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Base erosion and profit shifting in the applications economy– B2C

The 'Uber'economy

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Abbreviations and Acronyms

App economy	Applications economy
Apps	Applications
BEPS	Base erosion and profit shifting
CFC	Controlled Foreign Company
DMBM	Digital Mobile Business Model
DTA	Double Tax Agreement
DTC	Davis Tax Committee
ICT	Information and Communication Technology
IP	Intellectual Property
ISP	Internet Service Provider
ITA	Income Tax Act
MNC	Multinational corporation
MNE	Multinational entity
Mobile Apps	Mobile applications
MTC	Model Tax Convention
OECD	Organisation for Economic Co-operation and development
OECD MTC	OECD's Model Tax Convention
PE	Permanent Establishment
TP	Transfer Pricing
VAT	Value-added Tax
WHT	Withholding Tax

Abstract

Today's world is driven by mobile technology from which businesses' function by interacting and transacting with customers in such a way that allows no physical contact between the parties. This cloud transacting has been enabled by software applications that exist on mobile devices allowing trade to take place across borders within different jurisdiction. These software applications have eliminated the need to establish subsidiaries and branches in countries which makes it difficult to locate the jurisdiction from which the cloud transaction has taken place. This new shift in physical operations has enabled Multinational Corporations MNCs to exploit gaps created in the international taxation arena due to old tax laws that were created at the time when border controls and regulations in the capital markets were relied on to protect against base erosion and profit shifting (BEPS). The main purpose of this research paper is to interrogate the current gaps that exist in the tax legislation specifically relating to the applications economy, reviewing relevant case studies both locally and internationally, in an attempt to fill the gaps in the local tax regime. This research will propose solutions to these gaps in an attempt to contribute towards South African applications technology taxation literature.

Keywords

Multinational Corporations (MNCs), Base Erosion and Profit Shifting (BEPS), Organization for Economic Co-operation and Development (OECD), Model Tax Convention (MTC), Permanent Establishment (PE), Intellectual Property (IP), Controlled Foreign Company (CFC), Information and Communication Technology (ICT), Transfer Pricing (TP), Withholding Tax (WHT), Double Tax Agreement (DTA), Digital Mobile Business Model (DMBM), OECD's Model Tax Convention (OECD MTC), Internet Service Provider (ISP), Income Tax Act (ITA).

Chapter 1

Introduction

The digital applications economy is an economy created through economic activity that takes place over mobile devices facilitated by software programs that have been developed and installed in these mobile devices, and use the network to operate. The information stored on these mobile applications is often stored on an external server which frees up space on the mobile device as all the backend information is stored on an external server, allowing multiple applications to be stored on one mobile device at a time depending on the memory capacity of the device.

These mobile applications, depending on the types, can be used by consumers to purchase products and services any day anytime and anywhere around the world. The mobile devices where such applications are installed include smartphones and tablets, and exclude desktop computers. The economic activity in this market includes the sale of applications, advertising services, public relations educational services, the purchase of music and physical goods or other forms of services explained in this study.

In 2007, virtually no mobile apps existed. As of 2011, more than 25 billion apps have been downloaded.¹

Today's global economy is largely driven by technological advances imminent from innovation.² Innovation has created new businesses in new markets that were never imagined back when current tax laws were developed. Innovation has created new economies such as the digital applications economy referred to above where transactions may take place across borders with little or no exchange control policy restriction in many countries and less barriers to entry in the markets created by the digital applications economy. The digital applications economy has enabled Multinational Corporations (MNCs) to grow at a pace never been seen in previous times. Many of them have been able to penetrate new markets, generate profits without needing physical office space and multiple human resources, trade both day and night with ease being resident in one country but operating in multiple countries, including the home country, with or without the use of an agent in those countries.

¹ Techopedia.com, (2016).

² OECD. (2007)

The application economy has been enabled in most instances through the use of intangible assets. These intangible assets tend to drive all types of business and are recognized in tax systems and taxed accordingly.³ Technology companies however are making good legal use of discrepancies between national tax systems by relocating intellectual property (IP), an intangible asset, to tax havens or countries with low tax rates; away from the nation where it was created.⁴ This enables businesses to shift profits through payment of high licensing fees for the use of those intangibles.

Furthermore, the applications economy through the capacity to enable electronic trading, has allowed services and goods to be delivered to consumers without the need to be physically present in the countries in which they operate. This factor facilitates the bypass of traditional rules of physical presence, which forms the basis on which taxing rights in the current international tax legislation is rested.⁵

In terms of Article 7(1) of the Organization for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital, a contracting state will only have taxing rights in respect of the business profits of a foreign enterprise that is a resident of another contracting state if the enterprise has a “permanent establishment” (PE), as defined in Article 5, in that state to which such profits are attributable.⁶

To illustrate this factor from a local standpoint, currently in South Africa there appears to be very little guidance or rules regarding the collection of tax from a business that has no or a very short physical presence in a country especially at the corporate income tax level than at the indirect tax level to determine where the profits are to be taxed.

Due to this potential loss of tax revenue, the applications economy has raised a big concern for many tax jurisdictions. To this extent, the OECD has developed an action plan to address the challenges raised by base erosion and profit shifting in the digital economy. The OECD solution has come in the form of Action Plan 1. According to Deloitte, Action Plan 1 of the OECD plan in respect of the 2014 BEPS

³ Simpson, C. (2016)

⁴ Simpson, C. (2016))

⁵ Trepelkov, A., Tonino, H. and Halka, D. (2013).

⁶ Saica (2016).

recommends all VAT jurisdictions to apply the “destination basis”, and place of consumption rules set out by the OECD. In this way, the ability for MNCs to shift profits can be curbed as the imposition of VAT is based on where the recipient is located and not where the supplier may have established itself.⁷

The above guidance does not appear to have been implemented by many taxing states, or if implemented the guidance still falls short of addressing the collection of corporate taxes from an entity with no physical presence and PE status in the country. Even more interesting is when that service or goods do not require physical delivery such as a call center type of service provided by the MNCs such as Uber, advertising services on mobile applications consumed by millions of residents in different countries at a time, how the tax revenue from such operations are currently been collected in SA. Even though there is guidance available from the OECD, a lot of work to improve the triggers to taxing rights of revenue earned in this manner, whether it's through improving the determination of the point at which the non-resident creates a permanent establishment in the source state to be subjected to domestic laws, or the creation of a virtual permanent establishment rules, more work still remains to be done.

In June 2014, the National Treasury instigated legislation to levy Value-Added Tax (VAT) on foreign entities providing electronic services to local consumers within the South African market place in an effort to curb this base erosion. Currently, the scope is limited to educational services, games, auction services, e-books, audio visual content, still images, music and subscription based services and still expecting an amendment to include software.⁸ Even though VAT legislation requiring foreign owned entities in the technology industry to register and charge VAT on the above mentioned services, the gap still remains wide. Giants such as Uber and Airbnb have entered the South African market less than 5 years and through untightened transfer pricing rules, un-broadened scope in the definition of PE status, double tax treaty or

⁷ Deloitte South Africa. (2016).

⁸ Temkin, S. (2016)

treaty arbitrage and untightened exchange control policy rules, are able to repatriate profits out of the country paying little or no taxes in South Africa.

Currently the definition of permanent establishment in article 5 appears to exclude websites, software and servers however there's a suggestion to move towards virtual permanent establishment. Recent developments in this article will be considered to assist in establishing taxing rights to the profits generated in the applications economy. South Africa is not a member of the OECD (having observer status and an enhanced relationship only) but many of South Africa's double tax agreements (DTA's) are based on the OECD MTC and therefore this model is important and relevant in the analysis.

The aim of this research paper is to establish the current gaps that exist in the tax legislation specifically relating to the applications economy, using current local relevant legislation and making use of the relevant OECD articles, studying the permanent establishments (PEs) definition as laid out in Article 5 of the OECD model tax convention as this will be essential in providing guidance to determine the jurisdiction with the taxing rights to the profits generated in the applications economy.

This study seeks to highlight through case studies the advantages MNCs have over local companies in the country due to the lack of systems and processes to crack down base erosion caused by the digital applications economy and suggests solutions to curb base erosion created in this manner.

Problem Statement

The statement of the problem

Has South Africa ensured (by aligning its current tax laws to changes in the economic activity arising particularly in the digital applications economy) that it has appropriate and sufficient taxing rights to effect direct and indirect taxes to revenue

and profits earned by foreign owned companies operating in the applications economy within the South African market to guard against profit shifting and base erosion?

The Sub-Problems

1. The intentional Permanent Establishment (PE) status avoidance in an effort to avoid creating a taxable presence in a tax jurisdiction by multinational corporations (MNC's)
2. The inability to define the place of effective taxation as a result of the lack of a nexus between the revenue-generating activity and geographic location of digital transactions.
3. The OECD Actions plan 1 interpretation as well as international and local developments in the digital applications economy.
4. Double tax agreements, (treaties): The use of national tax systems differences that allow for treaty arbitrage and how South Africa has reacted to this.
5. Transfer pricing rules around intangibles: The transfer of patents and other intangibles from their country of origin/development to a low tax or zero tax country at low prices creating royalty payments (for the use of the intangibles) to countries with lower tax rates.
6. Uber case study in an effort to understand BEPS as a result of less rigid rules with Withholding Taxes:
- 7.

Research method

Due to the theoretical nature of this topic, a qualitative research method was followed. This required gathering specific articles and material on the subject matter from various sources such as the internet, books, on the subject. An in depth analysis of the OECD BEPS Action Plan, Davis Tax Committee's (DTC) interim report on the BEPS Action Plan, current South African tax legislation, available international law from countries such as India who have made progress in implementation of policies to tax the digital applications economy was performed.

Case studies were examined to determine the precedence set internationally in determining taxing rights of revenue from services and sale of goods earned via the digital economy to determine if the current SA framework is appropriate and determine whether measures put in place are sufficient in the local tax planetary to curb BEPS.

The research strategy will be an inductive approach, tabling observed trends and cases both locally and internationally.

Scope and limitations of this study

The scope of this study focuses mainly on profit shifts to tax havens or low tax jurisdictions by non-resident owned companies operating in the South African applications economy as a result of rules and regulations surrounding the taxation of e-commerce revenue from MNCs not being up to date. The reason for this focus on non-resident entities is because for South African residents there is limited scope to escape the controlled foreign company (CFC) and transfer pricing (TP) rules as contained in the Income Tax Act, 58 of 1962 (the Act). This study will however, explore the sufficiency of these rules as they currently exist and are applied.

This study will explore the direct and indirect taxes from revenue earned by mobile applications as well as websites and will specifically focus on royalties, the right of use of software and other types of intangible assets. This study will exclude capital gains tax implications.

Cases are analyzed and certain facts in the different cases altered to ascertain the taxing rights to revenues earned in the applications economy using a number of hypothetical situations and thereafter reach a conclusion.

Structure of the Research paper

The paper aims to highlight the gaps available in the South African Tax legislation that enable many multinationals operating in the digital applications economy to generate profits and shift these profits to other countries legally without paying their fair share of taxes especially after generating these profits in a country that taxes non-residents on source basis.

Each chapter of this dissertation investigates the different causes of base erosion in the digital applications economy and assesses the adequacy of available domestic legislation as well as the sufficiency of the OECD guidelines in combating BEPS in the growing digital applications economy.

