ADDRESSING BASE EROSION AND PROFIT SHIFTING IN SOUTH AFRICA
DAVIS TAX COMMITTEE INTERIM REPORT

ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY

1 BACKGROUND

Long before the OECD, released its 2013 BEPS Action Plan 1 on the challenges of the digital economy, concerns had been raised over the last two decades about global computer-based communications that cut across territorial borders, creating a realm of human activity that undermines the feasibility and legitimacy of laws based on geographic boundaries. This is especially so with regard to transactions are conducted electronically (e-commerce) over the internet, which ignoring international boundaries, since “place” has little meaning in the networked world.[1] E-commerce has been described as the wide array of commercial activities carried out by electronic means that enable trade without the confines of geographical boundaries.[2] E-commerce changes the distribution of taxable activities; it poses challenges to the jurisdiction to tax income and alters the balance of taxing authority, and results in the erosion of countries’ tax bases.[3]

The OECD has over the years shown particular concern about the challenges that e-commerce poses to taxation, in particular about the challenges to the tax treaty rules for taxing business profits, which apply the permanent establishment (PE) concept as a basic nexus/threshold rule for determining whether or not a country has taxing rights with respect to the business profits of a non-resident taxpayer. The PE concept as defined in article 5 of the OECD Model Tax Convention refers not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carries on business in the country concerned via a dependent agent. However, developments brought about by the digital economy are putting increasing pressure on the PE concept since it is based on the place from which wealth originates as the primary basis for taxation. Nowadays it is possible to

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1 AW Oguttu & BA van der Merwe “Electronic Commerce: Challenging the Income Tax Base” (2005) 17 *SA Mercantile Law Journal* 305–339; DR Johnson & D Post “Law and Borders: The Rise of Law in Cyberspace” (1996) 48 *Stanford Law Review* at 1367 and at 1370-1371; N Cox “The Residence of Cyberspace and the Loss of National Sovereignty” (2002) 11 *Information & Communication Technology Law* 241 at 244-245.

2 R Doernberg & L Hinnekens *Electronic Commerce and International Taxation* (1999) at 3; JW Fawcett, JM Harris & M Bridge *International Sale of Goods in the Conflict of Laws* (2005) at 493; SARS Discussion Document: *Electronic Commerce and South African Taxation* (March 2000) at 5; Department of Communications *Green Paper on E-commerce: Making it Your Business* (2000) at 9; RA Westin *International Taxation of Electronic Commerce* (2000) at 2; RL Doernberg, L Hinnekens, W Herrerstein & J Li *Electronic Commerce and Multi-jurisdictional Taxation* (2001) at 9; Suddards at 257.

3 R Doernberg & L Hinnekens *Electronic Commerce and International Taxation* (1999) at 341-343; H Suddards *E-commerce: A Guide to the Law of Electronic Business* (1999) at 255; JJB Hickey, R Mathew & C Rose *E-commerce: Law Business and Tax Planning* (2000) at 261.

be heavily involved in the economic life of another country, by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent). In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, current rules cannot ensure a fair allocation of taxing rights on business profits.[4]

Countries' tax authorities look more to traditional concepts such as how many employees the company has on the ground and how much risk a company is assuming in the country.[5] The identification of the necessary requirements to establish the existence of a PE of a non-resident entity (and of the required principles to attribute the profits to the PE) encounters difficulties in e-commerce. In particular, there are hindrances in identifying a "place of business" since the business activity is carried out through the network and so tracking a connection between an online transaction and a specific geographical location may be difficult.[6]

The highly mobile nature of e-commerce and the ability of residents to establish offshore companies could also lead to tax-driven migration of businesses to low-tax jurisdictions.[7] The anonymous nature of e-commerce also brings new challenges to tax compliance. E-commerce creates difficulties: in the identification and location of taxpayers, the identification and verification of taxable transactions and the ability to establish a link between taxpayers and their taxable transactions, thus creating opportunities for tax avoidance.[8] This is especially so with the development of various electronic payment methods such as Bitcoin, a decentralized digital currency that enables instant payments to anyone, anywhere in the world.[9]

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4 OECD "Report on Base Erosion and Profit Shifting" (2013) at 36

5 J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 October 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013

6 P Valente "Permanent Establishments and Jurisdiction to Tax: Debates in Italy" Tax analysts: World Tax Daily (3/9/2010)

7 R Buys & F Cronjé *Cyber law: The Law of the Internet in South Africa* 2 ed (2004) at 301.

8 SARS Discussion Document at 31; Hickey *et al* at 257; RL Doernberg, L Hinnekens & W Herrerstein W & J Li *Electronic Commerce and Multi-Jurisdictional Taxation* (2001) at 388 - 389; R Buys & F Cronje *Cyber law: The Law of the Internet in South Africa* 2 ed (2004 at 307.

9 Bitcoin uses public – key cryptography which relies on peer-to-peer net-working technology and proof-of-work to process and verify payments. It operates with no central authority issuing money or tracking transactions, rather, these functions are carried out collectively by the network. The supply of bitcoins is regulated by software and the agreement of users of the system and cannot be manipulated by any government, bank, organization or individual Building upon the notion that money is any object, or any sort of record, accepted as payment for goods and services and repayment of debts in a given country or socio-economic context, Bitcoin is designed around the idea of using cryptography to control the creation and transfer of money, rather than relying on central authorities. See "Bitcoin" https://en.bitcoin.it/wiki/Bitcoin accessed 2 October 2013; "Public Key cryptography" http://en.wikipedia.org/wiki/Public-key_cryptography

1.2 Previous OECD Work to Address some of the Above Challenges

The first initiative by the OECD to deal with the taxation of e-commerce commensed with the Turku conference of November 1997[10] which initiated work on developing taxation framework conditions for electronic commerce. The matters discussed at this conference culminated in the 1998 OECD report entitled: "Electronic Commerce: Taxation framework Conditions" which was discussed at the Ottawa conference.[11] In this report, the OECD noted that the taxation principles which guide governments in relation to conventional commerce should also guide them in relation to electronic commerce. These taxation principles are: Neutrality; efficiency; certainty and simplicity; effectiveness and fairness; and flexibility.[12] The OECD noted that the challenge facing Revenue authorities is how to implement these broad taxation principles identified in a rapidly changing e-commerce environment. With respect to international tax arrangements, the 1998 OECD Report noted that while the principles which underlie the international norms that it has developed in the area of tax treaties and transfer pricing are capable of being applied to electronic commerce, there should be a clarification of how the OECD Model Tax Convention applies with respect to some aspects of electronic commerce.[13]

Consequently, the OECD came up with recommendations on the challenges e-commerce poses to the PE concept, which are now set out in paragraph 42 of the Commentary on article 5 of the OECD Model Tax Convention. The Commentary makes the following observation:[14]

> "An Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" … as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.
>
> The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of

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10 An International Conference and Business-Government Forum organised by the OECD and the Government of Finland in co-operation with the European Commission, Japan and BIAC on "Dismantling the Barriers to Global Electronic Commerce" held in Turku, Finland, 19-21 November 1997.

11 OECD "Electronic Commerce: Taxation Framework Conditions" as presented to Ministers at the OECD Ministerial Conference whose theme was" *A Borderless World: Realising the Potential of Electronic Commerce"* on 8 October 1998*. Available at http://www.oecd.org/tax/consumption/1923256.pdf, accessed 6 November 2014.*

12 OECD "Electronic Commerce: Taxation Framework Conditions" para 9

13 OECD "Electronic Commerce: Taxation Framework Conditions" para 11.

14 Para 42.2-42.3 of the Commentary on article 5 of the OECD Model Tax Convention.

the enterprise …, even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met."

In summary the OECD Commentary makes it clear that a server, as distinct from mere websites (which cannot fulfil the geographical situs condition) could constitute a PE where the equipment is fixed and the supplier has the server at its own disposal. The OECD acknowledges that no PE would be created if the e-commerce activities carried on via the server are restricted to preparatory or auxiliary functions which are excluded under paragraph 4 of Article 5. It mentions some examples of activities which would generally be regarded as preparatory or auxiliary:[15]

- providing a communications link – much like a telephone line – between suppliers and customers;
- advertising of goods or services
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.

The OECD Commentary points out that:[16]

"Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise .., there would be a permanent establishment."

1.3 Challenges Encountered in Applying the OECD Guidelines

Generally servers are highly mobile and flexible in nature.[17] The location of a server can be easily moved (without affecting the underlying transaction) between different countries. Servers can transfer their programs almost instantaneously to a server in a different jurisdiction if necessary.[18] Servers can be shifted outside the country where an e-commerce firm is based or where the software products are developed as well as outside of the source country where e-commerce goods and services are

15 Para 42.7 of the Commentary on article 5 of the OECD Model Tax Convention.

16 Para 42.8 of the Commentary on article 5 of the OECD Model Tax Convention.

17 OECD "Dismantling the Barriers to Global Electronic Commerce" (Turku, Finland, November 1997). Available at http://www.oecd.org/LongAbstract/0,2546,en_2649_34223_2751231_1_1_1_1,00.html accessed on 4 June 2013.

