income of the non-resident business operating in South Africa, however transfer pricing provisions, in terms of s 31 of the Income Tax Act, may assist in the prevention of excessive deductions in attempts to avoid taxation in the country.

5.3.2. The avoidance of withholding tax

Intangibles, such as data collected from customers making use of an online retailer's website, may result in royalty payments being payable from the use of intangibles developed by a non-resident multinational entity operating within a jurisdiction. A multinational group of companies may separate the ownership and the use of the intangible assets between companies in the group, which may result in royalties being payable for the use of intangibles (OECD, 2014a:183). The payment of royalties to a non-resident entity may be subject to a royalty withholding tax, in terms of s 49B of the Income Tax Act, when the payment of the royalty is made from a source in South Africa.

Structures within a group of companies may be established where entities in the group structure may be subjected to a withholding tax in countries where it receives payments such as royalties or interest from payers in a country. Provisions in double tax agreements which

are entered into may enable a reduction or exemption of a withholding tax. Entities may therefore be established in countries where provisions of double tax agreements may enable the avoidance or reduction of withholding taxes that are paid (OECD, 2014a: 104).

5.3.3. Reduction or elimination of tax in the intermediate country and a reduction or elimination of tax in the country of the ultimate parent.

Companies may also allocate functions, assets or risks in low tax jurisdictions for the purposes of deriving benefits from the avoidance of tax. Tax is eliminated or reduced thorough the application of preferential tax regimes and the claiming of deductions to gain a tax advantage (OECD, 2014a:104). Business in e-commerce is flexible and mobile, therefore functions such as procurement and sales may be formed in locations which offer favourable tax rates to business (OECD, 2014a:104).

Developments in business and the integration of technology has exposed business to opportunities which enable the minimisation of income tax paid by business affecting governments, individual taxpayers and businesses (OECD, 2015a:5).

5.4. The effects of BEPS

The structuring of activities in e-commerce enables non-resident companies to avoid income tax, however as savings of tax are realised by business, these activities have an impact on various aspects of the economy (OECD, 2015a:5).

- **Governments**

The avoidance of income tax through the adoption of BEPS activities has resulted in the tax revenues of government being impacted. Global tax revenues lost because of BEPS activities are estimated to be between 4% and 10% of global tax revenues (OCED, 2015a:5) as companies shift profits that are earned in one tax jurisdiction to a jurisdiction offering lower tax rates.

- **Individuals**

BEPS activities have had an impact on tax revenues that are derived from corporate income taxes, with losses of corporate income tax revenues experienced by governments globally (OECD, 2015a:5). The South African tax revenues comprise of personal income taxes, value-added tax (VAT) and corporate income taxes which are key contributors of tax revenue (National Treasury, 2015: iv). Decreases in corporate income tax revenues which

may result from a loss of tax revenues, may affect tax revenues collected revenue authorities, where VAT and personal income taxes may constitute a greater percentage of tax revenues collected as corporate income tax revenues diminish due to BEPS activities. Diminishing revenue from corporate income tax may result in individuals bearing a greater share of the tax burden in attempts to meet the tax revenue targets for the delivery of goods and services in the country.

- **Business**

Businesses operating at a domestic level are also harmed by BEPS activities adopted by non-resident businesses operating in South Africa. Few opportunities are afforded to resident businesses to avoid taxation in South Africa, due to the application of the residence basis of taxation (Davis Tax Committee,2013:26). Resident businesses in e-commerce that offer the same products as a non-resident business are provided with little opportunities for the avoidance of income tax in South Africa and profits earned by these residents are subject to income tax (Davis Tax Committee, 2013:26). Resident businesses bear the costs of taxation whereas the non-resident business appears to gain a competitive advantage through the avoidance of taxation costs in South Africa.

5.5. Challenges to taxation arising from e-commerce

Non-resident business operating in an e-commerce environment provides challenges regarding taxation of profits arising from the transactions in e-commerce.