Chapter 1 gives an introduction as well as the research problem, research methods as well as the structure followed. The focus of this chapter is to provide a background into the applications economy, and providing a description of available business models operating in the digital applications economy as highlighting one of the relevant business model to this case study 'Uber'- B2C currently operating in the digital applications economy. The chapter highlights the rapid growth of the digital applications economy due to the constant development of ICT. This development has enabled MNCs to depart from traditional business models, which usually required some form of physical presence in order to have a large scale operation in a particular jurisdiction. This chapter will also identify the challenges from a taxation perspective resulting from the evolution of the digital economy.

Digital applications economy has enabled many multinationals to operate in the country remotely whilst resident in another country. This has enabled the multinationals to bypass the traditional methods of having a physical location from which to provide services and goods from and easily avoid meeting the PE status definition to be able to pay taxes in that country. Chapter 2 explores the definition of PE as defined by article five of the OECD MTC and seeks to highlight the short falls in the current PE definition. South Africa taxes residents on their world-wide income, while non-residents are taxed on their South African sourced income. The mobile

nature of the digital economy makes it difficult to determine the place of effective taxation.

Chapter 3 explains the difficulty faced in establishing the place of effective taxation and explores the challenges faced by the international tax community in establishing the nexus of transactions in this economy in order to assign taxing rights. This chapter explores the available guidelines suggested by the OECD and applies these to the current available South African framework for taxing the sale of goods via electronic to explore their adequacy and efficiency. Recommendations are made to improve the place of effective taxation.

Chapter 4 investigates the international and local developments on the taxation of the digital economy. The OECD BEPS Action Plan 1 and the DTC Interim Report on the BEPS Action Plan 1, international legislation analysing India's implementation of Digital applications economy taxation in comparison to local developments and trends are analysed in this chapter.

Chapter 5 discusses double tax treaties that allow for BEPS to easily take place in the digital markets. The chapter discusses in detail treaty abuses and different methods used by MNC's to exploit gaps available in the international tax community to pay little or no taxes.

Chapter 6 analyzes the current available legislation in South Africa around transfer pricing, with specific focus on IP transactions emanating from the digital applications economies by non- residents owned entities operating in South Africa to foreign owned entities and evaluate if currently the legislation sufficiently addresses the challenges brought by the applications economy.

Chapter 7 examines the current South African legislation dealing with withholding taxes as well as tax treaties relevant to the case study in question 'Uber' to determine if SA legislation currently sufficiently addresses the causes of BEPS in the

digital applications economy and suggests solutions of what can be done to address the loop holes currently seen in place.

Chapter 8 lists overall recommendations on BEPS in the digital applications economy.

Chapter 9 Conclusion

Overview

Has South Africa ensured it has appropriate and sufficient taxing rights to effect direct and indirect taxes to revenue and profits earned by foreign owned companies operating in the South African digital applications economy? Currently, the tax landscape of the digital applications economy worldwide is a major challenge for most taxing states because of the mobile nature of transactions which cut across physical territorial borders. With very little or unclear guidance in the current available tax legislation, it is no surprise that South African too has not caught up with the changes in the digital economy that have left SA losing out on billions of tax revenue due to transactions that go untaxed. For the foreign owned entity operating in this space this gives a competitive advantage and makes trading easier as these entities are able to keep costs lower compared to the local counterparts competing in the same space who have to share their profits with the government where as foreign entities in most cases do not.

Most recently, the digital application giant the Uber company, operating in the South African market has caused hostility in the private taxi industry leaving the metered taxi owners (competitors) disgruntled with the level of competition Uber has brought to the market. They can't compete with Uber on pricing to a point where to be heard by the government they had to shut down the Johannesburg International Airport. This is a clear example that demonstrates the level of intervention the government has to undertake, to ensure it has appropriate and sufficient taxing rights to effect

direct and indirect taxes to revenue and profits earned by foreign owned companies operating in the applications economy as this not only affects the pockets of many metered taxi owners, it affects the growth of the economy as a whole from revenue lost that could have been used to grow the South African infrastructures currently in place. If action is not taken this type of infiltration and takeover by foreign owned entities without the appropriate legislation that ensures everyone is on the same level plain field, can and will negatively impact the growth of the economy through either xenophobic attacks or other withering consequences.

Growth of the applications economy

Since 2007 when iPhone's first landed in the hands of many consumers, the growth in mobile applications has been increasing and has shown no signs of slowing down.⁹ By 2014, the iTunes apps store had 1.2 million apps and had seen by 2014, 75 billion app downloads.¹⁰ The digital applications available in the market have therefore developed into several digital business models, many of which have left the international tax community perplexed in the taxation of the cross border transactions stemming from these new models.

The resultant nature of such a fast paced economy is the ripple effect in governments' tax business models that do not catch on as fast as the technological changes and hence the business models stemming out from this economy. Extensive research done during the course of the BEPS Project indicates that between US\$ 100 billion and US\$ 240 billion is lost annually due to BEPS¹¹. This equates to between 4% and 10% of global revenues from corporate income tax and far exceeds the speculative estimate referenced in the Tax Justice Network report, "The Missing Billions", or Oxfam's attribution of US\$ 50 billion to lost revenue for

⁹ Perez, (2014)

¹⁰ Perez, (2014)

¹¹ (SAICA, 2016)

developing countries due to multi-national enterprises (MNCs) engaging in tax avoidance.¹²

Changes and innovative developments in the Information and Communications Technology (ICT) have played a significant role in the business landscapes of many corporations. The ICT has made it possible to conduct many types of business at substantially greater scale and over longer distances than was previously possible. It has allowed among many other benefits, ease of trade, faster processing, delivery of goods and services, easier cost efficient exchange of information, less barriers to entry in different industries globally, because many of these businesses that operate digitally in the applications economy need not operate from physical locations. Such changes are either not updated for in the global taxation framework leaving most states across the world deprived of potential tax revenue.

This scale of BEPS problem, resembles the problem with BEPS in the digital applications economy in South African currently, and if South Africa is to ensure that it obtains its fair share of tax revenue from the value creation of this economy, a better and sound understanding of the extend of the BEPS problem is critical.

The above stats indicate that e-commerce transactions are increasing at a rapid pace and they also clearly illustrate the significance of the digital economy and therefore highlight the need to ensure that it is regulated correctly.

Business Models in the applications economy

To understand the taxation of the digital applications economy, it is imperative to understand how the business models in this market operate in order to be able to understand the composition of the revenue and relates costs and how to tax the revenue and profit earned in this market.

¹² (SAICA, 2016)

A business model describes the logic of how a firm creates, delivers and communicates value to its customers out of a value proposition and ultimately captures value for the firm itself.¹³ According to Täuscher ¹⁴, business models in the applications economy are divided into the following clusters:

Cluster 1: The Efficient product transactions. Under this cluster physical goods are delivered to buyers. The platform offers access to a large market of potential buyers. This model is essentially a platform for sellers to meet buyers on a digital market. Two thirds of firms generate revenues from commissions; one fourth also generates revenues from subscriptions. These subscriptions are often charged to the seller side for additional services, increased visibility or access to customer data. In the cluster, half of the marketplaces charge fixed fees. The other half offers different fee options to customers. In particular, all subscription models are offered with different price options based on the included services.

Cluster 2: Product community. This cluster is a community based cluster market place which creates value to sellers and buyers by creating an active community of like-minded people. Firms in this cluster provide the highest share of social network functions. Most of the cluster firms apply a B2C model. Among revenue streams, commission fees are the dominant revenue form. If fees are differentiated, differentiation is most likely based on quantity.

The platform has built a community of independent authors, musicians and designers on the seller side. The platform engages buyers with community features such as the possibility to follow and interact with one's favourite creators. Sellfy (a mobile application that allows merchants to sell and discover products online),

¹³ (Slávik and Bednár, n.d.)

¹⁴ (Täuscher, n.d. pp.29-36)

charges a 5% commission fee on every transaction from the supplier side, while buyers are currently not charged at all.

Cluster 3: Product aficionados. This cluster consists entirely of marketplaces that facilitate the exchange of physical goods. It is labelled as 'product aficionados' since firms of this Digital Mobile Business Model (DMBM) type have in common that they build a community of people with a shared passion for a certain product type. Such users are drawn to the community to discuss these products and inform themselves. Examples include aficionados of independent art products (artsy), handmade design (solidarum), and educational products (educents). Two thirds of the digital marketplace business model in this cluster facilitates exchange between businesses and consumers (B2C) and one third between individuals (C2C). All marketplaces charge the seller side; either with a commission and/or subscription. Sellers set fixed prices for the products they but have to accept fixed fees from the marketplace. A large share of marketplaces in this cluster creates value from the image of the platform. Example is the product marketplace Storenvy which was founded in 2010 and located in San Francisco. The firm matches sellers and buyers of fashion brands.

Cluster 4: 'Offline services on-demand'. This cluster comprises marketplaces that match service firms with consumers. The exchanged services are delivered offline and therefore require some form of scheduling. Within the cluster, companies can be subdivided into two groups. A first group contains firms that act as aggregators for services that fully integrate the customer and therefore require exact time reservations. Examples include hairdressers (styleseat), car rides (technorides), or touristic activities (gidsy, headout). The second group of marketplaces serves firms with services that do not require the full integration of the customer and are therefore less time-sensitive. Examples include services for shipping (shyp), alcohol delivery (drizly) or construction work (buildzoom). In both groups, providers have limited capacity and therefore benefit from the scheduling process provided by the marketplace. Digital marketplace business models in this cluster provide the highest share of apps among all clusters which serve as a mobile scheduling device.

The companies in the cluster generate revenues through commissions from the sellers while buyers mostly use the marketplace for free. The marketplace fees are either fixed or differentiated between different marketplace features or segments. An exemplary firm of cluster 4 is StyleSeat, a start-up founded in 2011 and based in San Francisco. StyleSeat is an on-demand online and mobile marketplace that aggregates beauty salons, stylists, colorists, manicurists, masseuses and the like with anyone who is looking for beauty services.

Cluster 5: Online services Companies in this cluster share the characteristic that they offer services that are delivered via the internet. The cluster also includes firms that aggregate professional freelancers such as divorce attorneys, municipal financial investors, or scientific researchers. These marketplaces provide a high efficiency to the supply side in earning an additional income or even to substitute their formal employment. The marketplaces of this cluster monetize by charging sellers and/or buyer. The fee is mostly charged as commission or subscription. Udemy is a perfect example of this cluster. It offers individuals the possibility to create, distribute, promote, and sell their educational courses on topics such as entrepreneurship, software programming, or fitness. The platform's revenue model is based on commissions from both students and instructors. The commission system for instructors depends on whether the instructor has acquired a learner through her own marketing activities. Instructors pay a 3% commission fee if they attract users through their coupon codes. If students are acquired via the marketing and sales activities of Udemy (e.g. promotions, featured listings, blog posts), instructors pay a commission fee of 50%.

Cluster 6: Peer-to-peer offline services. According to Fraunhofer¹⁵ (p.35), this cluster consists of companies facilitating the exchange of offline services between individuals. Companies in this cluster can be further divided into two subtypes according to the seller side individuals sharing their physical resources and

¹⁵ (Täuscher, n.d. p.29-p.36)

individuals providing their time and skills Resource sharing firms include shared private accommodation (Airbnb), office space (sharedesk) and Uber with personal cars .The revenue model is based on commissions. Airbnb exemplifies peer-to-peer offline services. Airbnb provides value to its hosts by enabling them to generate additional income from renting out their private property. The firm creates value for their hosts by providing insurance for their property, automated payment systems, professional photographers and the promotion of their listings on the platform. Hosts pay a commission fee of 3%, while guests pay between 6% and 12% to the platform.