18 A Cockfield "Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation" (2001) 85 *Minnesota Law Review* (2001) at 1259.

purchased.[19] Thus, even though a server could constitute a place of business of an enterprise, if it is not located in a place for at least a year, it cannot be considered a PE. In addition, for a server to constitute a place of business that qualifies as PE, it should be suitably equipped with on-site managerial and operational management and employees.

The other challenge is the OECD view that the existence of a PE has to be determined using the traditional approach of the location of the server is based on the assumption that an enterprise will utilise only one server. However, technology has since changed. Now an enterprise can have more than one server and e-commerce suppliers can utilise multiple servers in multiple jurisdictions. In theory, one transaction can be processed with multiple servers in multiple jurisdictions. Applying the current OECD principles to determine PE may result in multiple jurisdictions claiming there is a PE in their jurisdiction because a server is located in their jurisdiction.

Taxation challenges are also posed by large internet-based companies, such as Google and Amazon, which are doing major business in countries but remitting very low amounts of corporate income tax in the countries they operate in. The argument is that the presence of such companies in any given country does not often amount to the level of creating a PE under existing tax treaty principles.[20] Companies like Google can collect user data in one country and use that data to sell targeted advertisements to advertisers in another country. Revenues collected from advertisements targeted to users in one country are then funnelled through subsidiaries in low tax jurisdictions, thus avoiding PE status in those countries in which the advertisements are collected.[21]

Revenue lost through the digital economy is a growing concern by governments internationally that lose substantial corporate tax revenue because of arrangements implemented by multinational enterprises which shift profits to low tax jurisdictions, thus eroding the taxable base. At their meeting in St. Petersburg on 5-6 September 2013, the G20 leaders fully endorsed the OECD BEPS Action Plan, noting that:[22]

> "In a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes is more than ever a priority. Tax avoidance, harmful practices and aggressive tax planning have to be tackled. **The growth of the digital economy also poses challenges for international taxation.** We fully endorse the ambitious and comprehensive Action Plan – originated in the OECD – aimed at addressing base erosion and

[19] Ibid.

[20] J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 october 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013

[21] SS Jonstone "News Analysis: Chasing Google -- The Global Struggle to Tax Ecommerce" 10 February 2014.n

[22] OECD "Public Discussion Draft: BEPS Action 1: Address the Challenges of the Digital Economy (March 2014). Available at http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf accessed 6 May 2014.

profit shifting with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. **Profits should be taxed where economic activities deriving the profits are performed and where value is created". (Our emphasis).**

2 OECD BEPS ACTION PLAN ON THE DIGITAL ECONOMY

In the 2013 OECD report on Base Erosion and Profit Shifting (BEPS), Action 1 points out the challenges the digital economy poses to international taxation. The OECD BEPS report[23] recommends that:

- Countries need to develop rules to address the tax challenges of the digital economy.
- Countries need to identify the main difficulties that the digital economy poses in the application of existing international tax rules and develop detailed options to address these difficulties. A holistic approach needs to be taken that considers both direct and indirect taxation
- Issues to be examined include, but are not limited to:
    - the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules
    - the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services;
    - the characterisation of income derived from new business models
    - the application of related sources rules; and
    - how to ensure the effective collection of VAT/GST with respect to cross-border supply of digital goods and services.
- Such work will require a thorough analysis of the various business models in this sector.

The OECD acknowledges that work on Action 1 plan will be impacted by work on Action 7 (preventing the artificial avoidance of PE status) which covers the possibility of changes to the model treaty.

3 CONCERNS RAISED BY COMPANIES INVOLVED IN DIGITAL TRANSACTIONS

After the release of the 2013 BEPS report on the digital economy the OECD received several complaints from high-tech consortiums and other companies with significant digital income about the imposition of a separate standard of taxation on mobile income.[24] On December 23, 2013, the Digital Economy Group, a lobbying group for high-tech companies, wrote a letter to the OECD arguing that:

> Enterprises that employ digital communications models operate in all sectors of the global economy. These enterprises constitute the digital economy. Accordingly, any options for

23 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 14.

24 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.

> addressing the digital economy should apply fairly and equally across all business lines. We believe that enterprises operating long-standing business models, subject to established international tax rules, should not become subject to altered rules on the basis that they have adopted more efficient means of operation. [25]

In response to these strongly worded comments, the OECD shifted its stance to refer to the digitalization of the economy rather than to digital companies.[26] In other words, the OECD changed its stance of defining digital goods or service providers differently from other multinational businesses using digital means to pursue commerce.[27]

4 APPROACHES BY OTHER COUNTRIES ON THE TAXATION OF THE DIGITAL ECONOMY

The OECD Commentary on article 5 (discussed above) which deals on PE issues relating to websites and servers reflects the views of the majority of the OECD member States. It is, however, worth noting that several OECD Member States have expressed negative observations to the conclusions reached by the OECD Commentary on article 5, notably the United Kingdom (UK), Chile, Greece and Portugal.[28] This because the current PE rules make it difficult for many countries to levy direct income taxes on e-commerce companies that transact with customers within their borders, some jurisdictions have become more aggressive about deeming that a PE exists or are seeking to levy indirect taxes on the transactions. [29]

4.1 United Kingdom

In relation to the Commentary on article 5, of the OECD Model Tax Convention, the UK takes the view that a server used by an e-tailer, either alone or together with web sites, could not as such constitute a PE. The UK tax authorities (HMRC) have confirmed that this is the case regardless of whether the server is owned, rented or otherwise at the disposal of the business.[30] In March 2014, the UK Treasury (HM Treasury) and the HMRC released a joint report entitled: "Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for

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25 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.

26 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" Tax Analysts 3 February 2014.

27 L A Sheppard "News Analysis: OECD BEPS Hybrid Developments" Tax Analysts 29 January 2014.

28 Para 45.5 – 45.11 of the Commentary on art 5 of the OECD Model Convention.

29 J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 october 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013

30 See HMRC International Manual INTM266100.

countering Base Erosion and Profit Shifting (UK Report on BEPS)”.[31] The Report observes that:[32]

> “…. it is not feasible to ring-fence the digital economy from the rest of the economy in order to apply entirely separate rules to it. Attempting to do so by creating artificial boundaries would cause unintended consequences, is unlikely to provide a long-term solution as the digital economy continues to evolve and could hamper prospects for growth in the UK. Instead, we think it is important for the OECD to analyse precisely how value is created in modern businesses which rely on digital technologies and complex systems, or where computing-related intangibles are central to revenue models, and consider how the existing rules can be updated to take this into account. Therefore, our view is that the key objective is to achieve consistent tax treatment of primarily digital companies and those where digital technologies are incorporated into their business models by focusing on comparable activities and seeking to ensure these receive consistent tax treatment within a jurisdiction.”

The UK Report acknowledges that:[33]

> “Some characteristics of digitised business models exacerbate existing challenges in applying the international tax rules consistently to companies. These include, for instance, the ability of businesses to deliver products and services into a market without the need to physically locate there and thereby create a permanent establishment; the ability to fragment activities within a group to ensure that the threshold for creating a permanent establishment in relation to any particular group company operating in that country is not breached; the growth in proportional value of mobile intangible assets and increased reliance in a value chain on computing power and infrastructure which can more easily be located in low or no tax jurisdictions; and the ability of some market-leading businesses to quickly establish a significant market share through multi-sided business models and the impact of network effects.”

The UK Report on BEPS concludes that there is a need to seriously consider revising the concept of a PE in order to take account of technological advances, including advances in functionality.[34] With respect to indirect taxes, the UK Report points out that the UK has been at the forefront of moves to modernise the EU VAT rules so that services are taxed by the Member State where these are used or consumed (the destination principle). It notes that the EU Ministers unanimously agreed to a series of changes to achieve that, with the final step being changes to be introduced across the EU on 1 January 2015.[35] This is a key step as the changes will ensure broadcasting, telecoms and e-services are taxed by the UK, when they are supplied to UK consumers from suppliers located elsewhere in the EU. This will bring the VAT treatment in line with the rules that already apply to suppliers located outside the EU.

