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

The challenges arising from the digital economy to the South African tax system and possible measures to address them (with a focus on corporate income tax for MNEs)

Applicant: Taruna Datadin

Student number: 476133

Supervisor: Mr. Reinhard Rudd

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Abstract

The advances in technology and innovation in recent years have resulted in the growth of the digital economy. The digitalisation has changed the way businesses operate. This has resulted in challenges to the international tax system which was set up over a century ago and has compromised the South African corporate income tax base.

This research report aims to understand the impact of the digital economy on South Africa's corporate income tax system and to assess the proposed measures put forward to address the associated challenges. The proposed measures examined in this report are global solutions proposed as well as unilateral measures proposed or implemented by other countries to address the corporate income tax challenges arising from the digital economy. The proposed measures analysed in the report were limited to the OECD's Two-Pillar Solution, Digital Service Tax and the Digital Permanent Establishment concept.

A qualitative research method was used for this research paper. The analysis has been performed through a detailed literature review.

Based on the analysis performed, a recommendation was reached in that South Africa should wait to implement the global solution (the OECD's Two-Pillar solution) to address the challenges arising from the digital economy. It was also found that at this stage, the unilateral measures of the Digital Service Tax and the Digital Permanent Establishment concept are not recommended to be implemented in South Africa.

Declaration

I declare that this research report is my own unaided work. The research report is submitted in partial fulfilment for the degree of Master of Commerce (specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted previously for any other degree of examination at any other university.

T.Datadin

Taruna Datadin

27 September 2024

Glossary and Terms of Abbreviation

Term	Meaning/ Abbreviation
4IR	Fourth industrial revolution
ATAF	African Tax Administration Form
CFC	Controlled Foreign Company
CIT	Corporate income tax
DST	Digital Service Tax
ETR	Effective Tax Rate
FANIL	Financial Accounting Net Income or Loss
GloBE	Global anti-base erosion
IF	OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting
IIR	Income Inclusion Rule
IP	Intellectual Property
MNE	Multinational enterprises
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
POEM	Place of effective management
QDMTT	Qualifying Domestic Minimum Top-Up Tax
SARS	South African Revenue Services
STTR	Subject to Tax Rule
The Act	Income Tax Act, No. 58 of 1962
The Companies Act	Companies Act, No.71 of 2008
UPE	Ultimate Parent Entities
UTPR	Undertaxed Payment Rule
WHT	Withholdings Tax

1. Introduction

1.1. Background

The digital economy is a term that refers to the economic activities that result from connecting businesses, individuals, data, devices, and operations through digital technology (Yasar K, 2023). This term was brought about during the third industrial revolution; however, the digital economy has evolved and grown significantly during the fourth industrial revolution ("4IR") with the advancements in technology (Yasar K, 2023).

During the 21st century, the world entered the fourth industrial revolution (McKinsey & Company, 2022). The fourth industrial revolution is a technological revolution that is changing the way people live, work, and relate to one another. (Schwab K, 2016). Klaus Schwab, the Founder and Executive Chairman World Economic Forum, has noted that while the third industrial revolution leveraged information technology and electronics to automate production, the fourth industrial revolution is building on that foundation but at an exponential rate (Schwab K, 2016). The fourth industrial revolution is blurring the lines between the digital, physical, and biological spheres (Schwab K, 2016). The 4IR has contributed to the rapid digitalisation and globalisation of the economy. (Yasar K, 2023).

Due to the recent digitalisation and globalisation of the economy noted above, this has brought into question the validity of international tax rules which were established in excess of a hundred years ago. (OECD, 2015a:3)

The fundamental principles of taxation were documented in detail by classical economists such as Adam Smith. These principles were underpinned by the key features of public economics and government spending (Smith A, 1776: Book V). In his book V of An Inquiry into the Nature and Causes of the Wealth of Nations (1776), Adam Smith takes a holistic approach where he explores government spending and establishes general tax principles to raise funding. Tax revenue collected by the government is therefore critical to ensure that the country can run successfully. If there are gaps in the tax legislation due to changes in the economy, it is crucial that this be identified, and measures are put in place to mitigate the risk.

South Africa has not been immune to the global changes in the economy noted above. The South African corporate income tax system was built around the traditional business models which rely on physical presence (SARS, 2023). The integration of national markets and economies has increased substantially in recent years due to the rise of the digital economy, and has impacted international tax rules, which were created more than a hundred years ago (OECD, 2015a:3). Business models have evolved because of globalisation and digitalisation whereby business can now operate in jurisdictions without any sort of physical presence. (Deloitte, 2021). This has therefore resulted in the system being put under strain as it is not equipped to fully deal with the changes to the global economy.

The digital economy has exacerbated the risk of tax planning by multinational enterprises (“MNEs”) which leverages gaps in the interaction of different tax systems to artificially lessen the taxable income or move profits to low-tax jurisdictions where minimal or no economic activity is actually performed (OECD, 2015a:16). The Organisation for Economic Co-operation and Development (“OECD”) have taken the lead in addressing the tax challenges of the digital economy globally within the context of their Base Erosion and Profit Shifting Project (Action 1) (OECD, 2015a).

A key measure proposed by the OECD as part of Action 1 from a corporate income tax perspective is their Two-Pillar solution (OECD, 2021:3). This proposed measure, once implemented, should align the taxation more to where the economic activities take place (OECD, 2015a:86).

Pillar One applies to large MNEs and gives taxing rights to market jurisdictions. This is done based on part of the residual profits earned by the MNE groups with an annual global turnover over 20 billion euros and 10% profitability (OECD, 2021:6). Pillar One seeks to address the risk of profit shifting through changes to the profit allocation and nexus rules applied to business profits (Deloitte, 2021:2). This solution provides taxing rights to market jurisdictions where the connected economic activity takes place (Deloitte, 2021:2).

Pillar Two is intended to impose a minimum effective tax rate of 15% on MNE groups with total consolidated revenue of 750 million euro and above (OECD, 2021: 8). This applies to all MNEs regardless of where these entities are headquartered or the jurisdictions they operate in (Deloitte, 2021:5). Where the MNE has an effective tax rate of less than 15%, the purpose of Pillar Two is to recover the balance from the MNE group (Deloitte, 2021:5).

Based on the OECD guidance, the above Two-Pillar solution should largely mitigate the impact of profit shifting in MNEs to lower tax jurisdictions and realign the taxation to where the economic activities actually take place thus restoring tax revenue to the correct jurisdictions (OECD, 2021:19).

While awaiting global solutions, some countries such as the UK, India, and Kenya have proposed and, in some cases, implement unilateral solutions to address the corporate income tax challenges that have come about due to the rise in the digital economy, the most popular being Digital Service Tax (“DST”) (KPMG, 2023). The objective of DST is to ensure that market countries have some form of taxing rights over the profits of digital service providers that profit from the local market irrespective of their physical presence (PwC, 2021). DST generally refers to a tax on gross revenues relating to digital services (PwC, 2021).

The European Union have also proposed new rules regarding taxing the digital economy in the form of their long-term and short-term solution for corporate income tax (PwC, 2018). The long-term solution proposed is to provide taxing rights to jurisdictions where entities have significant digital presence, even if they do not have physical presence there. (PwC, 2018). The long-term solution introduces the concept of a “Digital Permanent Establishment” (“Digital PE”) whereby taxing rights would be granted based on criteria relating to significant digital presence rather than physical presence (BDO, 2019a). The short-term solution proposed is that of implementing a DST until the long-term solution can be implemented.

The proposed measures and solutions noted above need to be assessed to understand whether these solutions can be practically implemented as well as to ensure that it achieves the desired objectives within a South African context.

1.2. Research Problem

This research report will analyse the impact of the digital economy on South Africa’s corporate income tax system. The report will then examine the measures put forward by the OECD as well as unilateral measures proposed or implemented by other countries to address tax challenges arising from the digital economy specifically relating to corporate income tax. These measures will be limited to the following:

- The OECD’s Two-Pillar Solution
- Digital Service Tax
- Digital Permanent Establishment rules

The report will provide an understanding of the digital economy as well as examine South Africa’s income tax rules for companies to determine any shortcomings of the system.

The proposed measures noted above will then be considered against the backdrop of any identified shortcomings of South Africa’s corporate income tax system. These measures will also be assessed against the practicality of implementation in a developing country such as South Africa.

Once the proposed solutions have been analysed, recommendations will be formulated.

1.3. Scope and limitations

The research report examines the challenges arising from the digital economy on South Africa limited income taxes only. The proposed solutions discussed in this research paper will be limited to the income tax solutions proposed by the OECD as well as certain unilateral measures proposed or implemented by other countries.

1.4. Methodology

A qualitative research method will be used in this research paper when evaluating the research problem. The analysis will be done through a detailed literature review. The sources of literature to be analysed include tax legislation, articles, OECD guidelines, books, and Journals.

2. Income tax challenges of the digital economy in South Africa

2.1. Chapter 2 Introduction

Chapter 2 will firstly provide a background of the 4IR and the Digital Economy, highlighting the changes from a traditional economy and stipulating the key features of digitalised business models. This chapter will then give an in-depth view of normal tax in South Africa. This will include defining South Africa's tax regime as well as providing an overview of the tax implications for residents and non-residents alike. Based on the background provided for the 4IR and the Digital Economy as well as the detailed assessment of normal tax in South Africa, an analysis of the normal tax challenges resulting from the Digital Economy will be performed.

2.2. 4IR and the Digital Economy

The fourth industrial revolution is characterised by an integration of technologies that is blurring the lines between the digital, physical, and biological spheres (Schwab, 2016). While the digital revolution started during the third industrial revolution, the fourth industrial revolution has distinguished itself by evolving at an exponential rate instead of a linear rate (Schwab, 2016).

The 4IR has facilitated the connection of billions of people through mobile devices, with extraordinary processing power, access to information and storage capacity (Schwab, 2016). During the 4IR there have also been technological breakthroughs in disciplines such as robotics, artificial intelligence, and the Internet of Things. (Schwab, 2016). The shift from simple digitisation (the third industrial revolution) to innovation and advancements of technologies (the 4IR) has forced entities to reconsider and evolve in the way they do business (Schwab, 2016).

The economic activity that stems from billions of everyday online connections among businesses, people, data, devices, and processes is known as the digital economy (Deloitte, 2023a). The digital economy has been evolving and expanding at a rapid pace due to the emergence of technologies and innovations (the 4IR) (Yasar K, 2023).

A crucial consequence of the above is that business models have evolved due to the globalisation and digitalisation of the economy, whereby business can now operate in jurisdictions without any sort of physical presence (Deloitte, 2021).

Some key features of business models that have evolved due to digitalisation include cross-jurisdictional scale without mass, reliance on intangible assets as well as data, user participation and the synergies with intellectual property (“IP”) (OECD, 2018:24).

2.2.1. Cross-jurisdictional scale without mass (OECD, 2018:24)

Advancements in technology and digitalisation has enabled businesses across numerous sectors to locate different parts of their production processes across different jurisdictions as well as given them access to a global customer base (OECD, 2018:24). Highly digitalised businesses have been able to operate substantially in jurisdictions without any or minimal physical presence, therefore attaining local scale without local mass (OECD, 2018:24).

2.2.2. Reliance on intangible assets such as IP (OECD, 2018:24)

Highly digital entities have a growing reliance on intangible assets (especially IP such as software, algorithms supporting their platform, websites etc.) which is not confined to a specific jurisdiction (OECD, 2018:24).

