UNIVERSITY OF THE WITWATERSRAND

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)

TAXING E-COMMERCE IN SOUTH AFRICA – A critical look at South Africa's income tax provisions in relation to international trends

ABSTRACT

Global digitalisation continues to accelerate its impact on economies around the world, triggering changes which challenge the rules for taxing international business income. These challenges create opportunities for companies with activities in multiple jurisdictions to leverage on their technological capacities and capitalize on the absence of synergies between the tax systems of jurisdictions in which they operate, to optimise their tax burden, to the detriment of the markets in which their profits are generated.

From a South African perspective, the growth and evolution of the digital economy therefore brings a primary concern to the forefront of the domestic fiscal agenda – how should digital activities be categorised for income tax purposes, and what are the elements necessary in order to build the appropriate taxing framework for these activities?

A critical analysis of key international tax guidelines such as the OECD BEPS Action Plan, and a qualitative and comparative analysis of the approach adopted to the questions above by key jurisdictions such as the UK and Nigeria, shows that there are certain factors which have achieved global consensus on their key nature to taxing the digital economy, and are now international trends to note when defining the tax treatment of income from e-commerce.

While South Africa's current income tax laws are able to tax income earned by non-residents from sources within the Republic, the digitisation of business and increased sophistication of digital business models does not always allow for the apprehension or proper categorisation of this income for tax purposes. South African legislature needs to draw inspiration from these international trends to build an appropriate framework for taxing income earned through the digital economy, while balancing a drive to generate fiscal revenue, with the need to stimulate domestic growth and attract foreign investment.

DECLARATION

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

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Ayuk Ndiep Takor

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GLOSSARY

The following words, phrases and acronyms shall be construed in accordance with the meaning given hereunder, unless the context clearly dictates otherwise.

4IR Commission	Fourth Industrial Revolution Commission
AfCFTA	Africa Continental Free Trade Agreement
AI.....	Artificial Intelligence
ATAF	African Tax Administration Forum
B2B	Business-to-Business
B2C	Business-to-Consumer
BEPS	Base Erosion and Profit Shifting
C2C	Consumer-to-Consumer
DMT	Domestic Minimum Top-up Tax
DST	Digital Services Tax
DTA	Double Tax Agreement
DTC	Davis Tax Committee
ECTA	Electronic Communications and Transactions Act, South Africa
ESS	Electronically Supplied Services
EUR	Euro
FNB	First National Bank
GAAP	Generally Accepted Accounting Principles
GBP	Great British Pound
GDP	Gross Domestic Product
GloBE	Global Anti-Base Erosion Model Rules
ICT	Information and Communications Technology
IF	OECD Inclusive Framework on Base Erosion and Profit Shifting
IIR	Income Inclusion Rule
IP	Intellectual Property
IT	Information Technology
ITA	Income Tax Act, Act 58 of 1962
MLI.....	Multi-Lateral Instrument
MLC	Multi-lateral Convention
MNE	Multi-National Entity (ies)
OECD	Organisation for Economic Co-Operation and Development
PE	Permanent Establishment
PoEM	Place of Effective Management

SARS	South African Revenue Service
TP	Transfer Pricing
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
USD	United States Dollar
UTPR	Under-Taxed Payment Rule
VAT	Value-Added Tax
WHT.....	Withholding Tax (es)

EXECUTIVE SUMMARY

The leading views on the challenges faced in taxing the digital economy and guidelines on how these can be mitigated are provided by the OECD in relation to their BEPS Action 1 plan. These guidelines have been implemented by several countries around the globe, resulting in the emergence of international trends in the taxation of income from e-commerce. From an African perspective, the guidelines have been subjected to contextualisation by ATAF as well as practical modifications by the African countries which have already enacted e-commerce income tax provisions. These international trends and their interpretation from an African perspective are analysed in detail in the report.

South Africa's income tax laws in principle, tax income from activities carried out by South African residents or which have a source in South Africa – however, the premise of these income tax laws is rooted in an understanding of business models, which differs substantially from the business models which have become very common in the digital economy. As such, there is an acknowledgement of the need to review the current income tax framework to cater for e-commerce activities and modern business trends.

The table below summarises the international trends discussed in this report, and the approach of South Africa's income tax law in response to each of these trends.

Table 1: International trends on taxing e-commerce income versus South Africa's approach

Factor	International trend	South Africa's approach
Nexus	Nexus is increasingly established on the basis of digital presence, especially for a business which only requires a reduced physical element for execution of its core commercial activities. The special purpose nexus rule which is based on the amount of revenue generated by the activity has been implemented as a possible solution.	South Africa does not recognise the establishment of nexus on the basis of digital presence. Nexus for SA tax purposes is currently established on the basis of the residence rule, or the source of income rule.
The valuation of data	Guidelines for monetising data are being put in place which rely on benchmarking the price paid for similar data by unrelated parties. This trend has, however been subject to controversy due to the subjective nature of data valuation.	South Africa has not assumed an official position on its approach to the valuation of data.
Characterisation of income	The nature of income subject to international taxation is being widened beyond the traditional categorisations. Other categories of business income have been added to the standard categories of royalties, interest, and dividends, to adequately capture hybrid or undefined types of income and eliminate double non-taxation due to potential jurisdictional mismatch in definitions.	South Africa's DTAs recognise foreign income earned outside a PE only to the extent it can be qualified as a royalty, interest, or a dividend. Guidelines on hybrid or undefined income have not been provided.
PE rules	The definition of standard PE triggers has been updated to include digital PEs. In this trend, a PE may now be said to exist if there is a Significant Economic Presence of the provider in-country – this SEP may be determined regarding parameters such as the number of digital content consumers in a jurisdiction, the amount of content consumed, or the revenue generated by these consumers.	South Africa has acknowledged the need to implement the change to standard PE definitions as a priority. However, current PE definitions at law and in jurisprudence follow traditional principles in requiring a physical element of commercial activity to form part of the triggers of a PE in-country.
DST legislation	Digital Services Tax legislation should be enacted which provides a starting point for the chargeability of e-commerce income to income tax, without requiring a significant change in existing income tax laws. However, there is an understanding that the OECD MLI will require the local DST to fall away once BEPS Pillar One Amount A Rules are adopted by member countries.	South Africa has not enacted any DST legislation, and it is not expected that the legislation will be adopted. The unofficial approach seems to lean towards the adoption of Pillar One Amount Two legislation once it is adopted.

It is apparent that there exists a significant amount of divergence between international concepts and guidelines on the taxation of income from e-commerce, and South Africa's currently enacted legislation. This lack of synergy results in an inability of the South African revenue authorities to extract a commensurate amount of tax value from the digital economy, thereby depriving the country of the opportunity to develop its own digital footprint and presenting a stumbling block to maintaining its position as a leading economic superpower on the African continent.

CHAPTER ONE – INTRODUCING THE REPORT

What is this paper about?

A. Background to the study

The digital economy has become one of the fastest growing contributors to GDP across the world, with an estimated worth more than USD 26.7 trillion, representing 19% of total retail sales and accounting for 30% of global GDP in 2020.[1]

The largest economies in the world have reported a minimum of 3% growth in their e-commerce market, with the UK seeing up to a 7.5% growth over previous year figures. These figures represent the real potential of trading activity carried out within digital economy to significantly contribute to the GDP of individual countries and boost the revenue streams of local tax authorities worldwide. The question which poses itself is therefore no longer whether to tax the digital economy, but how to formulate a set of taxing laws and guidelines which are adequate and that will produce the desired results. This is an issue which is hotly debated across the globe by revenue authorities, advisory bodies, and multinational entities alike.

There is a constant mismatch between the legislative approach to tax matters dealing with e-commerce, and the practical and commercial reality of digital trade. This mismatch has led to dissatisfaction of taxpayers, loopholes in e-commerce taxing laws where these exist, and a general inability of revenue authorities to extract a monetary value from the digital economy which is commensurate to the size of the economy itself.

It is also important to note that adequately understanding the workings of the digital economy with a view to effective taxation will have a tremendous impact on transfer pricing. This is because transfer pricing rules hinge on the creation of value in jurisdictions – this determination of the value add per jurisdiction is the basis on which revenue is allocated to a jurisdiction, and also drives the allocation of taxing rights. Unless the taxation of the digital economy aligns to this principle, the global fight against base erosion and profit shifting will continue to face this significant obstacle.

[1] United Nations UNCTAD Division on International Trade and Commodities (2021), *Global Trade Update*, available at https://unctad.org/system/files/official-document/ditcinf2021d2_en.pdf, last accessed February 2022.

B. Research objective and scope

As e-commerce transactions and models become increasingly sophisticated and interconnected, it has become apparent to regulators that the traditional rules of taxation may not provide adequate guidelines to effectively tax the digital economy. Indeed, the foundational principles of tax such as residence and source taxation, and the income versus capital debate do not seem to tie in with the reality of e-commerce. This reality is not peculiar to South Africa, but is a dilemma faced by other jurisdictions around the world. This essay will bring together the different considerations and schools of thought by regulators, advisory bodies, and scholars regarding the definition and composition of the digital economy and e-commerce, and the statutory approach best adapted in respect of the taxation of the digital economy.

The scope of this research report is limited to income taxes in respect of income earned either from trading in digital goods and services, or by using the internet as a trading platform for tangible goods and services.

The aim of this research is to understand how and why the digital economy should be included as an important part of the discussion on tax reform in today's economic environment in South Africa and provide foundational knowledge on some of the measures put forward for the execution of this reform.

The objective of the research is to pinpoint approaches which can be adopted in South Africa to boost tax revenue generation and promote synergy between the past and future advancements made with respect to the digital economy on the one hand, and the proportional contribution these advancements make to tax revenue on the other, by examining the efforts and perspectives of other noteworthy stakeholders.

C. Problem statement

The potential of developing countries to significantly boost the revenue earned from domestic taxes is intricately linked with digital transformation. Indeed, a mismatch between existing rules providing for the taxation of corporate income, and the business models proliferated as digitalisation increases, has become more and more apparent.

In Africa especially, the numbers speak for themselves. African countries realise only 16.5% of their GDP from taxes, compared against 33.9% realised by their European counterparts[2]. However, the spend on digital services is approximately 5.2% of the continent's gross GDP, and this is expected to quadruple in the next two decades[3]. There is therefore a need to align taxing policies in force with the tech disruption which fuels the digital economy, to enable economies to harness the revenue-generating potential of e-commerce.

The need above has not gone unnoticed in South Africa. According to the Davis Tax Committee in their 2015 report[4], there was a marked decline in corporate tax revue from 7.2% in 2008/9 to 4.9% in 2012/13[5], despite a reported increase in outflows of 11.2% for the same period. This exposed the need to consider cross-border transactions in closer detail, to ensure that the correct tax treatment was being applied to income earned because of these transactions. It was therefore imperative for South Africa to take the lead amongst African countries in the policy debate, by considering and updating their tax framework regarding e-commerce where necessary.

This paper presents an analysis of existing South African legislation with regards to the taxing of income earned from e-commerce and the digital economy, and a comparison of this legislation with international trends identified, and the efforts made by other African countries. The analysis in this report shall be restricted to the elements of the digital economy as defined therein, their intersection with tax legislation, and how the tax framework can be improved upon to adequately bring these elements within the South African tax net.

D. Research questions

This research report critically analyses the approach of South African income tax legislation to address the taxing challenges brought about by e-commerce transactions and makes recommendations of measures which can be considered for implementation to increase the efficiency of taxes on income earned from e-commerce.

This research report seeks to provide answers to the following two questions:

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[2] OECD (")"!), "*Tax Inspectors without Borders and partners pass USD 1 billion milestone in additional tax revenues for developing countries*", available at https://www.oecd.org/tax/tax-inspectors-without-borders-and-partners-pass-usd-1-billion-milestone-in-additional-tax-revenues-for-developing-countries.htm, last accessed in June 2023.

[3] IFC/World Bank Group (2020), "*e-Conomy Africa 2020- Africa's $180 billion internet economy future*", available at ad1166fd6e3289b5e6445c73e4cff5bbb9df1927d35cff4f4b5efa8ebb4fe16620d5ddb499d17956ea850bcac8f6d05faf1c2f1ca7f558bf1296b5303958f334 (googleusercontent.com), last accessed June 2023.

[4] Davis Tax Committee (2015), *Second Interim Report on Base Erosion and Profit Shifting (BEPS): Introduction*, available on 2 BEPS Final Report - Introductory Report.pdf (taxcom.org.za) last accessed June 2023.

[5] National Treasury (2013), *Budget*.

- Does the South African approach to taxing income from e-commerce and the digital economy, align with international trends?

To answer this question, a number of relevant sub-questions will be addressed, namely:

  - What is the digital economy?
  - What are the international guidelines applicable for taxing the digital economy?
  - What is the current South African approach on taxing e-commerce income?

Reference will be made to relevant portions of the South African Income Tax Act 58 of 1962 ("ITA"), particularly Sections 8 and 9 of the Act, to examine the approach of SA legislature to taxing income from e-commerce.

- What measures can be put in place to align the South African approach with the international trends identified, while keeping the focus on encouraging investment?

The sub-questions to be addressed under this main question are the following:

  - What measures have been proposed or put in place by the OECD, ATAF, and other EU/African countries (namely UK, Turkey, Kenya, and Nigeria) to address the tax challenges of the digital economy?
  - What measures has South Africa put in place to align its tax framework with these international trends?
  - What lessons can South Africa learn from these international trends, to shape future tax policy?
  - What is the current South African approach on taxing e-commerce income?

An analysis of the international trends as propounded by the Organisation for Economic Development ("OECD"), the Africa Tax Administration Forum, and other economies which have taxing measures in place with respect to income from digital trade, namely the UL, Turkey, Kenya, and Nigeria will be undertaken. These trends will be compared to the relevant provisions of the South African ITA, and measures proposed which can bring the SA into alignment with international trends while considering the specific nature of the SA economy.

E. Methodology

This study is based on a comparison of SA taxing laws in respect of income taxes on e-commerce income on the one hand, and international trends established by the OECD and

ATAF as well as existing legislation adopted by the UK, Turkey, Nigeria, and Kenya on the other hand.

The use of comparison to improve law and legal doctrine has been a method employed by scholars since the early 20th century[6]. According to Professor Saleilles, a renowned French scholar, comparative law is a useful instrument for 'renovating the fossilised approach'[7]. Glenn also held a similar position, opining that comparative law can be construed as a means to learn and acquire knowledge, whose use allows for the analysis of common evolution, understanding and improving legal systems, and harmonisation of law[8]. Consequently, a comparison done within the framework of a contextual approach is a recognised method of analysis to improve a target legal system.

Data used for the purpose of this comparison was collated via qualitative research carried out in the form of a desk review of existing primary authority in the form of existing legislation, publications and thought leadership issued by state governments and representative organs, international trade bodies, and published subject matter experts. No personal interviews or other such individualised contact was made or required.

Qualitative research is defined as the collection and analysis of data in a bid to form opinions, be informed on experiences, and understand concepts as presented. Its primary uses are to get in-depth insight into an issue or generate new ideas for research.

A desk review involves the secondary analysis of data that has been collected by others[9]. It covers several activities such as literature reviews and research reviews, both of which were used in this report.

The use of the combined methods of a desk review for collating of data and the qualitative analysis technique were judged to be most suitable for this report, as the intention of this report is to analyse existing legislation and literature to gain insight into international trends and best practice with respect to a specific taxing phenomenon, and use the insight gotten to generate proposals for the evolution of taxing methods within the framework of an agile digital economy.

[6] M.V. Hoecke, *Methodology of Comparative Legal Research*, Law, and Method Print ISSN: 2352-7927, Boom Uitgevers Den Haag, June 2015.
[7] R Saleilles, '*Droit civil et droit compare'*, Revue inter. Enseignement 1911, p22.
[8] P. Glenn, *Comparative Legal Families and Comparative Legal Traditions* published 18 September 2012, available at https://doi.org/10.1093/oxfordhb/9780199296064.013.0013, last accessed June 2023.
[9] Nick Moore, *How to Do Research*, published online by Cambridge University Press, 09 June 2018, available on https://www.cambridge.org/core/books/abs/how-to-do-research/desk-research/A76DC90D8C63BA9BD9C648E3CD50FB46, last accessed June 2023.

F. Research Structure

This research report is comprised of five chapters, with content as explained below.

Chapter One introduces the topic and lays the foundation for the origin of the question. This chapter analyses the components of the 'digital economy' and 'e-commerce' which are discussed further in the report.

Chapter Two identifies the issues specific to the digital economy which make taxing the income earned from e-commerce a difficult task. This chapter analyses the principles which are generally considered in the establishment of a taxing law or in determining tax rights and provides insight into how these principles are disrupted by e-commerce and digital trade. This chapter has as objective to identify the specific principles which will be used as the main points of comparison between the taxing approach adopted by South Africa, and its divergence from the international trends as discussed in Chapters Three, Four and Five.

Chapter Three provides general background on the current South African understanding and tax landscape where the digital economy and income taxes are concerned. In this chapter, focus is given to relevant sections of applicable legislation to understand the current taxing provisions which may be applied to income earned through e-commerce. In this chapter, the ITA provisions are looked at in detail to identify the principal tenets on which the provisions rely to impose a charge to an income tax, and e-commerce transactions are analysed to determine why and in what manner these transactions are not adequately covered by existing provisions of the ITA.

Chapter Four analyses international trends and measures which may be considered as 'best practice', to establish a possible roadmap or pertinent considerations to be noted when addressing the challenges with respect to taxing the digital economy. Reference is made to guidelines published by the OECD and ATAF, being the global and African organisations who are at the forefront of the development of cross-border trade concepts and principles to harmonise international trade. Reference is also made to tax measures put in place by the UK, Turkey, Nigeria, and Kenya. The UK was chosen because of its complex tax system, which bears significant similarity to the South African system in terms of origin and approach. Turkey is one of the first countries in Europe to implement an income tax pertaining specifically to income earned from e-commerce and has the benefit of having reliable data critiquing the set-up and implementation of the tax. Nigeria and Kenya were chosen as contextualised examples of the enactment of a specific tax chargeable on e-commerce income on the African continent, which has peculiarities and difficulties peculiar to this geographical

region. The aim of this chapter is to provide insight into the approach adopted by these bodies and countries, to use these as a basis for comparison with the South African income tax approach.

Chapter Five considers the current tax landscape in SA with respect to taxing e-commerce. This chapter analyses state willingness to implement such a tax and the possible guidelines to be considered, as well as posits by the relevant state bodies on the future possibility of such a tax. In addition, recommendations are made as to measures which may work to further align SA income tax laws with best practice, and better position the fiscus to extract value from this fast-changing and often complex economic environment.

Chapter Six concludes this report with a summary of the main points to consider from each chapter.

CHAPTER TWO – TAX CHALLENGES OF E-COMMERCE

What are the difficulties in administering income taxes, which are specific to e-commerce?

A. Introduction

It has been said that an individual who is aware of the cause of a difficulty is better equipped to think on how the difficulty can be precluded. In the case of taxing income from e-commerce, a fundamental starting point is understanding the digital economy, e-commerce in general, and the challenges inherent to taxing income earned within the digital economy.

This chapter breaks down the definition and components of the digital economy and introduces the conceptual mismatch between a traditional tax framework, and the business models often seen within the digital economy and e-commerce operations.

B. Defining the digital economy

To properly apprehend the scope of the digital economy, it is necessary to adequately define the concept, and understand the elements which are integral to the growth and evolution of the digitalisation of traditional methods of commerce.

The earliest recorded mention of the phrase 'digital economy' is thought to have been made by a professor and research economist during Japan's 1990s recession[10]. However, the term became widely popularised thanks to global IT expert Don Tapscott in 1995[11], and refers to the leveraging of technologies to achieve digital transformation. It surpasses mere automation of processes or digitisation of same and signals the move from the third industrial revolution to what is anecdotally called the 'fourth industrial revolution'.

In layman's terms, digital commerce has been defined as the carrying out of either local or cross-border trade using digital channels such as the internet, mobile networks, and commerce infrastructure.[12] This includes all aspects of the commercial journey, such as marketing activities, development of content, analytics, pricing, customer acquisition and retention, and customer experience.[13]

The digital economy refers to the part of the economy which relies on and exploit advancements in information and communications technology ("ICT") to disrupt traditional

[10] Wikipedia, "Digital Economy", available at https://en.wikipedia.org/wiki/Digital_economy, last accessed February 2022.
[11] Don Tapscott, 1994, *The Digital Economy: Promise and Peril in the Age of Networked Intelligence*, 1st Edition, published by McGraw-Hill, in January 1996.
[12] Bloomreach (2022), Digital Commerce Explained, Bloomreach Inc, available at Digital Commerce Challenges and Trends | Bloomreach, last accessed in February 2022.
[13] Gartner (2015), Hype Cycle for Emerging Technologies, G00289755, published 27 July 2015.

patterns of production and consumption, resulting in different methods for the marketing, trading and payment of goods and services. It extends far beyond the mere carrying out of operations, to include the use of digital channels and automated processes (such as artificial intelligence) in all aspects of a commercial transaction.

The UN recognised the development of the digital economy and its effects on traditional taxation in the 65th Session of the Trade and Development Board of the United Nations Conference on Trade and Development (UNCTAD). The deliberations on its agenda[14] resulted in one of the more apt encapsulations of what the digital economy refers to – according to this group, the existence of the digital economy can be attributed to the development of an intricate ecosystem of digital products and services, available on electronic platforms, and developed as a result of the generation and amalgamation of data on the internet. This data is the lifeblood of the digital economy, as it provides and holds past and present knowledge, which is essential to continued innovation and has proven to be the key to unlock exponential profits.