31 HM Treasury and the HMRC “Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting” (2014) (UK Report on BEPS).

32 UK Report on BEPS at 15 in para 2.4.

33 UK Report on BEPS in para 2.5.

34 UK Report on BEPS in para 2.6.

35 UK Report on BEPS in para 2.9.

4.2 Australia

Following a request from National Government, the Australian Treasury released a scoping paper (Paper) in June 2013 which analyseds the exposure to the Australian corporate tax system resulting from BEPS.[36] The Paper observes that global tax settings have failed to keep pace with changes in the global economy, which has led to growing concern around the world that some multinationals, while acting within the law, are taking advantage of outdated international tax laws to reduce the taxation contribution they make to the countries in which they operate.[37] The Paper notes the classical basis for the fiscal jurisdiction of a country, i.e. a country can assert the right to tax either on the basis of its sovereignty over its people (its citizens and residents) who derive benefits provided by the state (the benefits principle) or its sovereignty over the territory it claims authority over, i.e. based on the existence and extent of the economic relationships between the country and the income or person concerned (economic allegiance). Traditionally, the application of the economic allegiance and benefits doctrine, combined with the practical limits on countries' ability to assert sovereignty, gave rise to the two concepts that underpin the international framework for the taxation of cross-border income and capital: the residence (of individuals and entities) and the source (of income).[38] The Paper questions whether the concepts of source and residence continue to represent a reasonable proxy for the economic allegiance and benefit doctrines in the modern economy. In particular, it argues in relation to the digital economy and the broader knowledge economy that the concepts of source and residence may no longer adequately reflect the economic allegiance and benefits doctrine. It stresses that it is important not to lose sight of the fact that 'source', 'residence' and 'permanent establishment' are the tools for allocating taxing rights rather than the guiding conceptual frameworks.[39]

The Paper observes that the rise of the digital economy has meant that many transactions and functions that previously relied on a physical proximity with the market can now be undertaken more or less anywhere.[40] The Paper notes that the potential for developments in the digital economy to have an adverse impact on Australia's corporate tax base was identified in the Australian Tax Office's (ATO) 1997 report entitled: Tax and the Internet. The Paper points out that the nature and extent of those risks has shifted as the digital economy itself has evolved, and the international tax system has not adjusted sufficiently to reflect this.[41]

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36 Australian Treasury "Scoping Paper on The Risks to the Sustainability of Australia's Corporate Tax Base" (July 2013). Available at http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Aus-Corporate-Tax-Base-Sustainability accessed 5 May 2014.
37 Australian Treasury's Scoping Paper at 45.
38 Australian Treasury's Scoping Paper in para 19.
39 Australian Treasury's Scoping Paper in para 20.
40 Australian Treasury's Scoping Paper in para 54.
41 Australian Treasury's Scoping Paper in para 55.

The Paper observes that the PE rules date back to a time when the bulk of economic activity took place at a physical location. The rise of the digital economy, which essentially has no physical location, led to changes to the guidance material to: include examples of when electronic commerce (such as electronic equipment), facilities such as cables or pipelines or agents are treated as a PE; the exclusion of activities that were preparatory or auxiliary; and inclusion of alternative provisions that countries can use to allocate profits from the provision of services. The Paper expresses the view that although these modifications have been made to adjust to the changing international environment, the changes have sought to "shoehorn"' the developments to fit within the pre-existing concepts; the net effect is that it is 'possible to be heavily involved in the economic life of another country without having a taxable presence therein. [42]

The Paper concludes that to ensure an appropriate share of tax revenues between jurisdictions is achieved in the changing environment and to prevent the artificial avoidance of PE status, the rules need to be modified. It mentions one option to explore, i.e. whether a better balance can be achieved by changing the rules so they rely on the level of economic activity rather than on a physical presence.[43]

The Paper acknowledges that the underlying drivers of corporate tax base erosion are international in nature, and beyond the scope of any one country, acting alone, to resolve. Addressing the threat posed to the corporate tax bases of countries from base erosion and profit shifting will inevitably require effective multilateral action.[44]

4.3 France

France follows the OECD principles regarding e-commerce. Therefore, the existence of personnel in France operating a company's server, rather than the server itself would not constitute a PE. However; this would cause concern to tax authorities.[45] There is a growing disconnect between the theoretical French position on PE and the behaviour of the country's tax authorities, which have become quite aggressive. In recent times, tax officials, assisted by the police, have conducted highly publicised searches for documentation on the premises of Google and Amazon with the goal of finding information about business activity that would justify the determination of PEs in France. [46] If the French government decides that a company does have a PE and then determines that it was engaging in an undisclosed business, the company could be liable to heavy penalties on the tax that the undisclosed business is deemed to have avoided.[47] On 19 January 2013 the French Ministry for the Economy and

42 Australian Treasury's Scoping Paper in paras 169 – 171.
43 Australian Treasury's Scoping Paper in para 172.
44 Australian Treasury's Scoping Paper in para 184.
45 Ibid.
46 Ibid.
47 Ibid.

Finance published the Colin-Collin report (predating the BEPS Report), in which it proposed a new tax (commonly referred to as a Google tax) on database collection and the attribution of profits to a virtual PE based on the concept that data provided by Web users who search or shop on the Internet must be regarded as a source of revenue to digital companies. Basically, the proposed tax would impose a "link tax" to force companies like Google to pay French publishers for using snippets of their content in Google search engine results. The French government is contemplating redefining PE for the digital economy. Whereby PE would be defined as the provision of services in a country using data voluntarily uploaded by the consumer, and systematic monitoring of online users in that country. [48] French proposals to enact the Google tax were however stopped because of lobbying pressure. [49]

It is worth noting that in August 2012 Germany also tried to come up with a “link tax” in its proposed "ancillary copyright" legislation to compel Google and other search engines to pay for indexed links to copyrighted content. [50]

4.4 India

In India the Ministry of Finance appointed a High Powered Committee (HPC) to consider the need for introducing a separate tax regime for e-commerce transactions. [51] The HPC submitted its report in September 2001. The HPC concluded that applying the existing principles and rules to e-commerce does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source. The HPC also expressed the firm view that there is no possible liberal interpretation of the existing rules which can take care of these issues as suggested by some countries. The HPC, therefore, supported the view that the concept of PE should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE.[52]

The HPC pointed out that the concept of PE evolved because in traditional commerce physical presence was required in the source country if any significant level of business was to be carried on. The absence of a PE implied only

48 Ibid.

49 Ibid.

50 SS Jonstone “News Analysis: Chasing Google -- The Global Struggle to Tax Ecommerce” 10 February 2014.

51 The India Ministry of Finance HPC report is available at https://www.google.co.za/search?hl=en-ZA&source=hp&q=India+the+Ministry+of+Finance+appointed+a+High+Powered+Committee+%28HPC%29+to+consider+the+need+for+introducing+a+separate+tax+regime+for+e-commerce+transactions&gbv=2&oq=India+the+Ministry+of+Finance+appointed+a+High+Powered+Committee+%28HPC%29+to+consider+the+need+for+introducing+a+separate+tax+regime+for+e-commerce+transactions&gs_l=heirloom-hp.12...13228.13228.0.15288.1.1.0.0.0.0.0.0..0.0....0...1ac.1.34.heirloom-hp..1.0.0.242eEDfL6AE accessed 5 May 2014.

52 India, Ministry of Finance HPC Report at 11.

insignificant business activity could be overlooked for tax purposes. This concept lost relevance with the technological advance in communication and development of teleconferencing. With that and the development of the Internet in the 1990s, the correlation between the size of business and the extent of physical presence in the source country ceased to exist. In all transactions undertaken through the Internet, even where delivery is in the traditional manner, the tax base in the source country would be nominal.[53]

The HPC then referred to the paper presented at the IFA Asia Regional Conference on “E-Commerce and International Taxation” held at Mumbai in November 2000, by Professor Richard L Doernberg, suggesting a ‘base erosion’ approach in taxation of income streams in source countries. Prof Doernberg’s proposal requires taxation of any payment to a foreign enterprise, if it is tax deductible in the hands of a taxpayer. The implementation of the tax would be in the form of a low withholding tax, with the option of being taxed on net income in the source country.[54] The HPC concluded that that the ‘base erosion’ approach suggested by Professor Doernberg offers a possible solution for equitable tax sharing between residence and source countries provided:

- The concept is applied to all commerce and not just e-commerce;
- The tax is implemented through a low withholding tax on all tax-deductible payments to the foreign enterprise;
- Preferably, the withholding tax is final without option of tax on net income being given to the taxpayer or the tax administration.

However, the HPC advised that no changes should be made to the Indian Income Tax Act or the Indian DTAs until international consensus on abandoning the concept of PE is reached.[55] Nevertheless the Indian Government introduced a dispensation similar to the rules suggested by Prof Doernberg. For instance, in general, section 5(2) of the Indian ITA provides that a non-resident is subject to tax in India on income (i) received by or deemed to be received by the non-resident in India and (ii) which accrues to or arises in or is deemed to arise in India.

Royalties and fees for technical services paid to a non-resident or a foreign company, is in terms of the Finance Act 2013 increased the rate to 25% (previously 10%), but non-residents may be entitled to a reduced rate which may apply under an applicable DTA. A taxpayer which makes a payment to a non-resident which is subject to tax in India is required to withhold the tax in accordance with section 195 of the Indian ITA. Section 40(a)(i) of the Indian ITA provides that when a taxpayer fails to discharge his tax withholding obligations in respect of amounts paid to non residents, no deduction is allowed in respect of the expenditure so incurred. The taxation of income derived by non-residents from e-commerce transactions in India depends on a) the characterization of income, i.e. whether income earned is a

53 India, Ministry of Finance HPC Report at 12.
54 Ibid.
55 India, Ministry of Finance HPC Report at 14.

royalty, business income, service fee or capital gains, and b) PE issues that may arise due to the presence of a server in India, or hosting of websites. In the case of e-commerce transactions such as online shopping of tangible products, the income can be easily characterized as income from business profits. However in case of composite services like e-banking, access to paid databases and the sale of a digitized books, characterization may be more difficult.