2.2.3. Data, user participation and their synergies with IP (OECD, 2018:24)

In highly digital business models, the use of data, user participation, network effects and the provision of user generated content are often observed (OECD, 2018:24). For example, in social networks, all of these elements are needed to carry out their business (OECD, 2018:24).

2.3. Income tax rules for South Africa

Income tax is fundamentally territorial (De Koker, 2023:1.2). There are two main systems that most countries use regarding income tax, being a residency-based system or a source-based system (Benetello M, 2022:2.1).

The residency-based taxation system makes the test of tax liability a function of a person’s domicile (Benetello M, 2022:2.1). A residency-based taxation system is one in which a jurisdiction has a taxing right over its citizens (Robertson, R, 2012). The system has been established on the notion that a country provides its residents with certain privileges and protections and therefore has a right to tax its citizens to fund the cost of these services and facilities per *Kerguelen Sealing & Whaling Co., Ltd v CIR, 1939 AD 487, 10 SATC: 363.*

A source-based taxation system, in contrast, is where the income arising from a jurisdiction is taxed in that jurisdiction (De Koker, 2023:1.2). In this system, the income is taxed in the country from which it originates regardless of the legal or physical residence of the recipient of that income (Katz Commission, 2007:2). The rationale behind this system is based on the idea that a country that generates wealth by way of its natural resources or activities performed in country and is therefore entitled to a share of that income as determined in *Kerguelen Sealing & Whaling Co., Ltd v CIR, 1939 AD 487, 10 SATC: 363.*

Based on the rationale above, with either system, there needs to be a tax nexus or link between the person or income being taxed and the taxing jurisdiction as seen above.

South Africa has moved away from a source-based system and, since 1 January 2001, has implemented a primarily residency-based system (Lewis A, 2019:17.1). This generally means that residents will be taxed on their world-wide gross income in South Africa (SARS, 2023b:3). Non-residents could still be caught in the South African income tax net, but only on the gross income derived from a source within South Africa (SARS, 2023b:3).

2.3.1. Residents

A resident, other than a natural person, is defined in section 1 of the Act as being a person either incorporated, established, or formed in South Africa or if it has its place of effective management ("POEM") in South Africa. This specifically excludes any person that is deemed to be exclusively a resident of another country that has been established through the application on any tax treaty between South Africa and that another country (section 1 of the Act). Per South African tax law, a company is defined as a person (section 1 of the Act).

While "incorporated" is not defined in the Act, a company is considered to be incorporated in South Africa if the company is incorporated under the laws of South Africa (SARS, 2023a). In this case, it would mean that the company is incorporated in terms of section 13 of the Companies Act.

"Place of effective management" is also not defined in the Act, we therefore look to its ordinary meaning, taking into consideration international precedent and interpretation (SARS, 2023b:3).

In terms of Interpretation Note 6, a company's POEM is where the key management and commercial decisions which are required for the business to function overall are in substance made (SARS, 2023b:5). This practice is in line with the OECD's commentary on article 4 regarding POEM (SARS, 2023b:5).

From international tax cases, in the Wensleydale's Settlement Trustees v Inland Revenue Commissioners case it was noted that 'effective' implies realistic, positive management and is essentially "where the shots are called" (SARS, 2023b:5).

Effectively, the POEM test is that of substance over form (SARS, 2023b:16). The facts of each case need to be considered in order to determine who in the company actually "calls the shots" and exercises "realistic positive management" and their location while doing this (SARS, 2023b:16).

Based on the above, both tests for a company's tax residency in South Africa (incorporated and POEM) require the company to have some sort of physical presence in the country to be considered a tax resident, and therefore liable for tax in South Africa on their worldwide gross income.

2.3.1.1. Cross border transactions

2.2.1.1.1 Double Taxation

While South African tax residents are subject to tax on all amounts accrued or received by them (worldwide income) in South Africa, there could be situations where income earned from sources outside of South Africa may also be subject to tax in another country (source country) (SARS, 2022:4). This results in international juridical double taxation (SARS, 2022:4). The residence country usually grants relief for double taxation that's caused the imposition of tax on the same amount of income by both the source country and residence country (SARS, 2022:4).

The impact of the double taxation is addressed or eliminated in various ways as discussed below.

There are unilateral relief measures in South Africa contained in the Act which include exemptions or the disregarding (in full or partially) of specific types of foreign source income and capital gains which have been received by or accrued to a resident (SARS, 2022:6). An example of such unilateral measure is that of section 10B and para 64B of the eighth schedule. These measures were put in place so as to not discourage South African investors who have sufficient influence (10% of equity share or voting rights) in foreign companies from remitting foreign dividends back to South Africa (Koekemoer AD et al, 2021: 849). Dividend income from a substantial shareholding in a foreign company would qualify for the participation exemption in terms of section 10B (SARS, 2022:7). This exemption is somewhat echoed by an exemption of capital gains on specific disposals of the shares in foreign companies in terms of para 64B of the Eighth Schedule (SARS, 2022:7). Foreign dividends which have already been taxed in South Africa either through dividends tax or CFC rules (section 10B(2)(c)) are also exempt. Foreign dividends which do not fall within the above exemptions are subject to tax in South

Africa at a reduced rate which aligns the tax impact of foreign dividends to that of domestic dividends (section 10B (3)) (Koekemoer AD et al, 2021: 849).

Where South African tax residents incur foreign taxes on their income which is subject to South African normal tax, this would result in double taxation of the income (SARS, 2022:5). Relief for these foreign taxes in the form of a rebate or deduction could be provided for in terms of section 6quat of the Act when determining the normal tax liability for South African tax purposes (SARS, 2022:5).

In terms of section 6quat (1), rebate relief is provided in respect of foreign taxes paid or payable on income which has been derived from a foreign source which has also been included in the resident's taxable income (SARS, 2022:5).

Section 6 quat (1C) (a) provides for a deduction of foreign taxes that is paid or payable on income which has been derived from a South African source which is also included in the resident's taxable income (SARS, 2022:5). This relief is in the form of a deduction of the foreign taxes in the in the calculation of the South African taxpayer's taxable income similar to any other deductible expenditure (SARS, 2022:5).

Another mechanism to reduce double taxation would be in the form of Tax Treaties (SARS, 2022:5). Please see below in 2.3.3. where this is discussed further.

2.2.1.1.2. Controlled foreign company ("CFC")

South Africa has a residence-based taxing system whereby a resident is taxed on all amounts accrued or received by them in South Africa (worldwide income) (Engel, 2002:1). An important factor of this system is how income earned by foreign companies who are South African owned is treated (Engel, 2002:1). If income earned by South African owned foreign companies goes untaxed, South African residents could avoid tax through the foreign entities and only once the foreign entities repatriate the income as dividends will the income be taxed in South Africa (Engel, 2002:1). If South Africa is unable to impose immediate tax on these amounts, it will lead to the erosion of the South African tax based as taxpayers often delay the repatriation of income for years or may never repatriate this income at all (Engel, 2002:1).

The CFC rules contained in section 9D of the Act were introduced to respond to the risk that taxpayers were able to erode the tax base of their country of residence through shifting income into a foreign company that is controlled by the taxpayers (OECD, 2015b:9). Without such rules, CFCs give rise to opportunities for profit shifting as well as long-term deferral of taxation (OECD, 2015b:9).

Section 9D of the Act provides for the inclusion of CFCs net income in the taxable income of the South African owners (Engel, 2002:2). While this measure addresses the anti-deferral/ anti-avoidance issue noted above, having a pure anti-deferral regime would not encourage international competitiveness (Engel, 2002:1). In order to strike a balance between the two, section 9D supports international competitiveness by introducing exemptions when CFC income is derived from active operations (Engel, 2002:2). These include instances where the amounts of income are subject to a comparable amount of tax had they been taxed in the hands of the South African resident, which shows that this structure was likely not entered into for the tax benefit (Koekemoer AD et al, 2021: 860). This also includes where amounts have already been taxed in South Africa as well as amounts that are attributable to bona fide business activities outside of South Africa (Koekemoer AD et al, 2021: 860).

Generally, the anti-deferral measures applies where the income generated by the CFC is passive in nature or are from transactions that were entered into to avoid taxation (Engel, 2002:2).

To determine whether or not section 9D of the Act applies, there firstly needs to be income generated by a foreign entity and secondly this entity needs to be controlled by South African shareholders (Engel, 2002:3).

Where tax residents of a country have control of a foreign company, they could have the power to divert income that would have otherwise accrued to themselves, to this foreign company (OECD, 2015b:25). By doing this, the income would escape the South African tax net. To address this risk, a resident is required to include its proportional share of profits of the CFC in its own taxable income in terms of section 9D (2) of the Act which leaves the taxpayer in the same position had the income accrued directly to them (Koekemoer AD et al, 2021: 860). The CFC rules provides for the tax in the resident shareholders rather than the foreign company itself (Engel, 2002:2). As the same taxpayer is not being taxed twice on the same amount, there is no double taxation that arises (Engel, 2002:2). Therefore, this has no impact on any tax treaties (Engel, 2002:2).

2.2.1.1.3. Arm's Length Principle

Another important section within the Act is section 31 which deals with affected transactions and the arm's length principle (CDH, 2023). The provisions included in section 31 are aimed at preventing the erosion of the South African tax base through incorrect pricing or characterisation of specific transactions (Van Der Merwe, 2023).

Affected transactions include, inter alia, transactions entered into between connected or associated persons whereby one participant is a South African tax resident or a non-resident with a PE within South Africa and the other participant is a non-resident (CDH, 2023). If the terms of the transaction are different from those that would have been normally agreed upon by independent parties (at arm's length) they are dealt with accordingly within section 31 (CDH, 2023). To determine whether or not a transaction is at arm's length, OECD guidance provides that the arm's length principle is based on comparing the conditions of a controlled transaction with the conditions that would have been present had the participants of the transaction been independent from each other and had entered into a comparable transaction under comparable circumstances (OECD, 2020:39).

Where an affected transaction (as defined in section 31) results in a tax benefit, section 31(2) of the Act requires that the taxable income of the person who receives the tax benefit must be calculated as if the transaction had occurred at arm's length (CDH, 2023).

Furthermore, the Act provides for a secondary adjustment in terms of section 31(3) to the extent that the determined taxable per section 31(2) of the Act results in an adjustment in the computation of a taxpayer's taxable income (CDH, 2023). The secondary adjustment would either be in the form of a deemed dividend in specie if the taxpayer is a company, or a deemed donation for all other taxpayers (CDH, 2023).

2.3.2. Non-residents

Persons who do not meet the criteria of resident as noted above, could still be liable for income tax in South Africa on any gross income derived from a source within South Africa (SARS, 2023b:3). While "source" is not defined in the Act, there are specific transactions included in section 9 of the Act which are regarded as being from a South African source. For all other transactions that are not included in section 9 of the Act, the "source" must be interpreted by the courts (Benetello M, 2022:2.2).

In terms of section 9 of the Act, the source of several income streams (mainly passive income) such as royalties, interest, and dividends, has been stipulated. Per section 9 of the Act, the source of income is generally determined as being of a South African source if the expenditure/distribution is incurred by a South African resident or where the service was utilised in South Africa. Therefore, there is a physical link between the income and South Africa before it can be determined to be from a South Africa source.

Where the source of income has not been specified in the Act, case law is relied on to make the determination (Koekemoer AD et al, 2021: 814).