- **Application of the source basis of taxation**

A source basis of taxation is applied for the taxation of non-residents in South Africa, where reliance is placed on the location of activities which gives rise to income earned by a non-resident in South Africa, as established in *CIR v Lever Bros & Unilever,* in the determination of the source of income received by or accruing to a non-resident in South Africa to be included in the gross income of a non-resident in terms of s 1 of the Income Tax Act.

E-commerce has provided business with the opportunity to conduct operations on a global scale in the absence of physical premises in the market jurisdictions which they operate in, offering business the opportunity to take advantage of tax laws in the minimisation of taxes payable to revenue authorities (Li, 2015:430). As less reliance is placed on the physical presence of a business, questions arise regarding the applicability of income tax principles to

a business environment that exists in the absence of physical premises in the country of operation.

E-commerce has provided business with flexibility in the choice of the location of its operations, as geographical limitations associated with operating from a physical store are eliminated, as activities are conducted electronically (Khurana, 2016).

- **Permanent establishment**

Income tax is levied on non-resident businesses if the business profits of the entity can be attributed to a permanent establishment (Oguttu & Tladi, 2009: 213). The requirements for a fixed place of business in the definition of a permanent establishment, rely on the association of a business with physical premises in South Africa (Oguttu & Tladi, 2009: 213)

The concept of a permanent establishment was developed in 1927, a pre-digital era where transacting with target markets placed reliance on physical premises (Choudhary, 2011:42). The virtual environment within which e-commerce exists, has resulted in e-commerce business not meeting the requirements for a fixed place of business in the determination of the existence of a permanent establishment in the jurisdiction within which business activities are conducted (Choudhary, 2011: 39).

Premises in South Africa which may be used by non-residents for the functions of purchasing and delivery may be core functions of the business in e-commerce, however these premises are considered to be functions of an auxiliary nature in terms of Article 5(4) of the OECD model tax convention and are excluded from being considered as a permanent establishment (Choudhary, 2011:42).

- **Reliance on data**

Transacting in a digital environment has enabled business to gather data from customers from remote locations (OECD, 2014a:129). Data that has been collected by business serves as an input to the creation of value to business as this information is used to customise goods and services offered by business and to enable improvements to business based on information gathered from targeted markets that interact with business through e-commerce (OECD, 2014a:130). As data is collected from online activity of targeted markets, challenges arise regarding where revenue is generated from the use of the data that is collected (OECD, 2014a:131). Challenges also arise regarding the attribution of value from the

generation and the use of data gathered in a digital environment and the characterisation of the data for tax purposes (OECD, 2014a:131).

- **Characterisation of transactions**

Advancements in technology have resulted in tangible goods once sold being transformed into intangible goods such as a licence for the consumer to use (Li, 2015:432). The transformation of goods from tangible products into digital formats has created uncertainties related to the characterisation of payments that are made. For treaty purposes, uncertainties arise on whether payment for digital goods should be treated as royalties and therefore be subjected to a withholding tax or whether the payment for the digital goods purchased should be treated as business profits from the sale of goods (Li, 2015: 432).

Questions around the nature of the income from the use of data arise relating to whether the income should be treated as royalties and therefore subjected to withholding tax in terms of s 49B of the Income Tax Act or whether the income arising should be treated as business profits.

Various treatments of the income arising from transacting in e-commerce may result in differing tax treatments of income arising from transacting in e-commerce. Tangible products are transformed into a digital format where the manufacturing of goods may evolve into licencing of designs for a digital product attracting royalties. Different tax treatments may arise depending on whether income may be treated a business profits which will be subjected to income tax or whether income arising may be treated as royalties (Li,2015:432).

The taxation of non-residents in terms of the source basis of taxation and the application of treaty rules such as those related to permanent establishment are challenged in the e-commerce environment. These principles are challenged by the lack of physical presence of business operating in e-commerce.