Indeed, the use of digital data opens doors for the creation of value, and more especially the development and use of artificial intelligence across all spheres of the economy. This is most apparent in the way new value chains are being developed up, the automation of compliance processes, and the ability to ensure real-time reporting on commercial transactions – put together, the use of digital data has proven to greatly enhance and accelerate international trade.

The World Bank[15] defines the digital economy as the result of the transformation of traditional business models, as a result ofthe use of new digital technology. This new technology has, in addition to modifying traditional models, fostered the creation and widespread establishment of new business models which now pose challenges to the traditional methods of taxing economies.

Digital or e-commerce therefore connotes the provision of goods and services via support from ICT and its related products, while the digital economy refers to the "digitalisation of economic activity, in particular the incorporation of data-based methods and AI into production, consumption, formation of capital, cross-border flows and all aspects of finance".[16]

[14] United Nations UNCTAD (2019), *The value and role of data in electronic commerce and the digital economy, and its implications for inclusive trade and development*. United Nations, Geneva TD/B/EDE/3/2 first published 23 January 2019, at Page 1.
[15] Lucas-Mas, Cristian Oliver, and Raúl Félix Junquera-Varela. 2021. *Tax Theory Applied to the Digital Economy: A Proposal for a Digital Data Tax and a Global Internet Tax Agency*. Washington, DC: World Bank. Doi: 10.1596/978-1-4648-1654-3. License: Creative Commons Attribution CC BY3.0IGO.
[16] IMF, *Measuring the Digital Economy*, International Monetary Fund, published in February 2018, available at http://www.imf.org/external/pp/ppindex.aspx, last accessed in March 2020.

The digital economy and its underpinning digital technologies provide the opportunity to do business differently, which sometimes translates into huge savings in terms of efficiency and cost. It has also given rise to entirely new market structures through the rise of digital platforms which help to level the playing field between larger established businesses or businesses backed by huge amounts of capital, and newer, start-up businesses. Finally, the digital economy generates huge amounts of data, which first are a source of opportunities in terms of the analysis and marketing of this data, second result in the creation of a new type of service provider (who becomes a potential taxpayer), and third provide insight on how certain economic activities are performed. This allows for an in-depth analysis into existing processes to ascertain how they can be further streamlined to generate more value for investors and consumers alike.

Leading American economist Thomas Mesenbourg identifies the principal elements of the digital economy[17] to be:

- E-business infrastructure i.e., tangible, and intangible infrastructure i.e., hardware, software, human capital, telecom networks, etc;

- E-business processes i.e., any protocols and processes via stakeholders engage and communicate with e-business infrastructure, and;

- E-commerce – the actual transfer of goods and services or other commercial activity, carried out using e-business infrastructure and following e-business processes.

From a transactional perspective, the activity which makes up the digital economy can be broken down as follows:[18]:

- E-contracts for tangibles: These are transactions which are concluded on the internet which relate to tangible goods, which goods are transmitted to consumers by established courier services or postal services.

- E-contracts for intangibles: These are transactions which are concluded on the internet which relate to intangibles, which usually are also delivered wirelessly or via the internet.

- Digital marketplaces: This refers to platforms which bring together buyers and sellers to facilitate transactions for either tangibles or intangibles, between both parties. The

[17] T.L Mesenbourg, 2001, Measuring the Digital Economy, US Bureau of the Census.
[18] Op cit note 16 (IMF 2018 paper) at page 2.

service provider behind the platform may or may not own inventory or supply any service to the buyers in their own name.

The more recent (2019) study carried out by the World Bank supports the 2001 findings of Mesenbourg mentioned above, and identifies today's key foundations of the digital economy ecosystem as follows [19]:

- Digital entrepreneurship
- Digital financial services
- Digital infrastructure
- Digital platforms
- Digital skills and literacy

The bedrock of the digital economy is therefore conventional commercial activity, carried out via unconventional means i.e., via the use of information technology and new e-products which are enabling commercial development, while disrupting business as we know it.

As trade becomes increasingly digitalised, it is not only supply-chain structures or traditional trading activities which are subject to disruption by digitalisation – also, this disruption is seen via using ICT to make the value chain more data-driven and make the economy more susceptible to abuse and aggressive tax structuring policies. In principle, the digital economy should enable micro-, small, or medium-sized enterprises to upscale their productivity and market share, and therefore their revenue and profitability. However, this uptake in revenue and profitability is usually subject to draconian taxation laws whose drafting and implementation was driven by the expansion of multi-nationals, without considering their effect on smaller players in the economy. This results in a disproportionate effect on smaller businesses which are often ill-equipped to profitably engage in the digital economy and derive benefits therefrom, as a result of the absence of adequate tax laws.

Consequently, as the disruption of international trade because of the digitalisation of economic activities increases, it becomes more apparent that there is a need to address the tax treatment of e-commerce income, considering seemingly outdated taxation aspects of international trade agreements.

[19] World Bank Group. 2019. *South Africa Digital Economy Diagnostic*. World Bank, Washington, DC. © World Bank. https://openknowledge.worldbank.org/handle/10986/33786, License: CC BY 3.0 IGO, last accessed March 2020.

The lack of adequate taxation has given digital platforms a competitive advantage, and also serves to further weaken the countries which are at a reduced stage of preparedness with regard to the taxation of e-commerce and the digital economy – this results in differing priorities on trade policy and a mismatch in tax focus. Some countries have moved forward by recognising the impact of digitalisation and making the required changes or updates to their trade agreements as well as their local tax policy, while other countries demonstrate a high level of caution and are less reactive in the rapidly changing environment. The resultant inequalities and loopholes in cross-border taxation on a global scale are susceptible to exploitation usually by multi-national taxpayers and leads to a loss of revenue from the fiscus of various jurisdictions around the world.

The United Nations Conference on Trade and Development (UNCTAD)[20] recognised that a data-driven economy provides new and increased opportunities for the creation of wealth and revenue, but also raises concern particularly regarding taxation, as adequate policy responses need to be formulated to promote inclusive trade and development. As such, while taxing the digital economy may on the surface present a new and promising revenue stream, giving effect to such a method of taxation in a way that is equitable and respects the basic tenets[21] of a properly constructed tax system has so far proven to be a grey area where even the most experienced tax and legal regulators are not always accurate in their assumptions and judgments.

C. The disruptive effect of the digital economy

In principle, a regular commercial transaction involving the sale of a good or service would generate the following taxes:

- Income taxes on the recipient of the income (either via a Corporate Income Tax or Personal Income Tax on a local corporate or individual seller);
- VAT payable by the buyer;
- In the case of goods which cross the customs frontier, customs/excise duties and any other frontier or import levies and duties on the good or service.

However, the interposing of digitalised modes of sourcing or delivery creates an unsupervised transaction which may not be easily detectable by the authorities. This is particularly relevant in the delivery of services which is carried out over the internet, as the delivery does not require

[20] Op cit note 1 (UNCTAD *Global Trade Update*), at paragraph 2.
[21] SMITH, A. (2007), *An Inquiry into the Nature and Causes of the Wealth of Nations.* S.M Soares edition, MetaLibri Digital Library.

a physical presence in the country. Consequently, income generated by services such as digital marketplace provision, provision of streaming services or web-hosting and other such services is likely to escape the net of the revenue authorities.

It follows therefore that for tax legislation to align with the current landscape of the digital economy, and to keep up with its fast evolution, any changes made to tax legislation and the implementation of same must consider the current and future taxable transactions which may arise on these foundations.

D. General tax challenges introduced by digitalisation

According to the OECD, the increase in the use of digital technologies to do business presents a challenge to policy makers, as these technologies enable taxpayers and potential taxpayers to operate in ways that significantly reduce, avoid, or remove their tax liability[22].

The major challenges to taxing the digital economy have been identified as relating to nexus issues, determining the value of data, characterisation of income arising because of new business models, and the collection of VAT.

a) Nexus

Before the advent of the digital age, a cross-border provider of goods or services needed a certain level of local infrastructure and personnel in order to grow their customer base in a specific jurisdiction – this investment was necessary for the purposes of creating or adding value, sourcing inputs, and identifying customers in order to make sales. Businesses also required a significant physical presence in order to be able to market their products and do the necessary research and advertising.

The conceptualisation of traditional Permanent Establishment ("PE") Rules therefore proved adequate for ensuring that these activities were subject to taxation. Traditional PE Rules relied on a 'physical presence' or 'nexus' test, which when analysed on their own or in combination with a 'time period' test, allowed jurisdictions to claim taxing rights over income generated by business activities within their territory, or institute related profit attribution rules.

[22] OECD (2014), "Chapter 7 - Potential options to address the broader tax challenges raised by the digital economy", in *Addressing the Tax Challenges of the Digital Economy*, OECD Publishing, Paris, https://doi.org/10.1787/9789264218789-11-en, last accessed December 2022.

The bedrock of taxation of cross-border transactions was therefore the nexus of business activities the presence of a place where commercial activities were led or carried out by businesses.

However, advances made in digital technology have enabled the leveraging of digital infrastructure to enhance the ability of businesses to engage in remote activities, increase the speed at which they analyse, process, and utilise data, and expand the potential base of customers that can be targeted and reached. Consequently, processes previously executed by local personnel can now be executed by automated equipment, which changes the need for in-person staff, as well as the nature and scope of activities attributed to them. The digital economy is therefore largely characterised by the ability of a business to be significantly present in the economy of another territory without holding a fixed place of business or even exercising through a dependent agent in that other territory.

Also, the nature of the activities which would be considered as constituting a nexus for purpose of tax liability has become a challenge where the digital economy is concerned. Traditional PE definitions exempted activities defined as 'preparatory' or 'auxiliary' from the scope of nexus triggers – however, these activities would now have to be considered with regard to the actual business of the taxpayer. To illustrate, in principle a warehouse or area where goods are merely stored before dispatch to customers would not generally constitute nexus for PE purposes. However, where the potential taxpayer is sells physical products online, the process of maintaining that local warehouse could be construed as part of the core activity of the taxpayer, permitting a nexus to be established for PE purposes. In the same way, the location of a server of a high-frequency trading company which derives its competitive advantage from being faster than its competitors, may be an important consideration.

b) Determining the value of data

The creation of data is often the first step to creating value within the digital economy. The utilisation of data creates value by allowing businesses to segment target populations to tailor their offerings or otherwise improve decision-making and may also constitute a core commercial activity for businesses whose trade consists of collecting said data and analysing it, as a monetised service.

Digital technologies have enabled the quick, convenient, and accurate collection, storage, and use of data. However, a functional analysis of data collection (including the risks undertaken and assets used) for purposes of ascribing value does not always prove to be easy – while the processes used for data collection, analytics and utilisation may appear in the balance sheet of

a company (hardware such as computers, software such as apps, and service provider fees), the monetary value ascribed to the raw data itself would in principle not figure on the balance sheet of a business, and as such may not be easily determined in order to compute taxable income.

The determination of the value of data in terms of a business asset is subject to complications for several reasons. First, the straight disposal of data is one of the only ways data can be monetised. Also, the value of the data may be intrinsically linked with the business value itself, such that both are inseparable. Even when value is ascribed, the question of legal ownership of the data (and as such legal ownership of the proceeds to be taxed) arises, especially regarding increasingly strict privacy laws.

The remote collection of data and its effect on nexus rules as outlined above are also an important element in the cross-border tax context. The question of how to attribute value to data collected remotely, and how this value interacts with the principle of attribution of profits and other transfer pricing concepts, is one that may be answered by evaluation the risks assumed in relation to the data, the assets used as well as the functions performed by each person in the value chain. This also feeds into the question of the structure of the value chain of the preparation of data. Technology may be developed, and IP held in one country ("A"), and used to collate a data set in Country B, after which it would be analysed and processed country C, and used for decision-making in country D. The ascribing of value to this data at each stage of the value chain has not been extensively dealt with by current international tax principles – however, the continuous monetisation of data means that this discussion remains at the forefront of the issues faced by policy makers when faced with the growth and development of the digital economy.

c) Characterisation of income derived from new business models

E-commerce has influenced the proliferation of digital business models which may not necessarily be provided for by existing income tax laws. Businesses such as application hosting and cloud computing contribute significantly to turnover ascribed to the digital economy and are integral to almost every part of e-commerce. However, the categorisation of their income and tax consistency and certainty when dealing with similar types of transactions continues to pose a challenge to policy makers and revenue authorities charged with implementing this policy.

The question arises whether income from these new business models should be treated as royalties, (given that these models rely heavily on intellectual property ("IP") development,

which IP is usually provided for within the scope of taxes on royalties), service fees or profits derived from the activity of a PE. This is particularly pertinent given the specific treatments provided for each of these income streams, be it under domestic law or within the framework of bilateral tax treaties. While royalties are taxed in the countries where the holder of the IP is based, business profits are usually taxed in the jurisdiction where a PE was established – however as mentioned above, the concept of nexus for the purpose of establishing a PE does not appropriately capture the reality of the digital economy.

There is therefore a need to consider the objective of existing tax provisions and evaluate whether these provisions remain adequate in the current economic climate to produce the desired results in the digital economy. Where possible, this need extends to implementing synergy in the approaches to the challenges posed by the determination of nexus and the characterisation of income, as one would likely affect the other.

d) Collection of VAT on imports

As a general practice, countries which impose VAT on imports of goods do so at the time of importation, using the same channels and mechanisms employed for the collection of customs duties and related levies. Traditionally, importers (who would be duly registered with the local revenue authorities) would import significant volumes with significant values at a time – this allows revenue authorities to exempt low-value goods or minimal import quantities, and the identification of the importer eases revenue collection.

However, owing to the developments of e-commerce, it is not possible for goods to be sold and delivered to customers online, without the need for a local warehouse or shop. This provides businesses with the ability to stock their goods offshore and import them on demand (via digital purchase). By so doing, the business deliberately takes advantage of low-value threshold exemptions for each separate import, to escape VAT liability on these imports.

The collection of VAT on imported services also poses a challenge where the services involve a B2C supply of intangible products in the absence of a tangible presence of the provider in the jurisdiction of the consumer, whether directly or indirectly. For example, in principle the supply of streaming services of digital content such as movies would require payment of VAT on this supply – however where there is a lack of any physical asset of the service provider in the consumer's jurisdiction, and given that the consumer is an individual, the charging and collection of VAT on the transaction either directly from the supplier or even via the reverse charge mechanism becomes a significant challenge in the country into which the VAT is imported.

e) Administrative challenges

One of the most significant challenges to taxing the digital economy according to the OECD, is the administrative challenges stemming from the borderless nature of e-commerce. Principal elements of taxation such as determining the identity of the taxpayer, ascertaining the volume of taxable activity, the collection and analysis of information, and identifying any clients all have inherent challenges – these pose a threat to the tenets of a good tax system, being fairness, simplicity, adequacy, transparency, and ease of administration.

The inability to identify business structures in the digital economy arise from the general lack of updated domestic tax rules, requiring overseas businesses who sell remotely to consumers within a certain jurisdiction to identify or register with the revenue authorities in that jurisdiction. Even where these local rules may exist, it is often difficult for revenue authorities to keep up with the pressures of properly identifying these businesses and ensuring or enforcing their adherence to taxing provisions. The challenges faced with respect to identifying these businesses also has an impact on the ability to collect and verify information required for tax purposes.

Further to the lack of identification, it is also challenging to determine the extent of commercial activities of these businesses, particularly where their commercial activity is made up mostly of B2C transactions. The lack of access to accounting records, or reliance on the offshore seller to provide these records with limited power of enforcement greatly limits the capacity of the local revenue authorities to effectively administer taxes where overseas businesses are concerned. Even where bilateral or multilateral instruments provide for information sharing between jurisdictions, these must also comply with privacy laws and financial regulations and are often resource- and time-consuming.

E. Conclusion

In principle, income taxes should apply to income defined as such by domestic or international tax law. However, the law has often struggled to keep the pace with digital business models which modify existing business concepts and introduce new ones, which do not necessarily follow the form anticipated at the time these laws are enacted. To align and update tax law where necessary, it is therefore important to identify the areas where there is divergence between current business practice and modelling and taxing provisions and find innovative ways to create synergies without stagnating growth and international trade.

The next chapter looks at the South African tax provisions in their current state as they pertain to income earned from digital sources, and analyses the divergences mentioned above.

CHAPTER THREE – INCOME TAX LEGISLATION IN SOUTH AFRICA

How does South Africa approach the taxing of income earned from e-commerce?

A. Introduction

The growth of the digital economy in South Africa is apparent in every sector and every industry. Online banking has seen one of the sharpest growth curves, with banks like FNB[23] and Standard Bank[24] reporting growth in average e-commerce spend of up to 30% year-on-year, as at the first half of 2020. Consumer services, retail (online), tourism and other sectors have seen the same or even higher growth figures, with online ticket sales reaching a record high of R1.8bn sales in 2005, and all the major retail stores developing own apps for shipping and delivery of goods.

The digital economy owes its growth to developments in methods of ICT. These developments have facilitated the extensive and rapid application of business strategies that were hitherto largely economic theories, as they have become easier to employ in a digital context – strategies such as auctions, large-scale sharing of digital material or dissemination of information to name a few[25]. The developments have resulted in the application of technology throughout the economy at the lowest possible cost, leading to a reduction in the prices of products, and the accessibility of e-commerce to most traders and taxpayers globally.

As a result of the above, the number of persons involved in non-traditional types[26] of commercial activity has increased exponentially. Local companies involved in e-commerce have become highly profitable and are now regional and global players whose market capitalisations in some cases far exceed that of long-established companies in more traditional industries.[27]

The ability to trade in jurisdictions other than their jurisdiction of residence is also open to businesses, without the need to own inventory or having any tangible assets attributed to them for purposes of their trade cycle. This ability has resulted in low or no visibility of a growing amount of revenue generation by the tax authorities, which results in a tax base which does

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[23] Aluwani Thenga (FNB) (2020), Press Release "*E-commerce to be worth R225bn in SA in 5 years*", available at https://www.fnbcib.com/news/ecommerce-to-be-worth-r225bn-in-sa-in-5-years, last accessed 28th May 2022.
[24] Standard Bank (2020), Press release "*Lockdown causes a growth in online shopping and creates a surge in e-commerce*", available at https://www.standardbank.co.za/southafrica/news-and-media/newsroom/lockdown-causes-a-growth-in-online-shopping-and-creates-a-surge-in-ecommerce?utm_source=BusinessTech&utm_medium=SponsoredArticle&utm_term=February2021, last accessed on 28th May 2022.
[25] Op cit note 16 (IMF 2018 paper).
[26] Traditional types of commercial activity in this context would be those which make use of brick-and-mortar structures to meet and supply customers and receive payments.
[27] PIETZ M and WALDFOGEL J (2012), *The Oxford Handbook of The Digital Economy*, Oxford University Press, New York, on page viiii.

not reflect the reality of income generation[28]. The unexpected boom in what was hitherto a non-traditional mode of commerce has exposed the need for commercial and tax guiding principles, while highlighting the shortcomings of existing legislation which is largely based on preconceived notions and practices.

The South African tax system takes its cue from traditional corporate tax systems, which place tax claims based on jurisdictional provisions, ahead of claims jurisdictional tax claims over profits which rely on tangible evidence of trade in the form of physical assets of the income earner or taxpayer. For this analysis, we shall limit our review to corporate persons (i.e., companies), and shall not analyse the income tax provisions relating to income earned by individuals or non-corporate persons (such as trusts).

At its inception, the ITA relied on the source principle, which provided that income tax was applied on income of South African sources. However, this interpretation underwent two major changes, namely the 1997 introduction of Sections 9C and 9D which relaxed foreign exchange allowances for South African residents, and the 2000 inclusion of Section 9E which taxed the foreign dividends of South African residents. As a result, South Africa moved from a taxing income on the basis of source to taxing income on the basis of residence, thereby allowing the revenue authorities to bring all the income of all persons resident or deemed resident within its jurisdiction within its tax net.

This chapter highlights the core elements of these foundational principles of South African income tax and outlines how their interpretation is impacted by e-commerce and the digital economy.

B. A general overview of SA income tax provisions

To understand the foundational approach of South Africa in respect of the taxing of income, we will look at the provisions of the ITA with respect to the persons chargeable to tax, as well as the income subject to tax.

- The main charging provision in the ITA is Section 5 (1)(d) of the ITA – this provision charges an annual income tax, in respect of the taxable income received by or accrued to or in favour of:
- any person (other than a company), during the year of assessment ending the last day of February of each year; and

[28] ATAF, 2020, "Digital Economy and Cross Border Transactions: VAT Policy and administration considerations for African Countries", ATAF Tax Programmes Department, available at https://events.ataftax.org/media/documents/98/documents/Digital_Economy.pdf, last accessed February 2022.

- any company, during every financial year of the company.

The determination of the taxable income of a company begins with the calculation of its gross income.

Section 1 defines gross income to the following effect:

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

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

During such year or period of assessment, excluding receipts or accruals of a capital nature.

A joint reading of Section 5 (1) and the definition of gross income shows that the underpinning principles of an income tax charge under South African law are the principle of taxation on the basis of residency, and taxation on the basis of source of income.

1. Taxation based on residency

As mentioned above, South Africa moved its primary basis of taxation to the residency principle. A resident is defined in Paragraph (b) of the 'resident' definition in Section 1 (1) of the ITA as:

- In the case of a natural person, a person who is ordinarily resident in the Republic, or who was physically present in the Republic for an aggregate of 91 days or more in the relevant year of assessment, or per year in the five years of assessment preceding the current year.
- In the case of persons other than natural persons, a person which is incorporated, *established, or formed in the Republic or which has its place of* effective management in the Republic' (excluding persons deemed to not be residents under the provisions of an applicable DTA).