In the case of *CIR v Lever Brothers & Unilever Ltd (1946 AD)*, the primary test used to determine the source of income was noted by asking two key questions of, what is the originating cause of the income? And where is the originating cause located? If there is more than one originating cause, it was determined in *CIR v Black (1975 AD)* to base the source on the dominant cause. Where a dominant cause cannot be determined, it may then be appropriate to apportion the source per *CIR v Nell (1961 AD)*. Source is determined on a case-by-case basis and the general approach to source per *Liquidator, Rhodesian Metals Ltd v COT) (1938 AD) 379)* is that this is not a legal concept but rather something a practical man would regard as real source of income and is determined on a practical hard matter of fact. (Koekemoer AD et al, 2021: 814).

Based on this, there needs to be a tax nexus between the income and the jurisdiction.

The South African tax can either be collected in the form of normal tax or as a withholding tax (Koekemoer AD et al, 2021: 835). Should income be subject to a withholding tax, a corresponding exemption from normal tax would usually exists to prevent the amount from being subject to double taxation in South Africa (Koekemoer AD et al, 2021: 835).

2.2.2.1. Withholdings taxes (“WHT”)

It is often difficult for tax authorities in source countries to collect income tax on income earned by residents of other countries from activities carried out in the source country (Oguttu, 2014). As such, the WHT mechanism was introduced as a way to collect such tax from non-residents (Oguttu, 2014). The WHT mechanism is most commonly used where the taxpayer may not have sufficient presence in a source country to ensure the collection of tax (Koekemoer AD et al, 2021: 836). This mechanism normally involves a resident taxpayer who is deemed to be appointed as the non-resident’s agent and is obligated to withhold the tax from payments made to the non-resident and is paid over to the tax authority (Oguttu, 2014).

These taxes are generally levied on passive income such as interest and royalties which does not require the presence of a person in country (Koekemoer AD et al, 2021: 836). South Africa imposes WHT on non-residents for South African source income in the following circumstances:

Sale of immovable property

WHT applies on the amounts paid to a non-resident with regards to disposal or immovable property in South Africa in terms of section 35A of the Act. This includes interests in or rights to immovable property (section 35A of the Act).

Royalties

WHT on Royalties is included in Part IVA of Chapter II of the Act from section 49A to 49H. It applies to Royalties (payment for the use or right of use of intellectual property and know how payments) paid to or for the benefit of a non-resident from a source in South Africa (section 49B of the Act). There are exemptions to this WHT included in Act, for example, where the royalties are attributable to a permanent establishment, there would not be withholdings tax levied as the tax on these royalties would form part of the normal tax liability (section 49D of the Act). This is due to a permanent establishment having a stronger presence in South Africa, there is a reduced risk of not collecting the tax efficiently through the normal tax process (Koekemoer AD et al, 2021: 837-838). Where the WHT is applicable, section 10(1)(l) of the Act generally exempts the royalties from normal tax.

Interest

WHT on interest is levied in terms of Part IVB of Chapter II of the Act from section 50A to 50H. This applies to interest (as defined in section 24J of the Act, except for interest resulting from certain sale and leaseback transactions (section 50A)) paid to or for the benefit of a non-resident from a South African source (section 50B of the Act). There are exemptions to this WHT included in Act, for example, where the interest is attributable to a permanent establishment, there would not be withholdings tax levied as the tax on this interest would form part of the normal tax liability (section 50D of the Act). This is due to a permanent establishment having a stronger presence in South Africa, there is a reduced risk of not collecting the tax efficiently through the normal tax process (Koekemoer AD et al, 2021: 837-838). Where the WHT Is applicable, section 10(1)(h) of the Act generally exempts the interest from normal tax.

Dividends

This WHT applies to both residents and non-residents and is levied in terms of Part VIII of Chapter II of the Act from section 64D to 64N.

2.3.3. Tax Treaties

International juridical double taxation occurs where two or more states impose similar taxes on the same taxpayer in respect of the same amount (OECD, 2017d:15). This double taxation has a negative impact on economic relations between countries (OECD:2017d:15). In order to address the risk of double taxation, countries started to introduce tax treaties. Tax Treaties are usually based on model conventions such as the OECD Model Tax Convention on Income and on Capital as well as the United Nations Model Double Taxation Convention between Developed and Developing Countries (OECD, 2017d:18). The main purpose of tax treaties is to prevent double taxation to not hinder cross border trade and investment between two states (OECD, 2017d:19). Every treaty entered into is negotiated between the countries involved and could therefore differ slightly from the model conventions (Koekemoer AD et al, 2021: 819).

From a South African perspective, section 108(1) of the Act allows for the National Executive to enter into an agreement with the government of another country to prevent and mitigate double taxation. A tax treaty allocates the taxing rights between the contracting states to impose taxes with regards to their respective domestic laws. (Koekemoer AD et al, 2021: 820).

A tax treaty will apply to persons who are residents of either or both contracting states who have entered into the agreement (OECD, 2017d:37). Therefore, the benefits of the treaty will only be for a person who is a resident of the countries that are party to the agreement. A "resident" is defined in the treaty itself and often include rules, known as tie-breaker rules, to determine residency should a person be a resident of both contracting states from their own domestic tax perspective. (Koekemoer AD et al, 2021: 821).

The taxes covered in the treaty are specified in each agreement usually in article 2 (OECD, 2017d:38).

The tax treaty allocates the taxing right of income amounts between the country of the taxpayer’s residence and the country of source where the income arises to help mitigate the risk of double taxation (OECD, 2017d:19).

Therefore, it is important to consider double tax agreements/ tax treaties when determining tax liability.

2.3.4. Permanent Establishments

The purpose of the PE concept in a tax treaty is to provide a framework around the scope and level of activities an enterprise, which is a resident of one Contracting State, would need to conduct in the source Contracting State before the profits from those particular activities could be subject to tax in the source state (OECD, 2017b:1). For a resident of one Contracting State to be taxed in a source Contracting State, they would have had to create a significant "economic allegiance" in the source state (Horak W, 2019:18.1).

In terms of the OECD’s model convention, Article 5 paragraph 1 offers the general definition of a permanent establishment as being “a fixed place of business through which the business of an enterprise is wholly or partly carried on”. (OECD, 2017a:8). This implies the existence of a facility in the Source State that has a certain degree of permanence (OECD, 2017b:2)). The definition of a PE then goes on to specifically include, inter alia, an office, a branch, a place of management, and a factory but excludes places used solely for preparatory or auxiliary purposes in relation to the business. (OECD, 2017a:8) A PE could also be created where a person conducts business in a Contracting State on behalf of the company and habitually concludes contracts or plays a principal role in concluding contracts in the name of the non-resident company (OECD, 2017a:9).

While article 5 of the OECD's model convention defines a PE, the article itself does not allocate taxing rights (OECD, 2017c:1). Article 7 of the OECD's model convention then provides a mechanism for the allocation of taxing rights (OECD, 2017c:1). In terms of article 7, a source contracting state cannot tax the profits of an enterprise who is a residence of the other contracting state, unless the enterprise is carrying on its business through a PE situated in the source contracting state (OECD, 2017b:1). Article 7 further explains that the right to tax of the source contracting state in which the PE is located does not encompass the profits which the enterprise may receive from the source contracting state that is not attributable to the PE (OECD, 2017c:4). Through article 7, the source contracting state can then tax such profits attributable to the PE (OECD, 2017c:1).

The provisions noted above merely indicate the level and scope of activity that would be required for an enterprise of a resident state to conduct in a source state before the source state may exercise its right to tax the enterprise (Horak W, 2019:18.1). These provisions do not create a taxing right for the source state unless the taxing right exists under the domestic tax laws of the source state (Horak W, 2019:18.1).

From a South African tax perspective, if the non-resident enterprise generates income that is not regarded South African source per section 9 of the Act or as determined through case law as noted above in 2.2.2., South Africa would not have a taxing right even if the income is generated by a PE (Horak W, 2019:18.1).

Section 1 of the Act defines a permanent establishment as that in Article 5 of the Model Tax Convention on Income and on Capital of the OECD. The provisions of Article 7 have not been included in the Act therefore there is no mechanism for taxing a PE within the Act itself. The mechanism for taxing a PE is therefore only included in the relevant tax treaty which forms part of the Act in terms of section 108 as noted above in 2.3.

The PE concept has also been included in several provisions of the Act. The PE concept is featured in section 9 of the Act which outlines instances of income that are derived from a South African source which is broader for PEs than other non-residents. This concept is also included in section 25D of the Act which determines taxable income in foreign currency. Paragraph 2 of the eighth schedule also provides for the application of the schedule to any assets attributable to the PE whereas other non-residents would only need to apply the section in respect of immovable property (or interest in immovable property).

With respect to the withholdings tax provisions for interest and royalties included in sections 50A to 50H and 49A to 49H of the Act respectively, PE's are generally exempt from WHT (sections 50D and 49D respectively) while the interest and royalties are then not exempt and form part of their normal tax liability in sections

10(1)h and 10(1)l of the Act respectively as PE's have a stronger presence within South Africa.

Per the above, for a PE to be created in a jurisdiction there needs to be some sort of physical presence in the country. It is also important to note that PE's also have different tax consequences within the domestic law versus non-residents as indicated above.

2.4. Challenges

Due to the globalisation and digitalisation of the economy, business models have evolved and because of this, business can now operate in jurisdictions without any sort of physical presence (Deloitte, 2021). As such, this has resulted in challenges to the international tax rules which were designed over a century ago (OECD, 2015a:3).

While South African residents are taxed on their worldwide income as noted in 2.3.1. above, the challenges arising from the digital economy poses a risk to the income tax base in South Africa with respect to taxing non-residents.

From an international tax perspective, the starting point for taxing non-residents is to determine whether or not an enterprise has created a permanent establishment within a contracting state (OECD, 2017b:1). Per the discussion above in 2.3.4., the minimum level of scope and activity needed to establish a PE focus on whether or not the non-resident has sufficient physical presence within the contracting state for the contracting state (source) to have a taxing right. Digitalisation has evolved business models so much that companies are able to operate in jurisdictions without any form of physical presence (as discussed in 2.2 above). This compromises the income tax base as these businesses may derive profits from operating within a country, however, as the business does not have a physical presence, these profits could remain untaxed in the market country (OECD, 2015a:79). For example, a company with a digital business model may interact with customers in a source country remotely through a website or through other digital means without having any physical presence within the source country (OECD, 2015a:79). To create a PE, a degree of physical presence is required before a source contracting state has taxing rights, therefore companies with digital business models may not meet the threshold while still operating in market jurisdictions (OECD, 2015a:79).

Another significant risk posed by the new business models under the digital economy is the characterisation of income (OECD, 2015a:104). As a result of digital technology, products and services can be provided to customers in new ways (OECD, 2015a:104). The characterisation of income is especially important from an international tax perspective when determining the tax consequences for non-residents as the taxing rights of the contracting and source states differ depending on income streams for treaty purposes (OECD, 2015a: 104-105). The risk is that the classification of income could be influenced by the taxpayer to achieve the most effective tax outcome. This is purely an international tax risk as residents are already taxed on their worldwide income in terms of section 1 of the Act.

2.5. Chapter 2 Conclusion

In this chapter, an overview of the 4IR and Digital Economy and a detailed understanding of normal tax in South Africa was provided. Against this backdrop, an analysis of the normal tax challenges resulting from the Digital Economy was performed. Based on the findings, we note that the normal tax challenges stemming from the Digital Economy is mainly from an international tax perspective with regards to imposing tax on non-residents. Generally, for a source country to impose tax on non-resident enterprises, there has to be a degree of physical presence within the source country. Owing to advances brought about by the 4IR and the growth in the Digital Economy, companies are able to operate in jurisdictions without having physical presence. This has therefore started to erode the tax base of market jurisdictions and suitable measures need to be put in place to address this concern. Another challenge brought on by the Digital Economy is the classification of income brought on by the new digital business models.