From the challenges that are experienced in the taxation of non-residents in e-commerce, the protection of the country's tax base is important due to threats of e-commerce on the corporate income tax base (Li,2015:408) as government lose tax revenues due to the profit shifting activities of business. Income tax rules which cannot be applied to business operating in e-commerce may contribute to the reduction of the South African tax base as companies adopt BEPS structures which are artificial and are undertaken for the purposes of gaining a tax advantage rather than for business purposes (Li, 2015:435).

Chapter 6 – Solutions to address challenges to taxation arising from e-commerce

6.1. Introduction

The challenges to taxation of e-commerce are challenges that are faced by governments globally (Li, 2014:436). Failure to protect the tax base of a country from the challenges arising in e-commerce will result in an unfair environment in the taxation of resident and non-resident business (Li, 2014: 437), where non-resident business is able to avoid income tax due to mismatches that exist between income tax legislation and the operations of business in e-commerce.

Challenges to income tax arising from e-commerce and the need to protect the South African tax base have been recognised in as early as 1997 by the Katz Commission, which acknowledged the need for the protection of the South African tax base (Davis Tax Committee, 2014:24). The Katz Commission recognised the impact of e-commerce on principles of international taxation which have resulted in concepts related to the physical presence of a business in the country irrelevant in e-commerce (Davis Tax Committee,2014:24). The inadequacy of the South African legal framework in addressing e-commerce transactions resulted in the release of the *Green Paper on Electronic Commerce for South Africa* in 2000 in attempts to respond to the effects of e-commerce on taxation (Davis Tax Committee, 2014:25).

Characteristics of e-commerce such as flexibility, anonymity and the existence in a virtual environment have posed challenges to the taxation of business in e-commerce (Choudhary, 2011:51). These challenges have enabled business to avoid taxation in the country in which business operates. The challenges faced by governments to the taxation of business operating in e-commerce are global in nature, therefore global solutions are required in order to address taxation issues arising from e-commerce (Li, 2014: 37).

Challenges posed to the taxation of business in e-commerce have resulted in the consideration of alternatives and solutions by governments which aim to address BEPS issues arising. This chapter will examine the possible solutions and alternatives which may be adopted to address challenges posed to taxation by business in e-commerce.

6.2. Alternatives to address challenges posed by e-commerce to income tax

E-commerce has transformed the landscape of business; therefore, it is important to consider whether the transformation necessitates a shift in the thinking for the allocation of taxing rights to a country (Li, 2014: 436).

In addressing challenges posed to income tax by business in e-commerce, various alternatives have been proposed to address issues arising which have resulted in the avoidance of tax.

Solutions proposed in addressing tax challenges arising from the taxation of non-resident business can be categorised in the following manner (Choudhary, 2016: 51):

- Solutions which seek to preserve existing international tax system with minor changes that are effected to accommodate business in e-commerce;
- Solutions which argue for a shift in the emphasis from source to a residence-based taxation;
- Solutions which argue that international tax rules are not sustainable in the e-commerce environment due to imbalances created in taxation between taxpayers, with the alternative proposal being that of introducing a consumption based tax or a special tax on transactions conducted over the internet (Choudhary, 2016:52).

6.2.1. A modification of source rules

While the challenges faced related to the taxation of e-commerce transactions for the purposes of income tax are challenges that are international in nature, it is recommended by the Davis Tax Committee to await outcomes of the work undertaken by the OECD, rather than attempting to develop solutions for South Africa for a permanent establishment (Davis Tax Committee, 2014:27).

An expansion of the source rules in s 9 of the Income Tax Act are recommended by the Davis Tax Committee to include source rules covering proceeds which are derived from the supply of digital goods which are derived from South Africa, to enable the taxation of transactions arising from e-commerce (Davis Tax Committee, 2014:28). In modifying the source rules to cover transactions from e-commerce, it has been recommended that the source rules be based on where consumption of the goods and services acquired takes place (Davis Tax Committee, 2014:28).

