TAXATION OF THE DIGITAL ECONOMY: IS IT TIME FOR THE REPUBLIC OF SOUTH AFRICA TO BE DIRECT?

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DECLARATION

I declare that this report is my own, unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Laws (by Coursework and Research Report) in the field of Taxation at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

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ABSTRACT

The purpose of this research report is to address the direct tax challenges of the South African source-based taxation framework, which are imposed by social media platform providers, who derive an income from the sale of South African user data and targeted advertising services. This imposition is created since digitalisation provides a non-resident social media provider with the ability to have an 'operational scale without mass' in South Africa, which undermines the international tax law framework's capabilities to impose South African income tax on the business profits so created. This imposition is further exacerbated by the fact that the current solutions proposed to address this inability rely on the requirement of payment derived from a South African user which is usually not required by the business models of participative network platforms. In terms of these business models, South African users of social media platforms are regarded as data subjects who in exchange for the free use of the platform, pay with their personal information. In addressing this problem, the conclusion provides legislative reform by proposing a virtual presence requirement which in addition, is not solely reliant upon the payment of a fee from a South African user.

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I. INTRODUCTION

Through modern advancements in information and communication technology ('ICT'), non-resident multinational enterprises ('non-resident MNEs') have moved beyond the traditional brick-and-mortar business model, now conducting international business without the need for a physical presence in any particular market jurisdiction.[1]

In terms of traditional international tax rules, a physical presence is required in a market jurisdiction before the business profits of a non-resident enterprise can be taxed in that country.[2] Since digitalisation removes the requirement for physical presence in a market jurisdiction, there is a concern that through aggressive tax planning, non-resident MNEs which participate in the economy of a particular market jurisdiction circumvent paying direct taxes in that jurisdiction.[3]

South Africa in terms of its first National Policy on Data and Cloud,[4] is well aware that the commoditisation of its citizen's data is dominated by highly technologically advanced multinational companies in developed countries.[5] Furthermore, information on South African citizens which is converted to data through automated machine learning is freely obtained by non-resident social media MNE giants such as Facebook, Instagram and TikTok through user participation on their platforms.[6]

In recognising that South Africa's user data is a strategic commodity held by non-resident social MNEs, this report aims, through the prism of the benefit theory, to critically examine the effectiveness of the South African and international tax law framework to impose direct taxation on the value creation business models of non-resident social media MNEs.

In this regard, this report aims to propose legislative reform and considers the effectiveness of the awaited tax proposals of the Economic Co-operation and Development ('OECD') / G20's Inclusive Framework on Pillar 1.[7]

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1 OECD 'Addressing the Tax Challenges of the Digital Economy' (Action 1-Report 2015) at 54 para 7.2.
2 Ibid.
3 Ibid at 88 para 6.2.1.2.
4 *National Policy on Data and Cloud* at 126 (GN 2533 *GG* 50741 of 31 May 2024).
5 Supra at 6.
6 Action 1- Report 2015 op cit note 1 at 68 para 4.3.2.
7 OECD 'Base erosion and profit shifting (BEPS)' last accessed from *https://www.oecd.org/en/topics/policy-issues/base-erosion-and-profit-shifting-beps.html* on 1 October 2024.

II. THE DIGITAL ECONOMY – ONLINE SOCIAL MEDIA PLATFORMS

The phrase 'digital economy' is not defined in the Income Tax Act[8] ('ITA'), however in coming to its determination, the OECD in its BEPS Action 1 Report notes that to separate the digital economy from the traditional economy is a difficult task since digital technologies are integrated through all divisions of the economy.[9] Therefore, separating the economy from the digital economy would require unnecessary categories of what constitutes 'digital' and 'non-digital'.[10]

The OECD further notes that the digital economy stems from a transformative process initiated by ICT.[11] To adequately identify and address the tax challenges posed by the digital economy, the OECD suggests that it would be prudent to rather analyse the existing structures adopted by MNEs together with their business models and to concentrate on the key characteristics of the digital economy in relation to those business models adopted.[12] In this regard, two key business models of the digital economy will be addressed in this report, namely 'participative networked platforms'[13] (specifically social media networking platforms) and their use of 'online advertising'.[14] One of the key characteristics which underpins these business models is their reliance on user data and user participation.[15]

In terms of the first identified business model, leading social media providers such as Facebook, Instagram and TikTok[16] are some of the most popular forms of participative networked platforms which enable users to collaborate to develop, rate, comment and distribute user-created content ('UCC').[17] This UCC is usually posted by the users on the social media platform for free however the social media provider which features the UCC may in turn monetise the user's content through online advertising or by selling its user's collected data to other enterprises, which may be located offshore.[18]

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8 Income Tax Act 58 of 1962.
9 Action 1- Report 2015 op cit note 1 at 54 para 4.1.
10 Ibid.
11 Ibid at 11.
12 Ibid at 54 para 4.1.
13 Ibid at 62 para 4.2.7.
14 Ibid at 58 para 4.2.4.
15 Ibid at 68 para 4.3.2.
16 Statista 'Most popular social networks worldwide as of April 2024, by number of monthly active users' last accessed *from https://www.statista.com/statistics/272014/global-social-networks-ranked-by-number-of-users/* on 1 October 2024.
17 Action 1- Report 2015 op cit note 1 at 62 at para 4.2.6.
18 Ibid.

In terms of the second identified business model, the social media provider which publishes the UCC usually offers its users free access to its platform in order to ensure a huge amount of users are targeted by advertisements, as paid for by the advertisers, which may also be located offshore.[19] The social media provider targets its users with advertisements through the use of marketplaces where the advertisers pay to obtain access to the data collected from the users through the tracking and tracing of the user's online activities.[20] The advertisers may also be subject to a service fee as calculated by the social media provider which is based on 'cost-per-mile' (the advertisers pay per display of their message) or 'cost-per-click' (the advertisers pay when users click on advertisements) or 'cost-per-action' (the advertisers pay when a purchase is performed).[21]

In this regard, a key value creation provider can be identified for the social media MNE, namely their dependence on user data and the user's participation on the social media platform.[22] This is because social media platforms collect information from their users in exchange for the free use of their platform, and they convert that acquired user information to data, which is a valuable commodity.[23]

In both business models, the users of social media platforms can be seen as a 'data subject'[24] whereby their information, in the form of a barter transaction, is collected either through 'active' or 'passive' user participation techniques.[25] Active user participation refers to an explicit action of the user on a social media platform for example bookmarking, tagging, posting comments or uploading UCC in the form of pictures and videos.[26] Passive user participation however requires no active involvement of the user for example the downloading of the app, the location of the user, cookies, browsing history, or providing consent for user data to be collected.[27]

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19 Ibid at 58-9 para 4.2.4.
20 Ibid.
21 Ibid.
22 Ibid at 68 para 4.3.2.
23 OECD 'Tax Challenges Arising from Digitalisation' (Inclusive Framework-Interim Report 2018) at 39 para 2.3.3.
24 Arthur J.Cockfield 'Sharing Tax Information in the 21st Century: Big Data Flows and Taxpayers as Data Subjects' (2019) 67 *Canadian Tax Journal* 1179 at 1196.
25 Inclusive Framework-Interim Report 2018 op cit note 23 at 24.
26 Ibid at 54-5 at para 2.5.3.
27 Ibid.