3. Proposed measures to address income tax challenges

3.1. Chapter 3 Introduction

Chapter 3 discusses a few key proposals that have been put forth to address the tax challenges arising from the digital economy, focusing on normal tax for MNEs, that South Africa could possibly implement. The rationale for each measure is included in the chapter as well as a high-level description of the scope and rules of each solution. The proposed measures are limited to the OECD's Two-Pillar Solution, the Digital Service Tax, and the Digital PE concept.

3.2. The OECD's Two-Pillar Solution

The Two-Pillar Solution has been proposed by the OECD to address the tax challenges of the digital economy (action 1) under their Base Erosion and Profit Shifting project (OECD, 2021:3).

3.2.1. Pillar One

The aim of Pillar One is to have a fairer distribution of profits and taxing rights between countries with regards to the largest MNEs, which have reaped the benefits of globalisation (OECD, 2021:4). Pillar One applies only to the most profitable MNEs and reallocates the taxing rights of a portion their profit to the countries where their customers are located (i.e.: where the MNEs actually provide their services or sell their products) (OECD, 2022a:1). These MNEs are able to earn significant profits in a market with minimal tax obligations therefore, by implementing the rules of Pillar One, it realigns the taxing rights to where the economic activity takes place (OECD, 2022a:1).

Pillar One consists of 3 key elements being Amount A, Amount B and Tax Certainty (Deloitte, 2021:3).

3.2.1.1. Amount A

Amount A is the new taxing right, this is the share of residual profit that is allocated to market countries which is determined based on a formula to all in-scope businesses (Deloitte, 2021:3).

All MNEs with a global turnover above 20 billion euros who also have profitability of over 10% (pretax) will be in scope for Amount A (OECD, 2021:6). The turnover threshold could possibly be reduced to 10 billion euros in the future (OECD, 2021:6). This is contingent on the successful implementation which includes the tax certainty on Amount A, with the relevant review beginning 7 years after the agreement comes into force, and that review being completed within one year (OECD, 2021:6).

These rules exclude the Extractives, Regulated Financial Services and Defence industries (Deloitte, 2023b).

New special purpose nexus rules will be applied for Amount A whereby the source of revenue of in scope MNEs will be allocated to the end market jurisdictions where goods or services are being used or consumed (Deloitte, 2021:3).

Amount A will be allocated to a market jurisdiction when the in scope MNE derives at least 1 million euros in revenue from that specific jurisdiction per the new nexus rules (OECD, 2021:6). Where a country has a GDP lower than 40 billion euros, the threshold for the amount of revenue derived from that jurisdiction will be reduced to 250 000 euros (OECD, 2021:6).

The amount of residual profit allocated to market jurisdictions will be 25% of residual profit (which is defined as profit) that is in excess of 10% of revenue (OECD, 2021:6). This will be allocated to market jurisdictions with nexus using a revenue-based allocation key (OECD, 2021:6). Profit for the purposes of Amount A is the accounting profit or loss excluding items such as tax expense or tax income, dividends, equity gains or losses etc. (OECD, 2022b: 15).

Where there is double taxation of the profit allocated to market jurisdictions, relief will be available either using the credit or the exemption method (OECD, 2021:7).

3.2.1.2. Amount B

The objective of Amount B is to simplify the existing transfer pricing rules for all taxpayers (OECD, 2023b:1). The intention is to standardise the compensation received by related party distributors performing "baseline marketing and distribution activities" to ensure this is in line with the Arm's Length Price (Deloitte, 2021:3). These activities are common in MNEs in the jurisdictions they operate in and are increasingly being disputed from a transfer pricing perspective (OECD, 2023b:1). Amount B aims to provide tax certainty, reduce compliance and administrative costs, and assist low-capacity jurisdictions where obtaining local market comparables is difficult. (OECD, 2023b:1).

In scope transactions should be priced with reference to a pricing matrix (unless there are internal comparable uncontrolled prices available) (OECD, 2023b:1). The pricing matrix stipulates arm's length returns expressed as returns on sales. The specific arm's length return will consider the distributors specific attributes such as operating expenses, operating assets, and industry (OECD, 2023b:1). Geographical differences and data availability gaps will also be considered in the framework (OECD, 2023b:1).

3.2.1.3. Tax Certainty

Pillar One establishes innovative dispute resolution and prevention mechanisms in order to enhance tax certainty (Deloitte, 2021:4). The Blueprint has an embedded tax certainty system whereby the application of the new taxing right to a particular MNE group is agreed upon by all affected countries (Deloitte, 2021:4). For tax administrations working with in scope MNE groups, a panel system has been proposed to agree on the tax base, the outcome of the application of the formula as well as any other attribute of the new taxing right such as paying entities and the elimination of double taxation (Deloitte, 2021:4). The proposed rules for Pillar One include a mandatory and binding dispute resolution process with the caveat for developing countries where it can be elective in certain cases so as to not overburden low-capacity countries to enhance tax certainty (OECD, 2021:4).

3.2.2. Pillar Two

Pillar Two applies to a larger group of MNEs than in Pillar One (has a lower threshold) and aims to impose a global minimum corporate tax (OECD, 2022a:1). Many countries are involved in tax competition where they offer reduced taxation to draw in foreign direct investment (Deloitte, 2021:5). This has encouraged companies to focus on their tax planning and increased the risk of base erosion and profit shifting. In addition, the increasing use of intangibles have enhanced the ability of MNE groups to shift profit to jurisdictions that impose lower tax (Deloitte, 2021:5).

Pillar Two seeks to address these BEPS challenges by ensuring large MNEs pay a minimum of 15% tax, regardless of the countries they operate in or where they are headquartered (Deloitte, 2021:5).

Pillar Two consists of Global anti-base erosion ("GloBE") Rules and the Subject to Tax Rule ("STTR") (Deloitte, 2021:5).

3.2.2.1. GloBE Rules

The GloBE rules include an income inclusion rule ("IIR") which imposes a top-up tax on a parent entity where a constituent entity has low tax income, as well as an undertaxed payment rule ("UTPR") which disallows deductions or provides for an equivalent adjustment to the extent the low tax income of a constituent entity has not been subject to tax under an IIR (OECD, 2021: 8).

The GloBE Rules are proposed to have the status of "common approach" (OECD, 2021:8). This means that the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting ("IF") members are not required to implement the GloBE rules, however, if the members elect to adopt the rules, it will be implemented and administered in such a way that it achieves the outcomes desired for Pillar Two and is in line with model rules and guidance agreed to by the IF (OECD, 2021:8).

MNE groups with consolidated turnover of over 750 million euros will be in scope for the GloBE rules (OECD, 2023a:12). This revenue threshold based on a four-year test which is intended to provide more stable and predictable outcomes (OECD, 2023a:13). Countries are allowed to apply the IIR to MNE groups headquartered in their jurisdictions even if the threshold is not met. (Deloitte, 2021:6).

The following are excluded from GloBE rules: Government entities, non-profit organisations, international organisations, investment funds or pension funds that are Ultimate Parent Entities ("UPE") of an MNE Group or any holding vehicles used by such entities, organisations, or funds (OECD, 2021:8).

IIR is the primary mechanism used to achieve the GloBE rules with UTPR being the secondary mechanism (OECD, 2023c:4). The IIR rules trigger an inclusion at the shareholder level, at the UPE or intermediate parent, where the income is taxed below the effective tax rate prescribed ("ETR") (Deloitte, 2021:6). The UTPR only applies where a constitute entity is not already subject to IIR (Deloitte, 2021:6).

To determine whether there is a top-up tax payable, an ETR needs to be calculated in each jurisdiction where the MNE operates (OECD, 2023a:5). This is calculated by taking the adjusted amount of covered taxes (any tax on an entities income or profits) for a jurisdiction and dividing this by the adjusted profit (or loss) before tax for that jurisdiction as per GloBE guidelines (Deloitte, 2021:6). The top-up tax percentage due is then calculated as the difference between the prescribed minimum tax rate of 15% and the ETR calculated for the jurisdiction (OECD, 2023a:19). The top-up tax calculated is payable either by way of IIR or UTPR (Deloitte, 2021:6).

For the IIR, a top-down approach is used in each jurisdiction. The IIR is applied at the top, starting at the level of the UPE, and works its way down the ownership chain as needed (OECD, 2023c:4).

Where an entity has low taxed income and is held through a chain of ownership that does not result in the IIR being applied, the backstop provision of the UTPR would then apply (OECD, 2023c:4). Under the UTPR, an adjustment (such as a denial of deduction) is used to increase the tax payable at the level of the subsidiary (OECD, 2023c:4). This top-up tax is allocated proportionately between the constituent entities applying the UTPR in a coordinated manner (Deloitte, 2021:7).

3.2.2.2. STTR

This is a treaty-based rule that applies to specific cross-border payments ("covered payments") such as interest, royalties, marketing or other intermediatory services etc. between connected persons (Deloitte, 2021:7). This rule is triggered where these payments are subject to tax at a rate lower than the prescribed minimum rate in the payee jurisdiction (Deloitte, 2021:7). The difference between the minimum rate of 9% and the tax rate on the payment will be the taxing right (OECD, 2021:9).

The STTR has been designed to address the risk of BEPS of cross border structures as it relates to intragroup payments (Deloitte, 2021:7).

3.3. Digital Service Tax

As economies are becoming increasingly more digitalised, that digitalisation often enables highly digitalised companies (such as online marketplaces, search engines and social media platforms) to carry out business in market countries with no or very minimal physical presence in those countries (ATAF, 2020a:1). Owing to international tax rules, which usually allocate taxing rights to a country where a non-resident creates sufficient physical presence, it is becoming more difficult to establish taxing rights and poses a significant risk to tax base in these countries (ATAF, 2020a:1).

A digital service tax is a unilateral solution that has been proposed and, in some cases, implemented by countries while awaiting global solutions (KPMG, 2023). A digital service tax is generally a tax on gross revenues from digital services which occurs outside of any treaties (PwC, 2021). The purpose of DSTs is to give taxing rights to market countries over the profits of highly digital businesses that operate in their local markets regardless of the physical presence of the company (PwC, 2021).

The DST can cover a broad range of services such as online sales, data usage, streaming or downloading, digital advertising, e-commerce etc. (PwC, 2021).

ATAF has provided guidelines for drafting legislation on the DST to its member countries. Per the guidelines, ATAF suggest that a country impose a tax of between 1%-3% on digital services revenue derived by a company or MNE group from that specific country (ATAF, 2020a:3). Digital services revenue is the total amount of revenue derived directly or indirectly from or attributable to that country in connection with the provision of digital services (ATAF, 2020a:3). The definition of digital services is all-encompassing as services that are delivered over the internet or an electronic network including online platforms (ATAF, 2020a:3). The proposed definition includes a wide range of services that could form part of digital services as defined such as data services, online advertising services, services delivered through an online marketplace or intermediation platform, cloud computing services etc. (ATAF, 2020a:3).

The template proposed for DST legislation also includes de minimis thresholds based on the company or MNE groups worldwide revenue and country digital service revenue before the DST can be charged (ATAF, 2020a:6).