Conclusion

Understanding the history and scope of the digital economy and its size in the South Africa market and how the different business models operate is instrumental in understanding where the gaps are in the current legislation and why application of the old laws will not work on the digital business models. Without the understanding of revenue generating tools in this economy it will be close to impossible to draft recommendations that will assist in the alleviation of BEPS globally and locally.

Chapter 2 Permanent Establishment

Background

Transactions in the digital economy are not restricted to territorial boundaries, as such; it is possible that an entity operating in the digital economy will have cross-border trade and thus increasing the possibility of double taxation. To prevent double taxation tax treaties were created and created on the basis of what is called Permanent Establishment (PE) rule to enable jurisdictions to determine who would have taxing rights to source earned income. Permanent establishment (PE) is a term used when a business operates in a foreign country to an extent that local revenue is subject to corporate tax.¹⁶

In terms of Article 7(1) of the OECD's Model Tax Convention (OECD MTC) on Income and on Capital a contracting state will only have taxing rights in respect of the business profits of a foreign enterprise that is a resident of another contracting state if the enterprise has a "permanent establishment" (PE), as defined in Article 5, in that State to which such profits are attributable.¹⁷ This however, rests on the source rules which state; that the income generated must be from a South African source in order to be taxed here. South Africa would not be able to have taxing rights to such income; even if such non-resident creates a permanent establishment in South Africa if it's the revenue is not generated from a source in South Africa. Source is not defined in the Act and the courts have not attempted an exhaustive or all embracing, absolute definition: furthermore, however common law has defined in source as a place where there is cause. In other words, revenue is from a source in South Africa if it's caused in South Africa.

To avoid taxation in the contracting state from which profits are attributable, an MNC's will generally ensure that they do not have a PE even if the profits are from a source in the country. This enables such entities to legally avoid taxes and shifts profits from high tax countries to countries with lower tax rates.

¹⁶ (Shield GEO, n.d.)

¹⁷ (SAICA, 2016)

The permanent establishment concept is dealt with in Article 5 of the OECD MTC. It is defined by Article 5 as a fixed place of business through which the business of an enterprise is wholly or partly carried on. It is therefore based on geographic boundaries whereas the digital economy

cuts across territorial borders, creating a realm of human activity that undermines the feasibility and legitimacy of laws based on geographic boundaries¹⁸.

It includes a place of management, a branch, an office; a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

According to Article 5(5) of the Model Tax Convention (MTC), a person (other than an independent agent, as discussed below) acting on behalf of an enterprise will be deemed to be a PE of the foreign enterprise if, *inter alia*, he has and habitually exercises in South Africa, a general authority to conclude contracts on behalf of the enterprise, unless his activities are limited to certain specific exclusions, such as the purchase of goods or merchandise for the enterprise.¹⁹ MNC's would generally ensure that their contracts are not concluded in South Africa, to minimize the risk of triggering the PE status.

The PE concept is based on the place from which wealth originates as the primary basis for taxation. But nowadays it is possible to be heavily involved in the economic life of another country, e.g. by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent).²⁰ Through dependent agents, non-resident taxpayers can generate substantial profits from transactions with customers located in another country and pay effective taxation of close to nothing. This leaves questions whether the current rules ensure a fair allocation of taxing rights on business profits. This concern is relevant especially where the profits from such transactions go untaxed anywhere else including their own countries due to tax

¹⁸ Davis Tax Committee. (2014).

¹⁹ SAICA. (2016).

²⁰ (OECD.org, 2014)

planning strategies that allow the profits to be shifted elsewhere but their own countries as a result of existing loopholes in the legislation.

According to PWC,

South African businesses are at a competitive disadvantage as MNC players in the digital economy industry do not have a tax presence in South Africa and therefore cannot be taxed due to our current narrow legislation.²¹ The local legislation has not adopted and created mechanisms to tax many online services provided by foreign suppliers.²²

The aim of this chapter is to highlight challenges in the digital economy faced by both the international tax community as well as South Africa, stemming from the digital and highly mobile and flexible nature of transactions which makes it difficult to define where an entity might have triggered a PE status. This chapter will explore the possibility of a virtual PE in order to improve the tax revenue pool of profits generated from this economy.

Challenges in defining a PE in the digital applications market:

Transactions in the digital applications market operate through servers, some of which could be located in the “cloud” or a physical location. Generally servers are highly mobile and flexible in nature.²³ They can be shifted outside the country where an e-commerce firm is based or where the software products are developed as well as where e-commerce goods and services are.²⁴ Thus, even though a server could constitute a place of business of an enterprise, if it is not located in a place for at least a year, it cannot be considered a PE.²⁵ In addition, for a server to constitute a place of business that qualifies as PE, it should have an on-site managerial and operational team which most MNC’s in the digital applications economy do not have for that reason (to not trigger PE status).

Case Study

²¹ PWC,(n.d.)

²² PWC,(n.d.)

²³ Oecd (1997)

²⁴ Davis Tax Committee. (2014).

²⁵ Davis Tax Committee. (2014).

In a case considered by the DTC, in 2011, *ITO v Right Florists Pvt Ltd*, the Income Tax Appellate Tribunal had to consider the application of these rules in the context of e-commerce and the application of DTAs. The taxpayer was a florist based in India who advertised on search engines supplied by Google and Yahoo to generate business. The taxpayer made payments in respect of online advertising to Google Ireland Limited (Google Ireland) and to Overture Services Inc USA (Yahoo USA).

The assessing officer contended that the payments were subject to Indian tax and thus disallowed the deduction of such payments in calculating the tax liability of the taxpayer. The question that the Tribunal had to adjudicate on was whether the payment made for the above services to Google Ireland and Yahoo USA was taxable in the hands of those entities, because if the amounts were to be held taxable in India, non-deduction of tax at source from these remittances would result in disallowance of related payment in computation of business income of the taxpayer.

The Tribunal then considered, whether a search engine like Google or Yahoo can be said to have a PE in India. The Tribunal considered the comments of the OECD on e-commerce transactions in the OECD Commentary on Article 5 of the OECD MTC and came to the conclusion that a search engine, which has only its presence through its website cannot be a permanent establishment unless its web servers are also located in the same jurisdiction.

Mobile applications operate similar to websites, as they are stored on a server, in the same way as a website. The distinction between a website and the server on which the website is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the website.²⁶

These contracts typically do not result in the server and its location being at the disposal of the enterprise even if the enterprise has been able to determine that its

²⁶ (OECD, 2000)

website should be hosted on a particular server at a particular location.²⁷ In such a case, the enterprise does not even have a physical presence at that location since the website is not tangible.²⁸ In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement.²⁹

It would therefore be a different scenario if the enterprise carrying on business through an application owned the server which it has its application stored on.³⁰ The place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.³¹

With respect to the Uber case, according to a new market report from North American Data Centers, Uber has lined up large leases for data center space with Digital Realty in Dallas and northern Virginia markets, while also procuring space with CoreSite in Silicon Valley.³² Uber even though leases the premises from which their servers are stored; it owns its servers from which its mobile application hosted. These servers however are not located in South Africa and in this way; Uber is able to avoid the PE status in SA even though its income is generated from a source in South Africa.

Suggested Virtual Permanent Establishment

The concept of a virtual PE establishment would replace the current PE definition based on the place of economic activity rather than physical location. The definition of virtual PE by the OECD in action 7 would have to specify that a website alone can create a virtual PE and expand the definition of a PE to include an intangible asset. Currently there is no clear definition of a virtual PE by the OECD. A website's presence alone can constitute a business activity in the source state due to the fact

²⁷ (OECD, 2000)

²⁸ (OECD, 2000)

²⁹ (OECD, 2000)

³⁰ (OECD, 2000)

³¹ (OECD, 2000)

³² (Miller, 2016)

that transactions in the digital applications are virtual and are made in the virtual environment which makes sense that a virtual PE definition be effected.

The economic test can be applied to the place from which a transaction has taken place effectively from a website using address details of the recipient. If the receipt of a particular transaction is based in South Africa for example the taxation rights to the revenue and profit earned from that transaction would belong to South Africa.

Recipients of the purchase would not use incorrect shipping details as they that would like to receive their items. This would help avoid revenue leaving the country untaxed as Action 7 of the OECD Action Plan on BEPS recommends that the definition of a permanent establishment (PE) must be updated to prevent abuses.

Furthermore, 'many transactions made through the applications economy operate through the internet website which is a combination of software and electronic data, which does not in itself constitute tangible property'³³It therefore does not have a location that can constitute a 'place of business' as there is no 'facility such as premises or, in certain instances, machinery or equipment'³⁴ as far as the software and data constituting that website is concerned.

A website however if the definition of a PE is amended as suggested by the OECD, can pass for a PE. A server on the other hand because it is a machine can qualify as a permanent establishment if the conditions set out in Article 5 of the OECD Model Tax Convention are met.

Case Study

In the Dell Spain case, the Central Administrative Court concluded that the same group and structure of the companies gave rise to a PE.

³³ Davis Tax Committee. (2014).

³⁴ Davis Tax Committee. (2014).

The Dell group of companies had 17 subsidiaries in different European countries including the Spanish subsidiary as well as a subsidiary in Ireland which was made in charge of commercializing products in Europe. This subsidiary had no staff and resources in Ireland. The products brought to commercialize in the group were bought from another Irish entity in the group. The Spain Dell distributed and commercialized the products of the group as a full-fledged distributor until 1995 in their own name but on behalf of Dell Ireland.

After 1995, Dell Spain turned into an agent and because of this change, the portfolio of clients was transferred to Dell Ireland, which also assumed all the risks of inventories, clients and guarantees.