In realising that the transformation capacity of data into a valuable commodity is dominated by technological companies in developed countries, the Department of Communications and Digital Technologies, on 31 May 2024, published South Africa's first National Policy on Data and Cloud. [28]

This policy acknowledges that many downloadable applications require South African citizens to grant access to their data, often without any assurance that their data will not be shared or sold to third parties.[29] This policy requires that data protection authorities monitor these practices to prevent the abuse of data for financial reasons without any of the benefit accruing to South African citizens.[30]

In terms of this policy's interventions, the government of South Africa will pursue cross-border data-sharing agreements which must promote South Africa's own national interest which includes socio-economic development, security, and sovereignty.[31] National Treasury is one of the key stakeholders in developing frameworks necessary to support this policy's interventions.[32]

III. THE DOMESTIC TAX LAW FRAMEWORK

Broadly speaking, in terms of section 5(1) read with section 5(2) of the ITA, a MNE will be subject to South African income tax at the applicable annual corporate income tax rate (currently 27%)[33] on receipts or accruals that are included in the MNEs 'taxable income', these include , among others, amounts forming part of the MNEs 'gross income' as defined in section 1 of the ITA.[34]

Section 1 of the ITA in turn defines 'gross income' in relation to any year or period of assessment to mean:

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

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

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28 *National Policy on Data and Cloud* supra note 4 at 126.
29 Supra at 146.
30 Supra.
31 Supra at 149.
32 Supra at 156.
33 SARS 'Companies, Trusts and Small Business Corporations (SBC)' last accessed from *https://www.sars.gov.za/tax-rates/income-tax/companies-trusts-and-small-business-corporations-sbc/* on 1 October 2024.
34 A.P. de Koker *Silke on International Tax* (last updated 2024) at para 18.62.

Therefore, a MNE which is a South African 'resident' taxpayer as defined in section 1 of the ITA is required to include all worldwide receipts or accruals in its gross income.[35] However, a MNE which is not defined as a resident ('non-resident') is only required to include receipts or accruals derived from a South African source.

In this regard, it is noted that for a MNE to be subject to South African corporate income tax which is a direct tax, a nexus must exist between the income and South Africa. [36] The gross income definition forms this nexus based on two principles of taxation namely 'residence-based taxation' where residents are taxed on their worldwide income and 'source-based taxation' where non-residents are taxed on income originating from a South African source.[37]

(a) Residence-based taxation

To determine whether a MNE will be subject to South African income tax based on either residence or source-based taxation, it would be important to first establish whether a juristic person is considered a 'resident'. A juristic person is considered a 'resident' in terms of paragraph (b) of section 1 of the ITA when it is:

> *'**[I]ncorporated, established or formed in the Republic** or which has its **place of effective management in the Republic** but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation'* (own emphasis)

The terms 'incorporated', 'established' or 'formed' remain undefined in the ITA however, these terms would be satisfied if a company is formed and incorporated in South Africa[38] in terms of the Companies Act.[39] The term 'place of effective management' ('POEM') also remains undefined in the ITA however, in terms of SARS Interpretation Note 6 ('SARS IN 6'),[40] POEM is regarded as the:

35 Supra at para 31.5.
36 A.P. de Koker *Silke on South African Income Tax* (last updated 2024) at para 1.8.
37 Ibid.
38 Ibid at para 14.41.
39 Companies Act 71 of 2008.
40 SARS 'Income Tax Interpretation Note No. 6' Issue 3 (30 June 2023).

'[P]lace where key management and commercial decisions that are necessary for the conduct of business as a whole are in substance made'.[41]

The SARS IN 6 confirms[42] that this definition provided is consistent with that of the OECD's 2014 commentary on article 4 of the Model Tax Convention ('OECD MTC 2014').[43] It must however be noted as held in the case of *ITC 1675*[44] that SARS's Interpretation Notes do not hold binding authority over the courts or the Commissioner if they depart from the provisions of the ITA.[45] Furthermore, it was confirmed that the term POEM was also held to be consistent with the commentaries on article 4 of the OECD MTC 2014 in the unreported case of *Oceanic Trust Co Ltd NO v CSARS*.[46]

When a MNE is considered a tax resident in terms of section 1 of the ITA and also a tax resident of the domestic tax laws of another country, the tie-breaker provision contained in the relevant DTA which is based on article 4(3) of the 2017 OECD MTC[47] will deem the MNE to be a resident of only one country.[48]

For juristic persons, the tiebreaker test as contained in the old OECD MTC 2014 was solely reliant on the POEM.[49] However, the latest OECD MTC 2017 provides a wider scope for the residency tiebreaker test since countries by mutual agreement may deem a juristic person to be a tax resident of a country by considering its POEM, incorporation or other relevant factors.[50] The commentary to the OECD MTC 2017, notes that in coming to such a determination the respective countries would have to take in various factors such as where the 'board of directors meet, where the CEO carries on its activities, where the senior day to day management is carried on or where the headquarters are located'.[51]

In this regard, it is noted that residence-based taxation is fairly simple since it focuses on the person to form a taxing nexus with South Africa as opposed to source-based taxation which focuses on the character of the income and not the person.[52]

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41 Ibid at 5.
42 Ibid.
43 OECD 'Model Tax Convention on Income and on Capital: Condensed Version 2014' at 24.
44 (1998) 62 SATC 219.
45 Supra at 229.
46 [2012] JOL 28880 (WCC) (13 June 2011) at 145.
47 OECD 'Model Tax Convention on Income and on Capital: Condensed Version 2017'.
48 Ibid at 30.
49 OECD MTC 2014 op cit note 43 at 26.
50 OECD MTC 2017 op cit note 47 at 30.
51 Ibid at 113.
52 A.P. de Koker *Silke on South African Income Tax* op cit note 36 at para 1.8.

Furthermore from the terms 'incorporated', 'established', 'formed' and 'POEM', as found in both the 'resident' definition of section 1 of the ITA and the tie breaker provisions of article 4 of the OECD MTC 2017, it is noted that a MNE would have to have some degree of physical presence in South Africa before it can be considered a tax 'resident' of South Africa and therefore be subject to South African income tax on its worldwide income.[53]

Technology and the internet, however equip a non-resident social media MNE to be involved in the economy of South Africa without having to be physically present in South Africa.[54] Therefore, a social media MNE would essentially not be required to be incorporated or have its POEM located in South Africa, which refers to the practice of having an 'operational scale without mass' in South Africa. [55] In this regard, the social media MNE would not be a South African tax 'resident' and source-based taxation would need to be considered to subject its income to South African income tax.