Given that this report focuses on the taxation of corporate income, the following analysis of the principle of residency for the purpose of chargeability to South African income tax shall be limited to persons other than natural persons, that is, corporate persons or companies.

South African income tax law therefore places primary importance on the place of incorporation or establishment of a company to establish its residency. A high level of reliance is placed on the physical or tangible aspects of the entity's taxable activity, to provide a valid basis for taxation.

It is worth noting that the company does not have to be incorporated i.e., formally registered in the country – it suffices for the company to be established or formed in the country, for its income to be taxable.

The concept of a company being established or formed for tax purposes was introduced by the OECD in their model tax convention ("MTC"), which is the model most used by countries around the world as a reference guide for their Double Tax Agreements ("DTAs"). According to the Article 4 of the 2017 OECD MTC which is still in force, a company's residence may be determined:

- With respect to the existence of a 'permanent establishment', (i.e., a fixed place of business through which the business of the enterprise is wholly or partly carried out,)

- Or, with reference to its place of effective management ("POEM").

Consequently, where the incorporation status of the company does not align with the reality of circumstances, or where it is unclear where the company is established or formed, reference may also be made to the place of effective management of the company.

The POEM concept has not been extensively legislated under South African tax law – however, the proliferation of case law in this regard has contributed to the formation of robust policy and guidelines on an acceptable interpretation of POEM.

In the landmark *Oceanic Trust*[29] case, the courts held that a principal indicator of the POEM of a corporate entity was the location where the top level of decision-making was exercised. As such, in order to ascertain where a company was effectively managed, consideration needed to be given to the following factors:

- The place where the key decisions of the company were substantially taken. This included particularly management and commercial decisions;

[29] *Oceanic Trust Co Ltd NO v C: SARS* (2011) 74 SATC 127.

- Ordinarily, the location from which senior management of the company (such as a Board of Directors) would take strategic decisions which would be implemented by the entity.

The judgment above contributed to the update of SARS 2002 Interpretation Note providing for the determination of the residency of corporate persons using the POEM concept. Under the new SARS Interpretation Note 6[30] ("IN6"), the POEM of a company is the place where key management and commercial decisions necessary for the conduct of its business are in substance made.

IN6 went further to enumerate a list of factors to be taken into account for the purpose of determining POEM – these include amongst others the domicile of the Head Office, and/or Board of Directors, the venue for Board meetings, and the location of operational versus top level management.

It is worth noting that IN6 provides that the strength of a company's nexus with respect to a given country is irrelevant for the purpose of determining its place of effective management. The significance of this phrase will be discussed further in this report.

2. Taxation based on the source of income

As mentioned in Section 5, non-resident persons will be chargeable to South African income tax with regards to their income earned from South African sources.

Section 9 provides a list of the income considered to be of South African sources, summarised as follows:

- Dividends [paid by a South African resident];

- Interest attributable to an amount incurred by a resident, or is received or accrued to the non-resident in respect of the utilisation or application of any funds or credit in South Africa;

- Royalties attributable to an amount incurred by a resident, or that is received or accrued to the non-resident in respect of use or right to use any intellectual property in South Africa;

[30] SARS, 2015, *Interpretation Note: No 6 – Resident – Place of Effective Management (Companies)*: Issue 2, available at https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf, last accessed June 2023.

- Amounts received or accrued in consideration for the sharing or services in connection with scientific, technical, industrial, or commercial knowledge or information;

- Amounts received or accrued in respect of the holding of public office;

- Amounts received or accrued in respect of services rendered or work or labour performed for governmental or public institutions;

- Amounts received or accrued in terms of a pension, annuity, or similar fund;

- Amounts received or accrued in respect of the disposal of immovable property located in South Africa;

- Amounts received or accrued in respect of the disposal of an asset, where the asset is connected to a permanent establishment in South Africa;

- Amounts attributable to an exchange difference in respect of any exchange item as defined.

It follows therefore that where a non-resident's income is deemed to not be of South African sources by virtue of this list, that income will not be subject to South African income tax.

While there are other provisions in the ITA which provide for the taxing of named and specific elements of income, the principles mentioned above are the 'starting' principles for liability to tax. As such, in the case where it is impossible to apply the provisions above to the elements of the digital economy, the implementation of a right to tax the income earned within that economy under current income tax laws becomes a challenge for the South African fiscus. The ways in which the digital economy challenges the imposition of tax liability by virtue of the provisions above is analysed in the following section.

C. Tax challenges arising from the development of a digital economy in South Africa

Given the increased digitalisation of the global economy, African countries in general are reporting concerns about the tax challenges generated by this digitalisation[31]. Multi-national enterprises (MNEs) have come to rely heavily on digitalisation to grow their African footprint – as a result, these MNEs are able to carry on economic activities in African countries with a minimal amount of tangible assets or other physical footprint. This should be considered considering the continental tendency of African countries to tax income on a residence basis,

[31] ATAF, 2019, "*Ensuring Africa's Place in the Taxation of the Digital Economy",* ATAF, available at https://events.ataftax.org/media/events/19/documents/Concept_Note.pdf, last accessed February 2022.

with only limited taxing rights allocated regarding source (i.e., withholding taxes, as opposed to regular income taxes). Consequently, where the recipient of this income is not a resident of the African countries and the source is not formally acknowledged and/or taxation based on source is not provided for by statute, the income generated by the digital economy easily escapes the tax net of revenue authorities.

The inadequacy of tax laws in Africa is further heightened by the approach adopted in respect of how taxing rights are allocated, as provided in most of the DTAs in force across the continent. These DTAs where they exist are usually the primary authority on how taxing rights on income generated from cross-border activities are allocated between the jurisdictions involved. In principle, these DTAs are built on the OECD model, which tends to give taxing rights to the country of residence of MNEs – exceptions usually include income generated either from land-based activities, or via the use of a permanent establishment or other entity in the source country. In practice, this provision tends to undermine any existing tax laws on income arising from the digital economy, where these laws exist. As such, African countries continually see their tax bases eroded via treaty shopping and other tax avoidance loopholes in existing legislation.

According to the 2000 South African Green Paper on E-commerce[32], the areas of concern which require specific attention by statutory bodies include security or privacy, information infrastructure, commercial guidelines, and expansion of opportunities. For this report, our focus shall be limited to the commercial guidelines required to govern electronic commerce – these guidelines include amongst others, fiscal regulations with respect to the taxing of income earned from e-commerce.

In the executive summary of the Davis Tax Committee second interim BEPS report[33], several direct tax challenges were identified as having been raised by the digital economy.

1) Inadequate policy formation - the absence of an adapted statutory framework

Reference to a statutory framework in this regard encompasses policy formulation in terms of established legislature, but also jurisprudence and legal interpretation of principles of e-commerce as established by the courts.

[32] South Africa Department of Communications, 2000, A *Green Paper on Electronic Commerce for South Africa*, available at https://www.gov.za/sites/default/files/gcis_document/201409/electroniccommerce1.pdf, last accessed in February 2022, on page 11.
[33] Davis Tax Committee (2016), *Executive Summary of Second Interim Report on Base Erosion and Profit Shifting (BEPS): OECD BEPS project from a South African perspective: Policy perspectives and recommendations for South Africa*, available on 2 BEPS Final Report - Introductory Report.pdf (taxcom.org.za) last accessed June 2023.

- Established legislature.

An analysis of the policy discussions with respect to the Green Paper on E-commerce[34] exposes that the lack of adequate legislature on electronic commerce was having a negative effect on the development of jurisprudence. Indeed, the impact of this lack from a statutory approach was most felt regarding:

- The obligatory application of concepts which rely on the use of paper, to electronic communications;

- The extent to which electronic evidence could be admitted in legal proceedings;

- A verification of communications carried out electronically, for authenticity and integrity;

- The legal implications of e-commerce.

This translated to a lack of protections, both for the taxpayer and the revenue authority – as such, given that e-commerce cannot exist in a legal vacuum, it was proposed that an audit of South African Law on e-commerce be carried out, to identify areas which required updating, and propose measures via which they could be updated.

From a tax perspective, no globally acceptable definition has been established for the digital economy. In layman's terms, it describes a network of economic activities and commercial transactions executed by way of digitised methods, with heavy reliance on the use of internet and advanced ICT transmissions. According to the OECD Roadmap report[35], the digital economy consists of the provision of services via the use of digitised methods.

Consequently, to understand the intersection of the digital economy with the taxation of income generated by this economy, reference must be made to the definition of 'digital services' and how these services are interpreted and governed from a tax perspective.

Prior to 2014, no allusion to the digital economy could be found within tax legislature – the taxation of income derived from the digital economy was supposedly covered by existing income tax laws. It is worth noting that these traditional income tax laws as applied in South

[34] Op cit note 32 (SA Green Paper) at page 24.
[35] OECD (2020),*Roadmap Toward a Common Framework for Measuring the Digital Economy*, OECD 2020, available at https://www.oecd.org/sti/roadmap-toward-a-common-framework-for-measuring-the-digital-economy.pdf, last accessed January 2022.

Africa impose taxation on income by virtue of two principles – the first is where the recipient is a South African resident, and the second is where the income is from South African sources.

The first regulatory text on e-commerce was promulgated into law in August 2002 – named the Electronic Communications and Transactions Act[36]; this piece of legislature recognised the proliferation of electronic communications, and had as objective to,

"*enable and facilitate electronic communications and transactions in the public interest…*"[37]

The ECTA did not make express mention of or allusion to the tax aspects of electronic transactions. Nevertheless, arguments exist that the Act as is brings together the major internationally accepted principles in e-consumer law – SL Snail in his article[38] demonstrates how the Act covers important aspects such as the legal duties of e-vendors, the rights of the e-consumer and the jurisdiction of cross-border e-contracts.

However, the continued lacuna in the tax space and resulting uncertainty points to the fact that while the ECTA is a welcome starting point in terms of understanding and regularising the interaction between consumers and e-commerce with, it still falls short of aiding in the actual harnessing of the ability of the e-commerce and the digital economy to generate revenue for the Republic.

In the absence of any texts specifically regulating the tax aspects of e-commerce, one must make recourse to the general provisions contained in the ITA. However, as mentioned above, these provisions are of general application and not specifically formulated to address the taxation of the digital economy. This lack of adequate policy has resulted in a mismatch between the reality of the digital economy, and the availability of legislature catering for its taxation.

2) The difficulty in allocating taxing rights

Taxing rights refer to the right of a particular country or jurisdiction to tax a particular type or element of income. As mentioned above, these rights usually follow either a source nexus, a residence nexus, or a combination of both.

[36] Act 25 of 2002.
[37] Ibid, Article 2.
[38] S. Lindelo Snail, "*An Overview of South African e-consumer law in the context of the Electronic Communications and Transactions Act (part 2)*, The Quarterly Law Review for People In Business, ISSN 1021-7061, available at https://journals.co.za/doi/pdf/10.10520/EJC52594, last accessed May 2022.

According to the OECD, in the context of electronic commerce taxing rights may be allocated with emphasis on:

- Place of effective management rules
- The concept of a Permanent Establishment
- The attribution of profit to a server PE
- Transfer pricing.

The question of the allocation of taxing rights arises in cross-border transactions because an entity located in one jurisdiction earns income in another jurisdiction. This is dealt with in Double Tax Agreements, which rely on the PE concept to identify circumstances under which a country may establish the right to tax the income realised by a non-resident entity.

The DTAs concluded by South Africa generally follow the OECD Model DTA – this model provides that South Africa may only tax the income of a non-resident, where that income can be attributed to a permanent establishment of the non-resident in South Africa. A generally accepted definition of a permanent establishment refers to a fixed place of business through which business of an enterprise is wholly or partly carried on. As such this concept incorporates:

- A geographical element, usually in the form of tangible assets in a specific location; and
- A time period element i.e., the existence of the enterprise for a period which is not temporary (usually 6 months – 1year, or more).

As mentioned earlier, e-commerce is characterised by trading via the internet, such that a non-resident may earn significant amounts of income in South Africa without ever meeting the two requirements above. Indeed, as per OECD guidelines, neither a website nor a website hosting arrangement suffice as compelling standalone factors which trigger a PE – indeed, even the presence of a server is not guaranteed to constitute a Permanent Establishment, except where the functions performed are integral to the business, and not just preparatory or auxiliary[39].

Consequently, there is a need to either review the requirements of Permanent Establishments for the purpose of allocating taxing rights or move away from the concept of Permanent

[39] OECD Centre for Tax Policy and Administration, "*Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? Final Report*", OECD Publishing, at page 8.

Establishments altogether and devise another way of allocating these rights where e-commerce is concerned.

3) Attribution of profits

Generally, the attribution of profits for tax purposes follows the physical or geographical situation of any hardware or tangible asset involved in the commercial transaction. As mentioned above, this hardware may be an office or registered business, but often the only physical connection an electronic service or other digital transaction may have to a tangible asset is the servers used to provide connectivity and host software.

An electronic transaction may be processed using software hosted by numerous servers located around the world. Should this be the case, any sort of equitable taxation will require the tax authority to first test the involvement of each non-resident against the Permanent Establishment requirements, and then determine the profits of each PE for purposes of taxation. This allocation would generally have to reflect the value provided by each server, using the generally accepted principles of functions performed, assets deployed, and risks undertaken within that jurisdiction.

In practice, the allocation of profits according to the functions of servers would require a subjective approach, including tasking the tax authorities to be able to read and interpret code [40]. This would constitute a significant administrative barrier, and lead to a very complicated compliance environment.

Consideration would also need to be given to:

- Transfer pricing (TP) requirements – TP regulations require the use of traceable TP methods in determining how profits are allocated to different jurisdictions, to ensure that there is a proportionate payment of taxes in relation to the value generated in-country. This relies highly on the cooperation of the taxpayer in providing detailed information on the functions of each server or other tangible asset – where the taxpayer is a foreign entity, requiring them to provide this information to the South African revenue authorities may prove to be an administrative burden which would render the tax collection exercise disproportionately burdensome.

- Existing Double Tax Agreement (DTA) provisions - most DTAs in force between South Africa and other countries already allocate taxing rights on certain elements of income,

[40] Dale Pinot "*The Need to Reconceptualise the Permanent Establishment Threshold*" 60 Bulletin for International Fiscal Documentation (2006) at 279.

to one jurisdiction of the other. These would have to be considered in the drafting of tax laws to address e-commerce or could potentially trigger conflict between the DTAs and any new e-commerce tax provisions.

In addition to the challenges above, the challenges of nexus, data valuation, categorisation of income from digital business and imposition of VAT on services are also challenges faced by the South African fiscus and legislative.

4) Nexus issues

As mentioned above, the starting point for the chargeability to income tax in South Africa is the existence of nexus for tax purposes, between the Republic and the income[41]. This nexus can either be:

- A residence nexus - A company would meet the 'resident' definition by way of having a physical connection to the Republic, evidenced either via a formal incorporation, or via an informal proof of presence such as the existence of physical aspects of their business, or even the physical presence of the managers and decision-makers of the company. Once this physical connection was established, the resident company would be (or deemed to be) resident in South Africa, and as such is liable to tax on their income earned in South Africa.

- A source nexus, where a [non-resident] person would be taxed on income originating within the geographical confines of the Republic.

In a 'brick-and-mortar economy', the existence of tangible elements of a company's presence is therefore a principal parameter used in determining the nexus of a company, where and how it should be taxed.

However, the continuous modernisation of digital systems and their interaction with modern trade has created sophisticated systems which have changed the way business is carried out across the globe. Companies no longer need to be physically present in an area or even in a country to do business in that country – indeed the interaction of technology, finance, manufacturing, and service delivery has encouraged a proliferation of digital transactions which have greatly reduced the physical footprint which can be attributed to a single taxpayer.

[41] AW Oguttu and S Tladi "E-Commerce: A Critique on the Determination of a "Permanent Establishment" for Income Tax Purposes from a South African Perspective" (2009) *20 Stell LR 74* on page 213.

An analysis of a normal trade cycle exposes the difference between brick-and-mortar/traditional commerce, and e-commerce.

In a traditional commerce cycle, a client walks into a shop, sees a good displayed on a shelf or in a catalogue, and purchases the good. The good is either delivered to them on the spot for collection or earmarked for delivery to a place of mutual agreement. In such a case, the risk and reward lie with the seller, whose physical presence is established in their physical shop or sales outlet – it is relatively easy for the revenue authorities to ensure that the income earned from their sale is taxed accordingly.

However, the situation is different where e-commerce is concerned. In a digital sales transaction, it is not uncommon to have multiple companies intervening in one transaction – for example, a mere purchase of goods on the internet will comprise the actual seller of the good, the owner of the platform on which the sale is concluded, the payment intermediary, the company in charge of physical storage of the good, and the logistics company in charge of delivery. Each of these parties may be scattered around the globe, and it is likely that only the company in charge of storage and the company in charge of logistics will hold any sort of presence in the country within which the customer is resident, or from which the payment originates or to which the good is delivered. The companies with physical presence as such may only receive a service fee, which is likely to be a minor portion of the total price paid. It then becomes the responsibility and burden of the revenue authorities to identify and apprehend the real beneficiaries of the purchase price, establish their tax jurisdiction, and then compel them to pay taxes due on their income earned from a business which has a physical component in the customer's country of residence.

Where the digital economy is concerned, establishing residency for the purpose of taxing income proves more problematic. Companies trading principally or solely in e-commerce may only exist in cyberspace, or their country of registration may remain unclear. The digital economy allows for some business transactions to be completed electronically end-to-end, with limited physical interaction between provider and customer. Examples would be the supply of digital goods such as apps, online games, or services such as cloud computing and web hosting etc.

In such a case, the business activity would consistently fall out of the scope of the South African income tax law, which relies heavily on physical presence in South Africa as one of the determinant factors for imposition of an income tax law.

5) Determining the value of data as a commodity

The proliferation of, and ease of access to data, or 'big data' as it more commonly referred to in the digital space, is one of the principal innovations which digitalisation and the Fourth Industrial Revolution have established. Big data refers to the different, varied and often detailed data streams which are available in all sources and formats, from all sectors and covering all topics which now rely on digitalisation for proper functioning. The use of technology which can store massive amounts of structured and unstructured information is a tool which is increasingly monetised by IT firms and other stakeholders who have the knowledge and capacity to analyse, store and market this data. The collective benefits of big data and data analytics may provide a huge impact on the growth, development, and expansion of business in Africa – however, it is often difficult to put a value on data and data analytics, given that each user of the data may have a different goal to achieve from their use of the data, which in turn will affect their analysis and the value placed on the data. Consequently, ascribing taxable value to big data is not a straightforward exercise owing to the highly subjective nature of big data as a commodity, and the difficulty in obtaining contextualised comparables.

6) Collection of VAT on digital goods and services

With the growth of the digital economy, the loss of revenue because of the inadequacy of the VAT framework became increasingly significant. As such, in 2014 the "Updated Regulations" were promulgated via Government Notice 429 of 18 March 2019, which specifically included 'electronic services' within the VAT tax net and place the obligation to declare and pay VAT due on the foreign supplier of the service as opposed to the local client.

The Updated Regulations adopt international best practice in the case where there is a supply of electronic services, by first attempting a broad definition of an electronic service, and secondly adopting e-commerce place of supply rules. [42]

The VAT rules are however not without criticism, which in some cases has received the attention of the fiscus. For example, National Treasury in the 2019 Explanatory Memorandum to the Updated Regulations (at page 7) countered the criticism holding that the rules do not distinguish between business to business (B2B) and business to consumer (B2C) economic activities, with the explanation that such a distinction did not exist under the current VAT Act,

[42] Government Gazette (2019) Updated VAT Regulations, No 42316, published 18 March 2019, available on https://www.sars.gov.za/wp-content/uploads/Legal/SecLegis/LAPD-LSec-VAT-GN-2019-01-Notice-429-GG42316-18-March-2019-Electronic-Services.pdf at Regulation 2. Last accessed June 2023.

and as such introducing a similar distinction for foreign suppliers would result in an unfair advantage in the form of increased cash-flow. Nevertheless, there are several measures proposed to further streamline the VAT legislation on e-commerce, which are international best practice applied in jurisdictions with comparable VAT regimes such as Canada, New Zealand, and Singapore – these include:

- Additional technical amendments to the definition of 'electronic services'
- Drawing a distinction between B2B and B2C supplies
- VAT group registration
- Introduction of the self-supply taxing mechanism
- Zero-rating the supply of financial services.

7) The characterisation of income arising because of new business models

As mentioned above, the development of the digital economy has led to the proliferation of new business models, whose structure is not necessarily provided for by current South African tax law.

As mentioned above, Section 9 of the ITA provides that the following amounts may be deemed to have accrued or been received from within the Republic by a non-resident:

- Dividends;
- Interest as defined;
- Royalty as defined;
- Remuneration for technical/intellectual property or rights therein provided or services (or attributable to an amount incurred by residents);
- Receipts or accruals in respect of disposal of immovable property situated within the Republic;
- Pensions and annuities in connection with services rendered within the Republic.

The types of income listed above as being taxable under the ITA do not include any income earned as a result of economic activity within the digital economy, i.e., trading in digital goods and services, where those proceeds are from a source within South Africa. A core example would be the case of online marketplaces. The growth of the digital economy has encouraged the proliferation of online marketplaces which have disrupted the way in which businesses, especially small business, service and maintain a global customer base.

