

**TAX IN THE DIGITAL AGE: IS SOUTH AFRICA'S CURRENT INCOME TAX
LEGISLATION ADEQUATE FOR THE TAXATION OF THE DIGITAL ECONOMY
AND E-COMMERCE?**

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ABSTRACT

The purpose of this research report is to examine South Africa's current income tax legislation and determine whether or not it is appropriate for taxing the digital economy and related transactions and activities i.e. e-commerce. In particular this research report focuses on the source rules and the application of double tax agreements in respect of the permanent establishment concept, found in South Africa's income tax legislation, when applied to the digital economy and e-commerce. This research report critically analyses the solutions being pursued in other jurisdictions by legislators, tax administrators and international organisations and how these possible solutions could be considered and implemented into South African tax legislation.

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1. INTRODUCTION

The research question presented in this report seeks to determine if South Africa's ("SA") current income tax legislation is adequate in taxing the digital economy and electronic commerce ("e-commerce").

In order to answer this question, the report first looks at what the digital economy and e-commerce is. It then analyses SA's income tax legislation to determine if the legislation creates the requisite jurisdiction to levy income tax on e-commerce. In doing so, the report analyses SA's source rules, the application of double tax agreements and the permanent establishment concept in creating taxing rights in respect of the digital economy and e-commerce. The report seeks to identify inadequacies within the legislation, and analyses how these inadequacies can be addressed with solutions from both local and international developments with regards to the taxation of the digital economy and e-commerce.

What is the digital economy and e-commerce?

The digital economy can be defined as *"the global network of economic and social activities that are enabled by platforms such as the internet, mobile and sensor networks."*¹ The digital economy is led by the innovation and development of technology² and has been the main driver of the 'fourth industrial revolution'.³ Technological advances have enabled the delivery of goods and services via the digital space, allowing consumers to enter into a digital economy and for the world to enter into an age of e-commerce. Multinational Enterprises

¹ United Nations Department of Economic and Social Affairs (2014), *Protecting the Tax Base in the Digital Economy* at 5.

² Davis Tax Committee, *Second Interim Report On Base Erosion And Profit Shifting (BEPS) In South Africa* (2016) at 1, available at http://www.taxcom.org.za/docs/New_Folder3/3%20BEPS%20Final%20Report%20-%20Action%201.pdf (last accessed 27 March 2018).

³ Effoduh, Jake Okechukwu. "The Fourth Industrial Revolution by Klaus Schwab." (2016) *The Transnational Human Rights Review* 3, available at <http://digitalcommons.osgoode.yorku.ca/thr/vol3/iss1/4> (last accessed 28 March 2018).

(MNEs) have, as a result, had to evolve their operating models to encompass digital platforms to cater for this ever growing market.⁴

The OECD defines ‘e-commerce’ as:⁵

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

The digital economy and e-commerce have challenged existing international tax legal concepts:⁶

- a. In which jurisdiction is the income from e-commerce generated?
- b. How should the income from e-commerce transactions be classified?
- c. In which jurisdiction are these e-commerce transactions, activities and services being rendered i.e. where are they taking place?
- d. Does e-commerce transactions, activities and services conducted over an electronic platform such as the internet, create a presence? And if so, where is this presence created – on the creator’s or the consumer’s side?

⁴ The internet has changed and decentralised the manner of doing business all over the world and to put this in perspective IBM did a presentation using various companies all over the world to display the ‘Digital Disruption’ that has already taken place to date:

- *Uber*: the globe’s largest taxi company owns no taxis
- *Airbnb*: the biggest accommodation provider owns no real estate
- *Skype and WeChat*: the biggest phone companies own no telecommunication infrastructure
- *Alibaba*: the globe’s most valuable retailer has no inventory
- *Facebook*: the leading and most popular media owner creates no content
- *Netflix*: the globe’s largest movie house owns no cinemas
- *Apple and Google*: the biggest software vendors don’t write the apps

Presentation created by Sandy Carter, IBM for Entrepreneurs event, The Digital Disruption Has Already Happened, reported by John Kennedy, “How digital disruption changed 8 industries forever”, 25 November 2015, available at <https://www.siliconrepublic.com/companies/digital-disruption-changed-8-industries-forever>. (last accessed 18 March 2018).

⁵ The OECD’s definition of electronic commerce, available at <http://stats.oecd.org/glossary/detail.asp?ID=4721> (last accessed 18 March 2018).

⁶ Cyberlaw@SA II, R Buys & E Cronje (Editors), “The Law of the internet in South Africa”, 2nd Edition, 2004, published by Van Schaik at 314.

- e. Under which jurisdiction is the income sourced and generated by such e-commerce transactions and activities; and thus, where should it be taxed or where should the taxing rights fall?
- f. How do tax authorities tax such e-commerce transactions, activities and services?

The use of the internet as a platform for cross-border electronic commercial transactions does not align with the fundamental jurisdictional principles of taxation,⁷ which “*is at once intangible and in a constant state of mutation, growing larger and more complex with each passing second*”.⁸

The rapid innovation and development of technology,⁹ e-commerce and digital business models,¹⁰ as well as its automatic, virtual operation and remote application of the digital economy, has raised increasing complex questions in the tax arena and in particular around the taxation of non-resident companies providing digital offerings in jurisdictions where they have little or no ‘physical’ presence.¹¹

Under the current SA income tax framework, digital offerings may be broken down into two main segments a) the rendering of services and b) the provision of goods (tangible or intangible). The delineation between the two offerings may have a direct impact on the tax treatment applicable to the income derived in each case.

⁷ Lau, C., & Halkyard, A. “From E-Commerce to E-Business Taxation” (2003) *Asia-Pacific Tax Bulletin*, (January 2003), 2–13.; Azam, R. “E-Commerce Taxation and Cyberspace Law” (2007) 12 *Virginia Journal of Law & Technology* 5 at 1.

⁸ Schmidt, E., Cohen, J., “*The New Digital Age: Reshaping the Future of People, Nations and Business*”, (2014) at 3.

⁹ Technical Advisory Group on Monitoring The Application of Existing Treaty Norms for Taxing Business Profits, ‘*Are The Current Treaty Rules for Taxing Business Profits Appropriate for Taxing E-Commerce*’, Final Report, available at <http://www.oecd.org/ctp/treaties/35869032.pdf> (last accessed at 19 March 2018).

¹⁰ “*The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations.*” Davis Tax Committee op cit note 2 at 1.

¹¹ Edison Jakurti, “*Taxing the digital economy—It’s complicated*”, December 13, 2017 available at <https://www.brookings.edu/blog/future-development/2017/12/13/taxing-the-digital-economy-its-complicated/> (last accessed 28 March 2018).

Basis of taxation in South Africa

Countries impose taxes in accordance with their domestic tax rules, however, before a country may impose any taxes they must first determine whether or not they have the prerequisite ‘jurisdiction to tax’.¹² In order to determine whether SA has the jurisdiction to tax, we must first look at SA’s domestic tax law.¹³ SA levies income taxes on the ‘tax residence’ of the taxpayer or on the ‘source’ of the income. In the absence of a tax residence or source jurisdiction i.e. a jurisdiction to tax, found in the domestic tax rules, SA will not be able to impose any taxes.¹⁴

SA levies income tax on its residents on a world-wide basis (i.e. on any income irrespective of where it is derived), whilst income tax is levied on non-residents on all income received or accrued to them from a source within SA.¹⁵ In order to avoid double taxation of income derived by residents from foreign countries, SA will provide a tax credit for any foreign taxes paid on that income or in certain circumstances, a tax exemption for such income.¹⁶

SA departed from a source-based income tax system to a residence-based income tax system for years of assessment commencing on or after 1 January 2001. This means that a resident as defined in section 1 of the Income Tax Act 58 of 1962 (“the Act”) is subject to taxation on a worldwide income basis with certain exceptions and exemptions, irrespective of where that income is earned. Conversely, the source concept remains relevant in the context of a non-resident; such person being taxed on a SA source income basis (subject to the applicable provisions of a double taxation agreement (“DTA”)¹⁷ that may be applicable).¹⁸

¹² Olivier, L. & Honiball, M. 2011. *International Tax – A South African Perspective*. 5th ed. Cape Town, South Africa: Siber Ink at 11.

¹³ Ibid. at 1.

¹⁴ Section 5 read together with the definition of “gross income” and “income” (found in section 1) of the Income Tax Act 58 of 1962.

¹⁵ In terms of the definition of “gross income” found in section 1 of the Income Tax Act 58 of 1962.

¹⁶ For a better understanding please refer to Interpretation Note 18 of 2015, which is by no means a definitive authority but it is a guide produced by SARS (even though SARS is not bound to this guide ITC 1830, 70 SATC 123); 6quat of the Income Tax Act 58 of 1962.

¹⁷ The DTA is one of many double tax agreements entered into between South Africa and other countries. Its principal objectives are the avoidance of double taxation and the prevention of fiscal evasion. The enabling legislation is s 108 (1) of the Act.

¹⁸ Article 4 of the OECD MTC.

Therefore, in order to determine whether income derived by a non-resident in SA is taxable under SA income tax legislation, a two pronged approach must be adopted: (i) determine whether the amount is from a source in SA, and (ii) if there exists a tax treaty between SA and the relevant country of the recipient,¹⁹ determine if the DTA allocates taxing rights to SA.²⁰

The DTA is based upon the Model Tax Convention on Income and on Capital agreed to by the committee on Fiscal Affairs of the Organisation for European Economic Co-operation and Development (“OECD”), which has served as the basis for similar agreements that exist between many countries, this guide was released in 2014 and is expecting an update in 2017, herein after referred to as the OECD MTC.²¹

A DTA will effectively allocate taxing rights between the contracting states where broadly similar taxes are involved in both countries. DTAs achieve the objective of s 108 of the Act, by stating in which Contracting State taxes of a specific kind may be levied or that such taxes will only be taxable in a particular contracting state or, the DTA will state that a particular Contracting State may not impose the specific tax in defined circumstances. A DTA thus effectively modifies the domestic law and will be applicable in preference of the domestic law to the extent that any conflict exists.²²

A DTA will generally allocate taxing rights on business profits to SA if the non-resident has a Permanent Establishment (“PE”) located in SA.²³ Therefore, although a primary taxing right may be created by the location of a source within SA, the absence of a related PE would result in that income not being subject to SA income tax. To the extent that income is derived from a PE, one must consult the relevant DTA, if one exists between the two states. For DTA purposes, income derived from a PE generally falls within the business profits article (in the

¹⁹ Once brought into operation a double tax agreement has the effect of law. Its legal effect was described by Corbett JA in *SIR v Downing* 1975 (4) SA 518 (A) at 523A: “As long as the convention is in operation, its provisions, so far as they relate to immunity, exemption or relief in respect of income tax in the Republic, have effect as if enacted in Act 58 of 1962 (see s 108(2)).”.