(b) Source-based taxation

To determine whether income received by or accrued to a non-resident social media MNE is from a South African source, would require a hierarchical analysis of the South African source rules by first considering codified statutory provisions in section 9 of the ITA (statutory source rules) and then judicial precedents (common law source rules) and then reconciling these source rules with a double taxation agreement ('DTA') which is in force.[56] However, before performing this analysis, it would be useful to first understand the theoretical justification which underpins source-based taxation.

(i) A theoretical justification for source-based taxation

Stratford CJ in the case of *Kergeulen Sealing and Whaling Co Ltd v CIR*[57] provided a justification for source-based taxation as follows:

> *'In others (as in ours) the principle of liability adopted is 'source of income'; again, presumably, the* ***equity of the levy rests on the assumption that a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live****. In both systems, there is, of course, the assumption that the country adopting the one or the other has effective means to enforce the levy.'*[58] (Own emphasis)

53 Tshidzumba-Sengwane, Khodani 'South Africa's response to the Digital Economy's direct tax challenges – Part 1' (2023) 44 2 *Obiter* 366 at 370.
54 Inclusive Framework-Interim Report 2018 op cit note 23 at 51 para 2.5.1.
55 Ibid.
56 A.P. de Koker *Silke on South African Income Tax* op cit note 36 at para 5.3.
57 1939 AD 487.
58 Supra at 380.

Therefore, the theoretical justification for source-based taxation is premised on the concept that where a country like South Africa creates wealth or generates income for the non-resident MNE by reason of South Africa's resources including the activities of its citizens, South Africa is entitled and ought to share in that wealth created irrespective of where the non-resident MNE is located.

It can be seen that the justification for source-based taxation is premised on Vogel's benefit theory,[59] which centres on the principle that where a country provides the benefits essential to the generation of income, such a country carries the costs of the benefits and should therefore be entitled to the exclusive taxing rights as compensation.[60]

South African citizens who freely participate in and actively contribute their data to social media platforms, create a valuable asset for the non-resident social media MNE. The non-resident social media MNE in turn generates an income and therefore obtains wealth by either selling the data collected from the South African user or subjecting the South African user to targeted advertising as paid for by advertisers. Whereas the South African government bears the cost of providing the essential infrastructure and data security rights for its citizens.

It would therefore be seen in terms of the justification for source-based taxation, which is underpinned by the benefit theory, that South Africa ought to share in the wealth and income received by the non-resident social media MNE which is created from the participatory activities of South African citizens. It is submitted that this approach would align with the Department of Communications and Digital Technologies' proposed policy interventions of introducing cross-border data-sharing agreements to promote South Africa's own national interest (i.e., socio-economic development, security, and sovereignty).[61]

(ii) Analysis of the source rules applicable to non-resident MNEs

The pertinent question to be addressed is whether the current source rules as contained in the South African tax law framework are adequate to subject the income received by accrued to a non-resident social media MNE engaged in user data and targeted advertising business models to South African income tax. In deriving this answer, an analysis is performed in terms of the statutory and common law source rules, followed by an analysis of the international tax law framework.

[59] Vogel K 'Worldwide v Source Taxation of Income' (1988) *Intertax* vol 18.
[60] A.P. de Koker *Silke on South African Income Tax* op cit note 36 at para 5.1.
[61] *National Policy on Data and Cloud* op cit note 4 at 149.

IV. THE STATUTORY SOURCE RULES

The term 'source' is undefined in the ITA, however sections 9(2)(a)-(l) and subsection (3) of the ITA list 17 specific source rules which apply to 9 different types of income streams which are namely income from; dividends,[62] interest,[63] royalties,[64] imparting of knowledge,[65] holding a public office,[66] insurance,[67] immovable property,[68] disposal of assets,[69] and exchange differences.[70]

From this list provided, it is noted that the identified income streams of section 9 of the ITA do not specifically relate to the specified income derived by a non-resident social MNE. However, since these business models depend on intellectual property, it would be necessary to consider the statutory source rules relating to royalties.

(a) Royalties

Section 9(2)(c) and (d) of the ITA states that an amount is received by or accrues to a person from a South African source when it constitutes a 'royalty' that is:

'(c) ...attributable to an amount ***incurred by a person that is a resident****, unless that royalty is attributable to a permanent establishment which is situated outside the Republic'.*

'(d) ... received or accrues in respect of the use or right of use of or permission to ***use in the Republic any intellectual property*** *as defined in section 23I.'* (Own emphasis)

In terms of these two provisions, royalty income will be deemed to be from a South African source if the royalty income is incurred by a South African tax resident as an expenditure or if the royalty is received by or accrues to for the use of intellectual property ('IP') in South Africa.[71] In this regard, it does not matter where the IP was produced or where the use of the IP has been granted or where payment for the use of the IP is to be made.[72]

The term 'royalty' is in turn defined in section 9(1) of the ITA as:

'...any amount that is received or accrues in respect of the use, right of use or permission to use any intellectual property as defined in section 23I.'

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62 Section 9(2)(a) of the ITA.
63 Section 9(2)(b) of the ITA.
64 Sections 9(2)(c) and (d) of the ITA.
65 Sections 9(2)(e) and (f) of the ITA.
66 Section 9(2)(g) and (9)(2)(h) of the ITA.
67 Sections (9)2(i) of the ITA.
68 Section (9)(2)(j) of the ITA.
69 Section 9(2)(k) of the ITA.
70 Section 9(2)(l) of the ITA.
71 A.P. de Koker *Silke on South African Income Tax* op cit note 36 at para 5.18.
72 Ibid.

IP is further defined in sections 23l(1)(a)-(e) of the ITA to include patents, designs, trademarks, and copyrights as defined in their respective acts. However, section 23l(1)(f) of the ITA further includes to the definition of IP 'property of a similar nature'.

In terms of the aforementioned listed categories of IP, it was held in the case of *ITC 1735*[73] that they were:

> *'…all rights designed to protect the creators or their assigns of original intellectual works'.*[74]

Furthermore, the court in *C: SARS v SA Silicone Products* (*Pty*) *Ltd*[75] held that the common nature of the aforementioned listed categories of IP:

> *'…embrace their intellectual origins, i.e. their derivation from a creative mind.'*[76]

From these two cases, it is submitted for property to fall within the ambit of 'property of a similar nature' and therefore constitute IP, the property in question must protect original intellectual work as derived by a creator's mind.

In terms of passive user participation on social media platforms whereby South African user's data is obtained through cookies, browsing history or location and sold or used in direct advertising, it could be seen as held in the case of *ITC 1735* that this information such as a person's name, likeness and biographical details are not to be regarded as a 'creative effort' and will therefore not constitute IP of a similar nature.[77]

(b) Adequacy of statutory source rules

From the above analysis, it is submitted that the statutory source rules of section 9 of the ITA will not effectively impose South African income tax on non-resident social media MNEs which derive an income from the sale of data collected from South African users or the provision of targeted advertising services.