As transactions are carried out electronically in e-commerce, challenges arising from e-commerce relate to difficulties that are encountered in the identification of the location of a taxpayer and the activities that result in the generation of income earned by a non-resident (Davis Tax Committee, 2014:28). The Davis Tax Committee recommends that the provisions of the Electronic Communications and Transactions Act be considered to assist with the identification of e-commerce transactions (Davis Tax Committee, 2014:29). The Davis Tax Committee however highlights that care should be taken in ensuring that costs related to the compliance and enforcement of the amendments do not exceed the benefits that are derived with respect to the taxation of non-residents in e-commerce (Davis Tax Committee, 2014:29).

In the amendment of source rules as recommended by the Davis Tax Committee, administrative concerns are raised as non-resident companies may be required to declare income earned in South Africa to SARS and therefore submit tax returns even though these businesses do not have a permanent establishment in in a country of operation (OECD, 2014a:28). Administrative concerns also arise for the non-resident, as the non-resident may transact in a number of countries and maintaining separate records for each market jurisdiction in which non-residents operate may prove to be burdensome to the taxpayer (Davis Tax Committee, 2014:28).

6.2.2. Modification to Article 5 of the OECD Model Tax Convention

As income tax cannot be levied on the profits of a non-resident unless those profits of non-resident are attributable to permanent establishment in a jurisdiction (Oguttu & Tladi, 2009:213), a possible modification to the concept of a permanent establishment has been proposed by the OECD (OECD,2014:143). A modification to Article 5 of the OECD Model Tax Convention would assist in lowering the threshold for source country taxation to accommodate business in e-commerce, enabling profits earned to be subject to tax (Li, 2015: 440).

Possible modification to Article 5 may include the modification to subparagraph 4 which contains the exemptions to permanent establishment which relate to auxiliary functions of a business in the context of a conventional business model that placed reliance on operating from physical premises in the country (Li, 2015: 440). Functions such as the use of fixed places of business for the purchase and delivery of goods which are excluded from consideration as a permanent establishment in terms of Article 5(4) are functions that may

be core activities for e-commerce business (Li, 2015:440). An elimination of subparagraphs to Article 5(4) or the exemptions being made subject to the activity that is conducted in a business has been suggested (Li, 2015:440).

Action 7 of the BEPS project, suggests the possible modification of subparagraph 4, to prevent the avoidance of a permanent establishment by business, where the wording contained in Article 5(4) is amended, to enable the activities that are listed to be restricted to activities that are preparatory or auxiliary in character (OECD, 2015b:28). The aim of the proposed modifications to exemptions to permanent establishment, is to ensure that profits derived from core activities which are performed in a country are taxed in that country (OECD,2015b:38).

A clarification of the term *'preparatory or auxiliary'* used in Article 5(4) is provided in Action 7, where an activity is considered to be preparatory when it is carried on in contemplation of the carrying on activities that constitute the essential and significant part of the business (OECD, 2015b:30).

Activities of businesses such as the use of facilities for storage, display or delivery of goods as described in subparagraph a of Article 5(4) which would be excluded from consideration as a permanent establishment, are considered as part of Action 7 of the BEPS project where these activities may not qualify for the exemption since the activities may not be preparatory or auxiliary in nature when considered in the context of the business as whole. This may be applicable to online sales businesses, where storage, warehousing functions may be an essential part of the business (OECD, 2015b:31).

The modification to a permanent establishment may also include a consideration of the following:

a) Moving away from a fixed place of business to a significant digital presence

The OECD has suggested that there be a possible modification to permanent establishment to include business activities which are conducted digitally (OECD,2014:143). Businesses engaged in digital activities in a country may be deemed to have a taxable presence if a significant digital presence is maintained in the economy of the country in which the business transacts (OECD, 2014a:144).