²⁰ This can be done by referring to the tests laid out in article 4 of the OECD MTC. Note that depending on the Contracting state, one may have to look at the tests laid out in the United Nations (“UN”) and South African Development Community (“SADC”) Model Tax Conventions (“MTC”).

²¹ *Commissioner for the South African Revenue Service v Tradehold Ltd* (132/11) [2012] ZASCA 61 at paragraph 18.

²² *Ibid.* at paragraph 17.

²³ In its present form, under Article 5 in the OECD MTC (2014 and the updated version of 2017).

absence of a specific services article) which requires a PE in the source state before profits may be allocated.²⁴

This becomes problematic when we begin to look at the delivery of goods and services provided via an electronic platform(s). Why?

- 1) With regards to services, the common law principle is that service fees are sourced where the services are rendered. This means ascertaining whether the services are physically rendered in SA²⁵ via such electronic platform.
- 2) With regards to the sale of goods, one needs to determine the existence of physical presence i.e. a PE and whether the goods, delivered via an electronic platform, are attributable to that PE.

E-commerce characteristics and complexities, make it difficult to determine and implement such a jurisdictional tax norm and various and differing interpretations and attempts in dispensing tax on e-commerce transactions has created a scenario where taxing digital activities is perceived as an infringement on the rights of sovereignty of states.²⁶

The jurisdiction of SA to tax i.e. SA's source rules, and the PE concept are thus central to determining the tax consequences of the income derived from the digital economy and e-commerce, as explored in detail in Part 2 of this Research Report.

The Permanent Establishment Concept

In its present form, the concept of a PE relies on some sort of physical presence in a foreign jurisdiction in order to create taxing rights and obligations.²⁷ This is problematic as a key feature of e-commerce is the ability to do business in a foreign jurisdiction without establishing a physical presence.²⁸ Furthermore, it seems to be that the current tax rules and reform measures presented by various countries and civil organisations do not sufficiently

²⁴ In its present form, under Article 5 in the OECD Model Income Tax Convention (2014 and updated version of 2017).

²⁵ *COT v Shein* (1958) 22 SATC 12, SA 14 (FC) at 16.

²⁶ Cyberlaw @SA II, "*The Law of the internet in South Africa*" by R Buys & E Cronje (Editors), 2nd Edition, 2004 at 314.

²⁷ OECD MTC (2014 and the updated version of 2017).

²⁸ De Wilde, M., "Tax Jurisdiction in a Digitalizing Economy: Why 'Online Profits' Are Hard to Pin Down", (2015) 43 *Intertax*, Vol. 43, no 12, 2015 at 797.

address this fundamental issue, thereby restricting the number of sustainable solutions available. Accordingly, digital transactions do not always fall within the net of tax law of any particular jurisdiction, thereby creating what the Davis Committee, termed “*stateless income*”.²⁹

The tax loopholes have resulted in the issue of the digital economy escaping taxation and significantly eroding the tax base³⁰ of SA (and other countries around the world) – essentially creating inequalities in the ‘free market’.³¹ Business profits cannot be effectively taxed under the current taxation rules where entities and persons utilise the internet for cross-border commercial transactions. Unlike traditional companies, whose profits are taxed with value creation being the primary nexus (according to the OECD guidelines³²), digital business models and enterprises conduct most transactions electronically. This makes it difficult to determine where value is created, what it is, and how to measure it.³³

The impact of e-commerce and the challenges it has created in the realm of taxation, have resulted in countries banding together, under multiple global organisations,³⁴ in order to be able to create and implement a solution which addresses the challenges and the impact that e-commerce and the digital economy have had on the world of taxation, as explored under Part 3 of this Research Report. The primary purpose for these countries banding together is to combat Base Erosion and Profit Shifting (“BEPS”) and the digital economy facilitates a substantial amount of BEPS activities.

²⁹ Davis Tax Committee op cit note 2 at 2.

³⁰ European Parliament Directorate-General for Internal Policies Policy Department A Economic and Scientific “*Tax Challenges in the Digital Economy*”, 2016, at 17 -“*Income tax base in the digital economy is endangered by the fact that the MNEs are increasingly providing goods and services in countries without a physical or legal presence; by situations where customers pay for certain digital services by providing their personal data free of charge, thus generating visibility and customers in the market country without a value being attributed to it; by artificial contracts created for shifting profits ; by circumvention of withholding tax using transfer pricing practices such converting royalties into services*”, available at [http://www.europarl.europa.eu/RegData/etudes/STUD/2016/579002/IPOL_STU\(2016\)579002_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2016/579002/IPOL_STU(2016)579002_EN.pdf) (last accessed 28 March 2018); United Nations Department of Economic and Social Affairs (2014) *Protecting the Tax Base in the Digital Economy*, at 3.

³¹ R Doernberg and L Hinnekens *Electronic Commerce and International Taxation* (1999) at 341- 343; Davis Tax Committee Interim Report (2014), “*Addressing Base Erosion and Profit Shifting in South Africa, Action 1: Address the Tax Challenges of the Digital Economy*”, at 1.

³² OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, available at <http://dx.doi.org/10.1787/9789264202719-en> (last accessed 28 March 2018).

³³ Edison Jakurti op cit note 11.

³⁴ OECD; UN; European Commission (“EC”).

It would seem that most countries, including SA, appear to not have sufficient measures, or any measures, in place to effectively tax income derived from cross-border e-commerce transactions.

The OECD, in 2013, acknowledged the above perspective when it stated that *“the international common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment.”*³⁵

Whilst SA has developed its Value-Added Tax (“VAT”) legislation for e-commerce, it has not done the same with regards to its income tax legislation. SA income tax legislation, and in particular the current PE concept, have become outdated and are no longer adequate for determining taxing rights with regards to the digital economy and e-commerce.³⁶ The unique nature of the internet has caused the concept of physical presence to be redundant.

Tax administrations world-wide need to understand, accept and conceptualise the idea of a ‘virtual presence’ as a possible solution in order to be able to adapt their tax laws to accommodate the digitalised economy and e-commerce. A consistent and simple international solution is needed to address the problem effectively, otherwise many countries, including SA, will most likely continue to see a substantial loss in tax revenues.³⁷ Possible SA solutions are explored in more detail in Part 3 of this Research Report.

In Part 4 of this Research Report, we arrive at the conclusion that the current SA income tax legislation is inadequate to effectively tax e-commerce and the solutions proposed in Part 3 of the Research Report should be considered and implemented in order to address the inadequacy of the legislation.

³⁵ OECD (2013), *“Addressing Base Erosion and Profit Shifting”*, OECD Publishing, available at <http://dx.doi.org/10.1787/9786264192744-en>, at 5 (last accessed 28 March 2018).

³⁶ Cockfield, Arthur J *Should We Really Tax Profits from Computer Servers? A Case Study in E-Commerce Taxation* (2000) 21 Tax Notes International 2407, 2407.

³⁷ The estimated loss of Corporate Income Tax (“CIT”) suffered globally is assumed/estimated to be between four-to-ten per cent of global Corporate Income Tax revenues annually- OECD (2015), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD. Available at <https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf> Introduction, at 4, paragraph 2 (last accessed 28 March 2018).

2. BASIS OF SA TAXATION: SA DOMESTIC INCOME TAX LAW

a. Source

The ‘source of income’ is a domestic law concept,³⁸ this means that source rules will vary from country to country. There is no specific definition of “source” in the Act. However, the concept of ‘source’ and the source rules in SA can specifically be seen in section 9 of the Act in respect of certain income. Where the item of income is not covered by the source rules in section 9 of the Act, as is the case in respect of income derived from services, common law principles that have been developed through judicial precedent will determine whether or not the amount is received from a source within SA.³⁹

It must be noted that section 9 of the Act does not specifically mention e-commerce and there is no specific legislative provision dealing with income derived from services rendered through e-commerce goods or services. As a result, we must rely on common law to establish the source of such income.⁴⁰

When trying to determine the meaning of source, one must turn to the pivotal case of *CIR v Lever Brothers and Unilever Ltd*⁴¹, where Watermeyer CJ (at 450) stated –

“The source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the ‘quid pro quo’ which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity -in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these.”

³⁸ Olivier, L. & Honiball, M. 2011. *International Tax – A South African Perspective*. 5th ed. Cape Town, South Africa: Siber Ink at 10.

³⁹ *Zandberg v Van Zyl*, 1910 AD 302 at 309.

⁴⁰ *Ibid.*

⁴¹ 1946 AD 441.

The ratio from the case can be used when determining the source of income in SA. In this case, the court effectively set out a two-step test that must be applied when assessing and determining the source of the income—⁴²

Step 1: Determine the “originating cause” of the income being earned, i.e. ascertain what gave rise to the income.

Step 2: Determine the location of the “originating cause” i.e. ascertain the country where the activities were conducted that gave rise to the income.

The court in *Lever Bros* relied on the case of *Millin v CIR*⁴³ where the court found that the source of the royalties which a novelist had received from her publishers (that were based in the United Kingdom) was located in SA, the location where the novelist had used her “wits and labour” to write her novels.

It is not always a simple task to determine the ‘originating cause’ of a particular income stream, as is evidenced by the myriad of cases on this matter.⁴⁴ These authorities point out that the Legislature, most likely aware of the difficulty of determining whether or not the amount was received from a source within the republic, has not attempted to define the phrase “source... within the Republic” and has left it to Courts to decide on the particular facts of each case whether an amount was or was not received from such a source within the Republic.⁴⁵ Hence, each case has to be decided on its own facts and merits⁴⁶.

⁴² Olivier, L. & Honiball, M. 2011. *International Tax – A South African Perspective*. 5th ed. Cape Town, South Africa: Siber Ink at 12.

⁴³ 1928 AD 207, 3 SATC 170 at 174-175.