This view is supported by the Davis Tax Committee ('DTC') in terms of its second Summary Interim Report on BEPS Action 1 ('Summary Report').[78]

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73 (2002) 64 SATC 455.
74 Supra at 457.
75 [2004] 2 All SA 1 (SCA).
76 Supra at 18.
77 Supra note 73 at 457.
78 Davis Tax Committee 'Summary of DTC Report on Action 1: Address the Tax Challenges of the Digital Economy' (DTC Summary Report – Action 1) at 4 last accessed from *https://www.taxcom.org.za/docs/New_Folder3/3%20BEPS%20Final%20Report%20-%20Action%201.pdf* on 1 October 2024.

In its Summary Report, the DTC advocates that new statutory source rules in section 9 of the ITA should be introduced to adequately address income derived from 'the supply of digital goods and services derived from a source in South Africa'.[79]

In its advocacy for the expansion of a new statutory source rule, the DTC recommends that the new rule should be premised on the 'payor principle' as contained in the aforementioned royalty provisions of section 9(2)(c) and (d) of the ITA.[80] The DTC suggests that the proposed new source rule could provide that:

> *'…digital goods or services are* ***sourced where the recipient who pays for the digital goods or services is based****, which would be where the South African tax-resident;* ***physically present in South Africa****, is at time of supply.'*[81] (Own emphasis)

Even though in relation to the policy brief of Article 12B United Nations Model Tax Convention ('UN MTC'), which also sources the income (like the statutory source rules of royalties) to a country of the payer ('the payor principle'), the African Tax Administration Forum ('ATAF') in January 2024 noted[82] that free value created by user participation business models would essentially render the payor principle ineffective.[83] Therefore, the proposals of the DTC which is based on the payor principles of a royalty would also be ineffective in this regard.

In taking into consideration ATAF's criticism of the payer principle which indirectly addresses the proposal of the DTC, it is submitted that South Africa through the prism of the benefit theory ought to consider statutory source rules which both adequately consider the payor principle of royalties, and the free right of use in user participation business models.[84]

V. COMMON LAW SOURCE RULES

In the absence of statutory source rules which adequately address the sale of user data and the provision of digitalised advertising services, the courts of South Africa will be left with the task to determine whether the income so derived by a non-resident social media MNE will be regarded as being from a South African source.

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79 Ibid.
80 Ibid.
81 Ibid.
82 ATAF 'Taxing Digital Firms in Africa' (ATAF-Policy Brief) at para 3.5 last accessed from *https://events.ataftax.org/index.php?page=documents&func=view&document_id=232* on 1 October 2024.
83 Ibid.
84 Ibid.

In coming to such a determination, Watermeyer CJ in his majority judgment in the landmark case of *CIR v Lever Brothers & Unilever Ltd*[85] ('*Lever Brothers*') noted that it is most likely an 'impossible task' to formulate a universal definition which would produce a universal test in determining whether an amount is received from a South African source.[86]

Even though an impossible task, Watermeyer established a two-stage test to establish whether income is from a South African source.[87] The first stage is to determine the originating cause of the income and the second stage is to locate that originating cause.[88]

Watermeyer went on further to say that:

> *'...the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else.'*[89]

Applying, the two-stage test of *Lever Brothers* to the digitalised business models of non-resident social media MNEs may be difficult because it could create variables in determining the location of the originating cause of the income for example, would it be where the data is created for the MNE or where the server of the MNE which produces the data is located or where the customer of the MNE receives the data?[90]

(a) Types of common law source rules

A high-level overview of some of the relevant common law rules applied by the South African courts to derive at the source of the income which may be applicable in this regard is provided below.

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[85] 1946 AD 441.
[86] Supra at 13.
[87] Supra at 8 - 9.
[88] Supra.
[89] Supra.
[90] Khodani op cit note 53 at 372.

(i) The capital employment rule

In the case of *CIR v Black*[91] ('*Black*'), a South African resident taxpayer who was a stockbroker physically present in Johannesburg, received profits from trading in shares in London.[92] The taxpayer provided capital to a London firm which acted as an agent to speculatively trade on his behalf in shares on the London Stock Exchange.[93] The court held that the income from the trading in shares was from a source located in the UK as opposed to South Africa since the taxpayer employed its capital in London and his agents were able to effectively trade on his behalf.[94] In this instance, the common law source rule provided by this case is that the source of the income in question is located where a taxpayer employs its capital.

The usefulness of this rule was however criticised by Lord Aktin in the case of*, Rhodesia Metals Ltd (in liquidation) v COT.*[95] In this regard, it was questioned whether capital is productively employed at the place where it is either used to purchase the shares or where the shares are sold or where the directors make the decisions as to how the capital is employed.[96] In this regard, it was suggested that 'employment of capital' is essentially equivalent to 'carrying on a business' in a particular place[97] as was held in the case of *COT v William Dunn & Co Ltd.*[98]

(ii) The exercise of wits and labour rule

In terms of the case of *Millin v CIR*[99]*('Miller'),* the taxpayer wrote a novel in South Africa which was published, by the taxpayer's publishers in the UK.[100] The publishers were granted publishing rights and paid the taxpayer a royalty for such rights.[101] The court held that the taxpayer's business and therefore her capital was her 'wits and labour' in writing the novel as opposed to the use of capital in the form of currency.[102]

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91 1957 (3) SA 536 (A).
92 Supra at 390.
93 Supra.
94 Supra.
95 1940 AD 432.
96 Supra at 436.
97 Supra .
98 1918 AD 607 at 615.
99 1928 AD 207.
100 Supra at 170.
101 Supra.
102 Supra at 176.

Accordingly, her wits and labour produced the royalty income.[103] Therefore, since she employed her wits and labour in South Africa at the time of writing the novel the source of the royalty income was located in South Africa as opposed to the UK.[104]

In this instance, the common law source rule provided by this case is that the source of the income in question is located where a taxpayer employs his or her wits and labour.

(iii) The location of business activities rule

Watermeyer contended in the case of *Lever Brothers* that the source of the income could also be the activity which the taxpayer engages in.[105] However, Schreiner in his dissenting judgment disagreed with this contention.[106] This notwithstanding, this source rule was applied in the case of *CIR v Epstein ('Epstein')*.[107] The taxpayer in the *Epstein* case was a South African tax resident physically present in Johannesburg who carried on a business as an agent for foreign firms.[108] The taxpayer also entered into an agreement with an Argentinian firm to purchase asbestos in South Africa and to sell it in Argentina.[109]

The court identified the following activities as the originating cause of the business profits namely the taxpayer carried out its business in Johannesburg, the taxpayer rendered no services and spent no money outside of South Africa and the taxpayer used his own bank account in financing the transactions.[110] The court in this regard concluded that the taxpayer performed all of these activities whilst being physical present in South Africa and accordingly the source of the taxpayer's income was held to be in South Africa.[111]

In this instance, the common law source rule provided by this case is that the source of the income in question is located where the taxpayer performs the majority of its business activities.