A significant digital presence would accommodate business that is engaged in digital activities, where minimal physical elements are required in conducting activities of the business (OECD, 2014a:144). Considering whether a business has a significant digital

presence may require a consideration of the contracts that have been entered into for the provision of digital products and services, the prevalence of use of the digital goods and services in the country or considering whether substantial payments are made to non - resident businesses by local clients (OECD, 2014a:144).

b) Electronic or virtual permanent establishment

As an alternative to be applied to business in e-commerce, the concept of a virtual permanent establishment has been suggested involving the modification of the concept of permanent establishment to include a virtual fixed place of business and a virtual agency (OECD, 2005: 65).

Virtual fixed place of business

The extension of a permanent establishment would include the creation of a permanent establishment in the event of a non-resident business maintaining a website on a server of another enterprise located in a jurisdiction (OECD, 2005:66). Where business is operated from a website, the place of business would be the website (OECD, 2005:66) currently not considered by the OECD as a place of business. The evolution of technology and business operations have resulted in businesses being able to conduct their activities electronically in the absence of physical business premises in jurisdictions in which business operates. The alternative that is offered by a virtual place of business would result in the removal of the requirement for a place of business to be attached to physical premises as required by Article 5 of the OECD Model Tax Convention.

Virtual agency permanent establishment

The introduction of a virtual agency permanent establishment would serve as an extension to the dependent agent permanent establishment found in terms of Article 5. Contracts which are concluded electronically on behalf of a non-resident business with South African target markets would be covered by the concept of a virtual agency permanent establishment.

The concept of a virtual permanent establishment and a virtual agency permanent establishment discussed as alternatives would be extensions of the traditional concepts of

permanent establishment applied for the taxation of non-resident business in e-commerce. The concept of a virtual permanent establishment as a suggestion to address the challenges associated with the taxation of non-residents operating in an e-commerce environment, provides alternative thresholds in the determination of significant or continuing economic presence of a business that could be considered a sufficient level of participation in the economy of a country in applying the source basis of taxation when business operates in a digital environment (OECD, 2005:66).

The concept of a virtual permanent establishment has been considered in Spain where the application of the concept was tested in the 2012 case involving Dell (Sprague, 2013). In addressing the challenges associated with business operating in the absence of a physical presence or premises in the country where markets are located, the concept of a virtual permanent establishment has been considered in Spain (Sprague, 2013).

The application of the concept is found in the case of Dell Products Limited in 2012, where the *Tribunal Economico Administrativo Central* of Spain held that an online store qualified as a permanent establishment in Spain (Sprague, 2013).

In the 2012 Dell case, a non-resident company was subjected to income tax in Spain based on the reliance on virtual permanent establishment (Sprague, 2013). The case involved sales by an Irish member of the Dell Group into Spain where it was argued that a permanent establishment existed in Spain based on the grounds that the goods were sold into Spain through a website that was focused on the Spanish market and the Irish company's Spanish affiliate had employed staff who had translated webpage and reviewed website content, performing administrative functions on the website (Sprague, 2013).

The court concluded that a nexus could be established under the treaty provisions between Spain and Ireland even though physical presence in Spain was absent (Sprague, 2013).

The concept of a virtual permanent establishment considers that non-resident companies deriving income from transacting with local customers make use of the local digital infrastructure and would therefore be expected to contribute to the costs of the digital infrastructure as traditional business models contribute to the infrastructure under the source basis of taxation (Li, 2015: 443). An introduction of a virtual permanent establishment is regarded as assisting in aligning the rights to taxation of a country with the economic source

of profits earned by business in e-commerce while the threshold for a physical presence is removed (Li, 2015: 443).

c) Characterisation of income and imposition of a withholding tax

A possible alternative to address the challenges of e-commerce on income tax relate to the possibility of expanding withholding taxes to include payments for digital transactions (Li, 2015:446). A suggestion has been made for the imposition of a final withholding tax on payments made by a resident for digital goods and services which have been provided by the non-resident business. The withholding tax would be facilitated by financial institutions involved in paying the non-resident (OECD, 2014a: 146).

d) Introducing an internet specific tax

An introduction of an internet specific tax has been proposed to target e-commerce transactions (Choudhary, 2011:53). The introduction of an internet specific tax called a bit tax would result in digital data flowing over the internet being taxed (Choudhary, 2011:53). The tax suggested would involve a progressive system of taxation applied, to tax the usage of data by non-resident businesses operating online (OECD,2014a:147). The tax rate suggested to be applied for the internet specific tax would be based on the size of the operations conducted through e-commerce or the turnover of the business (OECD, 2014a: 147).