⁴⁴ The legal principles to be applied in determining whether or not an amount was received from a source within SA have been stated in a number of decisions, more particularly the most crucial being *Commissioner for Inland Revenue v Lever Bros and Another* 1946 AD 441; *Commissioner for Inland Revenue v Epstein* 1954 (3) SA 689 (A); *Commissioner for Inland Revenue v Black* 1957 (3) SA 536 (A) and more recently *Rhodesia Metals Ltd (In Liquidation) v Commissioner of Taxes* 1938 AD 282; *Rhodesian Metals Ltd (in Liquidation) v Commissioner of Taxes* 1940 AD 432 (PC). Furthermore, to the extent that an amount is received from more than one originating cause, against this ‘factual matrix’, the taxpayer must determine and define the dominant/main/substantial/real and/or basic cause of the receipt.

⁴⁵ *Commissioner for Inland Revenue v Lever Bros and Another* 1946 AD 441; *Commissioner for Inland Revenue v Epstein* 1954 (3) SA 689 (A); *Commissioner for Inland Revenue v Black* 1957 (3) SA 536 (A).

⁴⁶ In a number of cases in our Courts reference has been made (in various forms) to the following remarks of Isaacs J delivering the judgment of the High Court of Australia in the case of *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183, at 189 - 90: “The Legislature in using the word ‘source’ meant, not a legal concept, but something which a practical man would regard, as a real source of income (T)he ascertainment of the actual source of a given income is a practical, hard matter of fact.”, See *Rhodesia Metals Ltd (In Liquidation) v Commissioner of Taxes* 1938 AD 282, at 300; 1940 AD 432, at 436; *Lever Bros* case, *supra*, at 454.

In providing some guidance on this meaning, *Essential Sterolin Products (Pty) Ltd v CIR*⁴⁷ the Court expanded on the principles above and stated—⁴⁸

“...In applying these general principles, the courts have adopted certain rules and criteria for locating the source of particular types of accrual or receipt, such as dividends, annuities, director’s fees, interest, payment for services, rent, royalties, and so on. None of these would seem to have relevance to the somewhat unusual character of the inability consideration. In seeking the originating cause of this amount one must, in my view, have regard to the factual matrix underlying and giving rise to the agreement in terms of which it became payable and then apply thereto the basic principles outlined above.” (own emphasis).

In SA it is generally accepted that the source of income originating from services rendered, is generally the place where those services were rendered.⁴⁹ Since e-commerce is conducted over an electronic platform that does not belong to any specific location or jurisdiction. The internet ignores jurisdictional boundaries, the internet and allows a never-ending flow of money, goods, services and information across multiple jurisdictions. E-commerce lives in cyberspace, essentially a notional environment, which has caused a virtual market place that ignores the sovereignty of states i.e. leaving no one state with the right to impose tax on these transactions.⁵⁰ Consequently, one may be able to argue that there is no source.

If one is to use the two pronged approach, mentioned above, the originating cause of income is likely to be where the services are rendered or the goods are delivered i.e. where the income is earned and, continuing with step 2, the location of that originating cause with reference to transactions conducted through the internet is unlikely to be within SA, due to the fact that e-commerce has no physical location.⁵¹

⁴⁷ 1993(4) SA 859 (A).

⁴⁸ Ibid. at 870 C to 871.

⁴⁹ Olivier, L. & Honiball, M. 2011. *International Tax – A South African Perspective*. 5th ed. Cape Town, South Africa: Siber Ink at 15; *CIR v Epstein*, 1954 (3) SA 689 (A), 19 SATC 221; *COT v Shein*, (1958) 22 SATC 12, SA14 (FC).

⁵⁰ Cyberlaw @SA II, “*The Law of the internet in South Africa*” by R Buys & E Cronje (Editors), 2nd Edition, 2004, published by Van Schaik, at 314; Burke conceptualises this problem perfectly- “...the unique nature of the Internet may necessarily trigger constitutional limitations designed to limit governmental regulation originating outside the state’s physical borders.”. *Burke, Dan L. “Jurisdiction in a World Without Borders” (1997) 1 Virginia Journal of Law & Technology 3* at paragraph 6.

⁵¹ Oguttu, A.; van der Merwe, B. (2005). “Electronic commerce: Challenging the income tax base”, *South African Mercantile Law Journal* 17(3), at 313-315.

It must be noted that only where there is SA source income present can one have a PE, however, this does not mean that if source income is present there will automatically be a PE in existence. In the absence of SA source income, SA will not have the jurisdiction to impose taxes on the non-resident and there will be no basis for the application of a DTA in terms of which one may test whether a PE exists. This is due to the fact that the existence of a PE in terms of a DTA will generally allow the Contracting State, where the PE is located, to exercise its domestic taxing rights in respect of the profits that have been found to be attributable to the PE of a non-resident.⁵²

However, on the other hand, one could also argue that the services and good rendered over an electronic platform, are generally rendered to the consumer who is receiving such goods or services at a specific physical location and income generated from those electronic goods or services can be sourced in the location of the consumer.

For example, the transmission of content through a mobile application (or another electronic platform) to end users for a fee could appear be classified as a service or a licensing arrangement⁵³ (i.e. this would be the case for online games, newspapers, educational publications/platforms e.g. Lexis Nexis). On this basis, the source of the income should be determined with reference to where the services are rendered or where the company carries on its business.⁵⁴ The same would have applied if the income is regarded as derived from the sale of a good.⁵⁵

There is no specific common law precedent dealing with e-commerce activities.⁵⁶ This is due to the fact that much of SA common law predates the digital economy and e-commerce. Hence, in this regard, there is little to no case law, tax rulings or regulatory authoritative pronouncements on the issue.

⁵² OECD Commentary, 2014: C (5) – paragraph 1.

⁵³ *Ibid.*

⁵⁴ Or, in the guidelines of the OECD- the source of income should be “*the jurisdiction, in which value creation occurs*”- OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, available at <http://dx.doi.org/10.1787/9789264202719-en> (last accessed 19 March 2018).

⁵⁵ Section 9 of the Income Tax Act, specifically Section 9(1)(a); *Commissioner for SARS v BP South Africa (Pty) Ltd* 2006 (5) SA 559 (SCA).

⁵⁶ For the purposes of this argument; however, *Casino Enterprises v The Gauteng Gambling Board* (653/10) [2011] ZASCA 155 does mention online gaming servers in Swaziland, when trying to determine if the Company was contravening South African gambling laws.

Thus, it can be said that source still remains an uncertain issue. It may not always be clear what the originating cause is with regards to e-commerce and since these possible ‘causes’ may all take place in different locations, it can become difficult to identify the source.

If the conclusion that the source of income is unlikely to be in SA, with regards to e-commerce transactions, it is not relevant to consider the application of a DTA in these types of scenarios. However, if the conclusion is that the income is from a SA source, then one must consider the application of a DTA.⁵⁷ For DTA purposes, the income earned by such non-resident companies is likely to be regarded as business income or business profits.⁵⁸ As a result, that income may only be taxable in SA if those non-resident companies create PEs in SA and that income is attributable to those PEs.⁵⁹

In the case of the digital economy and digital enterprises: until a PE has been established, the source country, in this case SA, will be unable to tax the business profits attributable to that entity and the residence country has exclusive taxing rights on the business profits derived by its resident entity in the source country.⁶⁰ This often appears to be the case where non-resident enterprises use electronic platforms through which to carry out the sale of goods and services. Where the digital economy and digital enterprises are concerned, one must not that -

“...e-commerce transactions can generate income without substantially using infrastructure in any given physical location. Information technology has also made it possible for businesses to decentralise and to spread their functions (such as financial, administrative, marketing, sales,

⁵⁷ The provisions of a DTA do not create taxing rights, instead, it allocates taxing rights and such rights must exist under the domestic law of the country concerned. In the SA context, the taxing right is created on source-based payments to non-residents. In a SA context, international agreements (which include DTAs) are adopted in accordance with the formalities contained under section 231 of the Constitution of the Republic of South Africa, Act 108 of 1996 (“the Constitution”). In relation to tax agreements section 108(2) of the Income Tax Act provides that once Parliament has approved an agreement in terms of section 231 of the Constitution, arrangements of that agreement shall be notified by publication in a Government Gazette. The result of section 108(2) is that following publication in a Government Gazette, a DTA will have effect as if enacted in the Act, thereby being on equal footing with any other provision of the Act. Income earned from the rendering of services for the purpose of the DTA falls within the concept of business profits which is governed by Article 7 of the OECD MTC (2014).

⁵⁸ Article 5 read with Article 7 of the OECD MTC, 2014 and the updated version of 2017.

⁵⁹ *Ibid.*

⁶⁰ *Ibid.*

*delivery and customer support) across various jurisdictions to yield the greatest return on investment and to provide in the need of remote customers.”*⁶¹

It appears that the SA income tax legislation and source rules are currently inadequate or at the very least too vague to be adequate to tax the digital economy and e-commerce. SA can consider broadening their source rules to attract income from e-commerce, as suggested by the Davis Committee.⁶² Essentially, the SA source rules should be expanded and should be more closely aligned with the PE definition in order to attempt to close any loopholes that may exist in the taxation of the digital economy and e-commerce due to the fact that e-commerce most likely does not fall within the SA source rules. However, since the source rules could be argued and a source could possibly be found within SA, we would need to consider the application of a DTA and specifically the PE provisions.

Consequently, with reference to the digital economy and e-commerce, we must consider the application of DTAs, due to the fact that DTAs are intended to encompass not only existing taxes, but also taxes which may come into existence at later dates⁶³ i.e. such as the taxation of e-commerce.⁶⁴ The existence of a PE, in terms of a DTA, assumes that the specific DTA applies to the current circumstances.⁶⁵ Below we now analyse whether e-commerce would be captured by the PE concept and provisions.

b. Permanent Establishment

Article 7(1) of the OECD MTC states that a Contracting State will only have taxing rights in respect of the business profits of a foreign enterprise, which is a resident of another Contracting State, if the enterprise has a PE, as defined in Article 5, in the State to which such profits are so attributable i.e. the ‘source state’.

⁶¹ Oguttu, A.; van der Merwe, B. (2005). “Electronic commerce: Challenging the income tax base”, *South African Mercantile Law Journal* 17(3), at 313-315.

⁶² Davis Tax Committee op cit note 2 at 4.

⁶³ See Article 2(2) of the OECD MTC.

⁶⁴ *Commissioner for the South African Revenue Service v Tradehold Ltd* (132/11) [2012] ZASCA 61 (8 MAY 2012) at paragraph 18.

⁶⁵ Article 4 of the OECD MTC (2014 and the updated version of 2017).