(iv) The apportionment of multiple sources rule

As seen from the various source rules applied by our courts, difficulties may arise in locating the source of income where the activities which give rise to the income are partially performed in South Africa and in another country.[112]

[103] Supra.
[104] Supra.
[105] *Lever Brothers* op cit 85 at 9.
[106] Supra at 17.
[107] 1954 (3) SA 689 (A).
[108] Supra at 694.
[109] Supra.
[110] Supra at 699.
[111] Supra.
[112] A.P. de Koker *Silke on South African Income Tax* op cit note 36 at para 5.4.

In this regard, the court in *Black* sought after the 'dominant cause' of the income. [113] This narrow approach was also evident in the case of *Essential Sterolin (Pty) v CIR*[114] in which the court held that the court must consider factors to determine the dominant or main cause of the income. [115] Furthermore, Schreiner in his dissenting judgment in *Epstein*, noted that in the absence of statutory guidelines apportionment of multiple sources of income would be impractical.[116]

(b) Adequacy of the common law source rules

Even though the aforementioned common law source rules precede the complexities of highly digitalised business models,[117] it is nonetheless considered whether these source rules could be applied to non-resident social media MNEs.

In coming to such a determination, Gutuza contends that the common law source rules can be expanded to include a source rule which could allocate taxing rights to South Africa based on the location of a server or internet service provider (ISP).[118] Gutuza justifies this determination by using the common law source rule of employment of capital and through the lease of a taxpayer's movable property since these rules do not require physical presence from a taxpayer in a source country.[119]

In terms of the employment of capital rule, as formerly discussed in the case of *Black,* the rule dictates that the source of the income of a taxpayer is located where the taxpayer employs its 'capital' in the form of currency.[120] In terms of this rule, Gutuza argues that the term 'capital' can be extended beyond currency to include other forms of capital like electronic equipment such as a server or an ISP which would then be regarded as the source of a taxpayer's income.[121] This extension of the term capital is noted to be limited in the case of *Black* since Schreiner links the taxpayer's activities or the activities undertaken by its agents to the capital.[122] However, Gutuza argues[123] that in his dissenting judgment, Schreiner in the case *Lever Brothers* provides authority that some activity by a taxpayer is not always required in the

[113] *Black* op cit note 91 at 393.
[114] 1993 (2) ALL SA 644 (AD).
[115] Supra at 650.
[116] *Epstein* supra 107 at 234.
[117] DTC Summary Report – Action 1 op cit note 78 at 62.
[118] Tracy Gutuza 'Tax and e-commerce: where is the source' (2010) 127 *SALJ* 328 at 330.
[119] Ibid at 335.
[120] *Black* supra 91 at 393.
[121] Gutuza op cit note 118 at 333.
[122] Ibid.
[123] Ibid at 334.

determination of the source since the originating cause 'may take the form of employment of capital either by using it to earn income or by letting its use to someone else'. [124]

In terms of leasing a taxpayer movable property, as held in the persuasive judgment of *COT v British United Shoe Machinery (SA) (Pty) Ltd*,[125] Gutuza argues that the use of a lessor's movable property by a lessee is the originating cause of the income, and the originating cause may be located where the property is either used or where the business of leasing is undertaken which supports the proposition that physical presence of the taxpayer is not required.[126]

In considering the common law source rule of the location of the business activities as previously discussed in the cases of *Lever Brothers* and *Epstein*, Gutuza further argues that to justify that a server or ISP is the originating cause of income, a taxpayer's other business activities in deriving income would have to be limited. [127] Therefore, the server or ISP will not be regarded as the originating cause where the taxpayer, as in the case of *Millin,* applies its 'wits and labour' somewhere else at the time when business profits are earned.[128] However, since digitalised business models do not require maximum human intervention or decision-making with the use of automated machine learning the common law wits and labour rule will not be detrimental in the submission that the server or ISP is the originating cause of the income which requires no physical presence on behalf of the taxpayer in the source country.[129]

In considering apportionment rules, the cases of *Lever Brothers*[130] and *Millin*[131] acknowledged that there is a possibility where apportionment of multiple sources of income could be considered. However, in the absence of statutory guidelines, the South African courts in adhering to the separation of powers will be reluctant to apportion income derived from multiple sources as noted in Schreiner's dissenting judgment in the case of *Epstein.*[132] It is therefore advised that legislative amendments to the ITA, together with the provision of a SARS interpretation note (which is consistent with the ITA) be considered to encompass apportionment rules relating to multiple sources of income.

[124] *Lever Brothers* supra 85 at 9-10.
[125] 26 SATC 163.
[126] Gutuza op cit note 118 at 335.
[127] Ibid.
[128] *Millin* supra 99 at 176.
[129] Gutuza op cit note 118 at 335.
[130] *Lever Brothers* supra 85 at 10.
[131] *Millin* supra 99 at 175.
[132] *Epstein* supra 107 at 700.

VI. INTERNATIONAL TAX LAW FRAMEWORK

After the analysis of the South African source-based taxation framework applicable to non-resident social media MNEs, engaged in data and digitalised advertising business models, we turn to the international tax framework to consider whether these business models are adequately taxed in South Africa in terms of the application of a DTA.

It must however be noted that in terms of section 108 of the ITA which enacts the DTA into the ITA, that no liability for income tax will arise to the non-resident MNE if no such taxing right is first created in terms of the South African source-based taxation framework.[133]

It is also important to note that a DTA is negotiated by and between South Africa and another country based on different models.[134] South Africa, to a great extent, has adopted the OECD MTC as the foundation in drafting its DTA's and has generally made minimal adjustments to this model.[135] Therefore, the OECD MTC will also form the foundation for the purposes of this analysis. However, before considering the analysis it would be important to first discuss the relationship between South Africa, the OECD and the OECD MTC.

(a) South Africa and the OECD

The OECD is an international organisation that works closely with policymakers to establish evidence-based international standards.[136] Amongst these standards, the OECD provides policy advice with the aim of assisting governments to design and implement effective and efficient tax systems. [137]

In addressing the research question, two specific OECD tax policy issues are addressed namely tax treaties which encompass the OECD MTC[138] and cross-border tax which encompasses the OECD/G20 Inclusive Framework on BEPS ('Inclusive Framework').[139]

Although South Africa is not a member of the OECD and therefore is not required to follow the OECD policies, it has been regarded as a key partner of the OECD since 2007.[140]

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[133] A.P. de Koker *Silke on International Tax* op cit note 34 at para 20.1.
[134] Ibid.
[135] Ibid.
[136] OECD 'About the OECD' last accessed from *https://www.oecd.org/en/about.html* on 1 October 2024.
[137] OECD 'Taxation' last accessed form *https://www.oecd.org/en/topics/taxation.html* on 1 October 2024.
[138] OECD 'Tax treaties' last accessed from *https://www.oecd.org/en/topics/tax-treaties.html* on 1 October 2024.
[139] OECD 'Cross-border and international tax' last accessed from *https://www.oecd.org/en/topics/cross-border-and-international-tax.html* on 1 October 2024.
[140] OECD 'Members and partners' last accessed from *https://www.oecd.org/en/about/members-partners.html'* on 1 October 2024.