The taxation principle of neutrality appears to be affected with the introduction of a bit tax as the tax would only be applicable to digital transactions (Choudhary, 2011: 53).

6.2.3. Preventing the artificial avoidance of permanent establishment status

Tax avoidance strategies have been adopted by business, which have resulted in the avoidance of foreign business being considered to have a permanent establishment in a country of operation. Work has been performed as part of action plan 7 of the OECD BEPS project, aimed at the development of changes to the definition of a permanent establishment, to prevent the artificial avoidance of a permanent establishment by business (OECD, 2015b:14).

As part of action plan 7, an analysis of the avoidance of income tax through the use of commissionaire agreements has been performed as part of the action plan to address tax

avoidance due the absence of a permanent establishment of a foreign business when an agent is used. The use of commissionaire agreements, where a foreign business makes use of agents to sell its products in a jurisdiction, results in the avoidance of income as Article 5(5) cannot be applied, as the foreign business has no permanent establishment in the country where it's products are sold (OECD, 2015b:15). Action plan 7 proposes an amendment to Article 5(5) to deem an enterprise to have a permanent establishment in a country, where person habitually acts in that country on behalf of an enterprise and in doing so concludes contracts (OECD, 2015b:16).

6.3. Approaches taken by countries related to the taxation of business in e-commerce

The taxation of business operating in e-commerce has posed challenges to e-commerce globally and has become an important topic of debate globally. Various countries have taken a stand with regards to the topic of taxation of business operating in e-commerce. Discussed are some views which have been taken by some countries:

a) United Kingdom (UK)

The UK has acknowledged a need for a revision of the concept of permanent establishment to enable technological advancements that have integrated with business to be taken into account (Davis Tax Committee, 2014:8). In relation to the concept of permanent establishment, the UK has taken the view that a server that is used by business operating in e-commerce such as an online retailer cannot constitute a permanent establishment (Davis Tax Committee, 2014:7). Even in the event that the server, on which the online retailer's website is hosted, is owned, rented or at the disposal of the retailer the server will not be considered as a permanent establishment (Davis Tax Committee, 2014: 7).

Digital companies operating in the UK have made use of group structures which have resulted in the avoidance of taxes in the UK, translating to minimal taxes being payable to the revenue authorities in the jurisdictions in which they operate (Gapper,2016). The UK forms part of the biggest markets in which the businesses in e-commerce operate, however the complex structures have translated into minimal taxes payable to Her Majesty's Revenue and Customs (HMRC) (Gapper, 2016). Recently digital companies

such as Google have been investigated for tax avoidance practices which have resulted in £130 million being payable to the HMRC (Gapper, 2016).

b) Australia

In recognising the challenges to taxation arising from e-commerce, the Australian Treasury analysed the effects of BEPS on Australian corporate income tax (Davis Tax Committee, 2014:9). An observation made by the Australian Treasury is that taxation systems have failed in keeping up with changes that have occurred in economies, which has led to businesses taking advantage of taxation laws in attempts to reduce tax that is payable in their countries in which they operate (Davis Tax Committee, 2014:9). Australia has also acknowledged that the rules of permanent establishment may be outdated having been developed when the majority of economic activity took place at a physical location (Davis Tax Committee, 2014:10). The view taken by the Australian Treasury, with regards to e-commerce and taxation is that a possible modification in the treaty rules to prevent the avoidance of a permanent establishment by business may be necessary (Davis Tax Committee, 2014:10).

c) India

E-commerce in India has shown significant growth, growing approximately 34% since 2009 and estimated at $22 billion dollars in 2015 (Bijlani, 2015). In addressing the challenges associated with the taxation of e-commerce transactions, a separate tax regime, involving the introduction of a tax on e-commerce transactions, has been introduced in India (Davis Tax Committee, 2014: 11).