In SA specifically, a PE is defined in the Act, under section 1, to have the same meaning as the definition contained in Article 5, of the OECD MTC, as updated from time to time (most recently 2017), stated below -

"1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

- a) a place of management;*
- b) a branch;*
- c) an office,*
- d) a factory;*
- e) a workshop, and*
- f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;*
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;*
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*
- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;*
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;*
- f) the maintenance of 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.*

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.”

Under the above definition, a PE will be created if such entities have a fixed place of business through which it carries on its business (a so-called ‘fixed place’ PE) or if it has a dependent agent that habitually concludes contracts in SA (so-called ‘dependent agent’ PE).

Fixed place PE

A PE is defined in Article 5 of the OECD MTC as a “*fixed place of business through which the business of an enterprise is wholly or partly carried on*”.

In order for the existence of a PE, the following requirements must be met—⁶⁶

1. there needs to be a place of business in the form of premises or other facilities available to the enterprise;
2. the place of business needs to be fixed, i.e. it must be established at a distinct geographical place and with a degree of permanence; and
3. the business of the enterprise needs to be carried on and conducted through the fixed place of business. This means that the place of business needs to be at the disposal of the enterprise and requires some measure of control by the enterprise over the place of business.

The business of an enterprise is usually conducted and operated through its employees, but the 2017 OECD Commentary has alluded to the fact that a PE can be created through the absence of employees.⁶⁷ This commentary can be critical in the creation of a virtual PE.

⁶⁶ In terms of the OECD Commentary on Article 5, Paragraph 1; Note this is taken from the tenth edition of the condensed version of the "OECD Model Tax Convention on Income and on Capital". It contains the full text of the "Model Tax Convention on Income and Capital" as it read on 21 November 2017, “OECD Model Tax Convention (2017)” at 117, available at https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page119 (last accessed 28 March 2018).

⁶⁷ Paragraph’s 43 to 48 in the OECD Commentary refers to situations in which a PE can be created through the complete absence of employees; there are situations in which a level of automation can create a PE.

In the SA context, there is little judicial guidance on the application and interpretation of the PE principles in the treaty context. Therefore, it is necessary to consider foreign case law on the subject. In this regard two decisions of the Tax Court of Canada shed light: *Knights of Columbus v. The Queen*,⁶⁸ (“*Knights of Columbus*”) and *American Income Life Insurance Co. v. Canada*,⁶⁹ (“*AILP*”).

Although each of these cases embarked on discussions in respect of dependent agent PEs, both judgments dealt extensively with hallmarks to be used to determine if a fixed place PE has been established. The Court’s decision in each of these cases was reliant upon whether the place of business was “at the disposal” of the enterprise.

In *Knights of Columbus*, the court went on to state that –

*“The Knights of Columbus make no operational decisions at the Field Agent’s premises. The Knights of Columbus had no officers, directors or employees even visit the agents’ home offices, let alone have any regular access. All risks connected with carrying on business at the home offices are borne by the agents themselves. The agents are not carrying on the Knights of Columbus’ core business from these premises. Their premises cannot therefore be found to be a fixed place of business permanent establishment.”*⁷⁰ (own emphasis)

In *AILI*, the Court went a step further and provided a list of factors to be considered in determining whether the parent’s business was being carried on from the fixed place of business. These factors include -

1. use of premises by parent;
2. control by parent over premises;
3. legal right to exercise control over premises;•
4. degree to which premises identified with parent business;
5. who paid for expenses of premises;
6. who paid for equipment used at premises;
7. who made management decisions;

⁶⁸ 2008 TCC 307.

⁶⁹ 2008 TCC 306.

⁷⁰ *Knights of Columbus v. The Queen* 2008 TCC 307 at paragraph 80, available at <http://www.dentons.com/~media/FMC%20Import/misc/pdf/r/reasons%20for%20judgement.pdf> (last accessed 19 March 2018).

8. what contracts were concluded from premises;
9. what parent products were kept on premises;
10. did the parent have any Canadian employees; and
11. who bore the risk of the operation from premises.

Although the principles⁷¹ derived from the foreign decisions above will not be binding on a SA court they are of persuasive value and will be taken into consideration. Whilst the above two cases have previously been used as persuasive value, we have seen decisions from the Spanish⁷², Swedish⁷³ and Danish⁷⁴ courts which show developments and expansion in the interpretation of the creation of a PE. SA may take these developments into consideration in the future.

Dependent agent PE

Where a dependent agent acts on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to substantially negotiate or conclude contracts in the name of the foreign enterprise, that enterprise shall be deemed to have a PE in that State in respect of any activities which that person undertakes for the enterprise.⁷⁵

In order for an agent to be considered dependent, it is required that the dependent agent is both legally and economically dependent on the enterprise.⁷⁶ Legal dependence requires that the agent's activities are subject to the detailed instructions or comprehensive control by the

⁷¹ Including those relied upon from *Taisei Fire and Marine Insurance Co., Ltd. v. Commissioner of Internal Revenue*, (1995), 104 T.C. 535.

⁷² The Spanish High Court issued a decision (case number 182/2012), confirmed by the Supreme Court on 20 June 2016 and in line with BEPS Action 7.

⁷³ The Swedish Administrative Court of Appeal in the case of: Gothenburg(Kammarrätten i Göteborg) case number 2276-15; EY Global Tax Alert, "Swedish court rules PE exists in Sweden due to recurring nature of activities", 18 January 2017, available at [http://www.ey.com/Publication/vwLUAssets/Swedish_court_rules_PE_exists_in_Sweden_due_to_recurring_nature_of_activities/\\$FILE/2017G_00247-171Gbl_Swedish%20court%20rules%20PE%20exists%20in%20Sweden%20due%20to%20recurring%20nature%20of%20activities.pdf](http://www.ey.com/Publication/vwLUAssets/Swedish_court_rules_PE_exists_in_Sweden_due_to_recurring_nature_of_activities/$FILE/2017G_00247-171Gbl_Swedish%20court%20rules%20PE%20exists%20in%20Sweden%20due%20to%20recurring%20nature%20of%20activities.pdf) (last accessed 28 March 2018).

⁷⁴ In a binding ruling dated 26 September 2017 and published 12 October 2017 (SKM2017.584.SR); EY Global Tax Alert, "Danish Tax Board rules permanent establishment created by interrelated construction projects", 23 October 2017, available at <http://www.ey.com/gl/en/services/tax/international-tax/alert--danish-tax-board-rules-permanent-establishment-created-by-interrelated-construction-projects> (last accessed 28 March 2018).

⁷⁵ Article 5 of OECD MTC (2014 and the updated version of 2017).

⁷⁶ OECD MTC Commentary (2014) on Article 5(6), paragraph 37.

enterprise and the agent bears no entrepreneurial risk in respect of the activities conducted.⁷⁷ Economic dependence requires that the agent's very economic viability is dependent on the enterprise.⁷⁸

In terms of Article 5(5) of the OECD MTC and its relating Commentary the authority to conclude contracts needs to entail contracts relating to the 'business proper' of the enterprise. Therefore, the authority to conclude contracts relating to internal operations or contracts of an auxiliary nature will not create PE. Furthermore, it is provided that a dependent agent who has the authority to negotiate all the elements and the details of a contract which binds the enterprise would also create a PE, even if that agent does not actually sign the contract.⁷⁹

To the extent that the enterprise exercises supervision and control over the independent contractors or sub-agents in terms of the factors listed in Interpretation Note 17⁸⁰ and in terms of the Article 5(6) and the OECD Commentary⁸¹ there is a risk that the enterprise will create a PE in SA. Similarly, to the extent that it is concluded that the enterprise does not exercise supervision and control over the independent contractors or sub-agents, the PE risk dissipates.

Further, it is noted that the OECD update has proposed changes to the Commentary in respect of Article 5, the intention was to give more clarification on the definition of PE. Article 5(5) defines Dependent Agent PE ("DAPE")⁸² and Article 5(6) defines independent agent⁸³. The 2015 final report on BEPS Action 7⁸⁴ expanded the definition of DAPE while narrowing the

⁷⁷ *Ibid.* at paragraph 38.

⁷⁸ *Ibid.*

⁷⁹ OECD, Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report (OECD Publishing 2015) para 9 (BEPS Action 7 Final Report).

⁸⁰ Although the Interpretation Note is issued in respect of the employee/independent contractor distinction for employees' tax purposes and not e-commerce or the digital economy, I believe it would be in an enterprises best interests to note the list of factors contained in Interpretation Note 17 issued by SARS. I consider the principles set out therein provides a useful guide for determining whether the independent contractors or sub-agents will be regarded as being under the supervision and control of the enterprise.

⁸¹ On Article 5(6), paragraphs 37-38.

⁸² Article 5(5) stipulates that any person acting on behalf of the enterprise, who is not an independent agent, and habitually exercises the authority to conclude contracts in the name of the enterprise, this type of person is generally referred to as a dependent agent and any activities undertaken by such a person will be considered part of a permanent establishment of the enterprise.

⁸³ OECD also updated the actual MTC: there is a big tightening on things like DAPE, especially through effectively striking out commissionaire structures.

⁸⁴ Available at https://read.oecd-ilibrary.org/taxation/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report_9789264241220-en#page1 (last accessed 28 March 2018); Additionally, at the time of finalising this paper, the OECD released an updated report on BEPS Action 7 on 22 March 2018 – *"This report contains additional guidance on the attribution of profits to permanent*

definition of independent agent. Under the proposed 2017 OECD MTC changes, an enterprise could be deemed to have a PE where it conducts its business through sub-contractors or commissionaire arrangements.⁸⁵

There is no precedent in SA on the interpretation of the fixed place PE or the dependent agent PE in the current context i.e. mobile applications and e-commerce. SA is most likely to follow the OECD Commentary to the Model Tax Convention⁸⁶ due to the absence of case law on the matter. However, there is also no clarity from this Commentary on the circumstances in which income derived through electronic platforms such as mobile applications will be taxable in the source state.