In this regard, South Africa shows participation in the OECD by engaging in policy discussion in OECD bodies, taking part in OECD surveys and making voluntary amendments to the South African domestic tax legislation in line with the OECD tax policy recommendations.[141]

Even though South Africa is not a member of the OECD it is however a member of the Inclusive Framework.[142] Furthermore, the current ongoing work related to the Inclusive Framework is led by a 24-country Steering Group to which South Africa is a BEPS Associate to the Steering Group.[143]

(i) South Africa and the OECD MTC

Even though South Africa predominantly follows the OECD MTC, the OECD MTC has been criticised to favour developed capital-exporting countries over developing capital-importing countries. [144] In its criticism, it has been purported that the OECD MTC transfers tax revenues from developing countries to developed countries by narrowing revenue collected at source in developing countries.[145]

It has also been criticised that due to lack of funding and support from developed countries that the objectives of the other model convention namely the UN MTC (which favours capital importing countries by retaining tax revenue at source) [146] have been hampered in 'promoting greater inflows of foreign investment to developing countries'.[147] Therefore, developing capital-importing countries may erroneously enter into a DTA with a developed exporting country with the mistaken assumption that the developed country will stimulate investment.[148] However, investment is contingent on a beneficial environment for business, and it is therefore submitted that no DTA irrespective of which model convention is used has the effect of creating investment.[149]

[141] Ibid.
[142] OECD 'Base erosion and profit shifting (BEPS)' last accessed form *https://www.oecd.org/en/topics/policy-issues/base-erosion-and-profit-shifting-beps.html* on 1 October 2024.
[143] Ibid.
[144] A.P. de Koker *Silke on International Tax* op cit note 34 at para 1.3.
[145] Ibid.
[146] Annet Wanyana Oguttu 'A critique of international tax measures and the OECD BEPS project in addressing fair treaty allocation and taxing rights between residence and source countries: The case of tax base eroding interest, royalties and service fees from an African Perspective' (2018) *Stell LR* 314 at 314-5.
[147] UN 'Model double Taxation Convention between developed and developing countries 2021' (UN MTC 2021) at 4 para 4.
[148] A.P. de Koker *Silke on International Tax* op cit note 34 at para 1.3.
[149] Ibid.

It is further submitted that when interpreting a particular provision of a DTA which is entered into with South Africa based on the OECD MTC, the commentary relating to the OECD MTC will hold persuasive value for the courts of South Africa as was held in the cases of *SIR v Downing*[150] and *CSARS v Tradehold.* [151]

Furthermore, as noted from the title and preamble of the OECD MTC, the objective of a DTA is for 'the elimination of double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance'.[152] In this regard, international juridical double taxation occurs if two or more countries claim taxing rights on the same taxpayer in respect of the same income.[153] Therefore, in the event, that the non-resident social media MNE is taxed in terms of source-based taxation in South Africa and also taxed under the domestic tax laws of another state then juridical double taxation will occur and the DTA would follow its objective to eliminate double taxation and assign tax rights to either one specific country.

(b) Article 7 of the OECD MTC: Profit attribution

Article 7 of the OECD MTC is an important provision for a MNE of a residence state which conducts business in a source state like South Africa as it determines when the source state may impose income tax on the MNE's business profits.[154]

While section 108(2) states that a DTA has the same effect as domestic law, it does not provide that a DTA creates a tax liability for the business profits of the non-resident MNE and therefore the source state in question namely South Africa must first through its domestic tax laws create such tax liability before Article 7 of the OECD MTC can be applied.[155] This income tax liability for non-resident MNE is created by the South African tax law framework through the concept of source-based taxation, which encompasses a determination of first the statutory and then common law source rules as mentioned hereinabove.

Therefore, from a South African perspective, article 7(1) of the OECD MTC,[156] provides that where a non-resident MNE derives income which is subject to South African source-based taxation, such income will only be subject to South African income tax if the business of the non-resident MNE is carried on through a permanent establishment (PE) located in South Africa.

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[150] 1975 (4) SA 518 (A*)* at 524.
[151] 2013 (4) SA 184 (SCA) at 18.
[152] OECD MTC 2017 op cit note 47 at 27.
[153] Ibid at 376.
[154] A.P. de Koker *Silke on International Tax* op cit note 34 at para 20.1.
[155] Ibid.
[156] OECD MTC 2017 op cit note 47 at 33.

However, the income of the non-resident MNE will only be subject to South African income tax in so far, the business income is attributable to such PE.[157] Section 1 of the ITA in turn defines a PE as 'which is from time to time' defined in Article 5 of the OECD MTC. Therefore, article 7(1) should be read with article 5 of the OECD MTC.

(c) Article 5 of the OECD MTC: Nexus Rules

In terms of its general definition, a PE is defined in Article 5(1) of the OECD MTC as a:

'[F]ixed place of business through which the business of an enterprise is wholly or partly carried on'. [158]

The term 'place of business' essentially refers to a space that is available at the disposal of an enterprise irrespective of whether it is owned or rented.[159] The term 'fixed' ordinarily refers to that there must be a 'link between the place of business and a specific geographical point'.[160]

Articles 5(2)-(5) of the OECD MTC[161] provide specific inclusions and exclusions, to the general definition of PE. Article 5(2) of the OECD MTC specifically includes a place of management, a branch, an office, a factory, a workshop and a place for the extraction of natural resources. Article 5(3) of the OECD MTC specifically includes that a building site or construction installation will constitute a PE if the project lasts more than twelve months in a contracting state. Article 5(5) of the OECD MTC specifically includes to the general definition of PE a person acting on behalf of an enterprise and who habitually concludes contracts without material modification needed by the enterprise in a contracting state.

In terms of the above analysis, a PE in terms of its general definition and specific inclusions would require some degree of physical presence of the non-resident MNE in a source country before such source country in terms of article 7(1) of the OECD MTC may obtain taxing rights on the business profits of the non-resident MNE.[162] As previously noted technology and the internet enable a highly digitalised non-resident social media MNE to have mobility and therefore to have an 'operational scale without mass' in South Africa.[163]

Therefore, the non-resident MNE can participate in the economic activity of South Africa without requiring any infrastructure or personnel physically present in South Africa.