As business has evolved, the concept of a permanent establishment has lost relevance with technological advancements that are made in technology (Davis Tax Committee, 2014:11). There have been recommendations of an introduction of withholding tax to tax income derived from e-commerce, where payments to foreign enterprise will be subjected to a withholding tax (Davis Tax Committee, 2014:12).

In conclusion, the alternatives explored to address challenges posed to the taxation may assist in the mitigation of tax revenues that are lost by governments due to legislation that has not kept up with developments in technology and business operations. The proposed solutions, although assisting with the taxation of non-resident business in e-

commerce, should result in fairness where a method of transacting does not result in tax avoidance.

Chapter 7 - Conclusion

The integration of technology into business has resulted in e-commerce being available as a platform for cross border transacting, transforming businesses globally (Oguttu & van der Merwe, 2005:305). The ability of business to operate and transact electronically to service targeted markets globally has provided various benefits to business and has provided convenience to target markets (Khurana, 2016). However, the transformation of the landscape of business due to e-commerce has provided challenges to governments around the world in taxation.

The application of the residence basis of taxation may tax residents on worldwide income providing residents with limited opportunities for the avoidance of income tax in South Africa (Davis Tax Committee, 2014:26). As business activities in e-commerce are conducted in cyberspace, the establishment of a location of activities that are conducted becomes challenging in e-commerce (Davis Tax Committee, 2014:28). Principles related to the determination of a place of effective management and permanent establishment have become not applicable in e-commerce due to reliance placed on physical places of a business for classification as residents.

Although failing to meet requirements to be classified as residents may result in classification as a non-resident in South Africa for income tax purposes, where the source basis of taxation will be applied, challenges are still encountered in applying the source basis of taxation to business operating in e-commerce. The determination of source in terms of s9 and case law is challenged by business in e-commerce due the absence of physical premises in the countries in which the businesses operate. The ability to transact electronically without significant effects on the delivery of products and services has enabled foreign business to gain access to the South African market with ease when compared to traditional business models (Khurana, 2016). The application of South African income tax legislation therefore appears to be challenged by e-commerce, enabling an avoidance of income tax in the country where business in e-commerce transacts.

Globalisation as a result of technology has resulted in transactions that are international in nature on which international tax principles such as permanent establishment would need to be applied. Concepts such as permanent establishment have been challenged

by business in e-commerce, due to the absence of physical premises of business in e-commerce in the market in which it operates in.

Principles of income tax related to source and permanent establishment were developed in a pre-digital era, based on business models which relied on the physical premises established in the market jurisdiction in which the business operates (Choudhary, 2011:33). The digital era has presented challenges to South African income tax and international tax principles, which have resulted in businesses deriving revenues from South Africa and avoiding income tax. The avoidance of income tax by business in e-commerce has become a topic of debate internationally as governments seek solutions to the problem of tax avoidance.

Addressing the challenges faced to the taxation of business in e-commerce, have resulted in alternatives being explored, which aim to tax income earned by non-resident business in an e-commerce environment. Solutions explored range from the modification of treaty concepts such as permanent establishment to the introduction of a new tax regime with suggestions of a withholding tax to be introduced to e-commerce transactions (Choudhary, 2011: 51-53). The solutions explored may assist in addressing the challenges faced to the taxation of non-resident business, however further challenges may arise as the digital environment is a constantly changing environment which may result in changes that are made being irrelevant as technology advances further. The solutions explored may result in the taxation of transactions from e-commerce, however in the adoption of solutions to address challenges to the taxation of business, principle of taxation relating to neutrality, fairness, equity (OECD, 2005:10) need to be considered for an effective tax system to be established.

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