In a 2011 of *ITO v Right Florists Pvt Ltd,*[56] the Income Tax Appellate Tribunal had to consider the application of these rules in the context of e-commerce and the application of DTAs. The taxpayer was a florist based in India who advertised on search engines supplied by Google and Yahoo to generate business. The taxpayer made payments in respect of online advertising to Google Ireland Limited (Google Ireland) and to Overture Services Inc USA (Yahoo USA). The assessing officer contended that the payments were subject to Indian tax and thus disallowed the deduction of such payments in calculating the tax liability of the taxpayer. The question that the Tribunal had to adjudicate was whether the payment made for the above services to Google Ireland and Yahoo USA was taxable in the hands of those entities, because if the amounts were to be held taxable in India, non deduction of tax at source from these remittances would result in disallowance of related payment in computation of business income of the taxpayer. The Tribunal then considered whether a search engine like Google or Yahoo can be said to have a PE in India. The Tribunal considered the comments of the OECD on e-commerce transactions in the OECD Commentary on Article 5 of the Model OECD DTA and came to the conclusion a search engine, which has only its presence through its website cannot be a permanent establishment unless its web servers are also located in the same jurisdiction. That's not the situation here and it is not the case of the revenue that servers are located in India.

The Tribunal then had to consider the potential application of the deemed source provisions of section 9(1)(vii) of the Indian ITA, which provide that any income from technical services which is payable by a resident to a non-resident will be deemed to arise in India, irrespective whether or not the non-resident has a residence or place of business or business connection in India; or the non-resident has rendered services in India. The Tribunal established that 'fees for technical service', which are also taxable in the source jurisdiction under the India Irish DTA at a rate not exceeding 10%, is defined under Article 12(2)(b) of the DTA, as "payment of any kind in consideration for the rendering of any managerial, technical or consultancy services including the provision of services by technical or other personnel. The scope of "fees for technical services" in the DTA is thus not any narrower than the scope under the domestic tax law. The Tribunal considered the scope of the provisions and concluded that the common factor required before these provisions applied is that the services should be supplied by "human touch." The service which

[56] I.T.A. No. 1336/ Kol./2011.

is rendered by the Google search engine is the generation of certain text on the search engine result page. This is a wholly automated process with no human touch at all. The Tribunal thus concluded:

> "Since there is no human touch involved in the whole process of actual advertising service provided by Google, in the light of the legal position that any services rendered without human touch, even if it be a technical service, it cannot such a technical service which is covered by the limited scope of Section 9(1)(vii), the receipts for online advertisement by the search engines cannot be treated as fees for technical services taxable as income, under the provisions of the Income Tax Act in the hands of the Google."

The Tribunal came to a similar conclusion in respect of the payments to Yahoo. The Right Florists case thus illustrates that the penalty of non-deductibility of payments to non-resident suppliers will not allow the source country a better right to share the tax revenue generated by the e-commerce supplier, since the PE protection under DTAs exempts the e-commerce supplier from source country tax, which implies that the penalty cannot be enforced.

The issue of taxation of income derived by virtue of on-line reservations and bookings for airlines, trains and other travel agencies which are routed through a central reservation system (CRS) has been dealt with in several judgments by the Delhi Tribunal, notably in *Galileo International Inc v DCIT*[57] and *Amadeus Global Travel v DCIT.*[58] In the *Amadeus* case, it was found that the CRS, which was regarded as the source of revenue, was partially existent in the machines namely various computers installed at the premises of the subscribers. It was found that the taxpayer itself had placed those computers with subscribers and that the connectivity in the form of leased nodes was installed by the taxpayer through its agent. The computers so connected and configured, which performed the function of reservation and ticketing, were found to be part and parcel of the entire CRS. The installation of the computers required further approval from the local agent who allowed the use of such computers for reservation and ticketing. Without the authority of the agent, such computers were not capable of performing the reservation and ticketing part of the CRS system. The computers so installed could not be shifted from one place to another even within the premises of the subscriber, apart from the shifting of such computers from one person to another. The taxpayer thus exercised control over the computers installed at the premises of the subscribers. This was held to be a fixed place of business for carrying on the business of the enterprise in India. The supply of computers, the configuration of computers and connectivity, which were provided by the taxpayer either directly or through its agent, amounted to operating part if its CRS system through such subscribers in India and accordingly constituted a PE in the nature of a fixed place of business in India. The Tribunal thus concluded that the taxpayer could be said to have established a PE within the meaning of paragraph 1 of Article 5 of India-Spain DTA.

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57 (2008) 19 SOT 257 (Del).
58 (2008) 113TTJ(Delhi)767.

In the *Galileo International* case,[59] the Tribunal came to the same conclusion on similar facts. The decisions was based on the acknowledged case of automated equipment which can constitute a PE even where the activities of the personnel may be restricted to the setting up, operating, controlling and maintaining such equipment.[60] A PE may exist where the enterprise which sets up the machines also operates and maintains them for his own account, also if they are operated by a dependent agent of the supplier.[61]

It is important to note that in both cases the Tribunal held that, notwithstanding the presence of a PE, the foreign supplier had no further tax liability in India since the fee which was paid by the supplier to its agent in India constituted a sufficient allocation of profits to India, i.e. the Tribunal found that the income accruing to India was "consumed" by the amount paid to the agent in India". This conclusion was based on the fact that only part of CRS system operated or functioned in India. Major functions like collecting the database of various airlines and hotels which had entered into participating carrier agreement (PCA) with the supplier took place outside India. Furthermore, the majority of the assets, i.e. the host computer, which had a very large capacity to process information of all the participants, were situated outside India and the CRS was developed and maintained outside India. However, it was equally important to note that but for presence of the supplier's agent in India and configuration and connectivity being provided in India, income would not have been generated.

The Tribunal pointed out that the activities of the taxpayer in India were entirely routed through efforts of its agent (the agent was responsible for monitoring activities of subscribers enrolled in India, for establishing connectivity of computers of subscribers and maintaining them and was also responsible for training of subscribers in respect of use of CRS). It was common cause that the agent was appropriately remunerated for all these services rendered to the taxpayer. Thus in respect of activities carried out in India and considering income accruing in India, the remuneration paid to the Indian agent was held to have consumed the entire income accruing or arising in India. Therefore, it was held that no income was taxable in India.

It is doubtful that this attribution method applied by the Tribunal accords with the OECD Guidelines for the Attribution of Profits to a Permanent Establishment.[62] It is submitted that a portion of the remaining profits of the supplier could have been attributed to the PE in India. Whilst these are interesting and useful precedents in the area of e-commerce, it is submitted that such cases would not arise very often, and

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59 (2008) 19 SOT 257 (Del).
60 See the OECD Commentary on Article 5 of the OECD Model DTA, para 10 and para 42.4.
61 Ibid in para 10.
62 OECD "Report on the Attribution of Profits to a Permanent Establishment" (22 July 2010).

the more common scenario would be the situation illustrated in the Right Florists case, where it was held that the foreign supplier had no PE in India.

5 OECD WORK ON THE DIGITAL ECONOMY: POST BEPS REPORT

In September 2013, the OECD formed the Task Force on Digital Economy, a subsidiary body of the OECD Committee on Fiscal Affairs (CFA), with the aim of developing a report to identify issues raised by the digital economy and possible actions to address them by September 2014. On 24 March 2014, the OECD published a Discussion Draft entitled "BEPS Action 1: Address the Challenges of The Digital Economy".[63] The Discussion Draft on BEPS Action 1 examined the evolution over time of information and communication technology, including emerging and possible future developments (Section II). It discussed the spread and impact of ICT across the economy, provides examples of new business models and identifies the key features of the digital economy (Section III). The Discussion Draft then provides a detailed description of the core elements of BEPS strategies in the digital economy (Section IV) and discusses how the development of the measures envisaged in the BEPS Action Plan and the OECD work on indirect taxation are expected to address them (Section V). Finally, it identifies the broader tax challenges raised by the digital economy (Section VI) and summarises the potential options to address them that have been presented to, and initially discussed by, the Task Force (Section VII).

6 OECD SEPTEMBER 2014 REPORT ON THE DIGITAL ECONOMY

The matters addressed in OECD Discussion Draft Action Plan 1, culminated in the final report on in September 2014 entitled "Address the Challenges of The Digital Economy". The gist of this report is summarised below.

6.1 THE OECD NOTES THE FOLLOWING ABOUT THE BUSINESS MODELS AND KEY FEATURES OF THE DIGITAL ECONOMY

(i) The digital economy is the result of a revolution brought by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy. For example:

- *Retailers: c*ustomers can place online orders and are able to gather and analyse customer data to provide personalised service and advertising;
- *Logistics:* the ability to track of vehicles and cargo across continents;
- *Financial services:* customers can manage their finances, conduct transactions and access new products on line;

63 The full report can be found at: http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf

- *Manufacturing:* the ability to remotely monitor production processes and to control and use robots;
- *Education:* service providers are able to provide courses remotely;
- *Healthcare:* remote diagnosis and the use of health records to enhance system efficiencies and patient experience.
- *Broadcasting and media industry:* expansion of non-traditional news sources, and expanding user participation in media through user-generated content and social networking.[64]

(ii) The digital economy is increasingly becoming the economy itself. It is therefore difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes.