The Spanish market was divided in two segments of clients: big companies and administration, which was serviced by Dell Spain; and small companies, which were serviced by a call center of Dell Ireland, located in France and service was provided by the French subsidiary of Dell and the webpage of Dell Ireland³⁵ The Tax Administration in Spain concluded that there was a fixed place of business PE in Spain according to article 5(1) of the Spain-Ireland tax treaty because Dell Ireland had a 'complex operating settlement' in Spain, which means that more than auxiliary or preparatory activities are carried on within Spanish territory.³⁶ The reasons to reach that conclusion were that Dell Ireland has no human or material resources, which basically means that all its activity in Spain is conducted through other entities.³⁷

The concentration of activity in Spain forms a complex operating settlement since the main economic activity of Dell Ireland is carried on by Dell Spain with its own resources (market control, promotion of sales, marketing, logistics, virtual shops, technical assistance and guarantee etc.) based in Spain.³⁸ There is a high degree of confusion in the activities of Dell Ireland, Dell Spain and France, since there is no clear distinction of when one entity acts in a given segment of clients or contract, the client does not know with whom the contract is concluded until the invoice is received, personnel of Dell Spain and Dell France are used interchangeably for the

³⁵ (Jiménez, 2014)

³⁶ (Jiménez, 2014)

³⁷ (Jiménez, 2014)

³⁸ (Jiménez, 2014)

activities in Spain, payments for activities of both companies go to the same account etc.³⁹

This degree of functional confusion means that sales concluded in Spain by Dell France are attributed to Dell Spain.⁴⁰ The webpage for the Spanish market may give rise to a virtual PE if considered together with all the other activities carried on by the group in Spain through Dell Spain and Dell France, even if there is no server located in Spain (maintenance of the webpage is done in Spain, the domain name is owned by the Spanish subsidiary, Dell Spain processes orders made through the webpage etc.).⁴¹ In addition, the Spanish Tax Administration concluded that Dell Spain was a dependent agent PE of Dell Ireland in accordance with article 5(5) of the Spain-Ireland tax treaty.⁴²

Despite the fact that Dell Spain acts in its own name, for the Tax Administration, there was no doubt that Dell Ireland was bound by the contracts concluded by Dell Spain.⁴³ In reaching the judgement, a number of factors were taken into account:

Dell Ireland was the owner of the computers which were delivered directly from that company to the client.⁴⁴ According to the contract between Dell Ireland and Dell Spain, it was clear that the latter was a dependent agent of the former.⁴⁵ It is relevant in this regard that Dell Spain was part of the Dell Group and bound by its policy and it only acts for a single principal.⁴⁶

Dell Spain defined the contracts and acted on behalf of Dell Ireland.⁴⁷ The high degree of confusion in the activity of both companies proved that Dell Spain acted on behalf of Dell Ireland. The Spanish Tax Administration decided to attribute the PE in Spain. The commission paid to Dell Spain and Dell France was admitted as deductible expenses for the PE. The Central Administrative Court ruled that the interpretation of the fixed place of business should not be too rigid, it must adapt to

³⁹ (Jiménez, 2014)

⁴⁰ (Jiménez, 2014)

⁴¹ (Jiménez, 2014)

⁴² (Jiménez, 2014)

⁴³ (Jiménez, 2014)

⁴⁴ (Jiménez, 2014)

⁴⁵ (Jiménez, 2014)

⁴⁶ (Jiménez, 2014)

⁴⁷ (Jiménez, 2014)

the circumstances of the case, to the commercial and geographical coherence of the activity and always take into account the final goal of article 5(1) of the tax treaty between Ireland and Spain.⁴⁸

Recommendations

1. For South Africa, new or enhanced direct and indirect taxation rules taxing the digital market based on where consumption takes place as enabled by a new definition of a virtual PE establishment
2. The OECD will have to pioneer a change to the current rules around PE's which give taxing rights to profits based on PE status as defined by article 5 of the OECD MTC on the basis of physical location in a particular country.
3. Change DTA agreements to provide that digital goods or services are sourced where the recipient is. Where there is no DTA, implement default rules taxing the revenue in South Africa. If double taxation occurs, the onus will be on the relevant jurisdiction to renegotiate their affairs with SA in order to avoid cases of non-taxation.
4. The DTC report indicates that it is not in the interest of developed countries such as Germany or the USA to allow the expansion of the PE concept to grant source states a wider scope to tax profits of digital businesses. Reason is this would simply reduce the profits of these digital companies from developed markets as their profits are being taxed in the home state if not taxed where they have a PE status, or have not effected complex tax structures such as Double Irish. Reason for opposition would stem from the requirement of the residence state to now give foreign tax credits in respect of such source tax. This however is critical in containing the rest of the revenue that goes untaxed as a result of the narrow PE scope definition.
5. The clear distinction between a website and a server to enable easy definition of what constitutes a PE in case of both.

Conclusion

⁴⁸ (Jiménez, 2014)

PE as previously defined by the OECD if not adapted to the mobile nature of the digital market; many countries will still deal with BEPS issues for a lot more years to come and many countries will continue losing out on Tax revenue that could have assisted a country's developments goals. In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, current rules cannot ensure a fair allocation of taxing rights on business profits.

The case study in this chapter highlighted principles used by countries such as Spain adopted from the OECD article 5 of the BEPS Action Plan in defining what is a PE as well as some of the concepts carried on article 7. If adopted in SA, this could alleviate some of the circumvention of the definition by MNCs in the country.

The global trends are that companies are now forced to anticipate when certain types of virtual or electronic activity will trigger a Virtual Permanent Establishment in a specific country.⁴⁹ Specifically, online retailers, internet advertising, app stores and media sites can all generate revenue in a country without any type of physical presence.⁵⁰ To adopt this approach, many taxing states will have to change their DTA agreements to provide that digital goods or services are taxed where the recipient is, which would be where the South African tax-resident; physically is present in South Africa is at time of supply, and force the non-resident to account for their fair share of taxes.

⁴⁹ Shield GEO. (n.d.).

⁵⁰ Shield GEO. (n.d.).

Chapter 3: Inability to establish place of effective taxation as a result of lack of nexus between the revenue-generating activity and geographic location of digital transactions.

Background

According to Action Plan 1 of the OECD Action Plan, the overriding objective of the place of taxation rules for business to consumer supplies is to predict the place where the final consumer is likely to consume the services or intangible supplied. This chapter analyzes this guideline to determine the practicality of this approach in South Africa and considers if the current scope of taxing the digital economy can be expanded under the South African VAT electronic services provisions to ensure that the VAT net is not cast too narrowly thereby limiting inclusion.

Notably absent from South African legislation is location based services, (place of consumption) in broadening of digital applications transactions scope to incorporate similar guidelines. Furthermore, changing the current rules and suggestions on how the legislation can be improved to cater for the collection of the VAT to be levied or collected on an intangible service or goods purchased by a consumer from a virtual store with no PE status in the country especially in a case of service or goods do not require physical delivery.

Some of the ecommerce businesses that operate through digital mobile applications include several varieties of e-commerce online payment services, app stores, online advertising, cloud computing, participative networked platforms, and high-speed trading.⁵¹

For example, retailers allow customers to place online orders and are able to gather and analyse customer data to provide personalized service and advertising.⁵²

This has led to increased digital cross border transactions most of which operate through mobile applications which their servers exists on the “cloud” bypassing traditional tax rules. This collection of data could be used in effecting methods that are effective in the collection of taxes in this digital environment.

⁵¹ Oecd.org. (2014).

⁵² Oecd.org. (2014).

Predicting the place where the final consumer is likely to consume the services or intangible supplied.

If there is a company that is active in two different countries, it is not easy to determine which country has the right to tax the profits: Is it the country where the parent company is located? Or is it the country where the affiliate is doing the actual business? And what about modern forms of business where activities are no longer tied to easily traceable factories, but can be undertaken from any place in the world with global outreach, or carried out in the virtual space of the Internet? On what basis can countries still claim the right to tax profits from these types of global or even virtual activities?⁵³

This complication is created due to cloud transacting which makes it difficult to establish territorial owner, or even define source and residence to assign taxing rights to profits. Through the use of ICT, MNCs with the gaps created in the tax systems, are able to split transactions into several steps which can be performed from different locations. In these cases, not only will it be difficult to establish the true nexus of the income, the MNC will also be able to avoid creating a taxable presence. If however a system can predict through use of recipients address where the final consumption would take place in a case of B2C enterprises, it will be easier to tax profits at the place of consumption barring on the DTA agreements to also be amended to ensure that revenue does not get taxed twice.

In respect of business-to-consumer (B2C) transactions, where the recipient is an entity or individual not registered for VAT, the foreign supplying company is required to register for VAT in the recipient's jurisdiction and impose, collect and account for VAT on the supply to the revenue authority in the recipient's jurisdiction. The question is the practicality of this solution in SA. How will the revenue authority be able to police entities that do not register for VAT? Entities do not have to have a South African bank account to be able to transact and receive money from the South African territory unless the major banks in SA withhold the funds from being paid to the foreign entities through SWIFT and settlement which is a process used to make international transfer of currencies between banks. SWIFT itself is (a messaging network that financial institutions use to securely transmit information and

⁵³ South African Tax Guide. (2013).

instructions through a standardized system of codes⁵⁴ and settlement process is used to physically settle the foreign currency to a local bank.

Possible solution

When it comes to making online payments, 48 percent of consumers in 2014 preferred to use their credit cards, compared to 41 percent in 2013.⁵⁵ The preference for debit card use online also jumped from 22 percent in 2013 to 30 percent in 2014.⁵⁶ Preference for PayPal online fell from 22 percent in 2013 to 12 percent in 2014.⁵⁷

Currently there are four major credit card networks: Visa, MasterCard, American Express, and Discover and these dictate where credit cards and debit cards can be used. This means they have control and have access to information about each electronic transaction made over card payments. They are at a position to provide revenue authorities with detail information about revenue processed in a particular country at any given time. This could assist in performing a completeness test of the entities that have recorded transactions from South African territory; but they have not declared such transactions with SARS. Below table illustrates the dominant card transactions driver.

Market share based on number of cards in circulation (End of 2015)			
Visa	MasterCard	American Express	Discover
328 million	192 million	57.6 million	58 million
51.60%	30.20%	9.10%	9.10%

Sources: SEC filings from Visa, MasterCard, American Express and Discover

It must also be noted these are not the only forms of payment online that can be made with possibility of the tax authority being unable able to trace this or just be aware of it. There are more such payments which are MoneyGram or Western-Union amongst many others. . These types of transactions would generally not be operated

⁵⁴ (Seth, 2015)

⁵⁵ (Gonzalez-Garcia, n.d.)

⁵⁶ (Gonzalez-Garcia, n.d.)

⁵⁷ (Gonzalez-Garcia, n.d.)

by MNC but by small entities. Therefore the lost revenue would not be material compared to credit card transactions that would be operated by MNCs.

According to the DTC report, some multinationals, in terms of the B2C rules suggested by the OECD MTC, would be required to register for VAT in multiple jurisdictions. It therefore is crucial for a simplified VAT registration and administration process to apply to such foreign suppliers.⁵⁸ This is furthermore in line with the OECD principles of efficiency of compliance and administration and simplicity.⁵⁹ The B2B and B2C rules, along with the destination basis/ place of economic activity and the OECD five principles, allow for an effective application of VAT which may contribute to the reduction of BEPS.⁶⁰

Conclusion

The most urgent change requirement is a change to OECD definitions and recommendations to the place of effective taxation in a digital economic environment as many states are left to define for themselves how transactions effectively are to be taxed in this environment with no clear guidance from the OECD which still leaves room for double non taxation, or double taxation. If a system that can predict through use of recipients an address where the final consumption will take place in a case of B2C enterprises this will make it easier for the OECD to provide as guidance clear guidance to many states to effect rules that require a B2C business to register and charge VAT based on the address details provided by its recipients in the jurisdictions in which the revenue is generated from. Furthermore also keeping in mind that revenue of such businesses could be across many taxing states, a threshold of revenue bracket in each of the countries could be determined before being required to even register for VAT as a non-resident. The tax revenue that can be collected from such trades would include indirect taxes in the form of VAT as well direct tax in the form of corporate taxes. Non-residents will have to register for VAT, and upgrade their back-end systems where the revenue is recorded to charge input vat on each transaction made via their mobile applications. The invoice issued to the customer after each sale would include the VAT charged at 14% aggregated monthly

⁵⁸ (Deloitte, n.d)

⁵⁹ (Deloitte, n.d)

⁶⁰ (Deloitte, n.d)

and paid over to SARS. Of course Input VAT can be claimed on items purchased in production of the income.

The most important factor is to tax the revenue based on place of consumption. This therefore means it is not important where a transaction is effectively made, but where the transaction is to be consumed. Therefore a recipient address details can be used to determine the place of effective taxation in a case of purchases made through a website or an app where the physical delivery is important. The risk of incorrect address details provided is low as the receiver always wants to receive their physical goods, as such they will ensure the correct addresses are included. Only where service goods that do not require physical delivery, would further methods be required to determine place of consumption as it is easy here to provide incorrect details. The recipient however is not the one required to register and pay VAT effectively, the receipts would most likely include correct details as they have nothing to lose and thus risk of non-collection of VAT in this case also reduced.