The general guidelines highlighted above are in line with DST rules set out by the EU Commission (PwC, 2018). From a double tax perspective, the EU Commission have proposed that the DST be deductible against corporate income tax to reduce or eliminate the impact of double taxation (BDO, 2019a).

The use of a digital service tax in many countries is considered an interim measure that would be repealed if and when a global solution is finalised and introduced (ATAF, 2020a:2). The EU Commission has specifically noted that DST is a short-term solution that will be replaced by their long-term solution of the “Digital PE” concept once there is consensus (BDO, 2019a).

3.4. Digital Permanent Establishment rules

The proposed solution of implementing digital permanent establishment rules is a unilateral solution that has been proposed, and in some cases enacted into law, in many countries (KPMG, 2023).

The digital PE concept allows for a taxable nexus where there is “significant digital presence” even if there is no physical presence (PwC, 2018). These rules between contracting states gives taxing rights to one state on profits from an entity arising in that state without that company having any physical presence in the jurisdiction (BDO, 2019a).

The digital PE rules proposed by the EU Commission as part of their long-term solution specifically includes digital platforms as having a “significant digital presence” if at least one of the following criteria are met (PwC, 2018):

- The revenue from the platform exceeds 7 000 000 euros during the tax year in that member state (PwC, 2018);
- Users on the platform who are located in that Member State exceed 100 000 during the tax year (PwC, 2018);
- More than 3 000 business contracts regarding the supply of any such digital service are concluded in the tax year by users located in that member state (PwC, 2018).

If the criteria above are met, attributable profit (based on the profit split method) would be taxed in the member state with the significant digital presence (PwC, 2018). The rules proposed would be incorporated into the double tax conventions between contracting states (PwC, 2018).

The proposed digital PE rules allocates profits and intends to better reflect value creation by digital entities per jurisdiction (BDO, 2019a).

3.5. Chapter 3 Conclusion

In this chapter, 3 key measures were discussed that could potentially address the tax challenges arising from the digital economy (with a focus on normal tax for MNEs). These proposals were limited to the OECD's Two-Pillar Solution, the Digital Service Tax, and the Digital PE concept. This chapter provided a description of the rules as well as the rationale behind the solutions that would address the risk identified. This will be used as a foundation for chapter 4 where an analysis will be performed on these solutions.

4. Analysis of proposed measures

4.1. Chapter 4 Introduction

This chapter will analyse the proposed measures included in chapter three, namely the OECD's Two-Pillar solution and unilateral measures that have been proposed or implemented by other countries being Digital Service Taxes and the Digital PE concept. As part of the analysis, the impact upon tax revenue as well as cost to implement will be considered. This chapter will also take into consideration the practical challenges to implementation by the relevant tax administration as well as the response received globally.

4.2. The OECD's Two-Pillar Solution

4.2.1. Pillar One

4.2.1.1. Amount A

Amount A sets out to reallocate taxing rights of a portion of profit related to the most profitable MNEs to the countries where their customers are i.e., where their products are sold, or services are provided. (OECD, 2021:18).

Under Pillar One, the OECD have estimated that a minimum of USD 125 billion of profit will be reallocated to market jurisdictions in terms of taxing rights, with developing countries expecting to gain more than developing countries as a share of CIT (OECD, 2021:19).

The rules set out for Amount A ensures that smaller jurisdictions are also included by implementing the two thresholds for GDP as noted above (ATAF, 2021). This would aid in including more developing countries (ATAF, 2021).

The MLC for Amount A is set to be open for signature only in June 2024, with the number of jurisdictions needed to sign and ratify the MLC for it to come into force, it is unlikely that it will be effective until at least 2026 or 2027 (ATAF, 2024b:3). As such, there is concern around lost tax revenue with regards to the digital economy in the interim.

There is also concern around the complexity and length of Amount A (ATAF, 2024b:3). This is due to the published MLC and Explanatory Statement being more than 800 pages long (ATAF, 2024b:3). As such, the implementation of these rules could be difficult in developing countries given the resource constraints.

In addition, the OECD have noted that the Multilateral Convention for Amount A in Pillar One will require all parties to remove all unilateral measures implemented such as digital service taxes (OECD, 2021:7).

In recent communication, the OECD have tried to put a hold on IF members imposing newly enacted DSTs from early as 1 January 2024 depending on certain conditions being met without having the MLC in effect (OECD, 2023d:2).

The standstill of DSTs or similar measures is concerning as countries, especially developing countries in Africa, have stated the need to start taxing profits of highly digital businesses and not wait until the MLC is effective which is highly unlikely to be before 2026 or 2027 (ATAF, 2023). This is concerning as these countries will be losing tax revenues from taxing the digital economy from other measures as well during these years.

4.2.1.2. Amount B

The framework provided in the Amount B rules gives a simple and structured approach to the arm's length principle with regards to in-country baseline marketing and distribution activities. Several tax administrations in Africa have reported between 30% - 70% of their transferring disputes with taxpayers relate to such activities (ATAF, 2023). By implementing these rules, it would address some challenges faced by African countries where there are often no comparable activities being carried out independent companies in the market as this market is dominated by MNEs (ATAF, 2023).

4.2.1.3. Tax Certainty

The tax certainty mechanisms noted above could be costly and resource intensive to implement (ATAF, 2021). This is particularly concerning in capacity constrained developing countries where there is little risk of double tax (ATAF, 2021).

4.2.2. Pillar Two

4.2.2.1. GloBE Rules

The GloBE rules proposed for Pillar Two are in place to ensure that large MNEs pay a minimum rate of tax on their income by jurisdiction therefore decreasing the incentive for profit shifting (OECD, 2023a:3).

With the implementation of the GloBE rules, it is expected that approximately USD 150 billion in additional global tax revenues will be generated per year (OECD, 2021:19).

While, theoretically, the GloBE rules should achieve the objective noted above, ATAF is of the view that the minimum effective rate needed is at least 20%, rather than the 15% prescribed in the GloBE rules for this to have an impact on profit shifting out of Africa as most African countries have a corporate income tax rate of between 25%- 35%. (ATAF, 2021). For South Africa this is also true as the corporate income tax rate is at 27% (SARS, 2024).

At the minimum corporate income tax rate of 15%, there is still incentive for large MNEs to shift profit out of Africa and into lower tax jurisdictions as the corporate income tax rate in these countries are still significantly higher than the 15% (ATAF, 2021). By increasing the rate to at least 20%, this assists to disincentivise profit shifting out of Africa (ATAF, 2021).

As the Pillar Two solution would be implemented at a global level, IF members, through agreement on a coordinated set of rules, would be able to impose these rules without giving rise to double taxation (OECD, 2023a:3).

The complexity of the GloBE rules can be seen from the Model Rules and lengthy Commentary (Ernst & Young, 2022). As a result, significant resources would need to be invested by companies to comply with these rules (Ernst & Young, 2022). Tax administrations would also need to invest significant resources to enforce these rules which could be problematic in developing countries with limited resources.

The Model Rules and Commentary on the GloBE rules provide for a Qualifying Domestic Minimum Top-Up Tax (“QDMTT”) whereby governments can incorporate the minimum tax rules directly into the domestic legislation (Ernst & Young, 2022). The use of the QDMTT gives the primary taxing rights of the low-taxed profits to the source jurisdiction. (ATAF, 2024a:1). If countries integrate this rule into domestic legislation, there could be slight variations on the rules between the different jurisdictions therefore it could add to the costs for MNEs in terms of compliance and administration (Ernst & Young, 2022).

As part of the GloBE rules, to calculate the ETR, the starting point of the calculation is the financial accounting net income or loss (“FANIL”) which is based on the accounting standards that are used to prepare the MNE Groups’ Consolidated financial statements (i.e., IFRS or GAAP etc.) (OECD, 2023a:14). This FANIL is then subject to a few adjustments to try and align the income or loss more to that of taxable income (OECD, 2023a:16).

While the rationale for using financial accounting amounts for the basis of the calculation is to reduce compliance burdens and administrative resources, this should be carefully considered (PwC, 2019a:4-5). The purpose of financial accounts specifically to provide information to investors or potential investors to support investment decisions (PwC, 2019a:4-5). In general, tax accounting is based on historical cost measuring whereas as financial accounting is normally based on fair value accounting (PwC, 2019b:11). Relying on accounting profit for tax matters could have drawbacks considering the difference in objectives (PwC, 2019b:11).

The OECD have noted that they will support developing countries in building capacity and throughout the implementation process (OECD, 2021:19).

4.2.2.2. STTR

Under the treaty based STTR, it allows countries to retain taxing rights to certain payments made to foreign group companies which often presents a BEPS risk (OECD, 2021:19).

Many African countries have voiced concerns of BEPS risks relating to service fees among group companies crossing jurisdictions (ATAF, 2023). ATAF have noted, through their technical assistance work with their member countries, a smaller African country lost over USD 75 million in a 5 five-year period as a result of a reduced WHT on service payments in only one Tax Treaty (ATAF, 2023).

The STTR would act as a defense against the BEPS risks relating to intra-group payments providing that the WHT rate is appropriate (ATAF, 2023).

4.3. Digital Service Tax

With economies becoming increasingly digitalised, this has allowed highly digital MNEs to operate in market jurisdictions with little to no physical presence (ATAF, 2020a:1). This in turn has made it difficult for market jurisdictions to establish taxing rights over these profits (ATAF, 2020a:1).

The use of the DST would address this issue by giving taxing rights to market countries over profits of highly digital business that operate in the jurisdiction regardless of physical presence (PwC, 2021).

While this solution addresses some of the challenges of taxing the digital economy, there are both advantages and disadvantages to implementing this solution as noted below:

4.3.1. Advantages

The suggested rules for a DST are straightforward (as noted above) and therefore should be relatively simple to administer and compute (ATAF, 2020b:3).

There has been public concern of MNEs, especially those with highly digital business models, being undertaxed in jurisdictions where they operate but have no physical presence (ATAF, 2020b:3). By implementing a DST, it could enhance public confidence in the fairness of the tax system which is essential to promote voluntary compliance in the tax system (ATAF, 2020b:3).

While the revenue raised from the DST in African countries may not be significant at this point in time, the digital economy is growing rapidly as a proportion of the total economy of Africa (ATAF, 2020b:1). As a result, it is important for African countries to have a mechanism in place to ensure that the digital economy is taxed appropriately going forward (ATAF, 2020b: 1).

4.3.2. Disadvantages

There have been objections to the DST by certain countries (BDO, 2019a:2). American and Irish companies dominate the digital service industry and therefore these countries stand to lose tax revenue as a result of other jurisdictions implementing a DST (BDO, 2019a:2). The office of the United States Trade Representative has also initiated investigations regarding DSTs that have been implemented or proposed by certain jurisdictions (ATAF, 2020b:3). These investigations could potentially lead to tariffs being imposed on the country's exports to the USA (ATAF, 2020b:3). By adopting or considering DSTs, this could lead to similar investigations.

DSTs also raises concerns for MNEs due to the additional compliance obligations this brings (BDO, 2019a:2). As this is a unilateral measure, DST rules also differ from one jurisdiction to the next (Vasquez, 2023). As a result, there could be significant administrative burdens on the MNEs to comply with the different rules (Vasquez, 2023).

The administrative burden, along with the additional tax, could risk MNEs pulling out of certain jurisdictions.

As the DST applies in addition to income tax, this could mean that the DST and income tax are applied to the same income (ATAF, 2020b:3). The DST is also outside of treaty rules (PwC, 2021). As a result, this would increase the risk of double taxation.