It is generally accepted that:⁸⁷

- (i) a website does not create a fixed place PE for an entity carrying on business through that website. This is particularly the case, where the back-office functions in relation to the website are not undertaken in SA;
- (ii) a server is likely to create a PE in SA to the extent that the location meets the time threshold and on the basis that it constitutes a fixed place of business i.e. if space is rented on a server it will not create a PE.⁸⁸

There is however a binding private ruling⁸⁹ in which SARS held that a replica server under specific set of facts, does not create a PE.

establishments resulting from the changes in the Report on BEPS Action 7 to Article 5 of the OECD Model Tax Convention. This additional guidance sets out high-level general principles for the attribution of profits to permanent establishments arising under Article 5(5), in accordance with applicable treaty provisions, and includes examples of a commissionaire structure for the sale of goods, an online advertising sales structure, and a procurement structure. It also includes additional guidance related to permanent establishments created as a result of the changes to Article 5(4), and provides an example on the attribution of profits to permanent establishments arising from the anti-fragmentation rule included in Article 5(4.1)".

⁸⁵ OECD MTC 2017 (update to 2014); EY Global Tax Alert, "OECD Council approves 2017 update to OECD Model Tax Convention", 1 December 2017, available at [http://www.ey.com/Publication/vwLUAssets/OECD_Council_approves_2017_update_to_OECD_Model_Tax_Convention/\\$FILE/2017G_06575-171Gbl_OECD%20Council%20approves%202017%20update%20to%20OECD%20Model%20Tax%20Convention.pdf](http://www.ey.com/Publication/vwLUAssets/OECD_Council_approves_2017_update_to_OECD_Model_Tax_Convention/$FILE/2017G_06575-171Gbl_OECD%20Council%20approves%202017%20update%20to%20OECD%20Model%20Tax%20Convention.pdf) (last accessed 28 March 2018).

⁸⁶ Which is updated from time to time, hence the 2014 and subsequent 2017 update.

⁸⁷ Cyberlaw@SA III, "The Law of the Internet in South Africa", S Papadopoulos and S Snail (Editors), 3rd Edition, at 106.

⁸⁸ *Ibid.*

⁸⁹ Binding Private Ruling (BPR 082), valid from 31 March 2010 to 31 March 2015.

On the basis of the above, it may be deduced that services rendered through an electronic platform, via a replica server, should not create a PE in SA in the case where, the server hosting the electronic platform is not located in SA. This is on the basis that, a mobile application (a type of electronic platform) is a form of computer program (similar to a website), with no tangible fixed place.

Therefore, to the extent that enterprises operating in the digital economy do not carry on any other activity in SA relating to the delivery of content to end users, other than engaging a third party for invoicing purposes and locating or hosting the electronic platform through a third party, it is unlikely that such companies hosting mobile apps that provide services, will be regarded as creating a PE in SA. The mere invoicing activity is likely to be regarded as ancillary and thus not create a PE. It must be noted that 2017 OECD MTC Article 5 – the new wording of Article 5(4) means that certain activities – like having a local ‘marketing’ team to engage with local advertisers in the case of Google, Facebook – will likely create a PE now.

None the less, it is clear from the above analysis, that the current definition for PE and the requirement for a physical presence has restricted the PE principle from being applied to e-commerce. It is submitted that the current application of SA legislation and principles, is not sufficient nor is it effective when determining the taxation of the digital economy.

In the final 2015 BEPS Project Report⁹⁰, three tax options were suggested (but not adopted or incorporated) with regards to the sale of digital goods and services by foreign suppliers without an established PE:

1. A corporate income tax that could be levied on net income connected to and attributable to each economic activity;

⁹⁰ OECD/G20 Base Erosion and Profit Shifting Project, “*Addressing the Tax Challenges of the Digital Economy*”, Action 1: Final Report at 148 and at 276, Annex E; Additionally, at the time of finalising this paper, the OECD released an updated interim report on BEPS Action 1 on 16 March 2018 – “*This interim report of the OECD/G20 Inclusive Framework on BEPS is a follow-up to the work delivered in 2015 under Action 1 of the BEPS Project on addressing the tax challenges of the digital economy. It sets out the Inclusive Framework’s agreed direction of work on digitalisation and the international tax rules through to 2020. It describes how digitalisation is also affecting other areas of the tax system, providing tax authorities with new tools that are translating into improvements in taxpayer services, improving the efficiency of tax collection and detecting tax evasion.*”.

2. An excise tax, i.e., a tax similar to that of a final tax on consumption i.e. a tax based on that which you use; and
3. A withholding tax⁹¹ that could possibly be withheld and collected from the financial intermediaries that process the payments for the foreign purchases, i.e., banks.

It is evident from the above analyses that SA income tax legislation, and the OECD guidelines used by SA, appear to be inadequate for the taxation of e-commerce. It is thus necessary to consider solutions that may be suitable for SA. In order to find suitable solutions, this report will look at both local and international developments with regards to the taxation of e-commerce. Such developments are useful to analyse as they may help direct SA when proposing to implement a solution to the challenges that the digital economy and e-commerce pose in the realm of taxation.

⁹¹ It is interesting to note that SA did consider this solution, but never imposed it: A withholding tax on services in SA, was to be introduced on 1 January 2017 (at a rate of 15% subject to DTA relief) was withdrawn and replaced with onerous reporting requirements. Thus, no specific withholding taxes exist which would seek to impose taxes on the digital economy and the same shortcomings exist as are present in corporate income tax.

3. CONSIDERATIONS FOR A SOUTH AFRICAN SOLUTION

It must be noted that there has been both local and international developments with regards to the taxation of e-commerce.

Locally, SA has incorporated 'electronic services' into the VAT Act. On 28 March 2014 National Treasury published regulations listing various 'electronic services'.⁹² These include electronic services from the following categories: education; games and games of chance; internet-based auction services; miscellaneous services including e-books, audio-visual content, still images, music, subscription services, social media, web applications, software, online advertising services, information technology ("IT") related services and network services.⁹³ It also includes the provisions of these services "*by means of an electronic agent, electronic communication, or the internet*".⁹⁴

In the Budget Review of 2017,⁹⁵ it was stated that electronic services subject to VAT would be broadened to include cloud computing and other online services. National Treasury announced proposed changes to the definition of electronic services which would effectively broaden the definition to capture all types of electronic services⁹⁶- essentially anything that looks or feels like an electronic service is now in the net of taxation.

In February 2018 SARS released regulations prescribing electronic services for the purpose of the definition of "electronic services" in section 1(1) of the VAT Act, and will be deemed to have come into operation on 1 October 2018.⁹⁷ The regulations provide the updated and

⁹² GN R221 GG 37489 of 28 March 2014 available at <http://www.sars.gov.za/AllDocs/LegalDoclib/SecLegis/LAPD-LSec-Reg-2014-03%20-%20Regulation%20R221%20GG%2037489%2028%20March%202014.pdf> (last accessed 29 March 2018).

⁹³ *Ibid.*

⁹⁴ *Ibid.*

⁹⁵ National Treasury, Budget Review of 2017, available at <http://www.treasury.gov.za/documents/national%20budget/2017/review/FullBR.pdf> (last accessed 29 March 2018).

⁹⁶ Personal Finance, Major overhaul of VAT on electronic services, available at <https://www.iol.co.za/personal-finance/major-overhaul-of-vat-on-electronic-services-13469522> (19 March 2018).

⁹⁷ The charging provision Section 7(1) of the VAT Act, as of 1 April 2018, states that:

"...subject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax to be known as the value-added tax (a) on the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or

further expanded definition for electronic services.⁹⁸ The inclusion of “electronic services” in the VAT Act,⁹⁹ has provided that foreign suppliers of electronic goods and services are now liable to register for and pay for VAT in SA. The inclusion was done with the intention of protecting local suppliers (in order to place them on equal footing with foreign suppliers), addressing VAT leakages and to tax consumption in SA (thus, also protecting the tax base).¹⁰⁰ Entities outside of SA, i.e., non-resident entities supplying electronic services to SA citizens, will now be seen as carrying on an enterprise¹⁰¹ in SA.

The SA VAT legislation does not contain any place of supply rules.¹⁰² So if a person has any activity in SA which leads to a supply (irrespective if the supply is made in SA) of goods or services for a consideration that person will be conducting an enterprise for VAT purposes in SA. It is important to note that a foreign entity without a physical presence in SA will have a VAT registration liability if it conducts an enterprise and exceeds the VAT registration threshold.

furtherance of any enterprise carried on by him; (b) on the importation of any goods into the Republic by any person on or after the commencement date; and (c) on the supply of any imported services by any person on or after the commencement date, calculated at the rate of 15% on the value of the supply concerned or the importation, as the case may be”.

⁹⁸ Consolidated Regulations After Amendments To Regulations: Electronic Services For The Purpose Of The Definition Of “Electronic Services” In Section 1 Of The Value-Added Tax Act (21 February 2018), available at <http://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2018-25%20-%20Consolidated%20Regulations%20after%20Draft%20Amendments%20to%20Regulations%20electronic%20services.pdf> (last accessed 28 March 2018).

⁹⁹ The Taxation Laws Amendment Act, No 31 of 2013, introduced a definition of “Electronic Services” into the VAT Act.

¹⁰⁰ Folkert Gaarlandt and Jacques Harmse, *South Africa: New VAT rules for foreign suppliers of e-services*, 07/14 *Tax Planning International: Indirect Taxes Bloomberg BNA ISSN 1741-0886*, at 8-11.

¹⁰¹ An enterprise is defined in terms of section 1 of the VAT Act as:

“...any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration...”

An enterprise includes –

“(vi) the supply of electronic services by a person from a place in an export country, where at least two of the following circumstances are present:

(aa) The recipient of those electronic services is a resident of the Republic;

(bb) any payment to that person in respect of such electronic services originates from a bank registered or authorised in terms of the Banks Act, 1990 (Act No. 94 of 1990);

(cc) the recipient of those electronic services has a business address, residential address or postal address in the Republic”.

¹⁰² Van Zyl, S. P. (2013). Determining the place of supply or the place of use and consumption of imported services for value-added tax purposes: Some lessons for South Africa from the European Union. *South African Mercantile Law Journal* 25(4), 534-554; Beelders, DP. “Value Added Tax – Place Of Supply And The Taxation Of Electronic Cross Border Supplies Of Services And Intangibles”, unpublished Masters of Commerce dissertation, University of Cape Town (2015).

Internationally, countries have unilaterally imposed measures in order to combat the impact that the digital economy has had on their tax regimes and their tax bases, often not taking into consideration international treaties and double taxation agreements.¹⁰³ These measures vary from avoidance legislation (implemented by Australia¹⁰⁴), to diverted profits tax (implemented by both the United Kingdom¹⁰⁵ and Australia¹⁰⁶ and considered by France¹⁰⁷), to a withholding tax¹⁰⁸, to an equalisation levy (implemented by India¹⁰⁹), to a consumption tax (implemented by Japan¹¹⁰), to a virtual services PE (adopted by Kuwait¹¹¹) and a Web Tax (implemented by Italy¹¹²).