As mentioned previously, the traditional business model for goods (and most services) would typically consist of a supplier and a client interacting directly, which interaction if it ended in a sale resulting in income for the supplier and expenditure for the client. Other service providers which may be involved such as transporters, would likely form either an ancillary service to the sale, or a separate transaction which could be taxed accordingly.

However, in the case of online marketplaces, a typical sale transaction would involve multiple stakeholders, oftentimes with each in a different jurisdiction, but all interdependent on each other for the execution of the taxable transaction. For example, an online marketplace sale would involve the supplier of a good (in Country A), the service provider who owns the online marketplace or trade name/IP (this may sometimes be different from the operator, in case of a franchise) (location unknown), the entity providing the payment platform services (Country B) and the entity providing storage and delivery services (Country C) on one hand, and the client on the other (in Country D). In addition, there may be entities who also advertise to the client in Country D using the online marketplace.

The identification of each party in such a sale, determination of their contribution to the transaction and the real or market value which can be ascribed to that transaction is often where the real challenge is. In addition, the adequacy of taxing provisions is called into question with respect to determining what service is being provided, what the tax base is, and where the tax should be paid for each part of the transaction.

The above is only one of several examples possible - similar challenges exist especially with regard to transactions involving the collection, storage, and sale of digital goods like data, and hyper-fragmented digital services such as web hosting, application development and other IT/data engineering services.

In the absence of specific rules dealing therefore with such fragmented transactions, juxtaposing a tax system built for a different type of economy onto the digital economy is not likely to produce the desired effect, hence there is a need to adapt tax policy to the specifics of digitalisation

D. Conclusion

The challenges enumerated above are only some of the more readily apparent and immediate challenges which digitalisation of the economy presents from a tax perspective. Even if the tax policy framework were to be adequate, this framework cannot function in isolation - the South African legislative arm would have to extend these updates to other arms necessary for the

smooth execution of tax policy such as the provision of adequate digital infrastructure especially with regard to tracking/monitoring and collection mechanisms, upskilling of the labour force to deal with the increased interaction with taxpayers, and enhanced sharing of required information across platforms and cross-border where required.

The widely accepted principal canons of taxation[43] require that a good tax law is one which is in proportion to the revenue realised, is certain with regards to time, manner, and quantity of payment, convenient, and fair and equitable. The onus rests on the South African fiscus to enact a policy framework, as well as specific laws, that respect these and other accepted canons, while equally meeting the needs of the Republic with respect to development and revenue collection.

To accomplish this objective, consideration may be given to the approach of other interested parties and stakeholders, such as international trade bodies, and other economies which have considered the issue in some detail. The next chapter looks at a few examples which are examples of the international trends with respect to taxing income earned within the digital economy.

[43] Op cit note 21 (Adam Smith, *Wealth of Nations*) at Book V, Chapter 2.

CHAPTER FOUR – INTERNATIONAL TRENDS ON TAXING INCOME FROM E-COMMERCE

What are the international trends surrounding the taxation of e-commerce?

A. Introduction

There is an international push to reform international tax rules to keep the pace with an ever-increasing digitalisation of business. Current rules provide for the limited taxation of the income earned by non-resident companies, usually being where those profits can be attributed to a permanent establishment of the non-resident company in that country. The taxation of profits is also somewhat assured by transfer pricing rules, which mandates from a general perspective for the division of profits of a multinational company, between the group companies proportionately to their contribution to the profits generated.

Nevertheless, some countries believe that the above rules are not sufficient to ensure an adequate allocation of profits to the right jurisdictions. Circumstances such as the use of 'tax havens' (i.e., jurisdictions which set very low rates of company tax to attract multinational investment, as well as the proliferation of technology companies with sophisticated structures and digital platforms, have resulted in a failure of the traditional international tax rules to adequately levy taxes on the digital economy.

Consequently, there have been numerous attempts, by renowned trade bodies as well as some of the leading global and African economies, to put in place a system of taxing the digital economy which would ensure that there is a more equitable allocation of profits and taxing rights, and the resulting increased revenue base for tax collection purposes. Some of these attempts are examined in further detail below.

A. International trade bodies

i. OECD

The Organisation for Economic Co-Operation and Development ("OECD") is one of the world's leading international organisations which brings together governments, policymakers, and citizens to establish international standards based on real evidential data and find solutions to economic challenges amongst others. Since its inception in 1961, the OECD mandate to further world trade and foster economic progress has led to the inclusion of 38 countries to stimulate economic progress and world trade. Some of its key objectives involve improving economic performance, sharing best-practice, and setting international standards

for economic growth and development, through the provision of unique economic forums and knowledge hubs for data, analyses, and exchange of experiences.

The viewpoint of the OECD is relevant to the discussion, given that the OECD provides a reference for international taxation for majority of the major stakeholders in global international trade. While South Africa is not a member country and only has observer status, it remains a member of the OECD BEPS sub-committee – as such, the interpretation of OECD guidelines by the South African fiscus has a major influence on the interpretation adopted by other African economies.[44]

The 2014 OECD paper on the digital economy defines the digitalisation of the economy as the adoption of ICT to enhance productivity, enhance market outreach and reduce operational cost. [45] The OECD credits the development of the digital economy with the expansion of market reach, lowered costs, changes in business models, and changes in the way goods and services are produced and delivered. As a result, ICT has become central to new business models of companies across the economy – while these models are sometimes like traditional business, thanks to ICT they can now be executed at a greater scale and over a further distance than before.

The OECD's interest in understanding the effect that digitalisation would have on the hitherto 'traditional' brick-and-mortar economy dates as far back as November 1997, when governments and business around the world participated in a conference aimed at understanding and dismantling obstacles hindering the smooth execution of international electronic commerce. Thereafter, in 1998, the OECD Committee on Fiscal Affairs published the Ottawa Taxation Framework Conditions ("OTFC") as a basis for further developments on the taxation of e-commerce. These Conditions were based on the premise that the tax treatment given to e-commerce transactions should be the same as that given to traditional commerce with no discriminatory treatment and provides principles to guide governments and policy makers on their approach to ensuring that taxpayers pay the right amount of tax, while respecting the principal tenets of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, convenience, and flexibility[46].

[44] G20 Development Working Group Domestic Resource Mobilisation, "*G20 Response to 2014 Reports on Base Erosion and Profit Shifting and Automatic Exchange of Information for developing Countries*" (2014) available at 16 G20 response to 2014 reports on BEPS and AEOI for developing economies.pdf (utoronto.ca) at 15, last accessed June 2023.
[45] 2014, OECD "Addressing the Tax Challenges of the Digital Economy", available at https://www.oecd-ilibrary.org/docserver/9789264218789-7-en.pdf?expires=1644018294&id=id&accname=guest&checksum=34C2259F554C796BD260CED6B65C0477, Chapter 4 at page 70, last accessed January 2022,.
[46] OECD (2001), *Taxation and Electronic Commerce (Implementing the Ottawa Framework Conditions),* OECD Publishing, at page 10. This work references the tenets first propounded by Adam Smith in his book, op cit note 21.

According to the OTFC, taxes on consumption of cross-border electronic commerce should result in taxation in the jurisdiction where the consumption takes place[47] – while seeming to be a sound interpretation of international tax principles, this raises the question of practical difficulties in collecting consumption taxes in relation to intangible goods, from the customer.

In February 2013, the OECD released its report addressing Base Erosion and Profit Shifting (BEPS), which report contained proposals of measures to harness the digitalisation of the global economy and alleviate the strain it puts on the enforcement of traditional tax systems.

In this report, the OECD recognised that the international approach to taxing income had not stayed in line with business practices and the development of the trade in intangible assets, as well as the digital economy[48]. Non-resident taxpayers could therefore employ business practices through which they derive substantial profits from transacting with customers residing in a specific jurisdiction, without the need to have a taxable presence in the country, and without being subject to taxation in that or any other country that levies tax on profits.

The inadequacy of tax laws to properly include such business practices and their income in the tax net was further exacerbated by the lack of multilateral action at an international level. MNEs took advantage of the absence of an efficient, flexible, and certain international tax system which could be referred and adhered to by all to carry out tax avoidance by transferring profits to jurisdictions with low tax rates or no income taxes. Unilateral actions achieved an undesired effect, that of further fragilising an unstable global economy, harming investment, and slowing economic growth, which made it difficult for governments to collect tax revenue.[49] It was therefore necessary to approach the tax challenges via a consensus-based solution, which would increase tax equity between traditional and digital businesses, and in so doing secure the international income tax system.

Consequently, in July 2013 the OECD released an Action Plan to address BEPS and propose solutions to key concepts used by MNEs to facilitate tax avoidance. This Action Plan consisted of 15 'Actions', with Action 1 consisting of "Addressing the Tax Challenges arising from the Digitalisation of the Economy".

A deeper analysis of Action 1 and the challenges faced by tax authorities because of the merger between the efficiencies provided by ICT and traditional economies and business models was presented in a report published in 2015. In this report, the digital economy is defined as "*the*

[47] OECD (2006), *Working Party on the Information Economy, Online Payment Systems for E-Commerce*, OECD Publishing.
[48] OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, http://dx.doi.org/10.1787/9789264192744-en on page 7.
[49] OECD (2021) Press release: Action 1, available at https://www.oecd.org/tax/beps/beps-actions/action1/, last accessed February 2022.

result of a transformative process brought by information and communication technology".[50]

According to the OECD in their 2015 report[51], these business practices have been made possible thanks to the advancement in technology and falling costs of ICT. The use of general-purpose technology is now a central concept and principle of firms, allowing businesses to design and build operating models which rely heavily on their technological capabilities to improve their flexibility and efficiency, and propel their service offering into the global market.[52]

These new emerging business models have parallel traditional models but have leveraged on the deployment of ICT to conduct commercial activity on a large scale and across larger geographical distances than hitherto possible.

Examples of the more prominent businesses which have greatly leveraged on ICT, developed the digital economy, and increased profit shares are the following:

a) Electronic commerce

The OECD defines electronic commerce as "the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders".

The more prominent types of e-commerce models include:

- Business-to-business (B2B) models
- Business-to-consumer (B2C) models
- Consumer-to-consumer (C2C) models

According to the 2015 report, e-commerce experienced an average of 300% growth between 2000 and 2012 and was estimated to grow even more exponentially in the future.

b) Payment services

Payment service providers have used advances in ICT to provide a safe way to execute online payments, which does not involve the requirement for vendors or buyers to disclose their

[50] Op cit note 45 (*OECD 2014 report*), on page 11.
[51] OECD (2015), Addressing the Tax Challenges of the Digital Economy", Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241046-en last accessed December 2022.
[52] Op cit note 45 (*OECD 2014 report*), on page 72.

financial identity to each other. This has been made possible using measures like payment tokens, QR codes, cyber-wallets (more popularly known as e-wallets) as well mobile payment solutions.

Electronic payments have provided a viable alternative to traditional banking processes by introducing shorter timelines for payment clearance, the choice of transaction currency, ease of payment and heightened protection against fraud.

c) Online advertising

The diffusion of marketing messages using the internet has proven to be an efficient way to target a desired demographic, as well as monitor performance, marketing reach and effectiveness at a reduced cost.

Online advertising allows for more sophisticated methods of segmenting customers, tracking public interaction with the seller brand, and generating even more revenue when linked with content or user behaviour (such as search engine ads).

Online advertising has also largely fuelled the use of algorithms, which have paved the way for the collection, analysis, and processing of large and diverse amounts of user data in order to develop targeted advertising solutions. While traditional methods of advertising involved a wider net cast over a large area for a sustained period (leading to extremely high upfront costs which did not necessarily translate into sales), online advertising in the digital economy makes use of sophisticated mathematical rules to deliver content to consumers and prospective consumers which pulls from other data culled via their use of ICT in general. As such, payment from advertising has shifted from the traditional adverts in media houses and such, to compensation calculated via methods such as cost-per-mille (payment per thousand displays to consumers), cost-per-click (payment per ad click by consumers), and cost-per-action (payment per specific consumer action, such as a purchase).

d) App stores

As mentioned on section 4.2.3 of the OECD 2015 Report referenced above, app stores can be defined as a digital distribution platform – these are usually central retail platforms available to potential and existing consumers of services on most mobile computing devices.

They include applications developed by the retail businesses as well as third-party developers and serve as a more tailored advertising and transactional tool for businesses to utilise the

benefits of digital markets and potentially reach a wider market, at times which may often fall outside regular business hours.

The use of apps within the digital economy is growing exponentially, with purchases made through the app accounting for almost 50% of revenues realised.

e) Cloud computing

Section 4.2.5 of the 2015 OECD report referenced above describes the cloud computing business model as consisting of the provision of services such as cloud storage, the management of software and data, as well as computing solutions. This is a largely intangible service, which enjoys a limited physical footprint (given that the bulk of their hardware is servers, which may be distributed in multiple jurisdictions.

Cloud computing solutions are a cost-effective measure through which customers can purchase and maintain IT infrastructure and improves economies of scale, by sharing space and resources amongst clients so as to accommodate and promote a flexible need.

Addressing the challenges introduced – mitigation measures

As mentioned in Chapter 1, the OECD has identified the main challenges of the digital economy as consisting of nexus issues, determining the value of data, characterisation of income arising because of new business models, and the collection of VAT on imports.

Given that cross-border trade and business integration continues to grow and solutions are needed to tackle the taxing problem in the medium- as well as long-term, the OECD Digital Tax Force in its Roadmap report examined ways in which the application of tax treaty concepts to the taxing of profits derived from the delivery of digital goods and services can be modified, as this was a principal pressure point in response to the need of tax authorities to increase tax transparency and enforce the payment of taxes by MNEs.[53] The 2020 OECD Roadmap proposes various measures which may be put in place by jurisdictions based on their individual needs, which are designed to aid with the levying of taxes on profits realised by companies in their digital business, where these profits are not adequately covered by existing traditional domestic tax rules. The principal measures outlined by the OECD for consideration are introduced below[54].

[53] OECD (2020), *Roadmap Toward a Common Framework for Measuring the Digital Economy*, OECD 2020, available at https://www.oecd.org/sti/roadmap-toward-a-common-framework-for-measuring-the-digital-economy.pdf. on page 6.
[54] OECD (2014), "Chapter 8 - Potential options to address the broader tax challenges raised by the digital economy", in *Addressing the Tax Challenges of the Digital Economy*, OECD Publishing, Paris, https://doi.org/10.1787/9789264218789-11-en.

1. Direct tax options

- *Modifications to exemptions from PE status*

The OECD Model Tax Convention currently in force, which is the basis on which a significant number of bilateral DTAs are based, describes certain activities as preparatory or auxiliary, with regard to the functioning of traditional business models.

Given that these activities may no longer serve such a purpose because of the evolution of the digital economy, it has been proposed that these exemptions be reviewed considering new business models.

- *Nexus on the basis of digital presence*

To bring digital presence within the scope of existing taxable presence laws, it is suggested that an alternative nexus be considered, which would address circumstances where business activities are conducted only digitally. Digital activities which did not have any tangible elements or had only minimal physical elements for the performance of their core activities., could be deemed a taxable presence where a 'significant digital presence' was maintained in a jurisdiction. As mentioned in section 7.5 of the 2014 OECD Report referenced above, this significant digital presence would be determined on the basis of significant and sustained interaction within the economy of the jurisdiction concerned.

- *Replacing the concept of 'PE' with the concept of 'significant presence'*

It has also been proposed to modify the traditional PE rules with a 'significant presence' test, which would respond to changes in the nature of customer relationships in digital trade. The test would analyse the contribution of interactive customer relationships to the value of the business, taking into consideration elements such as:

- Customer interactions extending to periods over 6 months;
- Sales of goods and services via local websites, using delivery from local suppliers, using local banking facilities, and offering goods or services sourced locally.

This test would therefore combine digital aspects with a partial physical presence.

- *Creation of a withholding tax on digital transactions*

To combat challenges associated with nexus, the proposal of a withholding tax on income received as payment for digital goods and services, procured abroad by residents of a jurisdiction.

The option has been considered to require withholding by the financial institution involved in this payment, to avoid requiring withholding by individual customers.

- *Introducing a bandwidth or 'bit' tax*

The bandwidth tax would be a mechanism taxing the bandwidth use of websites, based on the number of bytes used. A de minimis annual usage threshold for bandwidth would be put in place, and usage in excess of this threshold would be subject to tax, according to different applicable tax levels (based on enterprise size or turnover).

The bandwidth tax paid could be offset against corporate income tax liability, to further promote equity in the taxation of digital businesses and traditional businesses.

2. Consumption tax options

- *Exemptions for imports of low-valued goods*

The exemptions for low-value imports are put in place to strike a balance between the administrative and compliance cost of taxing a low-value import, and the potential revenue loss and competition distortion which the exemptions would trigger.

It has been proposed that revenue authorities should increase tax collection and administrative efficiency – this will allow more capacity to deal with the increased volumes which a lower threshold would bring. Should the thresholds be lowered, the advantages enjoyed by offshore companies trading via e-commerce would be reduced and the tax base of import VAT would be increased.

- *Remote digital supplies to consumers*

The most viable option to ensure the collection of appropriate amounts of VAT on B2C supplies of services and intangibles, would be for foreign suppliers to register and account for VAT on their supplies within the jurisdiction in which their customers are based. The registration mechanisms would need to be clear and accessible, and access to third-party assistance (which may be crucial for small-and medium-sized enterprises) should be considered.

It is worth noting that this option has received the greatest uptake in domestic tax laws, since it was first put forward by the OECD in 2014. However, its implementation is still not free from challenges, such as enforcing collection and remittance by foreign suppliers, and accessing records.

3. Reallocation of taxing rights and profit attribution

Most of the established tax regimes rely on jurisdictional right to tax incomes, to be able to adequately capture taxable revenue within their tax net. This is equally the bedrock of the vast network of Double Tax Agreements (DTAs) in force globally – it is generally accepted that cross-border income-generating transactions will usually look to a DTA for the allocation of a taxing right (which allocation usually follows the resident principle, barring minimal exceptions such as in the case of landed property which follow the source principle).

However, using jurisdiction as a starting point for the allocation of taxing rights is particularly problematic where the digital economy is concerned. Transacting in cyberspace renders the physical location of a business almost irrelevant, as software or intangible elements of a business are easily moved from one place to another, and any hardware such as servers and the like can also be quickly divested and acquired. As such, traditional tax laws which require the determination of the seller's physical place of business would be quite difficult to enforce.

<u>The OECD Two-Pillar solution to address these tax challenges</u>

In October 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting ("IF") released a Statement and implementation plan of a two-pillar framework to address specifically, the tax challenge arising with respect to the allocation of taxing rights to market jurisdictions, and the profits to be attributed to these jurisdictions for tax purposes.

a. The Pillar One Proposal

The Pillar One proposal involves the implementation of modified profit allocation rules, which make use of formulaic principles including amongst others, a baseline return for the provision of distribution and marketing functions within a group, as well as an allocation of the overall residual profits of the group.

The scope of Pillar One covers multinational enterprises ("MNEs") with a global turnover more than EUR 20 billion (approximately ZAR 365 trillion), and profit before tax/revenue which exceeds 10% of turnover. MNEs in the extractive industry and regulated financial services are expressly scoped out of Pillar One.

The proposal as laid out in Annex 1 of the 2021 report referenced above, prescribes two approaches to harmonising taxation of the global digital economy, otherwise known as Amount A, and Amount B.

i. Amount A

Traditional taxing right rules currently in force in most jurisdictions across the world follow an entity-based approach, to the effect that taxing rights can only be claimed where there is the existence of a 'Permanent Establishment' or other physical structure in the affected jurisdiction. As such, where the MNEs provide services which are largely digitalised and do not rely on the use of any physical structures, these taxing rights under traditional laws cannot be exercised.

Amount A introduces an additional element to existing guidelines on profit allocation, by increasing the scope of the approach by market jurisdictions, to include the introduction of a new taxing right over a portion of an in-scope group's residual profit to market jurisdictions, which residual profit would be determined based on the consolidated financial statements.

This new taxing right (known as the "special purpose nexus rule") would apply irrespective of physical presence. For small market jurisdictions with GDP lower than 40 billion euros, the nexus trigger would be set at EUR 250,000. It is to the effect that a nexus may be established where an in-scope group company derives at least EUR 1 million in revenue from a market jurisdiction – should this be the case; profits would be allocated to that jurisdiction ("Amount A") on the basis of their portion of the group's overall residual profits.

This proposed nexus rule would only come into play upon the ratification of a Multilateral Convention ("MLC") by members of the IF. Following its ratification, members of the IF would be bound to implement Amount A in a manner which is coordinated, and consistent, which requirement would also extend to the domestic tax rules enacted to guide how Amount A is allocated to different jurisdictions.

The OECD has further proposed some elements to be considered with respect to domestic tax rules, which will support the nexus taxing right of allocated jurisdictions as proposed under Amount A while eliminating the possibility of Double Taxation on in-scope MNEs. The expectation is that jurisdictions which enact these rules into their domestic law within the guidelines outlined by the OECD would be in synergy regarding the implementation of Amount A. Some of these proposed elements are listed below.

Scope rules

These rules would contain de minimis thresholds which would be sufficient to ensure that Amount A is applied to the requisite large and profitable MNEs, and where necessary the MNE can be broken down into an In-Group Segment which is within scope, while the group as a whole is not.