According to the guidance issued by the OECD in respect of its Two-Pillar solution, the Multilateral Convention for Amount A in Pillar One will require all parties to remove all unilateral measures implemented such as digital service taxes (OECD, 2021:7). As such, this solution may be temporary solution until there is consensus of the global solution. The OECD have also noted that unilateral measures such as DSTs can be inefficient and result in disputes among countries due to the DST possibly leading to double taxation or trade retaliation (OECD, 2021:20).

The DST is also applicable on gross turnover rather than profit, therefore there is a risk the DST could apply to loss making entities or entities with low margins (ATAF, 2020b:3). While this is slightly mitigated by the de minimis thresholds (as large businesses are more inclined to be profitable) and the low rate of the DST, the risk cannot be completely mitigated (ATAF, 2020b:3).

4.4. Digital Permanent Establishment Rules

Introducing the concept of a digital PE is intended assist contracting states to tax the profits of a company in one state without having any physical presence as long as a significant digital presence exists (BDO, 2019a). By including the significant digital presence notion into the PE concept, this will support in driving effective taxation of the value created through the PE nexus (BDO, 2019a). This will help to address the tax challenges around taxing the digital economy and ensuring that countries do not lose out on their share tax revenue.

The mechanism for executing the digital PE rules is through the treaty rules (PwC, 2018). As noted in 2.3.3., treaties are usually negotiated and entered into between two contracting states. To introduce the new rules, a country would need to re-negotiate existing treaties which could be costly and time consuming.

For the new PE rules to be most effective, the underlying domestic law should also be updated for the impact of the digital economy (Davis Tax Committee, 2016:4). It is recommended that the source rules included under section 9 of the Act be expanded to include rules that address proceeds derived from the supply of digital goods and services from a South African source (Davis Tax Committee, 2016:4). Should the new rules noted above be based on the payor principle (similar to royalties), the rules could provide that the source of the income relating to digital goods and services be determined as the jurisdiction where the recipient of the digital goods and services is based (Davis Tax Committee, 2016:4). This would mean where the South African tax resident is physically present at the time of supply (Davis Tax Committee, 2016:4). It would also be helpful to clarify the characterisation of the regular types of income from digital transactions (Davis Tax Committee, 2016:4).

The digital PE concept is a unilateral measure that is being proposed (Ernst & Young, 2018). The EU Commission have noted that a multilateral approach would have been ideal given the global nature of taxing the digital economy (Ernst & Young, 2018), however, due to the consensus needed for a global solution it would take additional time to reach consensus and implement.

Based on the proposed rules for the digital PE concept, it may require significant resources relating to administrative systems and a highly skilled workforce to enforce (BDO, 2019a). Many African countries do not have the capacity or resources to implement such a solution effectively (BDO, 2019a).

4.5. Chapter 4 Conclusion

In this chapter, an analysis has been performed for each of the proposed measures discussed in chapter 3. This chapter has highlighted the effectiveness of each measure as well as noted gaps in the rules as well as practical issues relating to implementation. These findings will be taken into consideration in chapter 6 where recommendations will be made for South Africa.

5. Country specific analysis of unilateral measures

5.1. Chapter 5 Introduction

In this chapter country specific analysis will be performed where countries have already implemented the unilateral measures of the Digital Service Tax and the Digital Permanent Establishment concept. A detailed review will be performed into the rules implemented for two countries of each measure which will highlight the practical implications of implementing such measures (i.e.: the effectiveness of the measure, the cost to implement and how the measure has been received internationally).

5.2. Digital Service Tax

The DST has already been implemented in a number of countries (KPMG, 2023). Below is a detailed review of two countries DSTs which outlines the rules that were put into effect and provides an evaluation of the measure itself as well as practical challenges faced on implementation.

France has been selected for this analysis as their DST came into effect a number of years ago, therefore the system is more mature and a deeper analysis of the longer-term impact of the DST would be gained. France was also selected as the rules of their DST were based largely on the EU proposal (BDO, 2019b) which is in line with ATAF's suggested rules that were analysed above in 3.3.

Kenya was another country selected for the analysis as Kenya is a fellow African country which could be more comparable to South Africa.

5.2.1. France's DST

The DST has already been implemented in a number of countries (KPMG, 2023). Below is a detailed review of France's DST which outlines the rules that were put into effect and provides an evaluation of the measure itself as well as practical challenges faced on implementation.

During July 2019, France enacted its new DST (BDO, 2019b) which applies retrospectively from 1 January 2019 (KPMG, 2023). The DST for France is levied at 3% on gross revenue derived from certain digital services (Ernst & Young, 2020).

The rules of the DST are largely based on the EU proposal where there was no consensus reached therefore France enacted the legislation as a unilateral measure to combat the impact of the digital economy on their tax base (BDO, 2019b). This DST should be a temporary measure while awaiting the longer-term global solution being coordinated by the OECD (BDO, 2019b).

The scope of the DST requires 4 elements (Ernst & Young, 2020):

- The existence of taxable services (Ernst & Young, 2020)

  Taxable services in the scope for the DST in France includes digital intermediation and targeted advertising (Ernst & Young, 2020).

  Digital intermediation services allow users to interact with each other through a digital interface, this includes the supply of good and services through digital marketplaces as well as networking services such as social media platforms (Ernst & Young, 2020). This excludes the supply of digital content, financial services and the sale or purchase of services used for placing targeted advertising messages (Ernst & Young, 2020).

Target advertising relates to services provided to advertisers whereby they are able to purchase advertising space on a digital interface and the messages are targeted based on user data (Ernst & Young, 2020).

- The location of the taxable services should be in France (Ernst & Young, 2020)

  This generally relates to where at least one the users of the digital interface are located (BDO, 2019b). A user is said to be located in France when they access the digital interface from a terminal (such as a cellphone, computer or tablet etc.) which is located in France (Ernst & Young, 2020).

- Income to be received in respect of the taxable service (Ernst & Young, 2020)

- The revenue thresholds should be satisfied (Ernst & Young, 2020)

  The DST rules applies to companies who exceed, in the previous year of assessment, both of the following thresholds: 750 million euros for worldwide revenue for in scope activities and 25 million euros in French revenue for in scope activities (KPMG, 2023). These thresholds are calculated and applied on a consolidated group level (KPMG, 2023).

The tax base for calculating a DST includes worldwide revenues received by the taxpayer for taxable services (as defined above) multiplied by the French presence ratio which should then give the portion of taxable services related to France (BDO, 2019b). This is then multiplied by the 3% tax rate (BDO, 2019b).

The French presence ratio indicates the proportion of French users for each sub-category of taxable services (Ernst & Young, 2020). The ratio is considered on the level of each subcategory of taxable services and therefore each subcategory has its own ratio that would need to be applied (Ernst & Young, 2020).

The DST would then be deductible in France for corporate income tax purposes (BDO, 2019b).

The expected tax revenue in 2019 from the DST in France was 400 million Euros, with significant increases in the years following (Deloitte, 2019:2). However, based on the tax impact study conducted by Deloitte in 2019, it was expected that the total additional tax burden would be roughly almost more than 50% of the tax revenue raised (Deloitte, 2019:2).

The French Revenue Authority ("FTA") issued guidance on the new rules in 2019 and further guidance was provided in 2020 (Ernst & Young, 2020). While the concept of a DST appears to be simple, the rules provided, and guidance issued are complex (Ernst & Young, 2020). Due to the complexity, it requires more resources from the FTA to implement and enforce as well as increases the administrative costs for taxpayers.

Due to the DST being a unilateral measure, there is a risk of multiple taxation, meaning taxation of the same income in several jurisdictions, should other countries also enact similar DST legislation as that of France whereby the taxable base is based on worldwide income multiplied by an allocation key (Deloitte, 2019:36). If a common framework is not agreed upon globally, the ratio used for allocation in the different countries could overlay depending on how it is determined in that specific country and could result in multiple taxation of the same income (Deloitte, 2019:36).

Identifying taxpayers who satisfy the thresholds indicated above may be an extremely difficult task as some MNE groups may not report their worldwide revenue generated per activity in each jurisdiction in the granularity needed to detect the in-scope activities of the French DST (Deloitte, 2019:30). As a result, the FTA may need to send out detailed data requests to potential taxpayers and assess the results from there (Deloitte, 2019:30). This will add to the administrative costs for both the FTA and MNE groups as this exercise would be resource intensive (Deloitte, 2019:30).

The DST enacted by France has raised concern among other countries such as the U.S. The United States Trade Representative (“USTR”) conducted a section 301 investigation of France’s DST. This investigation is in terms of section 301 of the Trade Act and sets out to determine if there are any acts, policies or practices of a foreign country that either (i) are in violation of trade agreements; (ii) are unjustifiable (meaning are inconsistent with the U.S. international legal rights) and burden or restrict U.S. commerce; or (iii) are unreasonable or discriminatory and burden or restrict U.S. commerce (USTR, 2019:1) . If an act, policy, or practice is found to fall into one of the three categories, there are authorised actions the U.S. can take which includes imposing tariffs or other import restrictions on goods or services of the foreign country (USTR, 2019:1).

The USTR found that the DST enacted by France discriminates against U.S. companies and is not consistent with prevailing principles of tax policy and is unusually burdensome for the affected companies (USTR, 2019:1). As such, the U.S. could take action against France as noted above.

The following were just some of the reasons the USTR noted in support of their findings:

The USTR notes that the application of the French DST to gross revenue rather than income goes against prevailing tax principles and imposes significant burden on those companies potentially impacted by the DST (USTR, 2019:4). The use of revenue rather than income would create burdens to unprofitable companies or companies with low margins (USTR, 2019:4).

An additional consideration for companies or groups is the scope of the French DST (USTR, 2019:4). The taxable services noted above are very specific and the reporting systems of companies may not have the capability to categorise accordingly (USTR, 2019:4). This could lead to additional costs which could be passed on to customers (USTR, 2019:4).

The report also went against prevailing international tax principles as the DST applies to revenue streams which is not connected to a PE in France and therefore this income will be taxed by other countries where the company operates or is a resident (USTR, 2019:5). As such, there is a significant risk for double taxation without recourse (USTR, 2019:5).

5.2.2. Kenya's DST

In 2019, the Kenyan Government through the Finance Act, amended the Income Tax Act to include income accruing through a digital marketplace as income subject to tax (KPMG, 2023). A digital marketplace was also defined through this amendment as an electronic platform which allows the direct interaction between sellers and buyers of services and goods (KPMG, 2023). During 2020 the final Digital Service Tax regulations were issued for the implementation of the DST. The Digital Service Tax regime introduced aims to tax specific supplies made through the digital marketplace (KPMG, 2021).

The imposition of the DST has been limited to non-resident persons only and is considered as a final tax (KRA, 2023)

The DST is effective from the 1st of January 2021 at a rate of 1.5% of the gross transactional value exclusive of any VAT (KRA, 2023). The gross transactional value in this case means the payment received in respect of the digital service provided (KPMG, 2021). The following services are in scope for the DST:

- Downloadable digital content which includes mobile applications, films and electronic books (KPMG, 2021);
- Over-the-top services, for example, the streaming of films, television shows, podcasts, music, or any form of digital content (KPMG, 2021);
- The monetising of data collected on Kenyan users that has been generated from the users' activities on a digital marketplace (KPMG, 2021);
- Facilitating a digital marketplace (KPMG, 2021);
- Subscriptions to media such as news, journals and magazines (KPMG, 2021);
- Electronic data management which includes file sharing, website hosting, online data warehousing and cloud-based storage (KPMG, 2021);

- Digital booking or ticketing services which includes the online sale of tickets (KPMG, 2021);
- Providing automated help desk services and search engine services (KPMG,2021);
- Online training (KPMG, 2021); and
- Any other service offered via a digital marketplace.