¹⁰³ See EC Draft Response paper as the first signs of a single block adopting a common position.

¹⁰⁴ Tax Determination (TD) *TD 2018/12 Income tax: schemes that limit a taxable presence in Australia under section 177DA of the Income Tax Assessment Act 1936 – meaning of ‘directly in connection with’*; Australian Multinational Anti Avoidance Law, <http://www.ey.com/gl/en/services/tax/international-tax/alert--australian-parliament-passes-bill-for-maal--cbc-reporting-and-increased-penalties-with-wider-ato-public-reporting> (last accessed 28 March 2018).

¹⁰⁵ UK Diverted profits Tax Law, guidance released in December 2018 at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/768204/Diverted_Profits_Tax_-_Guidance__December_2018_.pdf (last accessed 12 January 2019); [http://www.ey.com/Publication/vwLUAssets/EY-diverted-profits-tax/\\$FILE/EY-autumn-statement-diverted-profits-tax.pdf](http://www.ey.com/Publication/vwLUAssets/EY-diverted-profits-tax/$FILE/EY-autumn-statement-diverted-profits-tax.pdf) (last accessed 28 March 2018).

¹⁰⁶ In the 2016–17 Budget, the Australian government announced that it would introduce a diverted profits tax (DPT). The DPT came into effect on 1 July 2017 and imposes a 40% tax. Available at <https://www.ato.gov.au/general/new-legislation/in-detail/direct-taxes/income-tax-for-businesses/diverted-profits-tax/?=redirected> (last accessed (12 January 2019); EY Global Tax Alert, “Australia passes Diverted Profits Tax and Penalties law”, 30 March 2017 available at <http://www.ey.com/gl/en/services/tax/international-tax/alert--australia-passes-diverted-profits-tax-and-penalties-law> (last accessed 28 March 2018).

¹⁰⁷ It is interesting to note that France included a proposed diverted profits tax in their draft Finance Bill for 2017 which was subsequently struck down by the French Constitutional Court, <http://www.ey.com/gl/en/services/tax/international-tax/alert--french-diverted-profits-law-struck-down-by-constitutional-court> (last accessed 28 March 2018).

¹⁰⁸ An option suggested by the OECD was a withholding tax that could be levied on payments made by resident customers for goods and services bought online. In order for South Africa to introduce such a levy it would have to specifically define the source and make sure that it is able to adequately address the digital economy and e-commerce transactions, this could possibly require new source rules. As mentioned above, South Africa previously abandoned the withholding tax it intended on introducing on service fees. This withholding tax was meant to address electronic services. The United Kingdom intends on implementing such a withholding tax i.e. the UK royalty withholding tax (intending on implementation in April 2019 subject to consultation).

¹⁰⁹ Equalisation Levy was introduced in India in the year, 2016 (*notification no. 37/2016: F.NO. 370142/12/2016-TPL*); EY Global Tax Alert, “India proposes equalization levy on digital e-commerce transactions in 2016 budget”, 2 March 2016, available at [http://www.ey.com/Publication/vwLUAssets/India_proposes_equalization_levy_on_digital_e-commerce_transactions_in_2016_budget/\\$FILE/2016G_CM6293_IN%20proposes%20equalization%20levy%20on%20e-commerce%20trans%20in%202016%20budget.pdf](http://www.ey.com/Publication/vwLUAssets/India_proposes_equalization_levy_on_digital_e-commerce_transactions_in_2016_budget/$FILE/2016G_CM6293_IN%20proposes%20equalization%20levy%20on%20e-commerce%20trans%20in%202016%20budget.pdf) (last accessed 28 March 2018).

¹¹⁰ <https://www.pwc.com/jp/en/taxnews/pdf/jtu115-dec-2015-en.pdf> (last accessed 28 March 2018).

¹¹¹ EY Global Tax Alert, “Kuwait Tax Authorities adopt “Virtual Service PE” concept”, 21 September 2015 available at <http://www.ey.com/gl/en/services/tax/international-tax/alert--kuwait-tax-authorities-adopt-virtual-service-pe-concept> (last accessed 28 March 2018).

¹¹² Law n. 205 of December 27, 2017 (Italy Web Tax, see also: EY Global Tax Alert, “Italy enacts Web Tax and new PE definition”, 29 December 2017, available at <http://www.ey.com/gl/en/services/tax/international-tax/alert--italy-enacts-web-tax-and-new-pe-definition> (last accessed 28 March 2018).

The OECD's BEPS Action Plan is specifically targeted at multi-national enterprises that have devised tax strategies and structures that exploit the loopholes and mismatches in tax rules. The BEPS Action Plan and the OECD MTC and the OECD Commentary act as a guideline for tax administration in OECD member countries, such as SA. BEPS Action Plan 1 specifically deals with the digital economy and further updates and guidelines are expected to be released in 2020.¹¹³ It is believed that the OECD may hasten their efforts to bring out these guidelines sooner,¹¹⁴ as many feel that the OECD have been too cautious in their 2015 Final Report and in their 2017 update of the OECD MTC,¹¹⁵ and consequently, the recommendations of the OECD do not yet adequately deal with the digital economy.¹¹⁶

The European Union, specifically the Economic and Financial Affairs Council configuration ("ECOFIN"),¹¹⁷ has expressed doubts with regards to the BEPS Action Plan and does not believe that it will be able to adequately address the tax challenges imposed by the digital economy.¹¹⁸ The suggested measures in the 2015 Final Report fails to address the core problem timeously, especially since the final report failed to establish a 'significant digital presence' test,¹¹⁹ which leads one to believe that this may be the reason for the European

¹¹³ Evaluating BEPS, New York University School of Law, "Colloquium on Tax Policy and Public Finance", by Reuven S. Avi-Yonah, 23 February 2016.

¹¹⁴ Guillermo O. Teijeiro, 'A call for a Sustainable Response to the taxation of Digital Economy within the International Income Tax System', Kluwer International Tax Blog, October 5 2017, available at <http://kluwertaxblog.com/2017/10/05/call-sustainable-response-taxation-digital-economy-within-international-income-tax-system/> (last accessed 28 March 2018); EY Global Tax Alert, "ECOFIN discusses development of new digital taxation rules", 19 September 2017, available at [http://www.ey.com/Publication/vwLUAssets/ECOFIN_discusses_development_of_new_digital_taxation_rules/\\$FILE/2017G_05322-171Gbl_ECOFIN%20discusses%20development%20of%20new%20digital%20taxation%20rules.pdf](http://www.ey.com/Publication/vwLUAssets/ECOFIN_discusses_development_of_new_digital_taxation_rules/$FILE/2017G_05322-171Gbl_ECOFIN%20discusses%20development%20of%20new%20digital%20taxation%20rules.pdf) (last accessed 28 March 2018).

¹¹⁵ On 11 July 2017, the OECD released the draft contents of the 2017 update to the OECD MTC. This particular update made changes to the Commentary on Article 5 (Permanent Establishments), integrating changes made to the BEPS Action 7 (*Preventing the Artificial Avoidance of Permanent Establishment Status*) of the OECD MTC.

¹¹⁶ Evaluating BEPS, New York University School of Law, "Colloquium on Tax Policy and Public Finance", by Reuven S. Avi-Yonah, 23 February 2016, at 14.

¹¹⁷ EY Global Tax Alert, "ECOFIN discusses development of new digital taxation rules", 19 September 2017, available at [http://www.ey.com/Publication/vwLUAssets/ECOFIN_discusses_development_of_new_digital_taxation_rules/\\$FILE/2017G_05322-171Gbl_ECOFIN%20discusses%20development%20of%20new%20digital%20taxation%20rules.pdf](http://www.ey.com/Publication/vwLUAssets/ECOFIN_discusses_development_of_new_digital_taxation_rules/$FILE/2017G_05322-171Gbl_ECOFIN%20discusses%20development%20of%20new%20digital%20taxation%20rules.pdf) (last accessed 28 March 2018).

¹¹⁸ European Parliament, "Tax Challenges in the Digital Economy", prepared by the Policy Department A: Economic and Scientific Policy, June 2016.

¹¹⁹ Guillermo O. Teijeiro, 'A call for a Sustainable Response to the taxation of Digital Economy within the International Income Tax System', Kluwer International Tax Blog, October 5 2017, available at <http://kluwertaxblog.com/2017/10/05/call-sustainable-response-taxation-digital-economy-within-international-income-tax-system/> (last accessed 28 March 2018).

Commission's discussions and proposed actions on the matter. As a result, Finance and Economic Ministers of the EU Member states met to discuss the challenges of tax rules in the digital world economy.¹²⁰ A two-phased approach¹²¹ was agreed to at the meeting and would be further assessed for viability (the first draft was released on 15 March 2018).

The meeting high-lighted and emphasised the fact that global tax rules have been unable to keep up with and adapt to the digitalisation of companies and their new business models (their proposed solution to this, which includes a PE concept suitable for electronic commerce, is discussed in detail in below) - this being especially visible in the international tax arena for the past decade.¹²² The above has essentially created a loophole (which companies such as Google and Facebook have taken advantage of)¹²³ that threatens to undermine the principle of tax neutrality and the pressure to close this loophole is growing.

Reflecting on the various global responses of tax administrations, it is apparent that not only is there a readiness to develop tax regimes to tax the digital economy, but there is a need for the taxation of the digital economy. Whilst SA has introduced VAT on electronic services, it possibly needs to develop its income tax legislation for a more significant and effective response or solution to the taxation of the digital economy and e-commerce.

It is submitted amongst a large portion of the academic community and policy-makers that the current rules of the international tax system are unfit for the digital economy and e-commerce activities. There is not much opposition among tax administrators, policy makers, and economists against a "virtual PE" if it is implemented as part of an internationally

¹²⁰ Economic and Financial Affairs Council configuration (ECOFIN) 5 December 2017 Meeting, available at <http://www.consilium.europa.eu/en/meetings/ecofin/2017/12/05/>. (last accessed 28 March 2018).

¹²¹ The two-phased approach intends on using a short-term interim targeted 'fix', while a long-term final and comprehensive 'fix' can be studied and appropriately modelled. Thus, the initial or transitional phase will focus on the adoption of an Equalisation levy, while the possible adoption of a digital PE concept can be studied and appropriately modelled for the long term. Once the model has been agreed to, there would no longer be a need for the equalisation levy (in theory) and the levy could be removed.