Special purpose nexus rules

These rules would contain quantitative thresholds for the identification of market jurisdictions which are eligible to receive Amount A. Consideration would be given to the amount of revenue generated by an MNE in the market jurisdiction, with lower thresholds put in place for smaller market jurisdictions. A key component of the special purpose nexus rules would be the rules relating to revenue sourcing, which would provide a formula used to determine the jurisdiction in which the MNE revenue is generated.

Tax base rules

The tax base rules are used to determine the gross on which the partial reallocation of profits is based. These rules provide steps to calculate profit or losses generated by an MNE, which would be used for the determination of Amount A. The starting point for these calculations would be the consolidated financial statements of an MNE, prepared under internationally recognised and acceptable financial accounting standards.

Profit allocation rules

Amount A provides for the allocation of 25% of a group's profit exceeding 10% of its revenue to be reallocated to market jurisdictions. The profit allocation rules provide guidelines under which the profit will be allocated, mainly in proportion to the amount of revenue generated in that jurisdiction, and subject to any adjustments.

Rules for the elimination of double taxation

These rules would be applied on the basis of quantity and jurisdiction, in order to o eliminate any double taxation that may arise from applying Amount A in addition to a system of profit allocation that is already in force.

Streamlined administration process

These rules will cover several areas where a harmonised administrative approach is warranted, with the aim of reducing the compliance and administrative burden of taxpayers as well as the correct application of the Amount A Model Rules. Requirements which will be covered[55] include *inter alia* information filing requirements, secondary liability for the non-payment of Amount A and uniform currency conversion rules.

Innovative tax certainty processes

The tax certainty rules provide three measures through which certainty over aspects of Amount A can be established, which should reduce the risk of adjustment by domestic revenue authorities, or tax audits which would be costly and time-consuming for the MNEs and authorities alike.

These mechanisms are listed as being a scope certainty review, an advance certainty review, and a comprehensive certainty review. They would be voluntary actions to be undertaken by interested MNEs, with the revenue authorities being obliged to coordinate the process and engage with the MNE.

Withdrawal of all existing digital service taxes and relevant similar measures

It is expected that the MLC will require the withdrawal of all existing digital services taxes and relevant similar measures, as well as a commitment to not enact these.

According to the Progress Report on Amount A of Pillar One[56], the ratification of this proposed nexus rule would have to be done by a 'critical mass' of member countries for the MLC to enter into force. These member countries would need to include particularly the jurisdictions within which the ultimate parent entities ("UPEs") of a majority of the MNEs falling within the scope of Pillar One Amount A would reside, as well as the key additional jurisdictions to which the profits would be allocated. This would permit a consensus to be reached with respect to measures to avoid any double taxation which may arise because of the implementation of Amount A.

[55] OECD 2022, *Progress Report on the Administration and Tax Certainty Aspects of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalization of the Economy, OECD/G20 Base Erosion and Profit Shifting Project*, OECD, Paris, https://www.oecd.org/tax/beps/progress-report-administration-tax-certainty-aspects-of-amount-a-pillar-one-october-2022.pdf, last accessed September 2022.

[56] OECD (2022), *Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalization of the Economy, OECD/G20 Base Erosion and Profit Shifting Project*, OECD, Paris, https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf, last accessed September 2022.

ii. Amount B

Amount B is the second Arm of the Pillar One proposal, put forward by the OECD as a measure to effectively tax the growing digital economy.

The background of the need for a solution as encompassed in Amount B, is rooted in the historic discrepancies in the pricing of in-country marketing and distribution activities by companies who are all entities within the same MNE but located in different jurisdictions. This is exacerbated by the lack of appropriate local market comparables through which Arm's-length pricing for these activities can be established.

The OECD has proposed a second component of Pillar One, otherwise known as "Amount B". Amount B refers to the determination of a baseline for the pricing of in-country marketing and distribution activities, via an application of the arm's-length principle which focuses on the needs of low-capacity countries.

Simply put, Amount B provides a methodology via which the Arm's-length price for in-scope transactions would be established, thereby ensuring that incidences of base erosion and profit-shifting are reduced. This methodology is intended to simplify and streamline the application of the arm's length principle based on OECD Transfer Pricing Guidelines.

The OECD proposal for measures to adopt in the determination of Amount B has been published and is currently awaiting public commentary. Nevertheless, 3 core areas have been identified as requiring particular attention[57], namely:

Scoping criteria and the definition of qualifying transactions

Tentative discussions around the scope of Amount B indicate that intra-group transactions in-scope would be buy-sell arrangements, and sales agency/commissaire arrangements[58].

Scoping criteria would include a mixture of qualitative assessments relating to economic characteristics of the transaction, and quantitative measurements culled from the financial statements of the distributor. However, the scope of Amount B would not include transactions provided for by bilateral or multilateral advance pricing arrangement between supplier and distributor jurisdictions.

[57] OECD (2022), *Pillar One – Amount B, Public Consultation Document 8 December 2022 – 25 January 2023*, OECD, Paris, https://www.oecd.org/tax/beps/public-consultation-document-pillar-one-amount-b-2022.pdf., last accessed December 2022
[58] Op cit note 53 (OECD *Roadmap*) on page 8.

The application of defined pricing methodology

The current proposed design of Amount B pricing methodology is based on the Transactional Net Margin Method ("TNMM"). According to the OECD Centre for Tax Policy and Administration[59], the TNMM is a transactional profit method which compares the net profit (after deduction of operating expenses) arising from controlled and uncontrolled transactions. Th appropriate weighting in respect of services activities, sales activities and asset-intensive activities are applied for purposes of appropriate weighting of the net profit.

The adequacy of the TNMM to price a transaction for purposes of determining Amount B is under discussion *inter alia*, because of two possible policy exemptions. The first of these is its accuracy where there are local market comparables available, and the second is where a method other than the TNMM may be more appropriate.

The need for balance between the adherence to the Arm's-length principle, and administration of Amount B

Amount B seeks to strike a balance between adhering to the Arm's-length principle, and the administrative processes required to administer TPG with respect to in-scope marketing and distribution arrangements. The main aim of this component is to reduce the burden placed on low-capacity jurisdictions to administer Amount B and ease its administrability using certain simplification measures (otherwise known as safe harbours).

The substantive rules on Amount A and B are in different stages of the drafting process, but overall are still being developed by the OECD in conjunction with public comments.

b. The Pillar Two Proposal

The OECD in its Pillar Two proposal as put together by the IF, proposes a streamlined approach to taxation which would result in MNEs paying a minimum amount of tax in each jurisdiction in which they carry out any commercial operations. The Pillar Two proposal consists of Global Anti-Base Erosion Model Rules, otherwise known as GloBE rules (hereinafter also referred to as "the Rules").

GloBE rules propose the imposition of a domestic "top-up" tax on profits, in jurisdictions where the effective tax rate is determined to be lower than the minimum rate.

[59] OECD (2010), Transfer Pricing Methods, OECD, Paris, https://www.oecd.org/ctp/transfer-pricing/45765701.pdf., last accessed December 2022.

These rules consider several elements in their proposal of how this minimum tax should be structured and levied on MNEs, as highlighted below:

i. Scope

The Rules would apply to entities within a Group which has an aggregate annual revenue of EUR 750 million or more (as declared in the consolidated financial statements of the parent entity of the MNE), for at least two years out of the four fiscal years immediately preceding the tested year.

ii. Charging provisions

The top-up tax calculated per the Rules would be payable by:

- The UPE in an MNE, to the extent that it directly or indirectly holds an ownership interest in an entity situated in a low-tax jurisdiction at any time during the fiscal year.
- An intermediate parent entity in an MNE, which directly or indirectly holds an ownership interest in an entity situated in a low-tax jurisdiction at any time during a fiscal year.

The amount of the top-up tax shall be equal to the allocable share of the parent entity of the top-up tax of the low-taxed constituent entity for that fiscal year.

iii. Computation of income or loss

The income or loss of an MNE computed for GloBE purposes shall be the financial accounting net income or loss determined for the low-taxed constituent entity for the fiscal year, as computed for the purpose of preparing consolidated financial statements of the ultimate parent entity. This net income or loss shall not take into account any consolidation adjustments, such as those eliminating intra-group transactions.

This income or loss shall be adjusted for specific items as laid down in the OECD proposed Rules.

iv. Computation of adjusted covered taxes

In order to compute the adjusted covered taxes, reference would be made to:

- The tax expense in respect of the covered taxes of a low-taxed group entity in the fiscal year, as recorded in its financial statements;

- This tax expense would have been adjusted for deferred tax, net additions and reductions, and any increases or decreases in the covered taxes (whether or not recorded in the comprehensive income statement).
- Any increases and decreases of amounts which are normally included in the computation of GloBE amounts will be taken into account, which would ordinarily be subject to tax by virtue of domestic tax provisions.

v. Computation of effective tax rate and top-up tax

A number of elements will be considered in the determination of the effective tax rate applicable, and the top-up tax to be paid. These include, *inter alia*:

- identifying low tax jurisdictions;
- determining the percentage of top-up tax applicable to every low-tax jurisdiction;
- applying the substance-based exclusion to determine excess profits;
- allocating the top-up tax to the different entities in the concerned jurisdiction, which is proportionate to the income contributed according to GloBE rules.

vi. Corporate restructurings and Holding Structures

The OECD has also considered rules to be applied in the case of corporate restructurings like mergers and demergers, acquisitions, disposals, and joint ventures.

These rules consider any restructurings which occur in the four years prior to the target year, and provide special provisions where:

- A consolidated revenue threshold is required by merger and demerger transactions which occur within the four-year period mentioned above;
- An entity exits or enters an MNE group during a fiscal year;
- Assets and liabilities are transferred, including as part of a reorganisation;
- There are joint ventures put in place;
- The MNE Group has multiple ultimate parent entities.

vii. Tax neutrality and distribution regimes

The following elements need to be considered with regard to the intersection of the Rules and the regimes of tax neutrality and distribution:

- Ultimate parent entities which are subject to a deductible dividend, tax transparency or other similar tax neutrality regime
- Tax regimes which subject an entity to tax on earnings which are distributed or deemed distributed
- Controlled investment entities which preserve tax neutrality without giving rise to leakages.

viii. Administrative measures

The administrative measures considered by the OECD to be necessary for the smooth application of GloBE Rules include *inter alia*:

- The filing of a standardised information return in all jurisdictions which apply GloBE Rules;
- The development and implementation of certain safe harbours; and
- Coordination between tax authorities with respect to the implementation of GloBE rules.

The Pillar Two proposal is under public consultation regarding elements such as the information return and tax certainty. However, it is expected that administrative guidance will be released by the IF in early 2023.

ii. The African Tax Administration Forum (ATAF)

Created in 2009, the African Tax Administration Forum ("ATAF") has positioned itself as being the data, statistics, and knowledge hub on African tax matters in Africa. The mandate of ATAF amongst others is to foster regional cohesion, by promoting cooperation of tax stakeholders in Africa, influencing regional and local policy on the continent, and improving the ability of African tax administrations in order to equip them to achieve their revenue objectives. ATAF produces scientific research backed by local data and drawing from international guidelines and best practice, which can be used to buttress tax administration reform, influence tax policy formulation and foster peer learning.

The viewpoint of ATAF is relevant to this analysis because South Africa is a member of ATAF, and through this organisation South Africa participates in mutual collaboration between tax authorities of the African member countries. The views of ATAF therefore present a contextualised interpretation of international taxing trends, which are relevant to the South African tax framework.

Where the specific issue of tax reform for the digital economy is concerned, ATAF aligns with the perspective of the IMF and OECD, with respect to the following transactions which are most common in the African digital economy [60]:

- E-contracts for tangibles
- E-contracts for intangibles
- Digital marketplaces

While all the transactions above present a loss of revenue risk for the authorities, the risk is significantly reduced depending on the type of transaction and the type of tax it is likely to generate under traditional circumstances.

Challenges to taxing the digital economy in Africa

ATAF recognizes challenges to taxing the digital economy, which align to the challenges recognized by the OECD. In their 2020 Statement proposing measures for digital economy taxes[61], the following challenges were identified as being of the highest significance to the African continent:

- The inability to establish taxing rights over profits made by MNEs from online trading. This inability was attributed to the fact that current international tax rules allocate taxing rights only where a foreign provider creates a nexus via 'sufficient physical presence' in a country, a requirement which was sidestepped in the case of highly digitised businesses.
- The impact of digitalisation on the value chains of a large number of erstwhile 'traditional' business models. This has led to the creation of new value streams which place increased reliance on intangible assets and user data, - however, the international

[60] Op cit note 53 (OECD *Roadmap*) on page 2.
[61] ATAF (2020), *ATAF publishes an approach to taxing the digital economy*, ATAF, South Africa, https://www.ataftax.org/ataf-publishes-an-approach-to-taxing-the-digital-economy, last accessed December 2022.

tax rules and guidelines with respect to the allocation of profit do not always adequately address the income derived from these value streams.

- The delay in achieving global consensus. The need to develop a consensual solution and the delay in achieving same further magnifies the financial cost to those African countries which wish to address the potential risk urgently.

Addressing the challenges

The proposals of ATAF towards counteracting the challenges in taxing the digital economy, are largely geared towards reviewing OECD proposals (as discussed above) from an Africa-wide perspective. The aim of their approach has been to examine standards and proposals discussed on the global scale, to determine whether these proposals are feasible and produce desired outcomes in the different countries of the African continent.

Some of the more notable contributions of ATAF towards the discourse are highlighted below.

1. *Proposed revisions to Pillar One*

In 2021, ATAF issued a proposal of reforms to the OECD Pillar One proposal, which is purported to take into consideration the specific needs of African countries. The rationale behind these proposed reforms was the view that the rules contained in Pillar One are burdensome, and only provide for the reallocation of minimal amounts of profits to market jurisdictions. Also, Pillar One fell short of addressing the inequalities noted with respect to the allocation of taxing rights between source and residence countries, which denied African countries of the opportunity to generate tax revenue.

The proposed reform to Pillar One therefore include *inter alia* the following[62]:

a) Adoption of a single global threshold to cover all MNEs that generate global sales revenue more a threshold.

ATAF suggest that Pillar One rules should be greatly simplified, by bringing all business sectors within the scope of Amount A, while keeping the current proposed exclusions. This would put an end to business segmentation.

[62] ATAF (2019), *ATAF Technical Note – Inclusive Framework proposals to address the tax challenges from the digitalisation of the economy*, ATAF, South Africa, https://events.ataftax.org/includes/preview.php?file_id=40&language=en_US, last accessed December 2022.

b) Increase of the amount of profits of MNEs to be reallocated to market jurisdictions

This proposal is to the effect that the profits to be reallocated to market jurisdictions should be determined on the basis of a percentage of the total and not the residual profit of the MNE, using a tiered approach. This would reduce complexity in determining allocable profits, result in a more level playing field between enterprises with current taxable presence and those without and may result in the threshold being further lowered to a proposed amount of EUR 250million.

c) Introduction of the new nexus rule as a standalone provision

This proposal is to the effect that new nexus rules which provide for the taxation of digital business activities in the market jurisdiction, must also consider the creation of value as a result of user participation. In consideration of potential technical complexities and the need to revise other DTA Articles in case of the enactment of new nexus rules, these rules should also stand alone as a separate measure, and not be included as an amendment of existing PE provisions (notably in Article 5 and 7 of the MTC).

d) Adaptation of the revenue threshold to market jurisdictions

ATAF opined that the revenue threshold to be achieved by global consensus should not be of a level that puts small African economies at a disadvantage, by being set at a level that will not create taking rights in their jurisdictions.

Instead, the use of an absolute number to establish the threshold should be scrapped, in favor of the adoption of a relative factor for each market jurisdiction. Other additional factors should also be considered in addition to the local revenue threshold.

2. *Digital Services Tax (DST) legislation*

The contribution to ATAF via drafting proposed DST legislation stemmed from the fact that the delay in achieving global consensus on how to address the tax challenges arising from digitalisation, was costing African countries millions of dollars in lost tax revenue. There was therefore a need to develop an approach which could be implemented in the short term.

The recent announcements by some African countries of their implementation or intention to implement unilateral or indirect forms of Digital Services Tax, also made it imperative that guidelines should be developed which would promote the application of internationally accepted principles.

Consequently, the ATAF Secretariat and ATAF's Cross-border Taxation Technical Committee, developed a Suggested Approach which provides illustrative content for legislation and/or regulations, as well as a draft structure. The Suggested Approach is built on a framework inspired by international trends observed from the DST laws already enacted in other jurisdictions, which trends have been contextualised to better fit the specific challenges faced by African countries.

Highlights of the Suggested Approach include:

- The levying of tax at the rate of 1-3% on the total amount of revenues derived directly or indirectly from or attributable to an African country, by a company which may or may not belong to an MNE Group;
- The setting of a de minimis threshold for the application of the DST;
- A wide definition of digital services;
- A wide definition of revenue derived from digital services;
- Rules for the determination of the location of users;
- Rules relating to tax administration, i.e., when the tax becomes due and payable and the duty to file returns.

In the backdrop of this Suggested Approach, ATAF cautions that the adoption of a DST by African countries may trigger political repercussions in the form of additional trade barriers, by the countries of residence of affected MNEs.

3. Domestic Minimum Top-up tax legislation

The Suggested Approach of ATAF regarding the Domestic minimum top-up tax rule drew its inspiration from the GloBE rules published by the OECD IF.

The need for reform was based on the fact that the Income Inclusion Rule ("IIR") under GloBE rules still prioritised the residence country taxation, to the detriment of source countries, which were usually developing countries.

The Approach of ATAF is therefore to suggest the application of the Under-Taxed Payment Rule (UPTR) in priority over the IIR, given that the UTPR either disallows deductions, or requires an equivalent adjustment to the extent that the low-taxed income of an entity is not subject to tax under an IIR.

If the GloBE rules are implemented as currently proposed, the top-up tax generated by tax incentives in source countries will be collected by residence countries, by virtue of the IIR. This skewed allocation of taxing rights can be corrected by the enacting of domestic minimum top-up tax legislation. Highlights of the DMT are listed below:

- The de minimis threshold of EUR 750million per the consolidated Financial Statements of the ultimate parent entity
- A combined effective tax rate of 15%
- The definition of 'covered taxes'
- The determination of the combined effective tax rate and top-up tax
- Substance-based income exclusions, and the graduation of applicable top-up rates.

Some of the challenges noted by ATAF which this Suggested Approach raises, to the effect that:

- Any DMT enacted would need to align with the IIR as required to be considered a 'Qualified DMT'. Should this not be the case, a DMT may potentially create a double taxation situation, which would impact adversely on foreign direct investment.
- Also, there should be robust stakeholder consultation particularly with regard to tax incentives. This would allow agencies in charge of granting incentives to understand the broader implications of these incentives and provide crucial buy-in and support for the legislative processes to be rolled out smoothly.

It is worth noting that while no guidelines or discussion papers have been published, other African trade bodies such as AfCFTA and COMESA have announced their intent to issue protocols and guidelines on e-commerce and taxation within their jurisdictions. It is therefore necessary to remain updated on developments in this space, which are likely to influence further evolution of the taxation of the digital economy across African countries.

B. <u>The approach adopted by other jurisdictions</u>

i. United Kingdom

The approach to taxing e-commerce by the UK is relevant within the South African context, given the similarities between the finance, law and tax systems of both countries, owing to South Africa's history as a former British colony. In addition, South Africa is the UK's largest Africa trading partner, accounting for 0.6% of total UK trade, and 1.2% of total UK outward

foreign direct investment in 2021[63]. Analysing the tax framework of the UK with an aim to achieving synergy is therefore important to preserve and boost this trade partnership.

The digital sector in the United Kingdom contributed GBP151 billion to the country's economy in 2019, and digital sector employees account for 9% of the country's total workforce. According to the OECD, the digital strategy employed by the UK is the second most comprehensive in the group which includes European economies, only behind Switzerland.

The rapid growth of the global digital economy, as well as the number of businesses deriving profits from jurisdictions where they have not established any physical presence, led to widespread criticism of the perceived inappropriate or insufficient taxation of large multinational enterprises in the jurisdictions in which they generate profits.

Consequently, in April 2020 the UK tried to tax the digital economy by the introduction of the Digital Services Tax ("DST"). This tax was levied on 2% of the gross revenue earned by search engines, social media services, online marketplaces which derive value from UK users, and associated advertising businesses.

Sone important characteristics of the UK DST[64] are outlined below.

In-scope activities

These activities were defined as follows:

- Social media activity – this was defined as any service which promotes interaction between users, including via content provided by other users, and enables user-created content to be shared with other users;

- Search engine activity – search engine activity was not defined per se. However, the practice in the UK is to include activity that allows users to search the internet for content, outside of the website itself or other related websites[65];

[63] ONS (UK government) (2021), *Dataset – UK total trade: all countries, seasonally adjusted (October – December 2021 edition)*, available at UK total trade: all countries, seasonally adjusted - Office for National Statistics (ons.gov.uk), last accessed June 2023.
[64] HM Treasury (2019), *Digital Service Tax – response to the consultation*, July 2019, Information Policy Team, National Archives London, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816389/DST_response_document_web.pdf., last accessed December 2022.
[65] PwC UK (2020), *Tax Insights from International Tax Services – UK publishes legislation and guidance on digital services tax*, 09 April 2020, PwC LLP UK, https://www.pwc.com/gx/en/tax/pdf/uk-publishes-legislation-guidance-digital-services-tax.pdf, last accessed December 2022.

- Online marketplaces – these were defined to include any activities which facilitate the sale and/or purchase of services, goods, or other property, advertises these to other users, or permits users to make these sales between themselves.