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[157] Ibid.
[158] Ibid at 31.
[159] Ibid at 118 para 10.
[160] Ibid at 121 para 21.
[161] Ibid at 31-2.
[162] Oguttu and Van der Merwe 'Electronic Commerce: Challenging the Income Tax Base?' (2005) *SA Merc LJ* 305 at 316.
[163] Inclusive Framework-Interim Report 2018 op cit note 23 at 51.

This would essentially enable the non-resident social media MNE to fall outside the ambit of articles 5 (PE) and therefore 7 (business profits) of the OECD MTC and escape South African income tax with respect to the income it derives from the sale of data and digitalised advertising services.

In addressing these shortcomings, it has been considered whether either a website or server would be able to fall within the general definition of PE.[164] In the first instance, a website (which is a combination of software and electronic data) is not considered to be a tangible asset or to have a location and therefore it cannot satisfy the requirement of having a 'fixed place of business'.[165] In the second instance, the computer equipment used to host the website, such as a server, could, however, have a physical location and therefore constitute a PE if it is used to conduct the business of the non-resident MNE.[166] This notwithstanding, a non-resident social MNE can, by logical extension, mitigate the creation of a PE by placing the server outside South Africa in a low-tax jurisdiction.

Furthermore, it has also been considered whether a software program which performs the work of a 'person acting on behalf of an enterprise' could fall within the ambit of the specific inclusion of PE in article 5(5) of the OECD MTC.[167] However, a 'person' is defined in article 3(1)(a) of the OECD MTC as an 'individual, company and any other body of persons'[168] and would therefore not include a software program in this regard.

As the OECD MTC is read on 21 November 2017, it is noted that there has been no amendments made to article 5 of the OECD to address the tax challenges arising with respect to highly digitalised business models which have an operational scale without mass in a source country. The OECD has nonetheless attempted to address these challenges through proposals in its BEPS Project Action 7.[169] However, the proposals of BEPS Project Action 7 have been criticised for having limited effect since they do not adequately address the requirement of physical presence which is still prominent in article 5 of the OECD MTC.[170] Therefore, in order to effectively bring highly digitalised business models with the ambit of the PE provision of article 5 of the OECD, it would require an amendment to the provision.

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[164] Oguttu and Van der Merwe op cit note 162 at 318.
[165] OECD MTC 2017 op cit note 47 at 152 para 123.
[166] Ibid.
[167] Khodani op cit note 53 at 372.
[168] OECD MTC 2017 op cit note 47 at 29.
[169] OECD 'Preventing the Artificial Avoidance of Permanent Establishment Status' (Action 7 – Final Report 2015) at 39-45.
[170] Ngidi Mzwandile 'Determining 'Permanent Establishment' in the Digital Economy Epoch: A Case for South Africa' (2022) 43 *Obiter* 509 at 528.

(i) Proposed amendments to Article 5 of the OECD MTC

In addressing the tax challenges arising from highly digitalised business models, Hongler & Pistone have proposed that a new PE provision namely article 5(8) be introduced to article 5 of the OECD MTC.[171] In this regard, the amendment to article 5 of the OECD MTC is proposed to read as follows:

> *'If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online marketplace or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum.'*[172]

In reading this proposal by Hongler & Pistone it can be seen that they suggest creating a taxing right for a country by means of a virtual presence as opposed to a physical presence PE which attributes the income so created to the location of the payor country. Similar to ATAF's critique on article 12B of the UN MTC it must be considered that through user participation business models, value is sometimes created through the sale of user data and provision of digitalised advertising services without the requirement of payment of a fee by the South African user of the social media platform which would essentially render the payor principle ineffective.[173] However, this proposal as per article 12B of the UN MTC would be politically sensitive for OECD member countries of the Inclusive Framework, which aims to rather rely on the solutions proposed by the unified Two Pillar approach.[174]

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171 Hongler, Peter and Pistone, Pasquale 'Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy' (IBFD - Working paper 2015) at 3 last accessed from *http://dx.doi.org/10.2139/ssrn.2586196* on 1 October 2024.

172 Ibid.

173 ATAF-Policy Brief op cit note 82 at para 3.5.

174 Jan J.P. de Goede 'The Concept of Permanent Establishment and the Digital Economy: The Challenges of Applying Traditional Principles to the New Business Environment'(2022) *Kwartalnik Prawa Podatkowegoa* 9 at 17.

VII. THE INCLUSIVE FRAMEWORK - PILLAR ONE AND AMOUNT A

(a) The history of Pillar One and Amount A

The Inclusive Framework was established in 2016 by the OECD and G20 to develop standards on BEPS-related issues and to review the implementation of the BEPS Package (which includes the OECD's Action 1 and 7 final reports). [175]

On 16 March 2018, the OECD issued an Interim Report which was titled 'Tax challenges arising from digitalisation'('Interim Report').[176] The Interim Report amongst others analysed highly digitalised business models and their key characteristics[177]as was addressed in part II of this report albeit in relation to non-resident social media MNE engaged in the sale of user data and the provisions of digitalised advertising services. In this regard, members of the Inclusive Framework (which includes South Africa) agreed to refine its analysis on value creation practices by reviewing the current nexus and profit allocation rules to propose new rules which would adequately address the direct tax challenges of the digital economy.[178]

In terms of its Policy Note issued on 23 January 2019 titled 'Addressing the tax challenges of the digital economy', the Inclusive Framework in being consistent with the OECD's Action 1 Final Report and Interim Report agreed to develop proposals for taxing the digital economy in the form of a Two Pillar approach.[179] In terms of this Policy Note it was noted that one pillar (Pillar One) focuses on the allocation of taxing rights and the second pillar (Pillar Two) addresses the remaining BEPS issues.[180]

On 14 October 2020, the Inclusive Framework released its Blueprint on Pillar One which set out the preliminary mechanics of its application.[181] The Blueprint acknowledges that Pillar One aims to adapt international income tax systems to new digitalised business models by changing 'the profit allocation and nexus rules applicable to business profits' by providing detailed source rules to expand a market jurisdiction taxing rights to include where the users are located. [182] Since the aim of this report is to consider the allocation of taxing rights, the broader tax challenges of Pillar Two will not be considered hereinbelow.

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175 OECD iLibirary 'OECD/G20 Base Erosion and Profit Shifting Project' last accessed from *https://www.oecd-ilibrary.org/taxation/oecd-g20-base-erosion-and-profit-shifting-project_23132612* on 1 October 2024.
176 Ibid.
177 Inclusive Framework-Interim Report 2018 op cit note 23 at 23-51 para 2.1-5.
178 Ibid at 173 at para 5.5 and 178 at par 6.2.
179 OECD 'Addressing the Tax Challenges of Digitalisation of the Economy' (Policy Note) at 1.
180 Ibid.
181 OECD 'Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint' last accessed from *https://doi.org/10.1787/beba0634-en* on 1 October 2024.
182 Ibid at 11.