¹²² EY Global Tax Alert, "*ECOFIN discusses development of new digital taxation rules*", 19 September 2017, available at [http://www.ey.com/Publication/vwLUAssets/ECOFIN_discusses_development_of_new_digital_taxation_rules/\\$FILE/2017G_05322-](http://www.ey.com/Publication/vwLUAssets/ECOFIN_discusses_development_of_new_digital_taxation_rules/$FILE/2017G_05322-171Gbl_ECOFIN%20discusses%20development%20of%20new%20digital%20taxation%20rules.pdf)

[171Gbl_ECOFIN%20discusses%20development%20of%20new%20digital%20taxation%20rules.pdf](http://www.ey.com/Publication/vwLUAssets/ECOFIN_discusses_development_of_new_digital_taxation_rules/$FILE/2017G_05322-171Gbl_ECOFIN%20discusses%20development%20of%20new%20digital%20taxation%20rules.pdf) (last accessed 28 March 2018).

¹²³ Johannes Becker, "*EU Digital Services Tax: A Populist and Flawed Proposal*", Kluwer International Tax Blog, 16 March 2017 (last accessed 28 March 2018).

coordinated reform.¹²⁴ The same, however, cannot be seen with the proposal for an interim and targeted solution in the form of an equalisation levy.¹²⁵

This report, in Part 1 and 2, submits that the majority of cross-border e-commerce transactions escape income tax due to the lack of appropriate legislation in SA for e-commerce activities and the digital economy as a whole. In order to address the impact and challenges that the digital economy has brought about, SA would have to introduce new tax policy or develop its current tax policy. The development of digital businesses, goods and services and e-commerce transactions, have created a necessity to modify, expand upon and develop the existing PE rules and/or to create new rules that will address these new types of businesses, their business models and transactions, digital goods and services and e-commerce transactions.

When doing so, SA should take into consideration the international guidelines for the creation and implementation of a tax policy or framework. The policy should be: neutral; efficient; certain and simple; effective and fair; and it should be flexible.¹²⁶

Further to this, in a report by the Davis Committee, a respected tax system or policy introduced should establish and contain the following characteristics:¹²⁷

- 1) The realisation of economic efficiency as a result of charging tax at low rates to a broad base;
- 2) The realisation of administrative efficiency as a result of using less resources i.e. reduce administrative and compliance costs;
- 3) The creation of equity through the use of the ‘ability to pay’ and the ‘benefit’ principle i.e. this can be realised when the tax burden is allocated to taxpayers based on the benefits they receive from the government;
- 4) The realisation of fairness i.e. the tax system should be fair with regard to the procedure followed and assurance of non-discrimination;

¹²⁴ *Ibid.*

¹²⁵ *Ibid.*

¹²⁶ OECD *Addressing the tax challenges of the digital economy*, 2014, Chapter 2 Fundamental principles of taxation, paragraph 2.1 at 30-31.

¹²⁷ Davis Tax Committee, *Executive Summary Of The Final Report On Macro Analysis Of The Tax System And Inclusive Growth In South Africa*, April 2016.

- 5) The realisation of a tax system that is clear, simple and easy to understand; and
- 6) The realisation of a tax system that balances fiscal policy and objectives with the characteristics of a 'good' tax system whereby all taxes in the system are viewed in a holistic manner.

The policy envisaged will need to clearly define jurisdiction, it must contain a clear distinction and reach of the state's taxing rights with regards to e-commerce transactions. The transactions and the circumstances in which they will give rise to a tax liability must be clearly defined. The policy must ensure that there is also sufficient economic activity to generate and justify levying such a tax policy upon such transactions.

The policy will have to be able to establish that an economic presence and virtual presence can constitute a legal presence in the country. A connection and essentially a tax and economic 'nexus' must be established between SA and the income or business profits derived from e-commerce transactions and digital activities.¹²⁸

Considering the above and the fundamental principles of a respectable tax system and tax policy, as well as looking at the international responses and developments with regards to the taxation of the digital economy, SA can consider incorporating the following two options to tax e-commerce. They could do so as a two phased approach (such as ECOFIN suggests) or implement the two solutions permanently.¹²⁹

The two-phased approach intends on using a short-term interim targeted 'fix', while a long-term final and comprehensive 'fix' can be studied and appropriately modelled. Thus, the initial or transitional phase will focus on the adoption of an Equalisation levy, while the possible adoption of a digital PE concept can be studied and appropriately modelled for the long term. Once the model has been agreed to, there would no longer be a need for the equalisation levy (in theory) and the levy could be removed.¹³⁰ SA could use the approach suggested by ECOFIN or they could consider leaving the Equalisation levy in as a catch-all clause, however, ensuring that no Double Taxation takes place. Both the equalisation levy

¹²⁸ AW Oguttu, "*International Tax Law: Offshore Tax Avoidance in South Africa*", 2015 at 67.

¹²⁹ Please refer to "Council conclusions on 'Responding to the challenges of taxation of profits of the digital economy'" found at <https://www.consilium.europa.eu/media/31933/st15175en17.pdf> (last accessed 29 March 2018).

¹³⁰ *Ibid.*

and the digital PE¹³¹ would need to be unilateral measures, until such time as other countries incorporate similar measures and countries can find agreeable terms for double taxation agreements.

A. An Equalisation Levy

An option first suggested by the OECD Report was an Equalisation levy that could be introduced to essentially level the playing field between local suppliers and foreign suppliers of goods and services.¹³²

ECOFIN has suggested in their first draft that a uniform tax rate of 3 % is to be levied on gross turnover (as a unilateral measure). SA can use the draft as a guideline to draft appropriate legislation for the equalisation levy. What must be taken into consideration with unilateral measures is that it possibly allows a situation where countries i.e. domestic law can override tax treaties unilaterally^{133 134}.

The basis of this equalisation levy concept is to tax companies (which is specifically targeted at multinationals) with business models wherein consumers contribute considerably to the value chain and value creation. The tax will affect all operators of “digital interfaces” that deliver one of the following three categories of services:¹³⁵

- (1) Advertising space for advertising that is aimed at consumers of that interface;
- (2) Intermediation services (such as those offered by Airbnb and Uber);
- (3) The sale or other process of the transmission of data collected about consumers based on and generated from consumers’ activities.

Under the ECOFIN first draft e-commerce platforms such as Amazon and companies which only provide media content or other digital services such as Netflix and Spotify are out of

¹³¹ Davis Tax Committee op cit note 2 at.5.

¹³² AW Oguttu, “*International Tax Law: Offshore Tax Avoidance in South Africa*”, 2015 at 302.

¹³³ This is commonly referred to as treaty override. This means that domestic law negates the effect of the treaty, in whole or in part. This would be unusual as in most countries treaties are given a superior status to that of domestic laws.

¹³⁴ Mukesh Butani, Sumeet Hemkar (BMR Advisors), “*Indian equalisation levy –progressive or regressive?*”, Kluwer International Tax Blog, June 27, 2016 , available at <http://kluwertaxblog.com/2016/06/27/indianequalisation-levy-progressive-regressive/>).

¹³⁵ *Ibid.*

scope.¹³⁶ My belief is that SA needs to draft the equalisation levy to bring such platforms into scope.

It must be noted that the European Commission's proposal above for an interim Digital Services Tax has not been well received by the international community. Becker¹³⁷ stated that the proposal for an interim Digital Services Tax is badly motivated, "mismatch" of value creation and taxation and fails to reach every objective (such as levelling the playing field between local and foreign suppliers) mentioned by the Commission. He goes on to state that the proposal creates a nightmare of complexity and legal uncertainty and that the proposal challenges Europe's most important trading partners.¹³⁸ Becker, sees no way in which this tax can be harmonized or collection enforced.

India has introduced an Equalisation levy of 6% of for specified services received by a non-resident (not having a PE in India), from a resident in India who carries out an enterprise (in the form of goods or services), or from a non-resident having a PE in India. The levy is specifically aimed at specified services delivered by means of the internet, and India's main target is online advertising. Whilst India does not follow the PE model of the OECD (unlike SA),¹³⁹ SA can look to India for a lessons learnt on how the levy was implemented and received.

It must be noted that, the implementation of such an equalisation levy may easily create a summative over-taxation in SA, resulting from the coinciding application of similar levies by other jurisdictions in the market, as well as causing an overlap with VAT on the importation of services, and more recently in SA 'electronic services'.¹⁴⁰ This is especially true in SA, where there is already VAT on 'electronic services'.

¹³⁶ *Ibid.*

¹³⁷ Johannes Becker, "EU Digital Services Tax: A Populist and Flawed Proposal", Kluwer International Tax Blog, 16 March 2017.

¹³⁸ *Ibid.*

¹³⁹ EY Global Tax Alert, "India's positions on permanent establishment in OECD's 2017 Update to Model Tax Convention and Commentary", 14 December 2017, available at [http://www.ey.com/Publication/vwLUAssets/Indias_positions_on_permanent_establishment_in_OECDs_2017_Update_to_Model_Tax_Convention_and_Commentary/\\$FILE/2017G_07079-171Gbl_Indias%20positions%20on%20PE%20in%20OECDs%20Update%20to%20Model%20Tax%20Convention%20and%20Commentary.pdf](http://www.ey.com/Publication/vwLUAssets/Indias_positions_on_permanent_establishment_in_OECDs_2017_Update_to_Model_Tax_Convention_and_Commentary/$FILE/2017G_07079-171Gbl_Indias%20positions%20on%20PE%20in%20OECDs%20Update%20to%20Model%20Tax%20Convention%20and%20Commentary.pdf) (last accessed 28 March 2018).

¹⁴⁰ Guillermo O. Teijeiro, 'A call for a Sustainable Response to the taxation of Digital Economy within the International Income Tax System', Kluwer International Tax Blog, October 5 2017, available at

Thus, SA should, moving forward, study and decide if it is feasible and fair to implement and enforce an equalisation levy in SA. If implemented, the equalisation levy does not only have to be an interim solution, it can be a long term solution too. There is no need to take the time to implement the legislation only to remove it. In order for less confusion and more consistency in the law, the solution can be kept as a catch all provision, so long as the principles of fairness and the Vienna Convention¹⁴¹ are followed when implementing such a solution. If SA is unwilling to implement the equalisation levy, it should abandon the implementation of such a tax (which it may find difficulty in enforcing) and solely focus on the implementation of “A Virtual or Digital or Significant Presence Permanent Establishment Concept”.