Chapter 4: OECD Action Plan 1 International and local developments

Background

South Africa although not a member of the OECD, having observer status, follows guidelines by the OECD; as such it is imperative to consider the recommendations made by the OECD with respect to BEPS project and review their sufficiency and appropriateness in combatting the South African BEPS as a result of the digital applications economy.

Action 1 of the BEPS project examined and considered three issues which had the approval of the G20 nations pertaining to the taxation of the digital economy. These options would enable countries to tax digital transactions of a foreign enterprise deriving considerable sales without physical presence in the country concerned.⁶¹ These were as follows:

1. A new nexus test based on significant economic presence.
2. Withholding tax on digital transactions.
3. An equalization levy.

The Davis Tax committee (DTC) analysis report on the BEPS Action Plan 1 report is reviewed in this chapter. Furthermore this chapter analyses the sufficiency of the recommendations made by the OECD within Action 1, as well as the view by the DTC on the BEPS Action plan. The chapter lastly considers the recommendations made by the DTC and international tax policy in countries such as India who have made headway on the Digital economy market in implementation of the suggested guidelines by the OECD on the subject matter and compare these to South Africa to evaluate how far in the digital applications tax legislation framework is the country from reducing the effects by BEPS..

⁶¹ (Venkataraman, 2016)

DTC analysis report on the BEPS Action Plan 1

According to the DTC report the following Action Plan 1 changes or recommendations are intended to ensure the alignment of taxation with economic activities and value creation as follows:

1. Restoring taxing rights at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company by preventing treaty abuse and preventing artificial avoidance of PE status. This could be sufficient if the loopholes in several treaties currently allowing for withholding taxes to be taxed at zero where there is a DTA in place between SA and the state the non-resident is resident in. The flow of transactions in such instances needs to be considered.
2. Taxation in the ultimate residence jurisdiction should be restored by strengthening controlled foreign company (CFC) rules (Action Plan 3). If jurisdictions tightened the CFC rules and ensured that residents with a controlled foreign company accounts for the share of profits in their current taxable income, many MNC's would not find it easy to shift profits to a territory with less taxes.
3. Neutralizing the effects of hybrid mismatch arrangements (Action Plan 2). Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.⁶² Tax rules between two taxing states where there are DTA's in place would require closer scrutiny and where it creates double non-taxation an anti-avoidance provision implemented to kick in. The OECD Action Plan states as examples:
 - Changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly;

⁶² OECD (2015),

- domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer;
- domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules);
- domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and
- Where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure.⁶³

4. Limiting the base erosion via interest deductions limitations and other financial payments (Action 4), by countering harmful tax practices more effectively (Action 5), and by assuring that transfer pricing outcomes are in line with value creation (Actions 8-10). The limitation of BEPS via interest deductions may seem too vague how this will be applied in which scenarios will be achieved. Furthermore countering harmful tax practices more effectively seems a broad statement that does not provide clear guidelines of how BEPS will be and can be achieved. Transfer pricing improvements are clear i.e. “in the area of transfer pricing, the rules should be improved in order to put more emphasis on value creation in highly integrated groups, tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits”⁶⁴ and are discussed further in chapter 6.

Sufficiency of recommendations by the OECD

Indirect Tax Recommendations

According to Deloitte:

⁶³ (OECD, 2013)

⁶⁴ (OECD, 2013)

If all VAT jurisdictions apply the “destination basis”, as endorsed by the OECD, and place of consumption rules set out by the OECD, the ability for multinationals to shift profits can be curbed as the imposition of VAT is based on where the recipient is located and not where the supplier may have established itself.⁶⁵

In terms of the destination basis VAT should be imposed in the jurisdiction where the goods or service is consumed, which is the jurisdiction where the recipient of the good or service is located. For collection of the taxes, in accordance with the reverse charge mechanism, the foreign supplier is not required to register for VAT in the recipient’s jurisdiction, however this does not imply that the supply will not be subject to VAT in the recipient’s jurisdiction but merely that the recipient is required to collect and account for the VAT to the revenue authority and not the supplier.⁶⁶

The imposition of this responsibility on consumers will be close to impractical due to the intense administrative burden on the consumer. If each individual in one country is required to hold taxes from each foreign supplier they purchase from, they would have to keep record and maintain an accounting system to be able to submit the tax return to SARS and pay over the withheld taxes. This will not be practical especially in South Africa given the nature of the number of literate and illiterate people living in the country on detailed matters of taxation such as this.

If however the transactions are classified between Business to Consumer and Business to Business transactions this might be relatively easier. In respect of business-to-consumer (B2C) transactions, where the recipient is an entity or individual not registered for VAT, the foreign supplying company is required to register for VAT in the recipient’s jurisdiction and impose, collect and account for VAT on the supply to the revenue authority in the recipient’s jurisdiction.

Direct Tax recommendations

⁶⁵ (Deloitte, n.d)

⁶⁶ (Deloitte, n.d)

The OECD continues to acknowledge that a special set of rules would not work because the digital economy 'is increasingly becoming the economy itself'.⁶⁷

Action plan one to address the digital economy challenges included the following recommendations:

1. Modifying the list of exceptions to the definition of Permanent Establishment (PE) regarding preparatory or auxiliary activities as they relate to a digital environment and introducing new anti-fragmentation rules to deny benefits from these exceptions through the fragmentation of certain business activities
2. Modifying the definition of a PE to address artificial arrangements through certain "conclusion of contracts" arrangements.
3. A correlative update to the Transfer Pricing Guidelines.
4. Changes to the controlled foreign company (CFC) rules addressing identified challenges of the digital economy.

Point 1 and 2 of the recommendations are addressed in chapter 3 of this paper and with respect to these two points; action 7 specifically deals with addressing such challenges. Action 7 therefore is concerned with two specific cases: agents agreements, which refers to article 5(5) of the OECD MTC and artificial fragmentation of activities to take advantage of the exemptions in article 5(4). OECD MTC.

Point 3 transfer pricing guidelines if amended will assist in curbing the extent of the current BEPS; however this will mean each state will have to consider changing domestic tax policy to align it with the suggested transfer policy guideline.

Current CFC Rules

The current CFC rules in SA are mainly targeted at residents of the country to prevent generating untaxed profits outside the country. These rules however are not

⁶⁷ (EY, (n.d))

directed at non-residents. Therefore alignment of CFC rules would have to apply to countries such as the United States where the Subpart F rules that allow for deferral of income thus leaving opportunity for BEPS in those countries where such rules are applicable. The OECD therefore recommends that where a digital business earns income in a CFC in a low-tax jurisdiction by locating key intangibles there and using those intangibles to sell digital goods and services without that income being subject to current tax, even if the CFC itself does not perform significant activities in its jurisdiction consideration should be given to CFC rules to be tightened.

India's current developments in the digital economy

Background

In India, the Income Tax Act 1961 and the various Double Taxation Avoidance Agreements (DTAA) envisage cross-border taxation in India only if it is income earned in India or income earned through a permanent establishment.⁶⁸ A seller of goods or a service provider in Chennai or Delhi that earns an income in India, or an overseas vendor setting up a sales outlet to deliver goods to Indian consumers, would pay tax on the income as a resident or as a permanent establishment. A service provider landing in India to offer advice and consultancy services will have to disclose income earned in India and pay tax. But digital e-commerce transactions through e-portals located outside India delivering the same set of activities in India go out of the tax ambit. This is similar to the case in South Africa where non-residents with no PE status in the country do not get to pay taxes in South Africa.

The digital economy is therefore exerting pressure on growing and consuming economies where activities and value get created but are not taxed.⁶⁹ After concerns with the taxation of the digital economy, a proposed tax called the equalization levy as recommended by the OECD which is specific to services provided by non-residents was implemented in India. This levy applies a 6% of consideration paid for

⁶⁸ (Venkataraman, 2016)

⁶⁹ (Venkataraman, 2016)

specific services to a non-resident by a resident in India carrying on a business or a non-resident having a permanent establishment (PE) in India. If a payment is to be made to a non-resident supplying services under the amid of the equalization levy in India a deduction of the levy amount from the payments made to non-residents must be made and deposited with the government. Interest and penalty would apply for the non-deduction/non-payment of the levy.

This levy applies to online advertisements, provision of digital advertising space or any other facility services for the purpose of online advertisements. The government has the ability to add other services that could fall into the scope of this levy. To avoid double taxation, income arising from payments on which equalization levy has been paid is proposed to be exempted under Income Tax Law.

SA developments in Contrast

According to Charles de Wet, head of indirect tax at PWC Africa, currently, in the South African digital applications market, multinationals that sell goods and services do not have to comply with the same rules as local companies. This position distorts competition between local and multinational companies because it places the multinational at an advantage over local businesses operating in the market. This is more so applicable to multinational companies that supply content via online streaming or subscription services in to the South African market, as they do not have to comply with the same tax rules as their local counterparts and in some instances are not taxed.⁷⁰ This is due to the current South African legislation being too narrow in defining and including which transactions must be taxed and how the revenue must be collected.

For example, the South African content streaming market has grown and includes countless service providers such as Netflix, DSTV Box-office, Hulu, Node, HBO Go, MTN Front Row, Vidi and Amazon Prime Instant Video, as well as online magazines,

⁷⁰ (PWC, n.d)

news and newspaper providers becoming household brands in South Africa. South Africans are accessing these services and most where such services have been purchased, no VAT is levied on the invoices received by them from the main suppliers. Countless South Africans meanwhile are accessing these services by means of 'location masking' virtual private networks (VPN) that also operate on mobile applications.

While foreign content providers relish the 'tax-free' nature of their services supplied to South African consumers, local suppliers are feeling the 'economic pinch', as domestic content providers are required not only to levy South African value-added tax (VAT) on services supplied to the local marketplace, but pay South African corporate income tax of 28% on profits generated.⁷¹ South Africa in reacting to the digital applications economy, implemented on 1 June 2014, the South African VAT electronic services provisions act which is applicable to education services, electronic games, internet based auction services, miscellaneous services such as eBooks, audio visual content, still images, music as well as subscription services.

Notice this does not include advertising services, or a service which one does not have to subscribe to such as those provided by Facebook, or services for the use of an application such as Uber technology. While the current legislative provisions seek to create equality between local and foreign electronic service providers, the legislation remains narrow and there continues to be an unfair advantage in areas such as these.

Furthermore, in South Africa, application of the VAT electronic services provisions are restricted to three proxies or presumptions, including payment from a South African bank, the consumer identifies as a South African resident and/or the consumer's address being a place in South Africa. Where a foreign supplier is able to confirm any two of these proxies, they are required to register with the South

⁷¹ (PWC, n.d)

African Revenue Service (SARS) and pay South African VAT of 14% on services supplied to South African consumers.⁷² For example, the European Union (EU) has developed more proxies in their qualifying provisions to ensure that the VAT net is not cast too narrowly thereby limiting inclusion.⁷³ Qualifying factors for registration and payment of VAT in the EU include the use of Internet Protocol (IP) addresses, Wi-Fi hotspots, customers phone numbers and other location based services which are notably absent from South African legislation which cannot be easily verified by the supplier, and which means many foreign electronic service providers are under the impression that they are not required to register and account for South African VAT.⁷⁴

According to the DTC report, the Commission recommends that South Africa should not seek to pioneer a whole new tax regime to cope with the changes brought about by e-commerce, but that it should internationalise its laws affecting international trade and investment. Accurate identification of the party responsible for paying taxes and a minimum standard of identification requirements of websites is required. Enterprises using a websites would need to disclose information such as: the trading name of the business; the physical as well as the postal address of the business; an e-mail address; telephone number and the statutory registration number of the enterprise.