The DST will apply to non-residents who provide digital marketplace services to consumers in Kenya (KPMG, 2021). Non-residents would be deemed to provide digital marketplace services to consumers in Kenya if (KPMG, 2021):

- the user accessed the digital interface through a terminal located in Kenya (KPMG, 2021);
- the payment of the digital services is done through a facility provided by a company or financial institution in Kenya (Bowmans, 2021);
- the digital services are obtained using an international mobile phone with a Kenyan country code or an internet protocol address registered in Kenya (KPMG, 2021); or
- the user has a residential, billing or business address located in Kenya (KPMG, 2021).

The DST excludes income already subject to WHT, services provided by Government institutions, financial services, and income earned through the transmitting of messages via cable, radio, television broadcasting, optical fibre, and internet satellite (KRA, 2023).

Concerns have been raised as there is no turnover threshold for the DST (KPMG, 2021). This could lead to significant administrative costs for non-residents that have limited transactions of a low value to comply (KPMG, 2021). It also costs the tax administration to enforce such rules, therefore by not having a revenue threshold, it may cost the tax administration more to enforce this rule on non-residents with low value transactions than the tax revenue gained.

Due to the lack of visibility of digital transactions by the revenue authority (“KRA”), this may hinder their ability to enforce the DST (Bowmans, 2020). In addition, as the DST is a unilateral measure it may be difficult to get non-residents to comply as there is no way to impose punitive measures (Bowmans, 2020) due to non-residents being out of the KRA's jurisdictional reach. These factors could reduce the effectiveness of the DST.

5.3. Digital Permanent Establishment Rules

The concept of a digital PE has been implemented in several countries and is also known as “Significant Digital Presence” (as noted above in 3.4.) or “Significant Economic Presence” (“SEP”) as below (KPMG, 2023). Below is a detailed review of two countries which outlines the rules that were put into effect and provides an evaluation of the measure itself as well as practical challenges faced on implementation.

Nigeria was selected for the analysis as Nigeria is a fellow African country which could be more comparable to South Africa.

India was also selected for analysis as both India and South Africa are developing countries.

5.3.1. Nigeria's SEP Order

Nigeria recently introduced the principle of SEP pertaining to the taxation of non-resident companies who operate highly digital businesses (KPMG, 2023).

In 2020, Nigeria's Honorable Minister of Finance, Budget and Planning, Zainab Shamsuna Ahmed issued the Companies Income Tax (Significant Economic Presence) Order, 2020 to provide guidance and clarity on the definition of Significant Economic Presence (“SEP”) as introduced in 2019 Finance Act (Ernst & Young, 2020b).

The SEP Order issued outlines the circumstances under which a foreign company that provides either digital services or technical, professional, management or consulting services (“TPMC”) to Nigerian customers from outside the borders of Nigeria (remotely) will be deemed to have a taxable nexus in Nigeria and therefore liable for tax in Nigeria (PwC, 2020).

Before the entry into force of the 2019 Finance Act, foreign companies were only liable for tax on their business income in Nigeria if there was a physical presence nexus between their business and Nigeria or if their related party transactions were not at arm's length (PwC, 2020). The Finance Act of 2019 expanded the conditions under which a foreign company would be liable for tax on their business income in Nigeria (PwC, 2020).

The SEP Order sets out the relevant activities that could potentially create a SEP in Nigeria including monetary thresholds where applicable as noted below (Ernst & Young, 2020b):

- Digital Services (Ernst & Young, 2020b)

  Digital services are further drilled down into three subcategories as below with their own thresholds:

  - The use of Digital Platforms (Ernst & Young, 2020b)

    The threshold for a SEP would be satisfied if a foreign company derives at least 25 million Naira (or currency equivalent) of gross income from services related to digital platforms in Nigeria (Ernst & Young, 2020b). These include the downloading or streaming services of digital content to any person located in Nigeria, transmission of data relating to Nigerian users, provision of goods or services through digital platforms to Nigerian consumers, and the provision of digital intermediary services that connect customers and suppliers in Nigeria (Ernst & Young, 2020b).

  - The registration of a Nigerian website or use of Nigerian domain name (Ernst & Young, 2020b)

There is no threshold for this category, a foreign company that registers a website in Nigeria or makes use of a Nigerian domain name will be deemed to have SEP in Nigeria (Ernst & Young, 2020b).

- Purposeful and sustained interaction (Ernst & Young, 2020b)

  There is no threshold for this category, a foreign company will be deemed to have a SEP in Nigeria if they are customising their digital platform to target Nigerians or reflect their pricing or payment options in local currency (Naira) (Ernst & Young, 2020b).

- TPMC (Ernst & Young, 2020b)

  Where a foreign company receives payment from a Nigerian resident or a fixed base or agent of a foreign company within Nigeria in respect of management, professional, technical, or consulting services would be deemed to have created a SEP in Nigeria (Ernst & Young, 2020b). There is no monetary threshold for this category, however, there are a few specific exemptions to the category (Ernst & Young, 2020b).

There is only a monetary threshold for one subcategory of Digital Service as noted above, and even so, the threshold appears to be trivial considering the estimated value to be generated from Nigeria in view of the volume of transactions that could be completed in respect of such services within a year (Ernst & Young, 2020b). As a result, this could mean most foreign companies engaging in digital services described above would be subject to income tax in Nigeria (Ernst & Young, 2020b). As a result of the minimal or absence of thresholds, this could become extremely burdensome on foreign companies which are involved in such activity in Nigeria due to the increase in compliance costs.

Furthermore, the SEP order specifies that if Nigeria enters into any multilateral agreement or consensus arrangement that is aimed to address the tax challenges arising from the digitalisation of the economy, the provisions of that arrangement or agreement would then apply (PwC, 2020). The SEP provisions in respect of digital services would no longer apply as the multilateral agreement or consensus arrangement would effectively override the provisions of the SEP Order with respect to any foreign company that is covered by that arrangement or agreement (PwC, 2020). This means that when the global solutions are introduced, this will no longer be effective to those countries who are party to those agreements. Based on the IF membership, countries which house most digital companies such as the U.S. and Ireland (BDO, 2019a) should be party to the global solution in the near future which would then render this unilateral measure ineffective for its purpose.

Where Nigeria has tax treaties in place with other countries, it follows (based on treaty supremacy) that foreign companies that operate from that other country, will not be affected by the SEP Order until the relevant changes are made to the tax treaties (PwC, 2020). This is due to most treaties basing the PE concept on article 5 of the OECD model convention which only results in a taxing right of a source contracting state if there is a physical presence within the country as discussed above in 2.3.4.

Another concern raised is with regards to profit attribution (PwC, 2020). Guidance on how profits attributable to the Nigerian SEP of affected foreign companies will be determined has not been provided in the SEP (PwC, 2020). This could result in uncertainties for foreign companies that need to comply (PwC, 2020).

As this is a unilateral measure, the Federal Inland Revenue Services ("FIRS") may have difficulty enforcing compliance without global consensus due to many affected companies being outside of the territorial reach of the FIRS (PwC, 2020).

5.3.2. India's SEP

Due to the digitalisation of the global economy, businesses are able to conduct their operations without creating a physical presence in the market jurisdictions (Ernst & Young, 2021). India recognised the need to update their domestic tax laws to counteract the erosion of their tax base as a result (Ernst & Young, 2021). In 2018, India first introduced a new tax nexus rule of Significant Economic Presence ("SEP") under their broader concept of "business connection" for taxability (Ernst & Young, 2021).

The provisions of the SEP extended the scope of a “business connection” whereby income of a non-resident which accrues or arises in India would be taxable in India (Deloitte, 2018). These provisions are effective from 1 April 2021 (KPMG, 2023).

In terms of the SEP provisions introduced, a business connection will be created in India if either of the below conditions are met with the relevant thresholds (KPMG, 2023):

- Revenue-linked condition: Where transactions regarding any services, goods, or property which are carried out between a non-resident and any person in India exceeds the revenue threshold of INR 20 million. This includes the download of software or data in India (KPMG, 2023).

- User-linked condition: Where the non-resident is systematically and continuously soliciting business activities or engaging in interaction with users located in India which exceeds 300 000 users (KPMG, 2023).

The transactions, activities and interactions noted above include but are not limited to the following:

- The selling or purchasing of goods, services, or property through a digital platform (Deloitte, 2018).
- Transactions concerning the download of software or data in India (Deloitte, 2018).
- Providing online training or gaming services (Deloitte, 2018).
- Online databases, cloud storage, websites and computing services which have a considerable Indian user base (Deloitte, 2018).
- The provision of online streamlining of content (Deloitte, 2018).
- Interacting with customers located in India (Deloitte, 2018).
- Targeted advertising to Indian customers or who access advertisements through an internet protocol (“IP”) address within India (Ernst & Young, 2021).
- The sale of data collected from users who resides in India or who uses an IP address located in India (Ernst & Young, 2021).
- The sale of goods or services resulting from the use of data collected from persons who reside in India or who make use an IP address located in India (Ernst & Young, 2021).

An SEP can be triggered regardless of whether the agreement for the transaction or activity was concluded in India, or if the non-resident performed the services in India or if non-resident has a residence or place of business in India (Deloitte, 2018).

If a non-resident meets the requirements of the SEP only income attributable to the activities of either the revenue-linked condition or the user-linked condition would be taxable in India (Ernst & Young, 2021).

There has been limited guidance provided in respect of the attribution of profits in India in respect of the SEP (RSM, 2021). This could cause confusion to non-residents who are required to comply.

The SEP provisions are not clearly defined (RSM, 2021). This could cause uncertainties and disputes for those who are required to comply therefore additional guidance should be given.

There could be challenges in getting the data required to determine whether thresholds have been met (e.g.: number of users etc.) (RSM, 2021). The tax administration could therefore struggle to enforce the tax effectively or additional resources could be required to set up an appropriate system.

The low thresholds and extensive scope of the SEP could result in many non-residents needing to comply with the provisions of the SEP (RSM, 2021) even if the value of transactions are low. This could create administrative burdens for these non-residents.

The SEP included in domestic law would not apply where India has existing tax treaties with other countries as the treaties include the standard concept of a permanent establishment that is used to determine the taxing rights of a source state on the business profits of a non-resident (Deloitte, 2018). The usual concept of a permanent establishment is in terms of article 5 of the OECD's model convention which only results in taxing rights of the source state if there is physical presence within the source country as discussed in 2.3.4. above. Therefore, there is a concern regarding the effectiveness of this measure if India are unable to change the existing tax treaties.

5.4. Chapter 5 Conclusion

In this chapter country specific analysis of unilateral measures (Digital Service Tax and Digital Permanent Establishment concept) has been performed. A detailed review has been performed on countries where these unilateral measures have been implemented. This chapter has noted the practical implications of implementing such measures including the effectiveness of the measures as well as costs to implement and the international response. These findings will be taken into consideration in chapter 6 where recommendations will be made for South Africa.

6. Recommendations

6.1. Chapter 6 Introduction

Chapter 6 will firstly give an overview of South Africa's response to addressing the normal tax challenges arising from the digital economy thus far. This chapter will then provide recommendations specifically for South Africa on addressing the challenges. The discussion below is limited to 3 key measures being the OECD's Two-Pillar Solution, Digital Service Tax, and the Digital PE Concept. Based on the analysis performed in chapter 4 and 5, each solution will be considered, and a recommendation will be made for South Africa.