- The BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by multinational enterprises (MNEs) together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns.
- Although many digital economy business models have parallels in traditional business, modern advances in ICT have made it possible to conduct many types of business at substantially greater scale and over longer distances than was previously possible. These include several varieties of e-commerce, online payment services, app stores, online advertising, cloud computing, participative networked platforms, and high-speed trading.[65]

(iii) The digital economy is in a continuous state of evolution and possible future developments need to be monitored to evaluate their impact on tax systems.

These developments include the:

- *Internet of Things:* This has resulted in the increase in networked devices;
- *Virtual currencies:* This includes bitcoin.
- *Advanced robotics and 3D printing:* This has the potential to bring manufacturing closer to consumers, altering where and how value is created within manufacturing supply chains, as well as the characterisation of business income.
- *The sharing economy:* This allows peer- to-peer sharing of goods and services.
- *Increased access to government data:* This has the potential to improve accountability and performance, and to allow participation of third parties in government business.
- *Reinforced protection of personal data:* This has become more widely available in the digital economy. [66]

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64 OECD/G20 Base Erosion and Profit Shifting Project *Addressing the Tax Challenges of the Digital Economy: Action 1 2014 Deliverable* (2014) at 11..

65 OECD/20 BEPS Project on Action 1, 2014 Deliverable at 12.

66 OECD/20 BEPS Project on Action 1, 2014 Deliverable at 13.

(iv) The digital economy and its business models present some key features which are potentially relevant from a tax perspective.

These features include *mobility*, with respect to:

- the intangibles on which the digital economy relies heavily,
- users;
- business functions: such as massive reliance on data, network effects, the spread of multi- sided business models, the tendency toward monopoly or oligopoly and volatility of the rapidly evolving technology.[67]

(v) The digital economy has accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations:

- In the past, a MNE group would establish a subsidiary in each country in which it did business to manage the group's business in that country. This structure was dictated by factors such as: slow communications, currency exchange rules, customs duties, and high transportation costs.
- Advances in ICT have resulted in reductions in currency and custom barriers, the move to digital products and a service-based economy which have allowed MNEs to operate much more as global firms;
- This integration has encouraged business to adopt global business models that centralise functions at a regional or global level, rather than at a country-by-country level.[68]

6.2 BEPS ISSUES IN THE DIGITAL ECONOMY AND HOW TO ADDRESS THEM

While the digital economy does not generate unique BEPS issues, some of its key features exacerbate the BEPS risks set out below.

- There are a number of tax structures that can be used to implement business models in the digital economy. These structures highlight existing opportunities to achieve BEPS so as to reduce or eliminate tax in jurisdictions across the whole supply chain, including both market and residence countries.
- The importance of intangibles in the context of the digital economy, combined with the mobility of intangibles for tax purposes under existing tax rules, generates substantial BEPS opportunities in the area of direct taxes.
- The ability to centralise infrastructure at a distance from a market jurisdiction and conduct substantial sales of goods and services into that market from a remote location,
- The increasing ability to conduct substantial activity with minimal use of personnel, generates potential opportunities to achieve BEPS by fragmenting physical operations to avoid taxation.

[67] OECD/20 BEPS Project on Action 1, 2014 Deliverable at 13.
[68] OECD/20 BEPS Project on Action 1, 2014 Deliverable at 13.

- Some characteristics of the digital economy exacerbate risks of BEPS in the context of indirect taxation, in particular in relation to businesses that perform value added tax (VAT) exempt activities. [69]

Action Plan 1 is intended to ensure the alignment of taxation with economic activities and value creation as follows:

- Structures aimed at artificially shifting profits to locations where they are taxed at more favourable rates, or not taxed at all, will be addressed by ongoing work on the BEPS Project so as to restore taxing rights at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company.
- Taxation in the market jurisdiction should be restored by preventing treaty abuse (Action 6) and by preventing the artificial avoidance of PE Status (Action 7).
- Taxation in the ultimate residence jurisdiction should be restored by strengthening controlled foreign company (CFC) rules (Action 3).
- Both market and residence taxation should be restored by neutralising the effects of hybrid mismatch arrangements (Action 2), by limiting the base erosion via interest deductions and other financial payments (Action 4), by countering harmful tax practices more effectively (Action 5), and by assuring that transfer pricing outcomes are in line with value creation (Actions 8-10).
- In the context of VAT, under certain conditions opportunities for tax planning by businesses and corresponding BEPS concerns for governments may arise to the extent that the OECD's Guidelines on place of taxation for business-to-business (B2B) supplies of services and intangibles are not implemented.[70]

6.3 SPECIFIC ISSUES GENERATED BY THE KEY FEATURES OF THE DIGITAL ECONOMY THAT WARRANT ATTENTION FROM A TAX PERSPECTIVE INCLUDE:

(i) Ensuring that core activities cannot inappropriately benefit from the preparatory or auxiliary exception from permanent establishment (PE) status, and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status.

- The work on Action 7 (preventing the artificial avoidance of PE Status) should consider the circumstances under which activities may be considered core activities. For example:
- Determining whether the maintenance of a local warehouse may constitute a core activity;

69 OECD/20 BEPS Project on Action 1, 2014 Deliverable at 13-14.
70 OECD/20 BEPS Project on Action 1, 2014 Deliverable at 14.

- Determining whether and how the definition of PE may be modified to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company. For example where online seller of tangible products or an online provider of advertising services uses the sales force of a local subsidiary to negotiate and effectively conclude sales with prospective large clients. [71]

(ii) The importance of intangibles, the use of data, and the spread of global value chains, and their impact on transfer pricing:

- Companies in the digital economy rely heavily on intangibles in creating value and producing income.
- A key feature of many BEPS structures adopted by participants in the digital economy involves the transfer of intangibles or rights to intangibles to tax-advantaged locations. It is then often argued that these contractual allocations, together with legal ownership of intangibles, justify large allocations of income to the entity allocated the risk even if it performs little or no business activity.
- Often this is accomplished by arguing that other entities in the group are contractually insulated from risk so that a low-tax affiliate is entitled to all residual income after compensating other low risk group members for their functions even if this affiliate has no capacity to control the risk.
- BEPS work in the area of transfer pricing and the transfer pricing guidelines, should take into account and consider the relationship between that work and the heavy reliance on collection, analysis and monetisation of data that characterises many companies in the digital economy.
- The implications of the increased integration of MNEs and the spread of global value chains, in which various stages of production are spread across multiple countries has to be considered. In particular the work will evaluate the need for greater reliance on functional analyses (assets used, functions performed, and risks assumed) and on value chain analyses and should also address situations where comparables are not available because of the structures designed by taxpayers and the unique intangibles involved.
- In specific situations the functional analysis may show that the use of profit split methods or valuation techniques (e.g. discounted cash flow method) is appropriate. For these situations, it would be helpful to provide simpler and clearer guidance on the application of transfer pricing methods, including profit splits in the context of global value chains. [72]

(iii) The possible need to adapt CFC rules to the digital economy:

[71] OECD/20 BEPS Project on Action 1, 2014 Deliverable at 15.
[72] OECD/20 BEPS Project on Action 1, 2014 Deliverable at 15.

- Although CFC rules vary significantly from jurisdiction to jurisdiction, income from digital products and services provided remotely is frequently not subject to current taxation under CFC rules.
- Such income may be particularly mobile due to the importance of intangibles in the provision of such goods and services and the relatively few people required to carry out online sales activities.
- A multinational enterprise in a digital business can earn income in a CFC in a low-tax jurisdiction by locating key intangibles there and using those intangibles to sell digital goods and services without that income being subject to current tax, even if the CFC itself does not perform significant activities in its jurisdiction.
- In developing recommendations regarding the design of CFC rules, consideration should be given to CFC rules that target income earned in the digital economy, such as income earned from the remote sale of digital goods and services.[73]

(iv) Addressing opportunities for tax planning by businesses engaged in VAT-exempt activities

- The digital economy facilitates the ability of businesses to acquire a wide range of services and intangibles from suppliers in other jurisdictions.
- These developments have allowed exempt businesses to avoid or minimise the amount of unrecoverable VAT they incur on the inputs used for their exempt activities.
- The OECD recommends that the implementation of Guidelines 2 and 4 of the OECD's International VAT/GST Guidelines on place of taxation for B2B supplies of services and intangibles will minimise BEPS opportunities for supplies of remotely delivered services made to exempt businesses, including exempt entities that operate through establishments ("branches") in multiple jurisdictions.[74]

6.4 BROADER TAX POLICY CHALLENGES RAISED BY THE DIGITAL ECONOMY

(i) The tax policy challenges relate in particular to nexus, data, and characterisation for direct tax purposes.

- Often these challenges overlap with each other. For example, the collection of data from users located in a jurisdiction may trigger questions regarding whether that activity should give rise to nexus with that jurisdiction and regarding how data should be treated for tax purposes.
- Increasing reliance on data collection and analysis, and the growing importance of multi-sided business models raise questions about valuation of data, nexus, and profit attribution, as well as characterisation.

73 OECD/20 BEPS Project on Action 1, 2014 Deliverable at 16.
74 OECD/20 BEPS Project on Action 1, 2014 Deliverable at 15.