The nature of the digital applications economy is that it eliminates “middle man”, so tax collection efficiency is reduced. According to DTC, to ensure efficient collection of taxes, a greater degree of international co-operation in revenue collection is required which is the reason for the implementation of Electronic Communications and Transactions Act for the facilitation and regulation of electronic communications and transactions. This Act contains certain provisions which, if complied with and effectively enforced, may alleviate some of the identification problems posed by e-commerce

⁷² (PWC, n.d)

⁷³ (PWC, n.d)

⁷⁴ (PWC, n.d)

Conclusion

The OECD as well as our own DTC committee can only provide guidelines as solutions to this ever growing and changing economy which seemingly has no clear cut solutions, only recommendations which have not been implemented as part of the final policy. Most of these recommendations are non-compulsory and are still not definitive, they are resulting in confusion amongst states as to how to move forward in implementing measures that will curb the BEPS currently experienced. For example, South Africa has not yet changed any policy regarding the indirect taxation of non-resident MNCs that generate service revenue in SA, where we have giants such as Facebook who are currently shifting a lot of profit from SA to a tax haven currently, yet the current suggestion in the Action plan says, revenue should be taxed where value is being created which is SA, but there is currently nothing legislated to enforce this on giants such as Facebook and Google. A definitive legislation is therefore key.

Chapter 5 Double tax agreements :Treaties

Background

Double taxation is caused when two taxing states tax the same income twice and is mainly because of the two concepts applied that often collide across the international taxation community; source and residence concepts. Both concepts arise from domestic tax law provisions, which distinguish between two types of taxpayers, namely non-residents and residents.⁷⁵ The first category of taxpayers would generally have limited nexus (connection) with the country in question, however the income received by these taxpayers will have an economic link will originate in the particular country.⁷⁶ The second category of taxpayers: (residents), would have a close personal and economic connection (nexus) with the country in question and the country chooses to tax this taxpayer on his/her worldwide income referred to as worldwide taxation and sometimes known also as unlimited tax liability.⁷⁷

For instance, states would tax income from a non-resident from a source generated within their country and tax residents on their worldwide income depending which concept or concepts they chose for their two types of tax payers. In South Africa, residents are taxed on their worldwide income while non-residents are taxed on income from a source within South Africa.

The clash between these two concepts has resulted in the international tax community entering into agreements (Double Tax Agreements) referred to as treaties to avoid double taxation. Double Tax Agreements and Double Tax Treaties are one and the same thing. A treaty is a bilateral agreement made by two countries to resolve issues involving double taxation of passive and active income.⁷⁸ It is an agreement that specifies which country has taxing rights, and, if they both have such

⁷⁵ (United-Nations, 2011)

⁷⁶ (United-Nations, 2011)

⁷⁷ (United-Nations, 2011)

⁷⁸ (Investopedia, n.d.)

rights, which one takes priority.⁷⁹ Treaties therefore offer a range of tax advantages which countries agree to grant to each other in order to prevent double taxation and eliminate the barrier that double taxation would create to cross-border trade, investment, movement of person's etc.⁸⁰.

With respect to juristic persons, tax treaty rules for taxing business profits apply the permanent establishment (PE) concept as a basic nexus/threshold rule for determining whether or not a country has taxing rights with respect to the business profits of a non-resident taxpayer.⁸¹ The term “permanent establishment” is defined in the Income Tax Act, 1962 (the Act) to mean a PE as defined in Article 5 of the Model Tax Convention which states that a PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on. This term fixed place of business includes, a place of management, a branch, an office, a factory, a workshop, and a mine, an oil gas well a quarry or any other place of extraction of natural resources. MNCs often take advantage of the exceptions provided for in Article 5 of the OECD's Model Tax Conventions to avoid PE status. This is one of the drivers of BEPS, especially in the digital applications economy given that most businesses in the applications economy operate through the “cloud” and need not have physical locations to operate.

Tax treaties are designed to avoid double taxation but they often result in double non-taxation. Companies set up their subsidiaries in countries to benefit from such treaties, which are called treaty shopping.

This chapter evaluates how MNC in the digital applications economy are able to take advantage of the gaps created with treaties across tax jurisdiction to pay little or no taxes in those states. Secondly through case studies the chapter will evaluate how

⁷⁹ (Anon., n.d.)

⁸⁰ (Baker, 2013)

⁸¹ (Davis Tax Committee, 2014)

treaty shopping has benefited Uber, one of the MNC from payment of taxes and suggest solutions for resolve.

Treaty Shopping – Digital applications economy

Treaty shopping' occurs where taxpayers who are not residents of contracting state seek to obtain benefits of a tax treaty by placing a company or another type of legal entity in one of the countries to serve as a conduit for income earned in the other country.⁸² This is not a new concept however it is a concept which is exacerbated in the digital applications economy and currently it is a challenge to the international tax community. MNC's operating in the digital economy through set up of conduit entities in a state that has lower tax rates, are able to use gaps available in the international tax legislation to shield their revenue earned outside of their countries of residence from being taxed in their country of residence, as well as shield their profits from being taxed in the countries in which they operate, by housing the intellectual property used in their businesses in countries that have low tax rates and double tax agreements with their countries of residence. This structure, through payment of high royalty fees to the entities established in the low tax jurisdiction that legally own the Intellectual property are able to have high tax deductions in the countries they operate and thus incur minimal taxes, whilst the profit moves to the country with a no taxes or a lower tax rate.

One of the entities operating in the digital applications economy reported to have been practicing treaty shopping is Uber. Uber is a new buzz word in the applications and technology space. It is an American online transportation company with its headquarters based in San Francisco California. Uber operates a mobile application which can be used by consumers to request a taxi ride from the application which sends a message to the nearest taxi driver who upon acceptance of the request, is provided with the location of the consumer and fulfils the requests by driving the consumer to the requested destination using in most cases the drivers privately

⁸² (Weyzig, 2012)

owned cars. Uber owns no cars. It only operates the application from which rides are requested.

Uber generated about \$3.76 billion in net revenue in the first nine months of 2016 and is on track to exceed \$5.5 billion this year. Uber's valuation is reported at \$69 billion, making it more valuable on paper than General Motors Co. and Twitter Inc. combined.⁸³ Johannesburg remains a key hub for Uber as the South African city ranks among Uber's top five out of 115 cities in the Europe, Middle East and Africa region, according to data given to Fin24 by Uber.⁸⁴ This data indicates the significance of the amount of cash through commissions that Uber receives that are leaving South Africa that potentially go untaxed due to taxation laws that are still catching up to the ever changing fast paced digital applications economy.

CASE STUDY: UBER

The following example by O'Keefe and Jones published on Fortune.Com⁸⁵ elaborates how Uber is able through tax planning, to avoid taxes in the countries in which it operates.

If you take a ride of say 20 dollars in Italy, that 20 dollars go to a company based in the Netherlands, called Uber BV, then Uber BV sends 80% of the money back to the Uber driver through another company called Rasier, The government will then get some tax through the Uber driver, when he declares that income through the normal income tax process. The remaining 20% of the ride fees stay with UBER BV, and that's 4 dollars out of the original ride. Uber then ends up paying taxes on only 1% of that revenue 20% revenue which is about 1 cent out of the original 20 dollars. Because Uber BV must deduct costs a small portion of which will filter to the Italian Government, through taxes paid by Uber's Local subsidiary in Italy. Then Uber sends the remaining money, up to 1% of revenue, as a royalty payment to another Dutch company called Uber International CV which lists its headquarter address in Bermuda because Uber International CV is a partnership controlled by a US company, the Dutch don't collect taxes on its income. Bermuda charges no

⁸³ (Newcomer, 2016)

⁸⁴ (Van Zyl, 2016)

⁸⁵ (O'Keefe & Jones, 2015)

corporate taxes on its income and the US see Uber international CV as a Dutch company and allow it to defer US Taxes indefinitely. Only a small royalty that Uber International CV sends back to US will be taxable. The result is almost none of Uber International CV revenue, a large portion of Ubers revenue is taxed.

Uber International story

The Uber international story in London.

Uber's U.K. subsidiary, called Uber London Limited, was established in April, 2012 to facilitate the company's expansion into London's massive transit market. ⁸⁶ Uber London is possibly paying high royalties to its holding company which is based in a tax haven. Uber London is owned by a Netherlands private partnership called Uber International Holdings B.V.⁸⁷ This Netherlands holding company is in turn owned by another Netherlands company, Uber International B.V.⁸⁸

This demonstrates the concept of a Dutch Sandwich, which is a tax avoidance technique employed by certain large corporations, involving the use of a combination of Irish and Dutch subsidiary companies to shift profits to low or no tax jurisdictions. The Netherlands is considered by the OECD to be a tax haven because its laws purposefully assist multinational corporations in offshoring profits from other nations.⁸⁹

South African Uber Story

In South Africa the key allegation with Uber is that all cab fares are paid directly to the Netherlands company, a company in a known tax haven, with 80% of the fare being repatriated to South Africa to pay the drivers of the cabs. This is the same as

⁸⁶ (Redmond, 2014)

⁸⁷ (Redmond, 2014)

⁸⁸ (Redmond, 2014)

⁸⁹ (Redmond, 2014)

previous discussion above. Uber appears to not be paying VAT on revenue earned on the application as per the report in the Mail and Guardian newspaper that says it issues the bills for the taxi ride on behalf of the independent taxi drivers and processes the payment on their behalf too. In other words Uber claims that it is not its responsibility to collect and pay taxes over to SARS from the Uber drivers. It is in essence an agent for the taxi drivers which therefore means it's only subject to tax on the service revenue it earns if its presence in SA constitutes a PE as defined in article 5 of the OECD.

Uber further also says it is not a transport company which would therefore mean the fares it charges should be subject to VAT. In South Africa all fare-paying transportation services are exempt from VAT.⁹⁰ If Uber is not a transport service company then it should be registered and pay VAT on the revenue earned.⁹¹ If a company does not qualify for the on VAT exemption related to public transportation then it would have to pay VAT and would have to stipulate on each bill to a customer what the VAT portion of the bill was.⁹² Currently Uber bills show no portion on them that relates to VAT.⁹³

Beneficial ownership concept

The concept of beneficial owner was introduced in the model in 1977 in order to deal with simple treaty shopping situations where income is paid to an intermediary resident of a treaty country who is not treated as the owner of that income for tax purposes such as an agent or nominee.⁹⁴ Payment of royalties by a local licensee to a foreign licensor triggers withholdings tax. In the case of South Africa, withholdings tax is set by our Income Tax Act at 15% per section 49B of the income tax act; however, Double Tax Agreements ("DTA") often reduce this tax in many instances to 0%. For example, Article 12.1 of the South African / Mauritius DTA provides:

⁹⁰ (Gedye, 2015)

⁹¹ (Gedye, 2015)

⁹² (Gedye, 2015)

⁹³ (Gedye, 2015)

⁹⁴ (OECD, 2014)

Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties.⁹⁵

A beneficial owner is a person who enjoys the benefits of ownership even though title to some form of property is in another name.⁹⁶ It also means any individual or group of individuals who, either directly or indirectly, has the power to vote or influence the transaction decisions regarding a specific security, such as shares in a company.⁹⁷

In SA, Uber does not have a registered company and it does not pay royalty payments to its Netherlands related party entity, however the 20% commission earned in South Africa does go to the Netherlands as a fee. So the beneficial ownership rule cannot apply to Uber.