6.2. South Africa's response

In June 2020 National Treasury together with SARS advised Parliament that South Africa had decided to not establish any unilateral measures to address the normal tax challenges resulting from the digital economy for the time being (KPMG, 2023). It was noted that South Africa was awaiting consensus on the global solution which is being led by the OECD (KPMG, 2023).

In February 2024 during South Africa's 2024 Budget Speech, the Finance Minister announced that the Global Minimum Tax Regime (which is part of the Pillar Two solution) will be implemented in South Africa (PwC, 2024). Draft legislation has been published which proposed two taxes, the IIR and QDMTT, which will apply retrospectively for fiscal years beginning on or after 1 January 2024 (PwC, 2024). The draft legislation essentially aligns with the Model Rules issued by the OECD as part of the Pillar Two global solution (PwC, 2024).

6.3. The OECD's Two Pillar Solution

The below discussion is based on the analysis performed in 4.2. above.

The OECD's Two-Pillar solution aimed to address the challenges arising from the digital economy by reallocating taxing rights to market jurisdictions (Pillar One) and by implementing a global minimum tax rate to curb the BEPS risk that was worsened by the digital economy (Pillar Two).

The complexity of the rules and guidelines are concerning as it would require significant resources to implement. South Africa is a developing country and may not have sufficient capacity and resources to implement such a solution. It has been noted, however, that as this is a global solution the OECD are prepared to assist developing countries with capacity building and through the implementation process.

As this is a global solution, there would be adequate coordination and agreements in place to prevent double taxation which would avoid international conflict.

The Two-Pillar solution has taken an extensive time to finalise as a result of this being a global solution and consensus needed to be reached in concluding the process. Pillar One of the solution is only expected to be implemented in a few years. As a result of the time lag, there is a risk that market countries like South Africa will be losing tax revenue from the digital economy in the meantime.

The tax revenue expected to be generated from these measures may not be substantial for South Africa. For example, in the GloBE rules, the ETR is set at 15% while the tax rate in South Africa is 27% therefore the top up expect is minimal. While this may be insignificant currently, this is still an added stream of revenue for the country.

Based on the above, implementing the global solution may be the best measure at this point in time for South Africa due to how this is structured, however, the tax revenue expected from the solution may not be meaningful as a result of the scope at this moment. Going forward, it would be important for South Africa to continue to participate in how the Two-Pillar solution evolves going forward. National treasury seem to be aligned on this recommendation based on South Africa's response thus far in 6.2.

The question now becomes whether South Africa should implement a unilateral measure in the interim before the global solution comes fully into force in the next few years to limit the lost tax revenues from the digital economy.

6.4. Digital Service Tax

The below discussion is based on the analysis performed in 4.3. and 5.2. above.

By introducing the DST South Africa would be able to generate tax revenue on profits made by non-resident digital business that would usually be outside the reach of South Africa based on internal tax rules. While the revenue expected in African countries may not be significant initially, the potential in the coming years as the digital economy grows means that it could be significant going forward. From the case study in 5.2.1., France expected a base DST with significant growth potential going forward, however, in the year of implementation the additional tax burden was expected to be more than 50% of the tax revenue raised.

The global solution stipulates the unilateral measures such as the DSTs would need to be removed once it comes into effect therefore this would be a temporary measure. As such, it may not be worth the cost to implement as the tax revenue expected from this measure now may not be meaningful and by the time it does become significant it would need to be removed.

The use of a Digital Service Tax appears to be the simplest measure to implement as the concept and rules are fairly straight forward and should theoretically be easier to administer. From the case study performed on France's DST, it appears that once the rules were put into effect, gaps were brought to light and additional rules and guidance had to be put in place which enhanced the complexity. This increased the cost for both the tax administration to enforce the rules as well as taxpayer to comply. South Africa is a developing country with limited resources therefore the cost placed on administering this rule may not be worthwhile.

There is also a challenge regarding recognising in-scope companies due to how companies report their results and categories used etc. As this is a unilateral measure, the rules and categories could differ between countries therefore it would be difficult to gain international support needed to get this information.

As this is a unilateral measure which does not have global support, there is a risk of non-compliance of non-residents as there is no way to impose punitive measures as they are out of jurisdictional reach as noted in the analysis of Kenya's DST (5.2.2.).

The DST has also come under scrutiny due to the risk of double taxation as the tax rules went against international tax principles and fell outside of the treaty rules. This could add to the administration costs as taxpayers may dispute the DST and there could be international conflict around this DST that may impact the country's economic interactions with certain countries. In the case study, France has experienced significant push back from other countries with the USTR performing an investigation and having the U.S. potentially imposing trade restrictions. If the DST is implemented, South Africa would need to consider the consequence of trade restrictions on the economy and whether imposing the DST would be worthwhile.

Based on the points above, it may not be worthwhile for South Africa to implement the DST as a unilateral solution at this point in time as the benefit of the DST could be outweighed by the costs and adverse impacts on the international front noted above.

6.5. Digital Permanent Establishment Rules

The below discussion is based on the analysis performed in 4.4. and 5.3. above.

Implementing the Digital PE concept in South Africa would provide a taxable nexus where there is a significant digital presence even if there is no physical presence. This would ideally address the challenge brought about by the digital economy whereby companies are able to operate in a market jurisdiction without physical presence and are not taxed in the market jurisdiction as international tax principles only allow for source countries to tax non-residents if there is some sort of physical presence (as discussed in 2.3.4).

For this concept to be most effective, it should preferably be integrated into the tax treaties that have been concluded by South Africa and other contracting countries. As tax treaties only allocate taxing rights, South Africa's domestic tax law should also then be amended to include the impact of the digital economy.

Based on the case study performed on Nigeria's SEP order as well as India's SEP, it was noted that the effectiveness of the Order and provisions is limited where tax treaties are in place with other countries as most follow the OECD's model convention which requires physical presence for the PE concept. Until Nigeria and India are able to negotiate the digital PE concept into the treaties the Order and provisions would only be applicable to countries without treaties and therefore would be ineffective in addressing the problem. Renegotiating tax treaties or using a multilateral convention to introduce the digital PE concept a would take time as consensus would need to be reached in order to implement.

Countries have also noted that should a global consensus be reached, those provisions will override that of the digital PE concept (which only exists in domestic law for now). Therefore, this could mean that this unilateral measure is only temporary.

Due to the nature and proposed rules of the measure, it would require highly skilled resources and costly administrative systems to implement effectively. South Africa is a developing country and may not have the resources necessary.

Based on the above, while the concept may more fairly represent value creation by digital entities by jurisdiction, in its current form as a unilateral measure, it may not be the best option for South Africa to implement at this point in time. The effectiveness of this measure is dependent on whether or not South Africa would be able to renegotiate tax treaties and that could be extremely time consuming and costly to come to an agreement. There is also a high cost to implementing this measure and, as this measure does not have global support, South Africa may not be able to successfully implement this measure outside its borders as seen in the Nigeria case study.

Should the digital PE concept gain international support in the future, South Africa should then reconsider the implementation of this measure as a global solution.

6.6. Chapter 6 Conclusion

In this chapter a high-level overview of South Africa's response to the normal tax challenges posed by the digital economy was provided. Recommendations were then developed based on the analysis performed in chapter 4 and chapter 5 of proposed measures to address these challenges. Based on the discussion above, it was concluded that it was in South Africa's best interest to implement the global solution of the OECD's Two-Pillar Solution. Due to the time delay in the global solution, there was a question as to whether a unilateral measure could be implemented in the meantime. Through the discussion in this chapter, it was determined that it would not be beneficial for South Africa to implement one of the unilateral measures analysed (being the Digital Service Tax or the Digital PE concept) in the interim while waiting for the global solution to come into force (due to cost, nature of measure, lack of global support etc.). It was noted that should the Digital PE concept be introduced as a global solution in the future, South Africa should only then reconsider the implementation of this solution.

Even though the OECD's Two-Pillar solution is the most suitable measure for South Africa to implement at this time, the amount of tax revenue does not appear to be significant therefore South Africa should be involved in discussions with the OECD that further develop the Two-Pillar solution and should also be open to introducing additional measures in the future relating to the same topic.

7. Conclusion

This research report examined the challenges arising from the digital economy on South Africa's corporate income tax system as well as analysed proposed measures to address such challenges to form a recommendation on the best course of action for South Africa.

The digital economy has been growing exponentially due to recent advances in technology and innovation (4IR). As a result, businesses have had to revolutionise the way they operate. Business models have evolved in that businesses can now operate in market jurisdictions without creating physical presence. This has in turn given rise to challenges to international tax rules which were designed over a century ago.

From the research performed, the primary risk from a South African corporate income tax perspective stemming from the digital economy is from an international tax perspective and South Africa's ability to impose tax on non-residents. The starting point for taxing business profits of non-resident enterprises in a source country is to determine whether or not that enterprise has created a permanent establishment in the source state. This usually involves the non-resident enterprise having a degree of physical presence within the source state. With the digitalisation of business models, companies may derive business profits from operating within a country, however, as there is no physical presence, these profits can escape the tax net of the market country. This would therefore compromise the corporate income tax base of the market country.

The proposed measures considered in this report were both global solutions as well as unilateral measures implemented or proposed by other countries. The proposed measures analysed were limited to the OECD's Two-Pillar Solution, Digital Service Taxes and the Digital Permanent Establishment concept.

The OECD's Two-Pillar solution is a global solution formulated by the OECD to address the tax challenges arising from the digital economy. The first part of the solution (Pillar One) aimed to have a fairer distribution of profit and taxing rights by reallocate taxing rights to market jurisdictions. This method is based on a formula to reallocate the taxing rights of residual profit of the largest MNE groups to market jurisdictions using a new revenue-based allocation key. The second part of the solution (Pillar Two) aims to curtail the BEPS risk that has been exacerbated by the digital economy through implementing a global minimum tax rate. The Digital Service Tax is a unilateral measure implemented or proposed in many countries. The DST is generally a tax on gross revenues generated from certain digital services. The aim of the DST is to give taxing rights to countries on the profits highly digital business that operate in the jurisdiction without creating a physical presence. The Digital Permanent Establishment concept allows for taxable nexus where there is significant digital presence without physical presence.

South Africa's response to the tax challenges arising from the digital economy thus far has been to wait for global consensus on the global solution, and South Africa has not yet introduced any unilateral measures. Due to the amount of time it takes to reach a global consensus, there is a risk that the profits from highly digitalised businesses may remain untaxed in South Africa for that much longer.

In terms of the analysis performed, while the unilateral measures may appear attractive to implement in the interim to ensure that there is no lost revenue, factors such as the cost (to implement, enforce and maintain), the complexity inherent these measure as well as lack of international support may mean these are not worthwhile measures for South Africa to implement in their current state. Should the digital permanent establishment concept gain international support in the future and is introduced as a global measure, South Africa should seriously consider the implementation of such.

The proposed measure of the OECD's Two-Pillar solution, once consensus is reached, will be supported globally and as a result, may be easier to enforce. While the Two-Pillar solution may not have a significant impact from a tax revenue perspective at this point in time, this is still an additional source of revenue for the country. Even though the Two-Pillar solution may be the most suitable measure to implement, South Africa should continue to contribute to the OECD's efforts as these rules evolve.

South Africa should also remain open to introducing additional measures to address the impact of the digital economy as these are constantly being developed.

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