- The appropriate allocation of taxable income among locations in which economic activities take place and value is created may not always be clear in the digital economy. This is especially so in cases where users and customers are an important component of the value chain, for example in relation to multi-sided business models and the sharing economy.
- The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, whether remote collection of data should give rise to nexus for tax purposes, and of ownership and how to characterise for tax purposes a person or entity's supply of data in a transaction, for example, as a free supply of a good, as a barter transaction, or some other way.
- The development of new digital products or means of delivering services creates uncertainties regarding the proper characterisation of payments made. This is especially so for new business models, particularly in relation to for instance cloud computing as well as 3D printing which raises characterisation questions as direct manufacturing for delivery could effectively evolve into licensing of designs for remote printing directly by consumers.
- These challenges trigger questions about the ability of the current international tax framework to deal with the changes brought about by the digital economy and the business models that it makes possible in order to ensure that profits are taxed in the jurisdiction where economic activities occur and where value is generated. This impacts on the allocation of taxing rights among different jurisdictions as:
    - digital technologies reduced the need in many cases for extensive physical presence in order to carry on business in a jurisdiction
    - the increasing role of network effects generated by customer interactions, raise questions as to whether rules that rely on physical presence are still appropriate
- These challenges also raise questions regarding the paradigm used to determine where economic activities are carried out and value is generated for tax purposes, which is currently based on an analysis of the functions, assets and risks involved.
- These challenges also create opportunities for achieving double non-taxation, for example due to the lack of nexus in the market country under current rules coupled with lack of taxation in the jurisdiction of the income recipient and of that of the ultimate parent company.
- In the area of indirect taxes, the digital economy raises policy challenges regarding the collection of VAT. Cross-border trade in goods, services and intangibles creates challenges for VAT collection, particularly where such products are acquired by private consumers from suppliers abroad.

- This is partly due to the absence of an effective international framework to ensure VAT collection in the market jurisdiction.
- For economic actors, and in particular small and medium enterprises, the absence of an international standard for charging, collecting and remitting the tax to a potentially large number of tax authorities creates large revenue risks and high compliance costs.
- For governments, there is a risk of loss of revenue and trade distortion, and the challenge of managing tax liabilities generated by a high volume of low value transactions, which can create a significant administrative burden but marginal revenues.[75]

(ii) Potential options proposed by the Digital Economy Task force to address these challenges.

- o Options discussed regarding nexus and data range from: changes to the definition of PE; the introduction of a new nexus based on a "significant presence" in a market, and the introduction of a withholding tax on sales of digital goods and services.
- o Because of the overlap between the issues of nexus, data, and characterisation, the options to address each of them would inevitably affect the others. For purposes of evaluating potential options, the Task Force agreed on a framework based on the overarching tax principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, in light of the proportionality of the changes in relation to the tax challenges they are intended to address in the context of the existing international tax framework.[76]

(iv) Based on its discussion of these challenges and potential options to address them, the Task Force reached the following conclusions:

- o The collection of VAT in business-to-consumer (B2C) transactions is a pressing issue that needs to be addressed urgently to protect tax revenue and to level the playing field between foreign suppliers relative to domestic suppliers. Work in this area by the working Party No. 9 of the OECD CFA shall be completed by the end of 2015.
- o The work in the context of Action 7 of the BEPS Action Plan (preventing the artificial avoidance of PE Status) shall consider whether activities that once may have been preparatory or auxiliary should be denied the benefit of the exceptions to the permanent establishment definition because they are core components of the business, and whether a reasonable, administrable rule to this effect can be developed.
- o Working Party No. 1 of the CFA shall clarify the characterisation under current tax treaty rules of certain payments under new business models, especially cloud computing payments (including payments for infrastructure-

75 OECD/20 BEPS Project on Action 1, 2014 Deliverable at 17-18.
76 OECD/20 BEPS Project on Action 1, 2014 Deliverable at 8.

as-a-service, software-as-a-service, and platform-as-a-service transactions).[77]

6.5 THE STAGGERED TIME FRAME OF THE BEPS PROJECT AND INTERACTION AMONG THE VARIOUS BEPS OUTPUTS MAKE IT DIFFICULT TO ADDRESS THE BEPS CONCERNS IN THE DIGITAL ECONOMY. ACCORDINGLY, THE TASK FORCE WILL:

- Advance the work on nexus, data, multi-sided business models, characterisation and potential options to address the broader tax challenges of the digital economy to ensure that these options are viable and fair, avoid double taxation, and can be implemented without exacerbating costs of compliance and administration.
- Provide input to the work carried out in the other areas of the BEPS Project to ensure that it appropriately takes into account and addresses the key features of the digital economy that exacerbate BEPS concerns. This work relates in particular to the work on the Artificial Avoidance of PE, on Transfer Pricing and on CFC rules and it will be carried out together with the work on the economic incidence of corporate income tax and VAT. This work will be completed by December 2015. [78]

7 ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY IN SOUTH AFRICA

In South Africa, the 1997 Katz Commission Report[79] recognised the need to protect South Africa's tax base, noting that e-commerce impacts on the basic methods of today's international taxation, making irrelevant the concept of physical presence in order to trade.[80] The Katz Commission noted that the manner in which goods and services can be contracted for, advertised and even delivered via electronic means, can lead to the erosion of South Africa's tax base. The Commission recommended that South Africa should not seek to pioneer a whole new tax regime to cope with the changes brought about by e-commerce, but that it should internationalise its laws affecting international trade and investment.[81]

77 OECD/20 BEPS Project on Action 1, 2014 Deliverable at 19.
78 OECD/20 BEPS Project on Action 1, 2014 Deliverable at 20.
79 Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa *The Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1997) at 31 ("Katz Commission Report (1997").
80 Ibid.
81 Ibid.

In devising an e-commerce policy for South Africa, a green/white paper process was developed with the intention of coming up with legislation on e-commerce.[82] This culminated into the Green Paper on E-commerce released in 2000[83] which pointed out that the legal framework in South Africa was insufficient to deal with e-commerce issues. The legislation was tailored for paper-based commercial transactions, there was therefore a need to formulate a new legal framework that includes electronically concluded transactions to ensure that the e-commerce environment in South Africa is fair and equitable for all stakeholders. The Green Paper noted that since accurate identification of the party responsible for paying a particular tax should be a requirement of any taxation system,[84] attention should to be given to drafting a minimum standard of identification requirements of websites. This would require enterprises using a website to disclose information such as: the trading name of the business; the physical as well as the postal address of the business; an e-mail address; telephone number and the statutory registration number of the enterprise. The Green Paper noted that many tax administrations consider such information as the only means of identifying businesses engaged in e-commerce.[85] With respect to the development of efficient tax collection mechanisms, the Green Paper noted that most tax collection mechanisms usually make use of a leverage point. A common example is PAYE where employers collect the taxes on behalf of SARS from the taxpayers. However, e-commerce tends to eliminate the "middle man", so tax collection efficiency is reduced. To ensure efficient collection of taxes, the Green Paper suggested that a greater degree of international co-operation in revenue collection is required.[86] As a result of the green/white paper process that forged an e-commerce policy for South Africa,[87] in 2002, the Electronic Communications and Transactions Act[88] was enacted. This Act repealed the Computer Evidence Act of 1983.[89] The preamble to the Electronic Communications and Transactions Act[90] *inter alia* states that it was enacted to provide for the facilitation and regulation of electronic communications and transactions. This Act contains certain provisions which, if complied with and effectively enforced, may alleviate some of the identification problems posed by e-commerce.[91] On the whole, however, the Act does not provide for taxation issues in respect of e-commerce transactions.

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82 M Groenewald & D Lehlokoe "Towards an Electronic Commerce Policy for South Africa". Available at >http://www.isoc.org/inet99/proceedings/1g/1g_4.htm< last accessed on 1 October 2009.

83 Department of Communications' Green Paper on E-commerce *Making it your Business* (November 2000) at 10-14.

84 Ibid.

85 Ibid.

86 Ibid.

87 M Groenewald & D Lehlokoe "Towards an Electronic Commerce Policy for South Africa". Available at http://www.isoc.org/inet99/proceedings/1g/1g_4.htm accessed on 1 October 2013.

88 Act 25 of 2002.

89 57 of 1983.

90 Act 25 of 2002.

91 Sec 23 of Electronic Communications and Transactions Act requires a disclosure of the time and place of communication, dispatch, and receipt of information. Se 24 deals with the expression of intent between the originator and the addressee. Sec 25 deals with the attribution

In 2003, section 74(1) of the Income Tax Act (now repealed) was introduced in the Income Tax Act to allow for electronic record keeping.[92] Electronic recording keeping is now provided for in section 30(1)(b) of the Tax Administration Act. However, the Income Tax Act does not contain provisions that can be used to verify whether a particular electronic document or information is linked to a particular taxpayer. Thus electronic records can easily be altered without trace, or maybe encrypted, in order not to reveal transaction information.[93]

7.1 DIRECT TAX: TAXING INCOME DERIVED FROM E-COMMERCE - THE CURRENT POSITION IN SOUTH AFRICA

As present there is very limited scope for South African residents to shift profits to offshore tax haven jurisdictions via e-commerce transactions. The application of the CFC rules under section 9D of the Income Tax Act in conjunction with the transfer pricing rules under section 31 make it difficult to shift profits to an offshore company unless significant substance is transferred to such CFC and a substantial physical base is established offshore, which is not feasible for most e-commerce businesses. Furthermore, the application of the effective management test to determine the residence of a company makes it impossible to manage such an offshore company from South Africa without becoming subject to worldwide tax in South Africa. It may however be necessary to make adjustments to the foreign tax credit rules and the CFC rules to cater more specifically for e-commerce, especially if the international developments succeed in allocating more taxing rights to source countries.