Furthermore, in terms of the Netherlands and SA tax treaty withholding taxes on royalty payments to the Netherlands are 0%⁹⁸. Uber International CV would in this case be the beneficial owner, a big opportunity to move significant portion of profits earned from an SA source, taxed at 0%, to a known tax haven, where these profits are also not taxed because Uber International CV is a partnership controlled by a US company, the Dutch don't collect taxes on its income. Bermuda (where Uber International CV is headquartered) charges no corporate taxes on its income and the United States see Uber international CV as a Dutch company and allows it to defer US Taxes indefinitely, effectively, rendering the profits from a SA source tax free.

Recommendations

1. A significant change to combat treaty shopping is to modernize the withholding tax rules, to withhold 15% of payments to non-residents and only

⁹⁵ (Zantwijk & Sibanda, n.d.)

⁹⁶ (Investopedia, n.d.)

⁹⁷ (Investopedia, n.d.)

⁹⁸ (Consultants-International, 2013)

receive a rebate on the amount deducted if there is proof that taxation of a certain percentage determined by a taxing state on such royalties was made in any other country. If 0% taxes paid, a 15% withholding tax would kick in.

2. To revise tax treaty provisions within South Africa to include provisions that taxes non-residents on profits from a source in SA, if a physical and Virtual PE status are established in accordance with new proposed rules as per PE chapter in this paper, and also provide for anti-avoidance provisions where such a treaty has allowed for effective taxation in a tax haven of less than a specified percentage by SARS, a particular withholding tax kicks in in SA.

Conclusion

Double non-taxation is the biggest tax advantage of the digital applications economy to MNCs, because apart from traditional transactions which still gave rise to cases of tax avoidance, the digital economy has exacerbated these issues, by bypassing most of the laws and regulations previously in place to preventing BEPS. All rules discussed require urgent attention from the OECD level to jurisdictional as well as entity level and adjustments as per recommendations if this country is to benefit from the current opportunity cost of lost tax revenue to MNCs.

Chapter 6 Transfer Pricing Challenges

Background

A significant volume of global trade nowadays consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within a MNC group and such transfers are called “intra group” transactions.⁹⁹ There is evidence that intra group trade is growing steadily and arguably accounts for more than 30 percent of all international transactions¹⁰⁰ which makes MNC have the flexibility to place their enterprises and activities anywhere in the world.

This trade across the globe, primarily follows contractual arrangements of transactions between associated companies. Due to the increasing globalization and segregation of value chains the contractual separation of risks and assets, in particular intangibles, from functions has emerged as a prominent tool for tax planning in the area of transfer pricing.¹⁰¹ The OECD argues that the technological features of the digital economy magnify this tax planning potential.¹⁰² In particular, transfer prices are used to minimize income allocable to functions, assets and risks in market jurisdictions and high tax countries.¹⁰³

Entities within a group of companies charge transfer prices amongst each other to be able to measure the performance of each individual entity in the group. Tax avoidance is often one of the key motivations in influencing an international enterprise to set transfer prices for its intra group transactions in higher tax countries to associated entities in relatively lower tax countries through either under charging or over charging the associated entity for intra group trade. This results in the groups’ effective tax rate being reduced. For example, a company operating in a high tax rate country may be overcharged for products so that its profits are sent to the country with a lower tax rate the result of which is an effective reduced group tax rate.

⁹⁹ (UN, 2011)

¹⁰⁰ (UN, 2011)

¹⁰¹ (Olbert, 2016)

¹⁰² (Olbert, 2016)

¹⁰³ (Olbert, 2016)

Should a related entity within the same group of companies provide IT services for example remotely to another entity, this will trigger associated charges by entity that provides IT related services to another. Because of the difficulties in establishing the arm's length prices when MNC transact with entities within the same group of companies under the new digital applications economy, this opens doors to profit shift for such MNC. The goal of the OECD is to aligning profit taxation with value creation and as such there is work currently by the OECD to revise the transfer pricing guidance within the BEPS project.

The OECD Discussion Draft under Action 8 suggests that the price of the asset transfer can be adjusted by tax authorities taking into account the income generated in reality. Final report on Actions 8-10 does not define the notion of value creation for purposes of designing tax policy but rather presents it as a modification of the existing arm's length standard.¹⁰⁴ Due to its technological features and globalized nature, digital business models constitute prime examples of integrated global value chains and should thus be directly affected by the ongoing transfer pricing policy that aims at outcomes aligned with value creation.¹⁰⁵

In the South African domestic tax law, transfer pricing provisions are applied to adjust prices in respect of transactions between resident and non-resident connected persons as defined in section 1 of the Income Tax Act, Act No. 58 of 1962 (the Act).¹⁰⁶

The rules essentially require that an arm's length, i.e. market related price be paid/charged in respect of the cross-border supply of goods or services between connected persons.¹⁰⁷ The Commissioner for the South African Revenue Service (SARS) (the Commissioner) may thus adjust the consideration for goods or services supplied or acquired in respect of any transaction between connected parties, with a cross border nexus, to reflect an arm's length consideration for such goods or

¹⁰⁴ Olbert, M. (2016).

¹⁰⁵ Olbert, M. (2016).

¹⁰⁶ SAICA. (2011).

¹⁰⁷ (SAICA, 2010)

services, resulting in a potentially higher tax liability for the taxpayer.¹⁰⁸ Should the Commissioner determine that there is an excessive consideration paid for the goods or services this excessive portion will be deemed a loan to the non-resident and attract interest at an arm's length rate.

Transfer pricing opportunities in the digital economy would usually occur early in the life cycle of the IP, possibly at the development phase as the cost thereof are not yet sizable. This would then allow for a company to make royalty payments from the country where operations take place (usually high tax country) to the country with a lesser tax rate. Rental of IP however occurs at any stage of the IP in question and allows for the resident to deduct the royalty payments to its lessor and thus obtaining a tax benefit through the deduction of the said royalty payments from taxable income and shifting those profits to the tax haven with a lower tax rate.

The aim of this chapter is to analyze the current available legislation in South Africa around transfer pricing, with specific focus on IP transactions emanating from the digital applications economies by non-residents owned entities operating in South Africa to foreign owned entities and evaluate if currently the legislation sufficiently addresses the challenges brought by the applications economy.

South African legislation

The rental or transfer of IP by non-resident entity to an SA resident to enable electronic trading via applications creates a transaction between two entities (resident and non-resident). A resident might pay royalties with respect to the use of the rented IP from the foreign entity and can deduct those expenses incurred as they would have been incurred to produce income. The price paid as royalties to the related party creates a transfer pricing issue where the said price is not the arm's length price.

Royalties would be deductible as costs incurred in the production of income. Income tax deductions available to South African taxpayers are regulated mainly by sections

¹⁰⁸ (SAICA, 2010)

11 to 19 and 23.¹⁰⁹ Several court cases have dealt with the deductibility of intellectual property payments for income tax purposes, whether in terms of section 11(a) or other specific sections. The case relevant to this analysis is the Supreme Court of Appeal decision in *BP Southern Africa (Pty) Ltd v Commissioner for SARS*¹¹⁰, where the court held that the purpose of expenditure is important and often decisive in determining whether the expenditure is capital or non-capital in nature. The court held that the royalty expenses were not of a capital nature and therefore deductible. It was made clear that royalty payments will not automatically be of a non-capital nature.

Section 11(gC) of the Income Tax Act applies to expenditure incurred to acquire/purchase certain intellectual property items (inventions or patents, designs, copyright, or other property of a similar nature, as well as knowledge essential for the use of such items or the right to have such knowledge imparted) on or after 1 January 2004.¹¹¹ In terms of section 102 of the Tax Administration Act, the onus of proof will be on the taxpayer to prove that a deduction must be allowed. Before a taxpayer may claim a deduction in terms of section 11, he, she or it must be carrying on a trade and must be earning income from that trade.¹¹² The term “trade” is defined in section 1 and includes the use of or the granting of permission to use any patent, design, trademark, copyright, or property of a similar nature.¹¹³

Being able to deduct royalty payments at transfer prices that are not arm’s length creates tax arbitrage. SARS introduced Section 23I of the income Tax Act to nullify tax arbitrage by prohibiting the deduction of expenditure incurred for the use or right of use of ‘tainted intellectual property’ (as defined), if the recipient of the royalty is not liable to South African tax. The reason for this was that the Act lacked effective mechanisms to prevent tax arbitrage where a taxpayer assigned South African intellectual property to a foreign entity which licensed that intellectual property back to fully taxable South African taxpayers (the licensee would make deductible

¹⁰⁹ (Oosthuizen, 2013)

¹¹⁰ 2007, SCA 7 (RSA) (69 SATC 79)

¹¹¹ (Oosthuizen, 2013)

¹¹² (Oosthuizen, 2013)

¹¹³ (Oosthuizen, 2013)

payments to the holder of the intellectual property rights). In many instances, the royalty payments were simply returned to the licensee/payer in the form of exempt dividends, whilst the tax deductions for payments made by the licensee might be so large as to reduce the licensee's taxable income to little or nothing.¹¹⁴

The reason for the transfer of products to another entity at relatively cheaper prices than market prices it would be because of the concept of earnings stripping. An earnings stripping is defined as a process by which a firm reduces its overall tax liability by moving earnings from one taxing jurisdiction, typically a relatively high-tax jurisdiction, to another jurisdiction, typically a low-tax jurisdiction.¹¹⁵

This section 23I falls short because it only addresses IP developed by a South African resident and not IP developed by a non-resident. Although the 3rd part of this provision below attempts to prevent a situation where a taxpayer will fall out of the provision by virtue of the fact that the IP in its entirety, was not discovered, developed, devised etc. in South Africa, however because there is no definition of "a material part", this will be subject to interpretation and possibly manipulation.¹¹⁶, a loophole in the current SA tax legislation.

Where such expenditure is regarded as royalty expenditure and subject to withholding tax, the South African licensee will be permitted to deduct one third of the amount of the license fee expenditure incurred. This will only apply as long as the withholding tax rate is not reduced below 10% by a double tax agreement entered into between the South African licensee and the non-resident licensor.

Section 23I currently applies to the following intellectual property:

Intellectual property that

¹¹⁴ (SAICA, 2012)

¹¹⁵ (Marcus, 2014)

¹¹⁶ (Camay, 2008)

- was the property of the 'end user' or 'connected person' in relation to the end user;
- is the property of a 'taxable person', excluding, inter alia, a non-resident;
- a material part of which was used by a taxable person in carrying on a business while that property was the property of a taxable person, and the end user of the property acquired that business or a material part thereof as a going concern; or
- was discovered, devised, developed, created or produced by the end user of that property or by a taxable person that is a connected person in relation to the end user, if that end user, together with any such taxable person, holds at least 20% of the participation rights in a person by or to whom an amount is received or accrues by virtue of the grant of use, right of use or permission to use that property or, where that receipt, accrual or amount is determined directly or indirectly with reference to expenditure incurred for the use, right of use or permission to use that property.