B. A Virtual/Digital/Significant Presence Permanent Establishment Concept

The current PE concept and its traditional principles have been rendered redundant by the digital economy and e-commerce. The OECD recommendations are unable to address enterprises that comprise of a pure digital business model.¹⁴²

The PE concept was created with the aim of aligning taxation rights with the country where the economic activities of the enterprise that give rise to business profits are performed i.e. where value is created. A PE cannot be established in a source country if it did not have a physical presence (*nexus*) and it was not sufficiently participating in the economic life of the source country- there needed to be a justifiable reason for the source country to obtain the taxing rights on the business profits derived by the non-resident enterprise within its jurisdiction.¹⁴³

In the OECD 2014 Draft Report a new *nexus* test was proposed as an option to address the challenges of the digital economy - the ‘significant digital presence test’. The test was not published in the OECD 2015 Final Report nor the OECD 2017 update.

<http://kluwertaxblog.com/2017/10/05/call-sustainable-response-taxation-digital-economy-within-international-income-tax-system/>) (last accessed 28 March 2018).

¹⁴¹ Vienna Convention on the Law of Treaties, 23 May 1969.

¹⁴² AW Oguttu, “*International Tax Law: Offshore Tax Avoidance in South Africa*”, 2015.

¹⁴³ Commentary on Article 7, 2014 OECD MTC, paragraph 11, at.134.

The author believes that a ‘virtual permanent establishment’ or a ‘significant presence permanent establishment’ should be introduced by SA. SA could use and expand upon such a concept by using the newly enacted Italian Web Tax and the economic nexus rule.¹⁴⁴

Additionally, SA can study the Web Tax introduced by Italy (mentioned above). SA could expand on its PE definition, found in s1 of the Act, to include a provision which states that “a significant and continuous economic presence in the territory of the State set up in a way that it does not result in a substantial physical presence in the same territory”¹⁴⁵ may constitute a PE.

This expansion will ensure that the term PE now applies to foreign enterprises that do not have a physical presence or nexus within SA, but rather the enterprise has a consistent and continuous economic presence in the country. SA can state that in order to fall part of the definition, the enterprise has to be proven to engage in ancillary activities that are a crucial component of its core business; or that the enterprise operates through representatives or other agents who do not enter into contracts in the name of the enterprise, but, however, still negotiate and secure the conclusion of contracts that are finally signed by the directors of the enterprise with no material modifications.¹⁴⁶

The economic nexus rule¹⁴⁷ can be used in order to show a significant or ‘economic’ presence in SA, with regards to digital enterprises and their business models or enterprises that operate using e-commerce activities i.e. their ‘economic’ activities. SA can look at the definition and approach used by Italy, the United States and Taiwan regarding the economic nexus rule. Thus, when using this rule, it must be stated in order to be considered to have a PE, a foreign enterprise in SA will create a PE whenever the foreign enterprise’s activities result in a

¹⁴⁴ Consistent the OECD Final Report on the *Tax Challenges of the Digital Economy* (Action 1), released under OECD’s *Action Plan on Base Erosion and Profit Shifting (BEPS)* on October 15, 2015; and one could incorporate the views of Peter Hongler and Pasquale Pistone, “*Blueprints for a New Nexus to Tax Business Income in the Era of the Digital Economy*”, 20 January 2015, published by the IBFD.

¹⁴⁵ Law n. 205 of December 27, 2017 (Italy Web Tax, see also: <http://www.ey.com/gl/en/services/tax/international-tax/alert--italy-enacts-web-tax-and-new-pe-definition>)).

¹⁴⁶ Marco Rossi “Italy Enacted The Economic Nexus Rule And Other Changes To The Definition of Permanent Establishment” *European Union and Italian International Tax Law Blog* (26 February 2018) available at <https://www.euitalianinternationaltax.com/2018/02/articles/international-taxation/italy-enacted-economic-nexus-rule-changes-definition-permanent-establishment/> (last accessed 28 March 2018).

¹⁴⁷ This is consistent and in line with the OECD Final Report on the *Tax Challenges of the Digital Economy* (Action 1), released under OECD’s *Action Plan on Base Erosion and Profit Shifting (BEPS)* on October 15, 2015.

‘regular, continuous and significant economic presence within the territory of the country’.¹⁴⁸ By using and incorporating the economic nexus rule, physical presence is no longer required for the existence of a PE.

In order to ensure that the definition is not too wide, SA needs to ensure that a list of activities (such as preparatory and auxiliary serves) which are excluded from the definition of PE must be included in the legislation or announced each year in the Government Gazette by the Minister of Finance.¹⁴⁹ It would also be necessary for SA to include an anti-fragmentation rule¹⁵⁰ into such a list.¹⁵¹

In order for completeness, when considering a dependent agency PE under the new definition, SA would have to ensure that the definition would now include commissionaire arrangements¹⁵² i.e. a dependent agent who habitually plays the principal role that leads to the conclusion of contracts that are consistently concluded without material modification by the enterprise. These contracts must:

- (1) be in the name of the enterprise; or
- (2) be for the transfer of the ownership of, or for the granting of the right to use, property (tangible or intangible) owned by that enterprise or that the enterprise has the right to use; or
- (3) be for the provision of services by that enterprise.

Even though, a virtual or significant presence PE concept will be created through the new definition of PE in the legislation, SA must still bear in mind international law and tax treaty principles engrained in the SA Constitution. Whilst there is no doubt that the new definition

¹⁴⁸ Marco Rossi “Italy Enacted The Economic Nexus Rule And Other Changes To The Definition of Permanent Establishment” *European Union and Italian International Tax Law Blog* (26 February 2018) available at <https://www.euitalianinternationaltax.com/2018/02/articles/international-taxation/italy-enacted-economic-nexus-rule-changes-definition-permanent-establishment/> (last accessed 28 March 2018).

¹⁴⁹ Such a provision would be consistent and in line with the clarifications that have been provided in the Commentary to Article 5 of the 2017 OECD Model Income Tax Convention, at paragraph 60; and with option A of Article 13 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profits Shifting, signed on 7 June 2017.

¹⁵⁰ As explained in BEPS Action Plan 7, the purpose of which is to prevent an enterprise or a group of closely related enterprises from “Fragmenting” a cohesive business operation into smaller business operations in order to argue that each performs a preparatory or auxiliary activity and thus cannot be said to create a PE.

¹⁵¹ Commentary to Article 5 of the 2017 OECD Model Income Tax Convention, at paragraph 60; and with option A of Article 13 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profits Shifting, signed on 7 June 2017. at 79.

¹⁵² This provision would be consistent and in line with Article 12 of the Multilateral Tax Convention and Action 7 of OECDs BEPS Action Plan.

needs to be incorporated in order to tax the digital economy, SA also needs to ensure that the legislation will not override Article 5 of existing treaties but perhaps just broaden its application.

Thus, SA should, moving forward, study and decide if it is feasible and fair to implement and enforce an equalisation levy at an appropriate rate; and if SA should consider changing the definition of PE as mentioned above. The Davis Committee has also suggested that SA change its source rules and incorporate new source rules that deal with the taxation of the digital economy.¹⁵³ This should be done bearing in mind all principles mentioned above, in order to maintain a fair, neutral and respected tax system. Once SA has included this into legislation with the above considerations, SA will need to renegotiate its tax treaties in order to achieve uniformity and consistency, whilst also bearing the new PE concept in mind and any relevant Conventions¹⁵⁴.

¹⁵³ Davis Tax Committee op cit note 2 at 4.

¹⁵⁴ *Ben Nevis (Holdings) Limited & Metlika Trading Limited v The Commissioners for HMRC (Her Majesty's Revenue and Customs)* [2013] EWCA Civ 578 at para 17-18.

4. CONCLUSION

As early as 2000, there have been predictions that tax administrations across the globe would have to adapt and develop as a result of the rapid development of the digital economy-

*“...tax authorities will have to adapt their application of existing tax principles, practices and procedures for an e-commerce environment. Alternatively, new methods of levying and collecting taxes will have to be devised. Taxpayers, on the other hand, will have to adapt their tax planning strategies and consider the impact of a changing business environment on their global tax charge.”*¹⁵⁵

The predicament above, has certainly rung true. E-commerce has caused wide spread panic and chaos in the international arena of tax. The impact and resultant challenges that e-commerce has caused for tax administrations globally is not a fiction.

The impact of the questions e-commerce has posed to taxation is evident from the discussions and commentaries published by the OECD, the European Commission (“EC”), the United Nations (“UN”), and the various and differing responses and international developments that have arisen as a result of these challenges (discussed above). There has been no cohesion or common agreement between countries on the matter- it suffices to say that there is no uniform response to a universal and common problem. Countries have unilaterally imposed measures in order to combat the impact that the digital economy has had on their tax regimes and their tax bases, often not taking into consideration international treaties and double taxation agreements.¹⁵⁶

It is submitted amongst a large portion of the academic community and policy-makers that the current rules of the international tax system are unfit for the digital economy and e-commerce activities. There is not much opposition among tax administrators, policy makers, and economists against a “virtual PE” if it is implemented as part of an internationally

¹⁵⁵ “Taxation of E-commerce: Income Tax”, Cyberlaw@SA, Van Schaik Publishers by B Du Plessis and M Viljoen, at 231.

¹⁵⁶ See EC Draft Response paper as the first signs of a single block adopting a common position.

coordinated reform.¹⁵⁷ The same, however, cannot be seen with the proposal for an interim and targeted solution in the form of an equalisation levy.¹⁵⁸

It is submitted that the current application of SA income tax legislation and source principles, are not sufficient nor is it effective when determining the taxation of the digital economy.

Implementing the solutions discussed in Part 3 will be the stepping stones to the start of recognising and taxing the digital economy. As one can see, the digital economy and e-commerce activities and their respective operating business models are ever adapting and evolving to unimaginable heights- tax systems and administrators around the world are going to have to evolve and adapt in the same way if they intend on keeping up and not having their tax bases eroded/diminished. Ideally, it would be best if tax administrations across the world would unite and combat the challenges posed by the digital economy with a uniform and consistent solution.¹⁵⁹

¹⁵⁷ *Ibid.*

¹⁵⁸ *Ibid.*

¹⁵⁹ See also European Commission on *Digital single market*, available at https://ec.europa.eu/commission/priorities/digital-single-market_en (last accessed 28 March 2018).

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