(b) Pillar One and South Africa

National Treasury in its 2022 Budget Review[183] noted that as a member of the Steering Group of the Inclusive Framework, South Africa will propose legislative amendments to implement the rules of the unified Two Pillar approach once the framework has been finalised.[184] In its 2023 Budget Review,[185] it was noted that the OECD guidelines for Pillar One have not been finalised and that no final agreement has been reached in this regard.[186] In its 2024 Budget Review,[187] it was noted that Pillar One will be implemented through a multilateral convention (MLC) however Nationally Treasury did not confirm when this would be implemented for South Africa.[188]

On 11 October 2023, (about eight months after the 2023 Budget review), the Inclusive Framework published the preliminary text of the MLC to implement 'Amount A 'of Pillar One.[189] Even though published, the MLC is not yet open for signature as it is pending the consensus of the Inclusive Framework's members.[190] In order for the MLC to enter into force it would require ratification by 30 countries, including the jurisdictions of the ultimate parent where 60% of MNEs are expected to fall within the scope of 'Amount A'.[191]

In its statement dated 11 July 2023, the Inclusive Framework indicated that its objective is to have the MLC enter into force during the year of 2025.[192]

(c) Amount A

In terms of Articles 4 and 5 of the MLC, Amount A uses a formula-based approach to assign taxing rights to a market jurisdiction where a MNE is 'in scope' of Amount A. [193]

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183 National Treasury '2022 Budget Review'.
184 Ibid at 46.
185 National Treasury '2023 Budget Review'.
186 Ibid at 51.
187 National Treasury '2024 Budget Review'.
188 Ibid at 41.
189 OECD 'Multilateral Convention to Implement Amount A of Pillar One' (the MLC) last accessed from *https://www.oecd.org/en/topics/sub-issues/reallocation-of-taxing-rights-to-market-jurisdictions/multilateral-convention-to-implement-amount-a-of-pillar-one.html* on 1 October 2024.
190 Ibid.
191 Articles 48 and 49 of the MLC.
192 OECD 'Outcome Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy' at 2 last accessed from *https://www.oecd.org/content/dam/oecd/en/topics/policy-issues/beps/outcome-statement-on-the-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2023.pdf* on 1 October 2024.
193 OECD 'The Multilateral Convention to Implement Amount A of Pillar One' (Overview) at 3 last accessed from *https://www.oecd.org/content/dam/oecd/en/topics/policy-issues/cross-border-and-international-tax/multilateral-convention-amount-a-pillar-one-overview.pdf on* 1 October 2024.

In terms of the nexus rule, article 8 of the MLC determines that a market jurisdiction will be entitled to taxing rights on Amount A if an in-scope MNE derives source revenue above EUR 1 million or EUR 250 000 (when a jurisdiction which has a GDP lower than EUR 40 billion) from that jurisdiction.[194]

The jurisdiction which is entitled to the taxing rights will in terms of the allocation rule be allocated 25% of the MNE's excess profit (group profit in excess of 10% of its revenue) through the use of revenue-based allocation keys.[195]

(i) MNEs which are 'in scope'

A MNE will be in scope of Amount A if it meets the definition of a 'covered group' as defined in Article 3 of the MLC. In this regard a quantitative threshold applies and the MNE will be regarded as a covered group if in a financial year, its adjusted revenues are more than EUR 20 billion and its pre-tax profit margin is greater than 10 per cent.[196]

(d) Determine the source of Amount A

Articles 6, 7 and Annex D of the MLC provide specific source rules which identify and determine the location of the market jurisdiction which an in-scope MNE derives its profits from. With respect to the analyses performed on the adequacy of the domestic source-based taxation framework, the Amount A sourcing rules will now be applied to in-scope non-resident social media MNEs which derive an income from the sale of user data and the provision of digitalised advertising services.

(i) The sale of South African user data

Article 7(1)(f) of the MLC, specifically lists the category of alienating user data which is regarded as arising in the country where the user associated with the data is located. In determining where the user is located, paragraph F of Annex D to the MLC provides a hierarchal list of reliable indicators which are as follows:

> '*(a) the user profile information of the user; (b) the geolocation of the device of the user through which the user data is transferred; and c) the IP address of the device of the user through which the user data is transferred*'.

[194] Ibid at 6.
[195] Ibid.
[196] Ibid.

By applying this source rule in line with reliable indicators, to a social media MNE which sells South African user data collected through the user's participation on the social media platform, it can be seen that Amount A will adequately allocate taxing rights to South Africa. This is due to the fact that the source rule is not premised on the traditional and proposed concepts of physical presence and the payor principle.

(ii) Target digital advertising services

Article 7(1)(d)(ii) of the MLC, specifically lists the category of providing online advertising services which is treated as arising in the country where the viewer is located. Paragraph B to the MLC assists in providing the location of the source and provides the following reliable indicators:

> *'(a) the user profile information of the viewer; b) the geolocation of the device of the viewer on which the online advertisement is displayed; and c) the IP address of the device of the viewer on which the online advertisement is displayed.'*

By applying this source rule in line with reliable indicators to a social media MNE which sells online advertising services which are targeted at South African users through the use of their data, it can be seen that Amount A will adequately allocate taxing rights to South Africa. This is due to the fact that the source rule is also not premised on the traditional and proposed concepts of physical presence and the payor principle.

VIII. CONCLUSION

The objective of this report was to address the direct tax challenges of the South African source-based taxation framework which are imposed by non-resident social media platform providers, who derive an income from the sale of South African user data and targeted advertising services.

It was first established that the statutory source rules did not contain specific source rules relating to this income and legislative amendments were proposed in line with the payor principle of a royalty. It was thereafter established that the common law source rules may provide that a server could constitute the originating cause and location of this income albeit subject to the requirement of minimal human intervention. However, by logical extension, a server being a tangible asset can be placed in any particular market jurisdiction.

It was further established that the domestic tax law framework should first be adequate to impose income tax on the income before the profit allocation and nexus rules can be applied in a DTA. In this regard physical presence is a key requirement to establish a PE in a market jurisdiction and in the absence thereof non-resident social media MNEs would escape South African income tax. To address this problem amendments were proposed to broaden the PE concept to include a virtual presence in line with the payor principle.

However, due to the nature of value-creation business models which usually require no payment of a fee from a South African user, it was submitted that these proposals would be ineffective. In addressing this problem, it was confirmed that the awaited implementation of Pillar One and Amount A would successfully allocate the source of the income to the market jurisdiction where the user associated with the data and where the viewer of the advertisement is located. Therefore, in both instances, no physical presence nor payment is required to allocate taxing rights to South Africa.

Consequently, these source rules, in line with the proposed payor principle, can form the foundation to adequately amend the domestic and international tax law framework to encompass smaller enterprises which are not in scope of Amount A. This approach would agree with the justification for source-based taxation as underpinned by the benefit theory, which will support the Republic of South Africa's proposed policy interventions contained in its National Policy on Data and Cloud.

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