Section 9(1)(b) of the Income Tax Act No. 58 of 1962 (the Act) deems any amount to be from a South African source if it is received by or accrues to any person by virtue of the use or right of use in South Africa, of any patent, design, trademark, copyright, model, pattern, plan, formula or process (or any property or right of a similar nature).¹¹⁷

The new section 49B of the Income Tax Act therefore requires a holding tax of 15% to be withheld on payments made to non-residents for the use of patents in the country. However with DTA's this can be avoided as explained in the double tax agreements? Where the non-resident is a connected person, this means an opportunity to move profits from SA, avoiding the 15% taxation to another jurisdiction where the tax rate is possibly lower.

Analysis of section 23I

This section prohibits the deduction of royalty payments if the IP was discovered, devised, developed, created or produced by the end user of that property. Most

¹¹⁷ (SAICA, 2007)

MNC's that operate in the digital economy develop their IP's outside the country and do not have their end users develop or create their IP, especially the case of Uber as their IP was developed in the United States.

It further prohibits deduction of royalty payments which was discovered, devised, developed, created, or produced by the end user of that property or by a taxable person that is a connected person, as defined in section 31 (1A), in relation to the end user, if that end user, together with any taxable person that is a connected person in relation to that end user, holds at least 20 per cent of the participation rights, as defined in section 9D, in a person by or to whom an amount is received or accrues by virtue of the grant of use, right of use, or permission to use that property or where that receipt, accrual, or amount is determined directly or indirectly with reference to expenditure incurred for the use, right of use, or permission to use that property (section 23I(1))¹¹⁸.

This all points to IP developed by South African residents and their connected persons and not clear regarding IP developed by non-residents which is important in the digital applications space especially amongst the multinationals. Most MNC's developed their IP outside the country. This implies there is no prohibition against making deductions for royalty payments by their SA owned entities to their overseas holding companies based in tax havens.

Below is an analysis of the current wording of section 31 that is performed to evaluate the sufficiency of the section in preventing profit shift by MNC manipulating transfer pricing rules.

Section 31 wording

¹¹⁸ (Oosthuizen, 2013)

(1) For the purposes of this section – “affected transactions” means any transaction, operation, scheme, agreement or understanding where –

(a) That transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both

(i)(aa) a person that is a resident; and (bb) any other person that is not a resident (ii)(aa) a person that is not a resident; and (bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;

(iii)(aa) a person that is a resident; and (bb) any other person that is a resident that has a permanent establishment outside the republic to which the transaction, operation, scheme, agreement or understanding relates;

(iv)(aa) a person that is not a resident; and (bb) any other person that is a controlled foreign company in relation to the resident. And those persons are connected persons in relation to one another.

(b) Any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm’s length; financial assistance’ includes the provision of any—(a) loan, advance or debt; or (b) security or guarantee.

(2) Where—(a) any transaction, operation, scheme, agreement or understanding constitutes an affected transaction and (b) any term or condition of that transaction, operation, scheme, agreement or understanding—(i) is a term or condition contemplated in paragraph (b) of the definition of “affected transaction” and (ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding, the taxable income or tax payable by any person contemplated in paragraph (b)(ii) that derives tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm’s length.

(3) To the extent that there is a difference between (a) any amount that is, after taking subsection (2) into account, applied in the calculation of the taxable income of any resident that is a party to an affected transaction; and (b) any amount that would, but for subsection (2), have been applied in the calculation of the taxable income of the resident contemplated in paragraph (a), the amount of that difference must, for purposes of subsection (2), **be deemed to be a loan that constitutes an affected transaction.**¹¹⁹

In applying the rules of section 31 to the Uber company, it appears, transfer pricing rules as far as South Africa to Uber is concerned are close to not applicable as there is no SA resident transacting with a non-resident to be able to meet the requirements of section 31 as tabled above, clearly showing the gaps in the SA tax system. Uber claims it is a technology company that connects a consumer with a taxi driver, who acts as an independent contractor to Uber. This places the onus for all regulatory and income tax compliance on the driver of the cab, and not on Uber, clear loophole that Uber identified in the system and exploited this opportunity.

¹¹⁹ (OECD, 2013)

Conclusion

The arm's length principle is used by countries as the cornerstone of transfer pricing rules.¹²⁰ It is embedded in treaties and appears as Article 9(1) of the OECD and UN Model Tax Conventions. The challenge in the digital applications economy is the determination of the arm's length price and how specifically in the digital applications economy is this determined and the rules regarding this. The OECD stresses this challenge and intends to better align profit taxation with economic activity and value creation. Currently there is no common understanding of the term "value creation" in the digital economy which would be a prerequisite for a consistent profit allocation within digital business models¹²¹, a further loophole in the domestic and international tax legislation. To therefore attempt to better align profit taxation with economic activity will have to start at state level where legislation governing the transfer pricing such as section 31 as well as section 23I are both amended.

¹²⁰ (Anon., 2015)

¹²¹ (Olbert, 2016)

Chapter 7 Uber Case Study – Withholding taxes

Base erosion in the digital economy is also affected by legislation such as section 49B of the income tax act that have not been updated for the possible abuse by MNC's operating in the digital economy and through use of available treaties are able to avoid being liable for withholding taxes in the states where economic activity and value is created from.

Definition of Royalties

The word "royalty" is used in South Africa's Income Tax Act No. 58 of 1962 (") at various points. Although there is a general understanding on the meaning of a royalty, there is no official definition for this term which can be used throughout the Income Tax Act (ITA). Section 49B of the ITA provides the strongest guidance of what a royalty is. This section however only applies to royalties and similar payments.¹²² According to Investopedia, a royalty is a payment to an owner for the use of property, especially patents, copyrighted works, franchises or natural resources. In most cases, royalties are designed to compensate the owner for the asset's use, and they are legally binding.

Application of the definition to Uber case

The nature of the transaction granting the taxpayer the use of intellectual property determines the tax treatment thereof and therefore the deductibility thereof.¹²³ Taxpayers may be able to claim deductions for the cost of using these items in terms of specific income tax sections or the general deduction formula as outlined by the Income Tax Act 58 of 1962.¹²⁴

¹²² (Ryan, 2012)

¹²³ (Oosthuizen, 2013)

¹²⁴ (Oosthuizen, 2013)

According to Forbes.com, Uber International C.V. agreed to pay Uber Technologies a one-time fee of \$1,010,735 plus a royalty of 1.45% of future net revenue for the right to use Uber's intellectual property outside the U.S. Uber appears to not have a registered company in SA, it has what it calls a greenlight spot located in Parktown quarter at an address 38 7th avenue, Parktown North. This appears to be an agency spot as currently no management deciding on the business of Uber takes place there. This is merely a location to assist in getting rides to the next location. It is unknown at whether business transactions are concluded at this location other than just customer temporary support.

The royalty payments paid by Uber International C.V, are outside the country and therefore currently section 49B cannot be applicable to Uber International C.V nor its drivers as the drivers themselves do not pay royalties to Uber International CV, they pay "fees" i.e. 20% of their ride costs, for the right of use of the software, and they do not withhold from this 20% the amount imposed by section 35 of 15%, to pay this over to SARS.

Section 51B of the Act levies a final withholding tax on services fees calculated at the rate of 15% of the amount of any service fee that is paid by any person to or for the benefit of any foreign person to the extent that an amount is regarded as having been received by or accrued to that person from a source within South Africa. 'Service fees' is a defined term. This withholding tax will only be effective from 1 January 2016. Exemptions may apply to certain non-residents or double taxation relief may reduce the rate of the withholding tax. The person making payment of such service fee to the non-resident must withhold the tax and submit a return and pay the tax to the Commissioner by the last day of the month following the month in which the service fee is paid. Again, a declaration needs to be submitted in order to claim exemption or a reduced rate of withholding tax in terms of a double taxation agreement. To our knowledge, such a declaration has not yet been made available by SARS.

Conclusion

Base erosion challenge due to transfer pricing is not a new phenomenon. It is a concept that is exacerbated in the digital economy. The review of current guidelines as well as practically of the guidelines by the OECD becomes very important in elevating the gaps in the transfer pricing space of the digital applications economy.

Chapter 8 Recommendations

The following recommendations could assist in improving the current tax environment in regulating the transfer pricing within the digital economy.

1. Improved section 23I to include a clear restriction on the allowance of a deduction for a royalty payment to a non-resident payment if that IP was developed outside the country and the resident company connected person pays no South African Taxes.
2. The tax treatment of intellectual property (IP) capital development and expense modifications in two key areas: the transfer pricing of intangible assets and tightening tax rules in the digital applications economy as it is currently very difficult to determine an arm's length transaction price, where the legislation is not clear how this should be determined. Currently entities are easily able to transfer royalty payments for the use of the IP to countries with low tax rates and are able to obtain deduction on the expenses paid for the use of the property.
3. According to the DTC, the OECD expects that the revision of the transfer pricing guidance will substantially address the BEPS issues exacerbated by the digital economy. The review of BEPS opportunities and broader challenges in the digital economy points at the allocation of assets, functions and risks within digital business models leading to undesired tax consequences.
4. Ensuring that core activities cannot inappropriately benefit from the preparatory or auxiliary exception from permanent establishment (PE) status, and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status.¹²⁵

¹²⁵ **Davis Tax Committee. (2014).**

Chapter 9: Conclusion

The fast paced, ever changing digital applications economy is a man-made economy. Therefore, the same way the economy was made, it is the same way policies, rules and governance structures can be implemented to fairly regulate the revenue generated therefrom. The understanding and of the different business models and the different markets involved as well as the physical transactions and assisted by manmade computer programs is essentially the key first step in effectively resolving the worldwide BEPS issues as a result of the digital applications economy .

Most transactions which are not performed through direct physical contact are performed digitally whether cross boarder or not. This spreads across payment via electronic means or sending money to a recipient in another location and receiving money. All these transactions have now been made digital and given that outside any complex transactions, simple transactions that used to be performed physically have now been digitised, it makes no sense to not adapt rules and policies to align activity to in a given market place to the rules surrounding the taxation of such transactions stemming from the very same digital market by keeping rules that still refer to physical location. If the move towards a suggested virtual permanent Establishment is not executed as fast as the digital economy itself is changing, the BEPS problem will forever be an issue.

Place of effective taxation is a subject that requires the understanding of where value is being created economically. If this is appropriately understood, it becomes easier to establish legislation or define new rules to appropriately tax transactions where value is being created. This will however require worldwide co-operation with countries who might not be in favour of reduction in own revenue tax pool as a result of rebates that will have to be given if the revenue now as a result of the new rules is taxed in the country in which economic value is being created and no longer in their own countries.

Double tax treaties would need to be revised as currently treaties are there to ensure that there is no double taxation and to distribute tax revenues fairly among contracting states, however in the digital applications economy it appears there are cases where treaties have enabled double non taxation instead through loopholes in the tax system, whereby MNCs can engage in treaty shopping and be in a position to avoid paying withholding taxes as well as avoid paying taxes in the country where the revenue is shifted (a tax haven) or pay little taxes thus resulting in an unfair advantage over local competitors. This change is a change that contracting states can already commence renegotiating its treaty arrangements together with the assistance of the OECD.

The transfer of assets at less than arm's length pricing would require more streamlined and clearer definition qualifiers of an affected transaction. The challenge of determining the arm's length price and how specifically in the digital applications economy is this determined and the rules regarding this. To therefore attempt to better align profit taxation with economic activity will have to start at state level where legislation governing the transfer pricing such as section 31 as well as section 23I and 49B withholding taxes would require amendments to improve the scope of taxation of profits generated from the digital economy.

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