The UK DST does not therefore operate as a tax on online sales, as did other DSTs in force around the world. Instead, it operates as a tax on the services provided by intermediaries to the online transaction, where their activities are not incidental but carried out in a substantial commercial way, and where these digital services form one of the main purposes of their commercial activity.

Thresholds

Businesses whose activities included any of the activities in scope above, would be liable to the DST where they were deemed to realise revenues from these activities which amounted to GBP 25 million or more from UK users, and GBP 500m or more globally, within a 12-month period. These thresholds would be prorated in case of a shorter accounting period.

A UK user was defined as any person who engages with a service, where the person is an individual normally located in the UK, or a business established in the UK. The test for determining whether a user was a UK user was a subjective test, to be decided based on reasonable assumption.

Calculating tax liability

Liability for the DST was calculated on a group revenue basis but charged to individual entities of the group whose revenue was earned from UK users. These entities were deemed to contribute to the threshold in proportion to their revenue contribution to group revenues and taxed accordingly.

Group companies were defined as a parent company and all its GAAP-consolidated subsidiaries. Non-GAAP subsidiaries were not considered for purposes of calculating thresholds and resultant liability.

Where the thresholds mentioned above were met, DST was levied at the rate of 2% of the deemed UK revenue in excess of GBP 25 million per annum.

Low margin businesses could opt for an alternative safe harbour basis of charge, which would reduce its tax base to 80% of its deemed profit related to UK in-scope revenues.

From its inception, the UK DST was designed as a temporary measure to harness the tax revenue generating potential of the digital economy, which the OECD completed its Proposals of coordinated and multilateral measures to establish an adequate global tax framework. consequently, Her Majesty's Revenue and Customs, the British tax authority, has announced that the DST will be repealed on the earlier of the coming into effect of Pillar One, or 31st December 2023.

The anticipated repeal of the DST is in line with OECD provisions contained in the Multilateral Convention ("MLC"), which provisions require all parties to the MLC to repeal any DSTs or similar measures in force at the time of implementation of the MLC, and to commit to not to introduce such measures in the future.

Consequently, the UK DST is set to be repealed no later than 31st December 2023, and any DST liabilities accrued between 01 January 2022 and the date of repeal will be credited against any potential tax liability arising under Pillar One.

ii. Turkey

The choice to include the viewpoint of Turkey regarding income taxes on digital services stems from the recommendation of the President's Commission on the Fourth Industrial Revolution, in their 2016 report[66]. In this report, the 4IR committee identified the Turkey [draft] law as a possible example for South Africa to follow and recommended that this law be analysed to ascertain whether it would be suitable for the South African context. In addition, Turkey is recognised as a major global economy and is a member of the G20 alongside South Africa and has extensively considered the need and impact of an income tax specific to digital services.

As far back as 1997, Turkey began the process of drawing a roadmap for the adaptation of its tax systems and legislature to the economic landscape, to accommodate the changes which were expected as a result of the rapid and widespread growth of e-commerce.

This took the form of the establishment of an Internet Tax Office as well as a special committee dealing with e-commerce issues, the E-Commerce Coordination Commission (ETKK). The ETKK was taxed with identifying lacunae in the traditional law with regard to its application to e-commerce and drafting resolutions which would make it possible for the government to

[66] Government Gazette No. 42388 (2019), Report of the Presidential Commission on the 4th Industrial Revolution (PC4IR), Staatskoerant No 43834. Also available at https://www.gov.za/sites/default/files/gcis_document/202010/43834gen591.pdf, on page 197, last accessed June 2023.

regulate e-commerce. Some of the major updates to Turkish legislation which were influenced by the work of the ETKK include the following:

- The 2004 Law of Electronic Signature No 5070. This is the principal text regulating e-commerce in Turkey and provides commercial security for e-commerce activities in general.
- The 2015 Law No 6563 on the Regulation of Electronic Commerce.

From a tax perspective, in March 2020 Turkey began enforcing the Digital Services Tax (DST) as provided by Law No 7194 on Digital Services Tax. Highlights of this tax are as follows[67]:

- Persons liable are providers of digital services such as advertisement services, in-app sales, paid services through social media and websites who act as intermediaries for sales of goods and services.
- The tax is calculated as a percentage of the revenue earned from the services in scope.
- All service providers are subject to the tax regardless of their residency in Turkey.
- The tax is imposed at a rate of 7.5%.

Some of the principal measures adopted by the Turkish tax authorities in response to the need to tax the proceeds of e-commerce:

a) The development of the concept of a 'virtual' Permanent Establishment

Turkey recognises two types of taxpayers – the first is taxpayers with full liability, which are those with a legal or business centre in Turkey, and taxpayers with limited liability, which are those with neither a business nor a legal centre in Turkey. Establishing what constitutes a legal or business centre is therefore crucial for Turkish tax purposes.

In the case of a server on which software is stored and accessed, the Turkish revenue authorities consider it to be tangible equipment with a physical location, and hence meeting the requirements of a business centre – as such the non-resident company operating the centre is likely to be declared a taxpayer with limited liability, and as such will be liable for paying corporate income taxes on the revenue generated from (or allocated to) their Turkish activity.

[67] Deloitte Turkey (2021), "The Law No 7194 on Digital Service Tax has been promulgated" Tax News No 2019/15, Verginet, available at https://www.verginet.net/dtt/11/tax-news-2019-15.aspx, last accessed May 2022.

However, the Turkish authorities have also moved past the requirement of a physical presence such as a server in Turkey, to argue that a company's website or other digital platform can per se constitute a PE in Turkey even in the absence of a server or other physical presence. Consequently, the practice of the revenue authorities in recent times has been to make tax assessments on non-resident digital companies in terms of the corporate income tax, advance corporate income tax, dividend WHT, VAT, and penalties for tax-loss and special irregularities. It is worth noting that these assessments were not upheld by the courts, especially given that they were contrary to PE rules under domestic legislation and applicable DTAs. However, the action of the Turkish revenue authorities is worth noting for future developments, as it is a practical application of the OECD Roadmap[68], and as such may be considered as an indicator of the willingness of the authorities to find a way to tax digital service platforms or other intangible operations even in the absence of physical assets.

b) The imposition of VAT on Electronically Supplied Services (ESS)

Turkish VAT law includes a reverse charge VAT mechanism, whereby a Turkish resident (whether an entity or individual) is responsible for declaring and paying any VAT applicable on the purchase of goods and services from non-residents. However, in practice, there is no provision for individuals to self-declare and pay this VAT, if they are not themselves registered for VAT.

Consequently, the Turkish revenue authorities introduced a new VAT regime in the General Communique No 17 of 31 January 2018, by virtue of which non-resident suppliers of goods and services are now obliged to register under the Special VAT Registration for E-service providers, and collect, declare, and remit VAT arising from ESS to non-VAT registered individuals in Turkey. This however applies only to goods and services supplied directly from overseas and will not apply if the supply is made via a PE in Turkey (which would fall under the general VAT rules applicable to Turkish residents).

c) The imposition of a WHT on online advertising

The 2017 Media and Advertising Investments Report of Advertising Association placed digital media in Turkey in second place with respect to a market share of revenue received from media and advertising investments – the share of digital media was placed at 25.9%. [69] Display or

[68] Op cit note 53 (OECD Roadmap).
[69] https://webrazzi.com/2018/03/19/2017-medya-ve-reklam-yatirimlari-raporu-dijital-mecralar-yukseliste/, (17.01.2019), last accessed September 2022.

click-based advertising investment grew by 14% in 06 months, but these investments were enjoyed mostly by non-Turkish social media companies and major search engine companies.

Consequently, a WHT on revenue earned from online advertisement services were enacted by virtue of the 2018 Turkish Presidential Decision No. 476. This WHT applied to all payments made to residents or non-residents, as well as their intermediaries. The purchaser of the services was thereby obliged to deduct:

- 15% WHT on payments made to non-resident entities or individuals, or their intermediaries;
- 15% on payments made to resident individuals and their intermediaries;
- 0% to resident entities and their resident intermediaries who were also entities.

d) Other noteworthy measures:

- The imposition of a stamp duty on any agreement concluded via an online platform and making use of electronic signatures, subject to certain exceptions.
- Domestic internet sales are subject to the Digital Services tax and VAT, in the same manner as cross-border internet sales.
- The establishment of a distinction between the different types of intangible revenues earned from electronic transactions.
    - On one hand there are royalties, earned from use of patented content or secret technical information, and downloading and operating software
    - On the other hand, there are commercial earnings, earned from activities such as providing digital products, data storage, website hosting, advertisements, and audio/music/video broadcasts.
- Legislation has been enacted which authorises banks to onboard new customers using distant identity verification methods.
- Licensing requirements have been put in place for on-demand streaming platforms – these platforms are expected to obtain a license from the Supreme Council of Radio and Television before providing services to Turkish residents.

- Social network provides with more than 1 million daily users from Turkey must appoint a representative in Turkey.

e) Criticisms of Turkey's approach / proposed measures

While the efforts made by the government of Turkey to tax the proceeds of the digital economy are amongst the most advanced in the world, their practical application is still wrought with various irregularities and pitfalls which render enforcement difficult. Some of these barriers to enforcement are analysed below.

- Legislative inadequacies

Overall, Turkish legislature governing the digital economy has been described as broad and vague. For example, its flagship Digital Services Tax ("DST") has been criticised for having a vague scope, especially with respect to the "digital medium" concept. Article 1/1-b of the DST defines a digital medium as 'any and all kinds of media where online activities are undertaken without any physical contact'. However, the sales of some complex software cannot be realised merely on a 'click-and-buy' basis but requires a degree of human interaction between the seller and the buyer. As such, the definition of 'digital medium' does not adequately represent the purpose of the DST Law as per the preamble and legislative history.

Also, the attempt to impose tax assessments based on virtual PE concepts have been criticised for having no legislative backing. While the concept of a virtual PE is one which has been analysed by the OECD and other international bodies, it remains largely undeveloped even by Turkish legislature. The attempt by the revenue authorities to enforce the virtual PE concept therefore did not crystallise as a result of this lack of legislative authority.

- Lack of consideration for DTAs

Finally, the proliferation of measures to tax the digital economy have rarely considered the provisions of existing DTAs. This has been the case with the concept of a virtual PE and the institution of the WHT on ESS. It should be noted that Turkey is a signatory to the MLI – however, it has not yet been approved and transposed into national law. As such, the conflicts opposing the new measures relating to the digital economy and provisions of existing DTAs continue to be a concern for the revenue authorities and taxpayers alike.

iii. Kenya

The analysis of Kenya's approach to taxing the digital economy is important with respect to the establishment of international trends from an African perspective, given that Kenya is the biggest and most advanced economy in the region of East Africa.

Kenya first attempted to introduce a provision to tax income generated from a digital marketplace in its Finance Act 2019. In this Act, the digital marketplace was defined as a platform that enables the direct interaction between buyers and sellers of goods and services through electronic means. The Cabinet Secretary at the time was mandated to draft regulations for the implementation of tax on income generated from this digital marketplace.

The Digital Services Tax ("DST") was therefore introduced in the Finance Act 2020 and came into force in Kenya on 02 January 2021. The rationale behind the introduction of the DST was to allow the Kenyan government to tap into the tax base provided using digital avenues to transact and generate revenue.

This DST is defined as a tax charged on income derived or accrued from the provision of services through a digital marketplace (i.e., any platform that uses electronic means to enable direct interaction between buyers and sellers of goods). A person may therefore be liable for the DST to the extent that they provide or facilitate the provision of a digital service to a user located in Kenya.

The tax is levied at the rate of 1.5%, charged to the gross transaction value of the service – this transaction value is defined as:

> (1) where digital services are concerned, all payment received as consideration for the service, and
>
> (2) where digital marketplaces are concerned, the total commission or fee paid to the digital marketplace provider in exchange for the use of the platform.

DST is applicable to both Kenyan tax residents and non-residents, on the condition that the user is in Kenya at the time of supply of the service.

The Kenyan DST law goes further to define the circumstances under which a user can be determined as located in Kenya, as follows:

- The debit or credit facility used to pay for the digital service is provided by a Kenyan company or financial institution;

- The digital interface is accessed from a terminal located in Kenya;
- The IP address of the device used to acquire the digital supply or service is either registered in Kenya, or used an international mobile phone country code assigned to Kenya;
- The user has a business, residential or billing address in Kenya.

A non-resident service provider liable for the DST is required by law to appoint a local tax representative, who will account for and remit the tax on their behalf.

The DST in Kenya has been criticised for not adhering to the general coherence criteria of efficacy, effectiveness, and efficiency. According to Nduati, a leading political analyst, the implementation of the e DST is not viable given the absence of the right tax infrastructure and architecture, which has resulted in an unclear Return on Investment[70].

Nevertheless, the Kenyan revenue authorities seem to consider the DST a success and have now proposed an increased rate in the draft Finance Act 2022 – should this provision be enacted as is, the rate of DST applicable will move from 1.5% to 3%.

It remains to be seen whether the implementation of the DST yields the desired results in the long-term. For the time being, the DST is a quickly evolving measure implemented by Kenya, in a bid to address the taxing challenges of the digital economy.

iv. Nigeria

The analysis of Nigeria's approach to taxing the digital economy is important with respect to the establishment of international trends from an African perspective, given that Nigeria is the biggest economy in the region of West Africa.

Attempts by Nigeria to provide statutory solutions to the tax consequences of the digital economy date as far back as 2019, when the Finance Act 2019 addressed key issues of the digital economy such as nexus and profit allocation.

[70] Nduati, M, The Digital Services Tax (DST) in Kenya: How incoherent regulation turns predatory in an economic slump, stifling growth & innovation, LinkedIn, Kenya, https://www.linkedin.com/pulse/desertification-silicon-savannah-how-incoherent-turns-maryanne-nduati, last accessed December 2022.

Corporate income taxation in the digital economy

Provisions of the 2019 Finance Act

The Nigerian Corporate Income Tax Act ("CITA")[71] in its Section 13 introduced the concept of digital services provided by a company other than a Nigerian company. According to this section, these services would be considered to be derived from and taxable in Nigeria to the extent that the company transmits, emits, or receives data of any kind by electronic or wireless apparatus to Nigeria, in respect of *inter alia* electronic commerce, electronic data storage, application store, online adverts, participative network platforms, and to the extent that the company has significant economic presence in Nigeria and profit can be attributable to such activity.

However, the CITA provided in (4) of the same section that the determination of 'significant economic presence' ("SEP") of a company other than a Nigerian company would be provided by Ministerial Order.

The approach of the 2019 Act was to specifically target foreign digital platforms which could by virtue of technology available in the digital economy, operate and earn income in Nigeria, without having a physical nexus hitherto required for levying of the CIT.

The Ministerial Order referred to in (4) defined the SEP of a company as established where:

- the company derives NGN 25,000,000 (approximately USD 56,000);
- the company uses a Nigerian domain name (i.e. .ng) or registers a website address in Nigeria; and
- the company purposefully fosters and sustains interaction with persons located in Nigeria, through actions such as customising its digital page or platform to target persons in Nigeria.

The provisions of the 2019 Finance Act relating to digital services and e-commerce bore a close resemblance to the recommended options in the OECD's 2015 Final Report[72]. Indeed, the Act provided a pioneering shift from the definition of a traditional permanent establishment, in line with OECD guidance and interpretations at the time.

[71] Act No. 28 of 1989, No 11 of 2007 as amended by the Finance Act 2019, Chapter C21.
[72] Op cit note 48 (*OECD 2013 Addressing BEPS Paper*) under Action 1.

However, this introduction of the SEP and the concept of a tax on profits earned from digital services faced several challenges, principal amongst which were administrative challenges, and the allocation of profit.

- Administrative challenges

The inherent challenges of administering a tax, be it from a communication, verification, or collection perspective, where the taxpayer has no physical presence in the taxing jurisdiction cannot be overemphasised. The Finance Act 2019 did not provide any further insights into the mechanisms of the enforcement of this tax levy – consequently, its implementation did not yield the expected return.

- Allocation of profit

The 2019 Finance Act also failed to provide guidelines for the allocation of profits. Reliance on disclosures by taxpayers to determine the revenue accruing from business activities is widely accepted to be a first step in the allocation of profits, which should be buttressed by the capacity of the revenue authority to verify these disclosures and access supporting documentation. The lack of certainty around profit allocation was therefore a major risk factor in the implementation of this provision.

Further refinement in the Finance Act 2021

The Nigerian legislative arm attempted a redress of the challenges noted in the Finance Act 2019, in their reform of the Finance Act 2021. The 2021 Act introduced taxation based on deemed profit for non-resident companies with a digital SEP in Nigeria.

According to this reform, in any year where the non-resident company has no assessable profits or declares profits which the revenue authorities believe to be less than expected, the company may be assessed to tax as a reasonable percentage of the turnover attributable to its SEP.

The reform brought about by the Finance Act 2021 has still received some criticism[73] for its lack of definition of the parameters for determine when the assessable profits declared are 'less than expected'. In addition, the law does not define the 'reasonable percentage' to be applied to turnover.

[73] PwC Nigeria (2021), Nigeria's Finance Act 2021 – Insights series and sector analysis, PwC, Nigeria, https://www.pwc.com/ng/en/assets/pdf/nigerian-finance-act-2021.pdf, last accessed December 2022.

While the law is still relatively new and its implementation remains to be seen, it is expected that the Nigerian Federal Inland Revenue Service (FIRS) will implement the same rules used for other PEs prior to the introduction of the concept of SEP. For these other PEs, the practice was to deem a profit margin of 20% on turnover, to which a 30% CIT was applied, resulting in an effective tax rate of 6%.

VAT in the digital economy

Non-resident companies

The Finance Act 2021 also provided guidelines for the collection and remittance of Nigerian VAT by non-resident companies, and the remittance of this VAT to the FIRS.

The scope of VAT according to the new rules shall include supplies of digital services by non-resident digital service providers, to Nigerian customers who cannot self-account for VAT. It consequently targets B2C transactions.

The VAT threshold for the mandatory registration of a non-resident company for VAT purposes is set at USD 25,000 per annum, or its equivalent in other currencies. Non-resident companies meeting this threshold will be obliged to adhere to the provisions of the FIRS Information Circular[74] providing a simplified regime of VAT registration, subject to a penalty for failure to register.

Digital services for purposes of the VAT imposition are defined as services which are rendered remotely, either online or by other electronic and digital means, to Nigerian residents or persons in Nigeria. Specific inclusions consist of inter alia:

- Streaming, downloading or access to digital content
- Online advertising
- Subscription-based social media platforms
- Cloud computing, and
- Online stores.

The rate of the VAT is 7.5%.

[74] FIRS Information Circular No 2020/02, Clarification on the Implementation of the Value Added Tax VAT Provisions in the Finance Act 2019, published on 29th April 2020.

By virtue of these new provisions, non-resident companies that make taxable supplies to customers in Nigeria must now register for, charge, collect and remit VAT. Should it not be possible to do in their name, the non-resident may appoint a representative to carry out certain administrative responsibilities – however, they will still be required to register in their name.

Intermediary platforms

Intermediary platforms will also be viewed as deemed sellers and share responsibility for registering, invoicing, collecting and remitting VAT on sales completed through their platforms. Where the intermediary registers and accounts for VAT, the underlying supplier would be exempted from any further VAT obligations.

Their involvement would include maintaining relevant records of transactions with Nigerian customers completed through their platforms.

Future measures in the pipeline

The above reform demonstrates that the Nigerian legislative arm holds a strong commitment towards addressing the tax challenges arising because of the digital economy. This is being implemented not through the enactment of a digital services tax law, but the incorporation of digital service provisions into existing tax frameworks. While this is not worded the same as a digital services tax, it has a strongly similar effect in that both taxes are levied on the turnover of digital platforms.

Another proposed measure to watch out for is the institution of a Ministry for Digital Economy and IT Management. The mandate of this Ministry is yet undisclosed, but it is expected that it will in part drive synergies between the commercial aspects of the digital economy and the tax aspects of revenue collection.

C. Conclusion

The countries and stakeholders whose approaches to taxing the digital economy were highlighted in this chapter are each of strategic importance to the formulation of South African tax policy, whether owing to historical and geographical ties, or because of their advancement in the discourse.

The common trends identified above can be summarised as follows:

- The contextualisation of OECD guidelines to local principles and practices.
- The balancing of the need to tax and the need to encourage cross-border trade.

- The recognition of a tax on digital services as a viable starting point for the introduction of income taxes specifically on income earned from e-commerce.
- The attention paid to issues such as new nexus concepts, the valuation of data, and the transformation of PE principles, as defining elements of a framework that can successfully develop the tax-revenue generation potential of the digital economy.

These trends are not peculiar to a certain geographical region or an economy with a certain level of development – as such it can be concluded that a country desiring to address the taxing challenges of the digital economy can begin by addressing these issues from a legislative perspective.

In the next chapter, we shall examine what measures, if any, have been taken by the South African fiscus to address the taxing challenge considering the above international trends, as well as the success of these measures, and further steps which may be considered from a policy perspective.

CHAPTER FIVE – OPTIONS TO ADDRESS CHALLENGES

What measures can South Africa put in place to align with international trends?

A. Introduction

South Africa's approach to taxing the digital economy has so far been tentative at best. The 2000 Green paper[75] recognises that the changes brought about by the development of e-commerce and digital products give rise to questions around the taxation of these new revenue streams, particularly:

- The characterisation of this income, under domestic law as well as under DTAs;
- The allocation of taxing rights; and
- Developing an adequate scope for digital services and e-commerce for tax purposes.