However, the situation is quite different with respect to e-commerce transactions conducted by non-residents with South African customers. Non-residents are only subject to tax in South Africa on any income derived from a source in South Africa. Thus the definition of gross income in Income Tax Act that deals with South African sourced income of non-residents can be applied to tax non-residents involved in electronic transactions in South Africa. The source basis of taxation for non-residents should be read with the double taxation agreements entered into by South Africa in terms of section 231 of the Constitution and section 108(2) of the Income Tax Act. In accordance with the source provisions under section 9 of the Income Tax Act, it is usually required that the non-resident must conduct some activity or operate via a

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of data messages to the originator. Sec 38 provides for the authentication of the products or services of service providers using an electronic signature. Sec 27 and 30 deal with cryptography to ensure the authenticity, integrity and reliability of Internet data. Sec 42 and 43 requires the supplier of electronic goods and services to display information on the website where the goods are offered. Sec 80 and 81 deals with the appointment of cyber inspectors. Sec 85 and 86 deal with the penalties of cybercrime.

92 S 67 of the Revenue Laws Amendment Act 45 of 2003 amended s 74(1) of the Income tax Act to provide that a "document" includes any printout of information generated, sent, received, stored, displayed or processed by electronic means. And that "information" includes electronic representations of information in any form.

93 Oguttu & Van der Merwe at 321; see also RL Doernberg, L Hinnekens & W Herrerstein W & J Li *Electronic Commerce and Multi-Jurisdictional Taxation* (2001) at 390; R Buys & F Cronje *Cyber law: The Law of the Internet in South Africa* 2 ed (2004 at 308.

some degree of physical local presence before business profits could be regarded as derived from a source in South Africa and thus be subject to taxation. However, the source rules in section 9 do not cover rules that deal specifically with electronic transactions. This implies that reference has to be given to common law principles. The common law source rules rely on the principle of originating cause (which is essentially what the taxpayer does to earn the quid pro quo and its location). However the common law guidelines developed by the South African courts to determine whether or not the source of income may be located in South Africa do not also take into account the complexities of the digital economy. Therefore, currently there is no adequate legal basis for the expansion of the South African fiscal jurisdiction to allow for the taxation of income derived by a non-resident from e-commerce transactions with South African residents. Thus companies like Google can avoid tax in South Africa because the originating cause of their income is not in South Africa. In terms of the above discussed OECD Guidelines on e-commerce implications for PEs,[94] the originating cause would be where the server is located. Google does not have a location in South Africa, only ancillary transactions which do not qualify as a PE.

In a treaty context, under Articles 5 and 7 of the typical South African DTA (mostly based on the OECD Model DTA), a company resident in the other Contracting State is only subject to tax on its business profits derived from South Africa if it has a PE in South Africa. To determine whether there is an e-commerce PE in South Africa, one has to first refer to section 1 of the Income Tax Act, which states that the meaning of a PE for South African purposes is as defined from time to time in Article 5 of the OECD Model Tax Convention. Therefore, South Africa also has the same difficulties as outlined above relating to the restrictions which apply under the traditional definition of a PE, which does not cater adequately for the digital economy.

Recommendations on Direct Taxes for the Digital Economy in South Africa

Since the challenges that South Africa faces with respect to taxation of the digital economy are of an international nature, it is recommended that South Africa awaits the outcomes of OECD's on-going work on the PE threshold for the digital economy. South Africa should not attempt to come up with provisions such as "link taxes" that other European countries have attempted to come up with. Taking a unilateral approach to reworking the PE rules for e-commerce is unlikely to work. It is best to address the issue in a multilateral, coordinated manner.[95]

- The proposals by the OECD to change the definition of a PE in double tax treaties will help to address this matter. South Africa should work hand-in-hand with developed and developing nations, in order to come up with a

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[94] Paragraph 42.1 to 42.10 of the Commentary on article 5 of the OECD MTC.

[95] J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 october 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013

feasible way of taxing e-commerce transactions. It is also important for South African legislators to note that technology is continuously changing, developing and evolving. In adopting any e-commerce legislation, it is crucial to understand the technology and ensure that South Africa does not implement taxing provisions which are attached to a particular type of technology because by the time the provision is promulgated the technology in question may be obsolete and redundant.

- To enable South Africa to impose tax on non-resident suppliers of goods and services via e-commerce to South African customers, new source rules that deal with the taxation of the digital economy need to be enacted. The current scope of the source rules under section 9 of the Income Tax Act needs to be expanded to include rules that cover proceeds derived from the supply of digital goods and services derived from a source in South Africa. The new rules should be based on where consumption takes place. The rules could for instance provide that digital goods or services are sourced where the recipient is, which would be where the South African tax-resident; physically present in South Africa, is at time of supply. The rules should also aim to clarify the characterisation of the typical income flows from digital transactions. Enacting of such rules would create the basis from which South Africa can apply the OECD recommendations on the taxation of the digital economy.
- Care should however be taken to design of source rules on the digital economy only include an appropriate portion of the profits realised into the scope of the source provisions. It would not be appropriate to include the full proceeds realised from supplies to South African customers since the country of residence of the supplier of a service or the country where the goods are manufactured would also have a legitimate claim to tax a portion of the proceeds.
- Apart from the gap in the source rules, there are also administrative concerns. Currently non-residents are only required to submit tax returns for trade carried on through a South African PE. If SARS cannot assess whether a non-resident has a PE in South Africa, how will such non-residents be taxed? The lack of data in respect of inbound flows, as well as the lack of discernment between inbound and outbound flows, has resulted in little evidence indicating tax abuse as a result of the digital economy in South Africa. SARS doesn’t keep a separate register for inbound foreign companies. There is a need to isolate and focus on foreign multi-nationals and get them to submit tax returns.
- Rules should be enacted that require non-resident companies with South African sourced income (excluding certain passive income) to submit income tax returns even if they do not have a PE in South Africa. This would ensure that such non-residents are included in the tax system. To ensure that such non- residents register with SARS, a system should be created that imposes an obligation on a resident that transacts with a non-resident to withhold tax on any payment to a non-resident otherwise they would be penalised.

- South Africa's existing source rules need to be aligned to accounting mechanisms and should not rely too heavily on tax law to attempt to reconcile and determine tax liability. The use of a single IT14 return does not support the BEPS identification specifically with regard to separate disclosure of inbound investment flows. This information disclosure should be based on fact. There should, therefore, be variations of the IT14 return e.g. IT14F for inbound companies since a one-size-fits-all approach doesn't appear to be working. The IT14 also needs to be re-designed as it starts out with legal questions instead of factual (accounting) questions.
- Since most of the challenges that e-commerce poses to the legislation relate to difficulties of identifying the location of taxpayers and their business transaction, it is recommended that this Income Tax Act be amended to provide that the provisions of the Electronic Communications and Transactions Act be taken into account for detection and identification purposes, so as to ensure tax compliance for taxpayers involved in e-commerce. However the administrative and compliance costs with respect to enforcing and implementing taxing provisions must not outweigh the benefits received with respect to the taxation raised. The legislators should also be aware of implementing a system which, realistically, cannot be effectively enforced.
- From a policy perspective, it is also important to create a level playing field so that South African companies dealing with digital goods and services are able to compete with the likes of Google. This is what prompted the concerns of Kalahari's e-books complaints. It should be noted that it is not in the interest of countries like Germany or the USA to allow the expansion of the PE concept to grant source states a wider scope to tax profits of digital businesses, since this would simply reduce the profits of the German or USA digital companies which may be taxed in the home state as the residence state would be required to give foreign tax credits in respect of such source tax.[96] In view of the strong presence of such digital companies in the highly developed OECD countries, it may be very difficult to obtain international consensus which is required before such major amendments could be made to DTAs.

Regarding the tax administration challenges of the digital economy, it is worth noting that OECD Action Plan 1 acknowledges that the borderless nature of digital economy produces specific administrative issues around identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers.[97] In general, a remote supplier of goods or services via e-commerce to customers in the source country will not be required to register for tax purposes in the source country. This makes it very difficult to identify the seller or to ascertain the extent of the sales in the source country. To verify the local activities,

96 R Pinkernell "Internationale Steuergestaltung im Electronic Commerce" 494 (2014) *Institut Finanzen und Steuern, Schrift* at 168.