South Africa is not a member of the OECD but became a key partner in 2007. It is therefore a major contributor to the OECD's work on the continent and charged with the promotion of direct and active participation in the initiatives of the substantive bodies of the OECD.

Where the BEPS project is concerned, South Africa is an associate and a key and active member of the IF for BEPS implementation Steering Group[76].

South Africa therefore enjoys a prime position of being able to contribute by providing one African perspective, for consideration by the OECD when formulating framework proposals such as Pillar One and Two.

It is therefore necessary for South Africa to commit to addressing the tax challenges of the digital economy, not just from a study perspective but also from a legislative perspective and give any agreed measures the full implementation force of the law.

Inasmuch as the work done by the OECD provides a solid foundation which can serve as a starting point for South African tax legislation relating to the digital economy. It is, however, necessary to examine a wide range of options, in order to identify and possibly implement only those which are most suited to an African context.

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[75] Op cit note 32 (SA *Green Paper*) at 4.1.

[76] OECD (2018), *South Africa and the OECD*, available at https://www.oecd.org/southafrica/south-africa-and-oecd.htm#:~:text=In%202007%20the%20OECD%20Council,%2C%20China%2C%20India%20and%20Indonesia, last accessed December 2022.

B. Addressing the specific challenges in South Africa

According to the DTC, recommendations on policy proposals to address the challenges of taxing the digital economy is dependent on analysing international tax policy considerations, while maintain a balanced approach that promotes access to technology solutions and development capital, while simultaneously encouraging foreign direct investment.

1. Identifying international trends with respect to taxing e-commerce

International tax policy considerations to be considered would be international best practice as discussed in Chapter 3 – these would be proposals put forward by organisations like the OECD and ATAF, as well as measures which have been tried and tested in other economies. A number of those measures identified in Chapter 3 are summarised below.

Preceding analyses of reports by the OECD, ATAF, as well as summaries of measures put in place by comparative economies as per the preceding chapter, show that there are several common factors recognised to be central to the formulating of a robust tax policy framework for taxing the digital economy, and which may provide a starting point for the policy discussions required to effect such a change.

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The commonality of these factors point to the international trends which are shaping the global approach to e-commerce income tax policy – the approaches adopted by the comparative stakeholders as analysed in the preceding Chapter are summarised in the following table:

Table 2: International trends on income taxes on e-commerce

Trend / Stakeholder	Nexus	Digital PE/Significant Economic Presence	Income taxes (DST or others)
OECD	An alternative nexus is required which provides for business models in which activities are only executed digitally, with little or no need for phyiscal presence.	The concept of PE should be updated to include a 'Significant Economic Presence, without relying on physical elements or triggers in terms of duration. Triggers of SEP could include longstanding relationships with resident customers, sales of goods or activities via local websites, or the use of local banking or delivery facilities.	A withholding tax on payments made abroad for digital goods or services should be considered and enacted.
ATAF	ATAF aligned with the OECD approach above, with their principal addition being that new nexus rules must take into consideration the value created by user participation (ie data creation and valuation), and should be established as a standalone provision and not within PE rules	ATAF aligned with the OECD approach above, with the qualification that revenue threshholds taken into account to determine SEP must be contextualised for Africa, and the de minimis amount should not be at a level that puts smaller African economies at a disadvantage.	African countries should consider adopting a digital tax on revenue attributable to an African country, by a company providing digital services (whether or not part of an MNE), at a rate between 1-3%.
UK	The UK has no pblished any specific guidance or comments relating to changes to the interpretation of nexus. However, the DST rules require that the tax is imposed where the provided only supplies digital services, to the extent that the user is located within the UK. There is therefore a hybrid approach which takes into consideration the digital factor as well as a physical element to the parties in the transaction.	HMRC Guidance and commentary issued does not prima facie consider a digital PE where there is digital activity, even where there is an phyiscal element. For example, in the case of a website and the server on which it is stored/accessed within the UK, it is required that the prospective taxpayer must own or lease the server - where the server is owned by a third party, eg and ISP, and the prospective taxpayer only rents storage, a PE is not likely to occur.	A Digital Services Tax has been enacted at an effective rate of 2% of the gross revenue earned by digital platforms the income derived or accrued from the provision of servies through a digital platform, charged on the gross revenue as defined. This tax is applicable to residents as well as non-residents.
Turkey	Turkey has not published any official guidance in relation to a digital nexus. However, there have been attempts by the revenue authorities to issue assessments for corporate tax on the basis of the existence of income generated from digital activity involving Turkish residents.	The Turkish revenue authorities have not published any official guidance in relation to a digital PE. However, attempts have been made to issue assessments on non-resident digital companies, on the basis of the fact that a digital platform or website can suffice to create a digital PE in Turkey.	A Digital Services Tax has been enacted at an effective rate of 7.5% on the income derived or accrued from the provision of services through a digital marketplace, charged on the gross transaction value of the service. This tax is applicable to residents as well as non-residents.
Kenya	Kenya's legislative arm has not specifically published any guidance or comments which define nexus on the basis of digital existence, as propounded by the OECD. However, the DST rules show that the Kenyan authorities implement a hybrid approach to nexus, and no longer rely on physical attributes of the business model. for example, factors to be taken into consideration in determining whether a transaction is chargeable to the DST include the physical location of the payment processing company, the accessing of the digital interface from a terminal in Kenya and the IP address or country code of the device used	Nigeria's legislative arm has not specifically published any paper that defines a nexus on the basis of digital existence, as propounded by the OECD. However, the enactment of a DST, the formulation of SEP guidelines and the most recent imposition of CGT on gains from the disposal of digital assets shows that, there is recognition of the authorities of a local digital economy incolving foreign residents, and the income or turnover of this economy needs to be taxed accordingly.	A Digital Services Tax has been enacted at an effective rate of 6% on the income derived or accrued from the provision of servies through a digital marketplace, charged on the gross transaction value of the service. This tax is applicable to residents as well as non-residents.
Nigeria	Nigeria's legislative arm has not specifically published any guidance or comments which define a nexus on the basis of digital existence, as propounded by the OECD. However, tthe enactment of a DST, the formulation of SEP guidelines and the most recent imposition of CGT, the formulation of SEP on gains from the disposal of digital assets shows that, there is recognition of the authorities of a local digital economy incolving foreign residents, and the income or turnover of this economy needs to be taxed accordingly.	An SEP standard is in force, which considers SEP to exist where a foreign company derives gross turnover or income exceeding NGN 25million or other currency equivalent, from an exclusive list of digital services as defined, or from providing technical, professional, management or consultancy services to persons or companies resident in Nigeria or with a fixed base or agent in Nigeria.	A Digital Services Tax has been enacted at an effective rate of 1.5% on a deemed profit margin (as calculated in line with existing CIT rules).

Source: KPMG 2023 Report[77]

The most common factors appearing in global trends on taxing the digitalised economy are briefly highlighted below.

a) Nexus

A starting point for the imposition of a tax on proceeds from the digital economy has been the systematic specific inclusion in tax law, of income received or accrued with respect to electronic, digital, or otherwise incorporeal transactions which have an incidence in the Republic. Inspiration can be drawn from the implementation of such laws in other countries, which expand the requirement to establish nexus from focusing mainly on a physical presence or other proof of incorporation, to also an established digital presence in the form of an

[77] KPMG LLP USA (2023), "*Taxation of the digitalized economy: Developments summary*", available at Taxation of the digitalized economy - Developments Summary (kpmg.us)" from page 8, last accessed June 2023.[78] KPMG LLP USA (2023), "*Taxation of the digitalized economy: Developments summary*", available at Taxation of the digitalized economy - Developments Summary (kpmg.us)" from page 8, last accessed June 2023.

electronic footprint determined with respect to the location of a user/customer, or a [substantial] portion of the key elements of the transaction, such as payment clearing houses.

b) Acknowledging a digital PE – inclusion of the SEP standard

A common element identified by various stakeholders as a principal consideration in taxing the digital economy, is the Significant Economic Presence ("SEP") standard, which provides a modification of the traditional definition of permanent establishments.

In brief, the SEP originated in a recommendation by the committee charged with analysing the OECD BEPS Action 1 on taxing the digital economy – this recommendation proposed that in additional to traditional PE rules, consideration should be given to PE triggers relating to digital economy activity. As such, a country may be considered to trigger a digital PE where it is deemed to have significant economic presence. This economic presence would be decided based on standard factors such as the number of users or consumers of digital content within a specific jurisdiction, the revenue generated through sales to persons within a specific territory, or even the volume of digital content consumed by residents of a specific territory. The SEP rules however required de minimis thresholds and other guidelines to function adequately – as a result, Pillar One of the OECD proposals as discussed above (see Chapter 3, Section A (i)(3)(a) provides the summarised view of the OECD on this standard and how it may be implemented.

In addition to the consideration of a digital nexus as mentioned above, the establishment of a 'digital PE' via the SEP standard would involve a shift from considering certain activities as preparatory or auxiliary. Such a change would be beneficial considering the fragmentation of transactions made possible by digitalisation, such that an activity instead of being regarded on a standalone basis, can be reviewed as part of a wider transaction, and evaluated on that basis.

c) The introduction of a digital services tax

As seen above, some countries are leaning towards an interim measure of enacting a specific income tax on digital transactions, in the absence of a more in-depth review of existing income tax laws. The inclusion of this measure as international best practice may be controversial, in light of OECD guidance around the introduction of Pillar One and Two whose implementation is expected to address concerns around base erosion and profit shifting affecting developing countries. However, the de minimis thresholds contemplated by Pillar One and Two have been criticised for not being adequate to address the taxing challenges in developing countries.

Consequently, the introduction of a digital services tax may remain a viable interim option while waiting for an OECD approach which is more contextualised.

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It is worth noting that 31 countries globally have enacted a form of legislation instituting a tax which directly targets e-commerce income, either via a DST, a withholding tax, or digital PE Rules. From an Africa perspective, five countries have enacted a Digital Services Tax ("DST"), which broadly focuses on taxing income accruing as a result of commercial activities on a digital marketplace, usually targeting such activities where carried out by non-residents. These countries consist of Kenya, Nigeria, Sierra Leone, Tanzania, and Zimbabwe. Highlights of the approach of these countries have been concisely summarised below:

Table 3: Summary of DST enactment across Africa

Country	Tax rate	Type of tax	Summary
Sierra Leone	1%	DST	A DST is charged on the turnover realised by foreign or local providers from all digital and electronic transactions.
Tanzania	2%	DST	A DST is charged on the turnover realised by foreign providers of digital services.
Zimbabwe	5%	DST	This DST is posited as a general income tax on income received by foreign providers, from the provision of e-commerce platforms or satellite hosting services to residents. The DST however follows a different compliance procedure from the general corporate income tax of 24.72%.

Source: KPMG 2023 Report[78]

2. *Efforts made to address the challenges faced by the South African fiscus*

For the last decade, numerous conversations have been had and reports issued as to the need for SARS to address the tax challenges triggered by the growth of the digital economy.

a) The Davis Tax Committee Reports

Following the release of the final package of the BEPS Action Plan in 2015, the Davis Tax Committee executed a mandate to review the OECD Action Plan and its interaction with South Africa's domestic and international tax policy. In the executive summary to their second interim report, the DTC specifically considered OECD BEPS Action 1 relating to the tax challenges of the digital economy and opined that South Africa's main inefficiencies with

[78] KPMG LLP USA (2023), "*Taxation of the digitalized economy: Developments summary*", available at Taxation of the digitalized economy - Developments Summary (kpmg.us)" from page 8, last accessed June 2023.

respect to the taxation of the digital economy stemmed from the source rules, and as such some of the OECD proposals could be adopted to address these inefficiencies.

The DTC identified several key issues and factors which South African policy makers needed to consider as central to formulating and updating policies on the tax treatment of the digital economy[79], as follows:

- *Amendment of the definition of a PE, as well as updating the list of exceptions*. This would counteract artificial structuring of trade cycles within a group, such that a PE cannot be held to exist, and widen the scope of activities considered to trigger a PE for tax purposes.
- *Anti-fragmentation rules*, which penalise the use of PE exceptions to escape taxation by fragmenting business activities amongst closely related enterprises.
- *The revision of the transfer pricing guide on intangibles*, to clearly distinguish between legal ownership of an intangible, and the right to enjoyment of returns generated using that intangible, and to integrate a functional analysis into the allocation of returns relating to intangibles.
- *The redesigning of CFC Rules*, to include income that is usually earned by virtue of trading in the digital economy, within the scope of income taxes in the jurisdiction of the ultimate parent company.

The 2000 Green Paper raised concerns around the progress of digital technology in business, in the absence of proper mechanisms to tax the revenue generated by electronic economic activities. These limitations include the difficulty in defining jurisdictions, as well as administering and enforcing tax laws within the digital economy[80].

In the same vein, the Parliamentary Budget Office in their June 2020 report[81] mentioned that the current digital taxation provisions are clearly not broad enough to include the other digital economic activities created by data-driven activities. As such, there is a need to specifically focus on tax income or profits generated from digitalised economic activities.

The ask has therefore been the development of a taxation framework which is fair, predictable, and stays in line with the policies of the e-commerce partners of South Africa so as not to distort or disrupt the conduct of business.

[79] Op cit note 33 (*DTC 2016 Executive Summary*), on page 5 et seq.
[80] Op cit note 32 (SA *Green Paper*) on page 36.
[81] Parliamentary Budget Office (2020), Tax Brief: Digital Economy and Taxation Policy Considerations – June 2020, Parliament of the Republic of South Africa.

b) The 4IR Commission and consideration of the introduction of a digital tax

Some steps have been taken to achieve the objective of developing a taxation framework as proposed by the Davis Tax Committee. One of these is the consideration of the introduction of a digital tax. As mentioned above, in 2019, a Presidential Commission on the 4th Industrial Revolution (4IR Commission) was created with the objective of evaluating the new epoch in technological advancements which is connecting the biological, physical, and digital worlds, and their resulting infrastructural requirement.

The Commission was tasked with understanding how to harness these advancements in the South African context and putting forward proposals of measures which may be undertaken to ensure readiness for the upcoming shifts.

In 2020, the 4IR Commission published their report[82], which contained a number of these measures – from a tax perspective, the most important of these was the proposed introduction of a digital tax.

According to the proposal, the introduction of the digital tax came within the ambit of moving towards a 'smart government', i.e., the development of tax policies which are better adapted to the transactions undertaken by digital and virtual companies, and which are flexible enough to match the exponential growth of these companies as well as the dynamic nature of their service offerings.

The 4IR Commission proposed that South Africa draws inspiration from the digital tax and other related measures implemented by Turkey to regulate e-commerce and its different elements, while adapting these to the local context. More information on the Turkish digital tax as well as other measures are discussed in Chapter 3.

c) Introduction of VAT on digital services

Another effort made to develop a taxation framework as proposed, was the updating of VAT regulations to specifically include digital services in the scope of South African VAT. Indeed, the efforts made by the South African Revenue Service ("SARS") to impose VAT on e-commerce transactions are by and large the most insightful and impactful efforts to date to address the challenges of trade digitalisation.

[82] Government Gazette No. 42388 (2019), Report of the Presidential Commission on the 4th Industrial Revolution (PC4IR), Staatskoerant No 43834. Also available at https://www.gov.za/sites/default/files/gcis_document/202010/43834gen591.pdf, last accessed May 2022, on page 197.

Background

Upon its promulgation in 1991, the VAT Act[83] did not recognise e-commerce transactions per se as falling within the scope of transactions subject to VAT. Indeed, Section 7 of the VAT Act imposed a VAT charge only in the following circumstances:

> *"(a) On the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him*
>
> *(b) On the importation of any goods into the Republic by any person on or after the commencement date, and*
>
> *(c) On the supply of any imported services by any person on or after the commencement date."*

The effect of the above was that the onus remained on the domestic recipient of the service to declare and pay VAT on any services supplied from abroad. The revenue authorities could not heavily rely on recipients declaring VAT on imported services, as this could not be easily monitored for compliance and collection purposes.

Introduction of VAT on digital services

With the growth of the digital economy, the loss of revenue because of the inadequacy of the VAT framework become increasingly significant. As such, in 2014 the "Updated Regulations" [84] were promulgated, which specifically included 'electronic services' in the scope of services subject to VAT and transferred the onus of declaring and paying VAT on these services from the local recipient of the service to the foreign supplier of the service.

As provided in the Explanatory Memorandum to the Updated Regulations, the need for this specific exclusion stemmed from the fact that cross-border supplies of services were largely invisible to tax authorities. These services were provided electronically, via the internet in the form of the cloud, or other forms of electronic agents or other communication methods. As such, the potential for tax avoidance grew as the digital trade in goods and services grew. It was therefore necessary to introduce new legislation that would rectify unintended non-taxation and provide clarity and certainty regarding VAT on the digital economy.

[83] Value-Added Tax Act 89 of 1991.
[85] Davis Tax Committee (2018), *Final Report on VAT*, available on 20180329-Final-DTC-VAT-Report-to-the-Minister.pdf (sataxguide.co.za) at page 3-4, last accessed June 2023, on page 34 et seq.

The Updated Regulations adopted international best practice in the case where there is a supply of electronic services, by first attempting a broad definition of an electronic service, and secondly adopting place of supply rules which apply specifically to e-commerce.

As such, the definition and scope of 'electronic services' now includes:

"Any services supplied by means of an electronic agent, electronic communication, or the internet for any consideration, other than –

(a) Educational services supplied from a place in an export country and regulated by an educational authority in terms of the laws of that export country; or

(b) Telecommunications services; or

(c) Services supplied from a place in an export country that is not a resident of the Republic to a company that is a resident of the Republic if –

(i) Both those companies form part of the same group of companies; and

(ii) The company that is not a resident of the Republic itself supplies those services exclusively for the purposes of consumption of those services by the company that is a resident of the Republic."

Criticism of the VAT provisions on digital services

Despite acknowledging the efforts and successes of the Updated VAT Regulations, the DTC report[85] on VAT identified several areas in the 2014 Regulations which it recommended receive further adaptation, as follows.

1. Flexibility

According to the report, legislation providing for technological changes needed to be flexible, in order to adapt most effectively. The Updated Regulations were criticised for instituting a rigid definition of electronic services – a comparison was drawn to Canadian and EU law which had removed reference to an exhaustive list, in favour of 'categories' of service which would be liable to VAT. It was proposed that an exhaustive list should either be scrapped in favour of categories which could be further explained in a guide, or if an exhaustive list was maintained for the list to be reviewed and updated at regular intervals.

[85] Davis Tax Committee (2018), *Final Report on VAT*, available on 20180329-Final-DTC-VAT-Report-to-the-Minister.pdf (sataxguide.co.za) at page 3-4, last accessed June 2023, on page 34 et seq.

2. Time of supply

The Regulations required that the time of supply rules be updated such that the VAT vendor would be under obligation to consider the time of supply on an invoice basis, but that the vendor retains the option to adopt VAT accrual for accounting purposes on a payment basis, subject to meeting certain requirements set out at law.

3. Invoicing

Given the electronic nature of transactions, the DTC believed that the requirement for the systematic issuing of a VAT invoice was incongruous and not in line with international norms with respect to indirect tax responsibilities. As such the DTC recommended that this requirement be scrapped.

4. Non-harmonisation with international principles

By far the most significant criticism of the Updated VAT Regulations was its lack of harmonisation with international principles.

A total of 116 countries globally have enacted a form of legislation instituting indirect taxes on the digitalised economy, either via VAT or a GST. Twelve of these are African countries, being Cameroon, Egypt, Gabon, Ghana, Ivory Coast, Kenya, Nigeria, Sierra Leone, South Africa, Tanzania, Uganda, Zambia, and Zimbabwe. Other countries such as Mauritius, Rwanda are considering the same approach, and are in the process of drafting legislation with a view to enactment. The following table summarises the approach of these African countries to indirect taxes in respect of digital services.

Table 4: Summary of VAT rules on e-commerce across Africa

Country	Current status	Date of enactment	Summary
Cameroon	Legislation enacted	Jan-20	As from FY2020, foreign vendors using online foreign or local marketplaces or other platforms to market and sell goods and services which are available in Cameroon must carry out a VAT registration, collect VAT and remit to authorities. No threshold is provided.
Egypt	Legislation enacted and updated	January 2022, March 2023	Foreign vendors providing any remote services, whether digital or not (subject to exceptions for professional and consultancy services), to non-business customers in Egypt are under obligation to carry out a VAT registration, collect VAT and remit to authorities. A monthly threshold of EGP 500,000 in any 12-month period is provided.
Gabon	Legislation enacted	Aug-21	The sale of goods or services within Gabon using foreign online platforms will be subject to VAT. Guidelines for the implementation of these provisions are awaited.
Ghana	Legislation enacted	Oct-22	Foreign vendors providing digital services to corporate and non-corporate customers in Ghana are under obligation to carry out a VAT registration, collect VAT and remit to authorities, or designate a local agent for this purpose. An annual threshold of GHS 200,000 in any 12-month period is provided. Registration is possible through an online portal. Digital services have been clarified to include e-commerce as well as telecommunications services.
Ivory Coast	Legislation enacted	Dec-21	VAT source rules have been clarified to include online sales to corporate and non-corporate customers, to simplify the procedure required for compliance, as well as to implement sanctions for non-compliance. Guidelines for the implementation of these provisions are awaited.
Kenya	Legislation enacted	July 2022 and March 2023	Foreign vendors providing digital services to corporate customers are under obligation to carry out a VAT registration, collect VAT and remit to authorities. Registration is possible through an online portal. Digital services have been clarified to include e-commerce, that is, the sale of goods, services, or property to other people via the use of a digital marketplace or other online platform. Platforms for the hailing of transportation, the monetisation of data, the trade of digital assets as well as the promotion or execution of online payments have also been specifically included.
Nigeria	Legislation enacted	January 2020, April 2021, December 2021	All foreign vendors providing digital services to corporate as well as non-corporate customers are under obligation to carry out a VAT registration, collect VAT and remit to the tax authorities. The obligation to register is not subject to de minimis threshold rules. The VAT compliance regime for foreign vendors engaging in e-commerce has been simplified – rules affected include the scope of goods and services in question and conditions to qualify for registration. There is also an intention to implement a Payment gateway that will provide the revenue authorities with the real-time ability to collect taxes in relation to online gaming activity.
Sierra Leone	Legislation enacted	May-23	Digital platforms which facilitate the provision of services to local consumers have the obligation to collect GST. Guidelines on the implementation of this legislation.
Tanzania	Legislation enacted	June 2022. February 2023	Foreign vendors providing digital services to non-corporate customers are under obligation to carry out a VAT registration, collect VAT and remit to authorities. An annual threshold of TZS 100 million is provided. The VAT compliance regime for foreign vendors engaging in e-commerce has been simplified – these vendors are able to file returns and make payments via a digital portal.
Uganda	Legislation enacted and modifications proposed	July 2021 and April 2023 respectively	Foreign vendors providing digital services to non-corporate customers are under obligation to carry out a VAT registration, collect VAT and remit to authorities, regardless of the number of sales. Guidelines on the implementation of this legislation have been published, which provide amongst others for the services in scope as well as the applicable sourcing rules. The current proposal of an Amendment Bill provides changes to the definition of digital services to specifically include highly digitised business models such as e-hailing services, data warehousing, streaming platforms, cloud storage, advertising platforms and subscription-based services amongst others.
Zambia	Legislation enacted	Dec-22	Foreign vendors providing digital services to non-corporate customers are under obligation to designate a local agent to collect VAT and remit to authorities on their behalf. A threshold of ZMW 800,000 is provided. Guidelines on the implementation of this legislation, including the return to be used for this purpose, are awaited.
Zimbabwe	Legislation enacted	Jan-20	Foreign vendors providing digital services to corporate and non-corporate customers are under obligation to carry out a VAT registration, collect VAT and remit to authorities. A threshold of ZWD 1 million is provided.
Mauritius	Legislation introduced	Aug-20	The Finance Act 2020 introduced a VAT charge on the provision by foreign vendors of digital services to residents, which services would be utilised locally. Actual VAT legislation or guidelines are awaited.
Rwanda	Legislation announced	Mar-22	There are plans to introduce requirements for foreign vendors providing digital services to corporate and non-corporate customers to carry out a VAT registration, collect VAT and remit to authorities.

Source: KPMG 2023 Report[86]

To a large extent, the VAT rules enacted as mentioned above are inspired by the OECD International VAT/GST Guidelines[87].

[86] Op cit note 77 (KPMG *Taxation developments summary*) from page 82.
[87] OECD (2016), "*Recommendation on the Application of VAT/GST to the international trade In services and intangibles*", available at OECD Legal Instruments, last accessed June 2023.

A review of most of these rules shows that they have several core principles in common, being:

- Definition of e-services and widening of scope to include prevailing digital business models
- Determination of residency of recipient of service
- Determination of nexus using place of consumption
- De minimis thresholds specific to e-commerce
- The use of a local representative for VAT compliance
- Simplification of the registration and compliance process.

According to the 2018 Davis Tax Committee ("DTC") report on VAT[88], the Updated Regulations have had the desired effect on tax collection and taxpayer compliance, resulting in the narrowing of the 'assessment gap', despite an increase in the collections gap[89]. As published in the Parliamentary Budget Report[90], within three years of introducing the taxation on the consumption of digitalisation of goods and services in 2014, an associated additional R 2 billion of tax revenue was raised by 2017. In addition, more than two-hundred new foreign taxpayers were registered in the same period.

However, the taxation rules on the consumption of digital goods and services did not distinguish between the business to business (B2B) and business to consumer (B2C) economic activities. Distinguishing between B2B and B2C allows the tax system to target consumption, although this can be complex in cross-border transactions.

However, as laid out in the DTC report mentioned above, South Africa's VAT rules did not necessarily follow these international trends. The Report therefore recommended that several measures be put in place to further adapt the VAT legislation on e-commerce and align with best practice applied in comparable VAT regimes such as Canada, New Zealand, and Singapore. A general overview of international trends and how South African VAT rules measure up to these trends are summarised in the following table:

[88] Op cit note 84 (*DTC Final Report on VAT*).
[89] Ibid, page 3.
[90] Op cite note 38 (*S Snail, Overview*) on page 18.

Table 5: International trends versus South Africa's approach to VAT chargeability of e-commerce.

Concept	Interntional trend	South Africa's approach
Definition of e-services	The scope of electronic services should be wide enough to include all services supplied via the internet, irrespective of the platform on which they are supplied. The use of an indicative list is recommended, but the list should not be exhaustive to allow for changing business models. In addition, a distinction should be drawn between electronic services and intangible services such as telecommunications services, such that the latter should have place of supply rules which are specific and contextualised.	The VAT Regulations in the definition of electronic services did not include specific services commonly seen in the regulations published by other countries, such as data warehousing, downloads and streaming, and website hosting. In addition, the use of an exhaustive list severely limits the application of the VAT rules to the plethora of business models within the digital economy, which generate significant amounts of income.
VAT neutrality	Taxpayers subject to a VAT charge/obligation should be able to offset their input VAT against the output VAT, and only pay a net amount or balancing charge to the revenue authorities	South Africa's VAT regulations and guidelines do not provide a clear view on the approach to ensuring tax neutrality in application of VAT rules. Even though place of supply rules are implicitly provided in certain sections, general rules are not provided – as such there is a need for clear guidelines.
Destination principle - determination of nexus for digital services	The destination principle in VAT requires that the tax should only apply where there is final consumption of the good or service, which happens within the taxing jurisdiction. As such, the mere addition of value within a jurisdiction should not suffice for the application of VAT.	The VAT regulations are aligned to the destination principle, such that imports are taxed and exports are zero-rated, and the taxable revenue is deemed to sit in the place of supply to the final consumer.
Distinguishing between B2B and B2C suppliers	Where international trade in B2B transactions is concerned, the customer's jurisdiction retains taxing rights. If the customer has multiple jurisdictions, then taxing rights become likesimilar to those in B2C transactions, such that these taxing rights are given to the jurisdiction where the entity which uses the product or service is located.	The VAT regulations do not make a distinction between B2B and B2C transactions – as such, avoidable issues of double taxation or double non-taxation are observed in the execution of current rules. Indeed, the failure to distinguish between these transactions, and the granting of some concessions for B2B purposes has led to the exclusion of some B2C transactions from the scope of the VAT Regulations.
VAT group registration	In response to the increasing practice of MNEs to appoint a specific member company of the group as general 'paymaster company' for intragroup services, consideration should be given to subjectively deciding the place of supply for this purpose – the primary factors in such a transaction should not be the direction in which the payment flows, and/or the location of the [paymaster] company itself.	South Africa's VAT regulations do not provide for VAT group registrations. However, the adoption of this international standard will promote cost efficiencies and effectiveness, while removing the compounding effect of non-recoverable VAT in intra-group services and charges.
Simplification of the registration and compliance process	VAT registration and compliance procedures should be simplified to the widest extent possible, consideringtaking into account options such as reverse-charging, appointment of a local representative, and online registration and declaration of obligations.	The current de minimis threshold refers to taxable turnover of more thanin excess of R1million in any 12-month period for general VAT registration – for electronic service suppliers this is reduced to R50,000 in any month, without specifying the time period. The current de minimis threshold is therefore considered to be too low and unclear

Consequently, while the updating of South African tax policy with respect to VAT on e-commerce remains a laudable effort, it appears that much like in the case of income tax provisions, the tax framework in force does not necessarily align with international trends.

While the income tax policy framework can therefore copy the efforts made by the South African fiscus with respect to VAT on electronic services, one must not lose sight of other issues which ideally should be addressed as well, to provide a holistic updated policy. Some of these other issues to be considered are discussed below.

3. Proposal of other areas of focus for South African policy

In 2020, SA decided against the adopting of unilateral measures to deal with direct tax treatment of the challenges of the digital economy[91]. It was National Treasury's decision to delay any taxing measures until such time when global guidance would be available via the final OECD report on tax challenges arising from digitalisation - this report was expected to contain multilateral solutions which would be in line with international trends.

This option of the South African National Treasury was in line with OECD preference, which was to suspend the taxation of the digital economy until such a time when global consensus could be achieved.

As mentioned in the previous chapter, the OECD research and studies in this regard have culminated in the publication of the GloBE guidance containing the Pillar One and Two proposals. The next important question is when these rules and Proposals will come into effect. Some important elements to note are as follows:

- The IF proposed that the introduction of Pillar One and related changes would take effect from 2023. However, this has now been delayed at least until 2024, while affected countries debate on whether to adopt its rules into law and commit to the provisions of the MLI.
- The Pillar Two proposals estimated that the IIR rule would begin to see enactment in different jurisdictions in 2023, with enactment for the UTPR rule following in 2024. However, it is worth noting that a significant number of the countries which would be most affected by Pillar Two have indicated their intention to defer implementation of Pillar Two, in some cases to 2025, with some outliers indicating their desire to defer the implementation of Pillar Two to such a time as after the implementation of Pillar One.

Suffice to say then, that the implementation of OECD proposals is not imminent. This was one of the major challenges raised by ATAF, who anticipated that deferring to the OECD proposals and an EU-led timetable, would jeopardise the ability of African countries to realise the collection of taxes from the digital economy which continues to grow and evolve at exponential rates.

There have been numerous state commission reports reiterating the need for a comprehensive regulatory framework surrounding e-commerce in South Africa, from a legal as well as a tax

[91] South Africa Ministry of Finance (2020), *Media statement – African Tax Administration Forum discusses taxation in digitalised economy*, Ministry of Finance, http://www.treasury.gov.za/comm_media/press/2020/20200826 01%20Media%20statement%20-%20African%20Tax%20Administration%20Forum.pdf., last accessed December 2022.

perspective. The challenge remains how to balance revenue collection and an enabling environment which fosters the development of new technologies and encourages local and foreign investment in the sector.

Further to the above analysis, it can be concluded that South Africa has adopted a subtle approach towards the imposition of taxes on the digital economy. The subtlety may be attributed to the political will to avoid the introduction of policies that may not be in harmony with existing bilateral treaties and other international agreements which South Africa has signed. Indeed, as mentioned by National Treasury, the official policy position is to wait for the international guidelines currently being elaborated by the OECD, to be established and implemented.

However, one must weigh this policy decision against the criticism that the IF has faced. The Pillar One and Two proposals have been criticised for effectively only offering protection to the tax base of EU member states, firstly by the exclusion of the income of key industries such as financial services, mining and other extractives, and international travel (i.e. airline and shipping industries) from application of the rules, and secondly by proposing rules which attribute a minimal profit to market jurisdictions (which are usually developing countries), while continuing to give the resident jurisdictions of the parent entities of MNEs (which incidentally are mostly found in the EU), the actual taxing rights over global income.

In addition, the US proposal of a safe harbour regime for the implementation of Pillar One has been interpreted as a bid by a principal residence jurisdiction of MNEs to transform Pillar One into a voluntary measure. In 2019, the US Treasury secretary expressed serious concerns over profit allocation and nexus rules under Pillar One, citing potential departures from Arm's-length transfer pricing and taxable nexus standards, which were both enshrined principles of international tax. The proposed workaround? The possibility for companies to opt out of the unified approach provided by Pillar One, subject to the application of other agreed measures.

These criticisms of the Pillar One and Two proposals are an indication that achieving global consensus may not be an easy or quick task, and even when achieved it may fail to provide adequate relief to African economies seeking support to tax the digital activities of non-resident MNEs in their jurisdictions.

It may therefore be necessary for National Treasury to revisit their 2020 choice not to impose any taxing measures on the digital economy and propose some interim taxing measures pending the implementation of OECD proposals. This would be in line with the practice by the UK.

Should this be the case, the next task for National Treasury would be how to balance these tax measures, with the need to boost growth and development in the digital economy. Some options which may be explored by National Treasury are examined below.

1. *A regulation of platforms*

One school of thought holds that the way to go may be a regulation of platforms. In the words of_Strowel and Vergoter, the correct behaviour to adopt would be to regulate the digital platforms which are a mainstay of the digital economy. Strowel and Vergoter refer to the economic definition of a digital multi-sided platform, as one which has two or more groups of customers who need each other in some way and require a digital catalyst to facilitate value creating interactions between them. [92]

One of the most disruptive attributes of the digital economy is that it gives buyers and sellers the ability to transact without the use of conventional communication and exchange methods which are well known to the tax authorities. However, the principal of an economy remains even digitally – there is a buyer, a seller, a good (or a service), and the place where they meet. Taxing a digital transaction at the point where it interacts with the platform may be the best chance for tax authorities to currently apply the necessary taxes to the digital economy. This has been the approach adopted regarding MNEs with highly digitised processes and complex nexus rules like Uber, Airbnb, eBay, and Amazon.

The regulation of platforms is the approach adopted by the UK in its DST. This approach may be criticised for limiting the tax base only to the revenue received by the digital platforms, and not by the parties to the transaction hosted thereon. However, it provides a starting point for taxing the digital economy and may serve as a critical pillar for the identification of taxpayers and customers, which is a focal point of the discourse.

2. *Increased automation of processes*

Remote tax collection and remittance liability has become the norm across the globe. Tax authorities worldwide are increasingly using sophisticated technology to tax more widely, and autonomous, cloud-based, tax automation platforms have become the future of tax.

A key focus for National Treasury in the bid to address the tax challenges of the digital economy should be the largescale automation of tax administration processes. There is a need

[92] A Strowel and W Vergote, 2016, *Digital Platforms: To Regulate or Not to Regulate*, EU Commission, available at https://ec.europa.eu/information_society/newsroom/image/document/2016-7/uclouvain-et-universit-saint-louis_14044.pdf, last accessed February 2022, on page 7.

to improve revenue collection and compliance via digital technologies and automated processes.

The promotion of online registration, filing and payment and a seamless integration with other related services such as identification and document verification would reduce the time and resource cost of compliance, improve transparency, and facilitate compliance. These are all critical elements to the growth of full and voluntary tax compliance.

For the automation of tax processes to be fully efficient, it must be implemented alongside the adoption of feed-in technology. Elements crucial to tax compliance such as payment records when digitalised, would leave digital footprints which would be easier to audit. If minor audit processes and other administrative compliance checks were digitalised and executed via AI, this would allow tax officials to focus their resources on high-value activities. Other aspects which would benefit from AI and automation would be the use of cloud computing to store data, prefilled tax returns, sharing of data with banks, and streamlining the interface between taxpayers and tax officials.

3. *Payment systems and the use of cyber cash*

Cyber cash is an element of an unaccounted payment system, which allows a transfer of value independent of any third-party involvement. The use of cyber cash does not produce records of the type which can be exploited by tax authorities for verification purposes, and as such this payment method poses a challenge to the taxing of the digital economy.

Traditional methods of payment are built on the use of accounted systems, which require payment to be carried out through a third party who is not the payer or the recipient. As such, records are generated, which are in turn linked to all parties involved in the transaction.

The lack of a regulatory framework and even internationally accepted principles governing the creation and use of cyber cash creates scope for the misuse of this payment system, to perpetuate tax avoidance as well as related foreign exchange control policy non-compliance and financial crimes.

It is therefore important to legislate for the digital economy and the use of accounted as well as unaccounted payment systems, in a way that allows cash flows to be monitored and regulated accordingly.

4. Customs duties and excise

In line with the discussions that have taken place with respect to the Work Programme on Electronic Commerce since 1998, South Africa continues to honour the moratorium on customs duties and electronic transmissions[93].

However, South Africa has recognised that this moratorium needs to be reviewed. In their 2018 joint proposal to the World Trade Organisation ("WTO")[94], concerns were expressed over the introduction of additive manufacturing technology via 3-D printing, and its effect on a drop in customs revenue. The lack of customs duties on electronic transmissions meant products imported in digitalised form would escape duties, thereby undermining existing schedules of tariff concessions.

The decrease in physical supports of electronic content and increase in digitalised transmissions led to a revenue loss by developing countries of USD 10billion in 2017[95]. This loss has been worsened by phenomena such as the proliferation of streaming content and the lockdowns occasioned by the COVID-19 pandemic, which created exponential opportunity for delivering content online.

It is therefore necessary for South Africa to renew and intensify efforts to lift the moratorium on the imposition of customs duties on electronic transmissions, as this has the potential to provide a significant boost to revenue collection by the tax authorities.

5. Tax administration and compliance

The challenges which the South African Revenue Service would face in the administration and compliance of taxes on the digital economy seems to be one of the most important barriers to this taxation, after the nexus and profit attribution issues.

[93] World Trade Organisation (2020), *Work Programme on Electronic Commerce – Communication from South Africa and India*, WTO, WT/GC/W/82, available at https://docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/WT/GC/W812.pdf&Open=True, last accessed December 2022.
[94] World Trade Organisation, *Moratorium on customs duties on electronic transmissions: Need for a re-think*" WT/GC/W/747, available at https://docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/WT/GC/W812.pdf&Open=True, last accessed December 2022.
[95] United Nations Conference on Trade and Development (2019), *Growing Trade in Electronic Transmissions: Implications for the South*, UNCTAD Research Paper No. 29, UNCTAD/SER.RP/2019/1/Rev. 1, UN, https://unctad.org/system/files/official-document/ser-rp-2019d1_en.pdf, last accessed May 2022.

Multiple issues are distinguishable which relate to tax administration and compliance, as examined below.

The first and most important of these is the identification of parties involved. This is a fundamental requirement for the imposition of taxes on a transaction. Traditional business benefit from having a physical location, as well as persons attached to the business who have been identified and vetted at the time of registration. However, tracing the owner/provider of a digital service is often a time-intensive process, with little guarantees of success particularly where there is concerted effort to conceal identities.

Implementing digital access to trader verification databases and imposing a minimum standard of documentary evidence to be provided to platforms before access is granted to trade online, can be a measure to counteract this challenge.

Second, even where the service provider and/or user are identified, the problem of accessing and verifying transaction information for purposes of imposing taxes or verifying same would still prove difficult. Digital records are susceptible to being manipulated in ways which are not obvious to highly trained professionals, and the verification of these records would require additional human resources which could render the cost of implementing the tax higher than the expected return.

Finally, compliance issues with respect to the enforcement of collection of the taxes would be another issue that would require specific attention from the revenue authorities. In principle, compliance enforcement mechanisms usually make use of a leverage point – this would involve the use of a middleman to collect and remit the tax. This is the basis of the collection mechanisms for taxes such as PAYE and VAT.

However, the digital economy has as one of its main proponents the elimination of a middleman to the greatest extent necessary. The closest semblance to a middleman in most digital transactions would be the digital marketplaces, and the payment providers. However, applying this system within the framework of an income tax provides an increased scope for wrongful application of the law, as well as significantly higher administrative burdens on the middlemen, for which they get limited commercial benefit. In addition, most digital marketplaces may themselves present a challenge of identification, which reintroduces significant issues discussed above.

C. Conclusion

In conclusion, the progress made by South Africa with respect to taxing income earned within the digital economy remains tentative. The divergence between international best practice and the current income tax provisions in South Africa demonstrate that there is a need for the South African legislative to implement tax policies that take into consideration the current and future revenue generation potential of the digital economy. In addition to their actual enactment, these policies must show a key factor of flexibility, which will extend their usefulness in the face of a very dynamic sector.

CHAPTER SIX: CONCLUSION

Taxing the digital economy is an effort that has proven to be significantly challenging across the globe in developed and developing countries alike. This is because the digital economy largely involves cross-border interactions, and unlike traditional cross-border trade; it leaves intangible footprints which are often hard to follow. It is therefore necessary to formulate policies which enhance global trade and provide the opportunity for the right jurisdictions to tax their fair share of profits.

A major consideration of South Africa in formulating an adequate policy framework, would be balancing the need to align with best practice, with formulating considerations which do not present a fresh set of challenges for South Africa. It should be noted that for an emerging economy like South Africa that has a significant group of home-grown multinational enterprises, extensive taxation may stifle the growth of local provides, as well as discourage foreign direct investments which is relief on to improve local access to technology and capital[96]. As mentioned by the DTC in their executive summary, South Africa is therefore under pressure to ensure that this balance is achieved in its response to BEPS challenges, as the OECD proposals would require significant trade-offs. The focus would be to '*encourage the competitiveness of home-grown multinationals, (…) weighed against profit shifting opportunities that are likely to increase with such an expansion*'.

South Africa has indicated a preference to delay any unilateral taxing measures, until global consensus is reached – however, the current delays in reaching global consensus mean that South Africa continues to apply a statutory framework that is ill-suited to the realities of a practical problem – as a result, millions are being lost in potential revenue.

The mismatch of current tax legislature and the structure of the digital economy should therefore be given due priority by the South African fiscus and National Treasury, to maximise revenue collection and in any case, prepare for the implementation of global solutions as and when they are consensually finalised, and rolled out for implementation and enactment into law.

[96] Op cit note 33 (*DTC 2016 Executive Tax Summary*) at 1.1.

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    a. Finance Act 2019.

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