97 OECD 2014 Discussion Draft Report on Action Plan 1 at 61 – 62.

the tax authorities of the source country may need to seek information from non-residents who have no operations in the source country.[98] This raises potential conflict relating to the excessive expansion of the fiscal jurisdiction of the source country. The OECD Report on Action 1 observes that while exchange of information can be a very useful tool where the proper legal basis in place, this is predicated on knowledge of where the offshore entity is tax resident and information retained or accessible by the reciprocating tax authority.[99] The OECD Convention on Mutual Administrative Assistance in Tax Matters aims to improve the exchange of such information:

> "The amended Convention facilitates international co-operation for a better operation of national tax laws, while respecting the fundamental rights of taxpayers. The amended Convention provides for all possible forms of administrative co-operation between states in the assessment and collection of taxes, in particular with a view to combating tax avoidance and evasion. This co-operation ranges from exchange of information, including automatic exchanges, to the recovery of foreign tax claims."[100]

- South Africa recently signed the OECD Mutual Administrative Assistance in Tax Matters Convention which aims for information sharing among signatories in matters of tax.
- SARS should actively utilise the procedures established under the Convention and similar provisions under applicable DTAs to ensure the frequent and efficient exchange of information and assistance with the enforcement of tax collection.

7.2 INDIRECT TAXES AND THE DIGITAL ECONOMY

Given the difficulties under the existing PE rules for countries to assert direct income taxes on e-commerce, assessing indirect taxes on the transactions has proven much easier.[101] The argument is that when companies like Google scoop up local customer information and resell it to advertisers, the digital upload is a business-to-consumer transaction requiring no physical presence of the business (in terms of the permanent establishment principle). It doesn't matter what the business is selling - there is value creation wherever there is a customer base, regardless of data

98 Such as the USA Foreign Account Tax Compliance Act (FATCA) provisions which require foreign financial institutions, such as banks, to enter into an agreement with the IRS to identify their U.S. account holders and to disclose the account holders' names.

99 OECD 2014 Discussion Draft Report on Action Plan 1 at 62.

100 OECD "Convention on Mutual Administrative Assistance in Tax Matters" Available at http://www.oecd.org/tax/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm accessed 6 May 2014.

101 J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 october 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013

sharing. The presence of the immobile local consumer and the economic activity of the non-resident business should be the focus.[102]

In Spain for instance, a web presence, server and even inventory located in the country may not create a PE for income taxation. However, it is likely enough to find jurisdiction for VAT collection purposes.[103] In Canada the tax authorities are less concerned with PE and profit allocation than collecting customs duties and the goods and services tax (Canada's VAT analogue). The focus on a transaction tax, rather than a profit tax, in an e-commerce environment makes sense.[104] There is a case to be made that getting the VAT determinations correct "is more important than figuring out if a PE exists.[105]

7.2.1 OECD Recommendations on applying indirect taxes to the digital economy

At the 1999 Ottawa Ministerial Conference on Electronic Commerce,[106] leaders from governments (29 OECD member countries and 11 non-member countries), heads of major international organisations, industry leaders, and representatives of consumer, labour and social interests discussed plans to promote the development of global electronic commerce. The leaders welcomed the 1998 OECD's Report "Electronic Commerce: Taxation Framework Conditions",[107] and endorsed the set of taxation principles which should apply to electronic commerce.[108] In the field of consumption taxes, the core elements of the Taxation Framework Conditions can be summarised as follows:[109]

- Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction.
- For the purpose of consumption taxes, the supply of digitised products should not be treated as a supply of goods.

102 L Shepperd "What should the OECD do about Base Erosion?" Copenhagen precise of 2013 International Fiscal Association annual Congress" 9/9/2013.
103 J Arora & LE Shepherd "Adjusting Jurisdictional Concepts for E-commerce Tax Analyst 8 October 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+195-1?OpenDocument&Login accessed 29 October 2013
104 Ibid.
105 Ibid.
106 OECD "Forum Background: The Ottawa Conference" (October 1999). Available at http://www.oecd.org/sti/ieconomy/forumbackgroundtheottawaconference.htm accessed 5 May 2014.
107 OECD "Electronic Commerce: Taxation Framework Conditions" (1998). Available at http://www.biac.org/members/tax/BEPS/Ottawa_tax_Framework_923256.pdf accessed 5 May 2014.
108 OECD "Discussion Draft of "BEPS Action 1: Address The Challenges of The Digital Economy" (2014) in Annex 1.
109 OECD "Discussion Draft of "BEPS Action 1: Address The Challenges of The Digital Economy" (2014) in par 3.3 of the Annex 1.

- Where business and other organisations within a country acquire services and intangibles from suppliers outside the country, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers.

In 2003 the OECD Committee on Fiscal Affairs (CFA) released its E-commerce Guidelines. The CFA also released the Consumption Tax Guidance Series along with these Guidelines, consisting of three papers providing guidance on the implementation of the Guidelines in practice. These Guidelines and Guidance papers are summarised in the OECD Discussion Draft Report on Action Plan 1 as follows:

> "Destination based taxation of cross-border e-business was the governing principle of the E-commerce Guidelines. Under the destination principle, tax is ultimately levied only on the final consumption within the jurisdiction where such consumption is deemed to occur. Exports are not subject to tax with refund of input taxes (that is, "free of VAT" or "zero-rated"), and imports are taxed on the same basis and at the same rates as domestic supplies. The E-commerce Guidelines provide that:
>
> - For business-to-business transactions, the place of consumption for cross-border supplies of services and intangibles that are capable of delivery from a remote location made to a non-resident business recipient should be the jurisdiction in which the recipient has located its business presence. This was referred to as the "main criterion". The Guidelines indicated that countries may, in certain circumstances, use a different criterion to determine the actual place of consumption, where the application of the main criterion "would lead to a distortion of competition or avoidance of tax." This was referred to as the "override criterion".
> - For business-to-consumer transactions, the place of consumption for cross-border supplies of services and intangibles that are capable of delivery from a remote location made to a non-resident private recipient should be the jurisdiction in which the recipient has its usual residence."[110]

These OECD Guidelines essentially provide that consumption taxes (such as VAT) should be levied in the jurisdiction where consumption takes place. This principle was again confirmed in the International VAT/GST Guidelines released by the OECD Global Forum on VAT.[111]

The OECD notes that with increased cross-border transactions as a result of e-Commerce it is crucial that legislation is not adopted which will cause difficulties in imposing VAT on the supply or result in double taxation with another VAT jurisdiction. Despite the local objectives and the desire to protect the local tax base, e-commerce cannot be effectively taxed if principles are adopted which are in contradistinction with principles of a good tax system I.e. neutrality; efficiency; certainty and simplicity; effectiveness and fairness; and flexibility). The OECD recommends that countries adhere to the principles of a good tax system. Reference

110 OECD Discussion Draft Report on Action Plan 1 in para 242.
111 OECD "International VAT/GST Guidelines: Draft Consolidated Version" (February 2013) http://www.oecd.org/ctp/consumption/ConsolidatedGuidelines20130131.pdf accessed 6 May 2014.

is made to promoting the use of "shared basic principles", in developing VAT legislation for e-commerce in order to "prevent double taxation, involuntary non-taxation, tax evasion and distortion of competition".[112] The OECD International VAT/GST Guidelines, Draft Consolidated Version 2013 in particular supports and reiterates this concept of neutrality, noting that:

> "The concept of tax neutrality in VAT has a number of dimensions, including the absence of discrimination in a tax environment that is unbiased and impartial and the elimination of undue tax burdens and disproportionate or inappropriate compliance costs for businesses. Neutrality is one of the principles that help to ensure the collection of the right amount of revenue by governments."[113]

The OECD notes however that it may be appropriate for tax administrations to impose specific compliance requirements on different categories of business. This may apply, for example, to small enterprises and enterprises in specific sectors. It may also apply to foreign businesses. Indeed, dealing with foreign businesses with no "legal" presence in a jurisdiction inevitably brings an element of risk for tax administrations and they may need to take appropriate measures to protect against fraud or avoidance. Tax administrations should also seek to balance these appropriate measures with the need to prevent unjustified discrimination. In other words, specific rules applicable to foreign businesses should not result in a disguised form of discrimination. It is also important that such specific requirements are clear, consistent and accessible to foreign businesses.[114]

With respect to the principle of "efficiency" the OECD VAT guidelines require that compliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.

The VAT registration threshold is supported by the OECD and applied by several VAT jurisdictions. The OECD notes that "the threshold model is fairly well established internationally". Furthermore, "thresholds ensure that the compliance burden is eliminated where it would reduce or negate the incentive to carry on business activity". The OECD Working Party studied the advantages and disadvantages of registration thresholds for B2C (Business-to-Consumer) transactions on the basis of competitive equity between domestic and non-domestic suppliers, and the compliance burden imposed on private-sector stakeholders. It noted that thresholds can act to reduce the administrative burden, by permitting tax administrations to focus resources where the return is likely to be high."

[112] OECD Consumption Tax Trends, VAT / GST and Excise Rates, Trends and Administration Issues

[113] OECD "International VAT/GST Guidelines: Draft Consolidated Version" (February 2013) http://www.oecd.org/ctp/consumption/ConsolidatedGuidelines20130131.pdf accessed 6 May 2014.

[114] OECD *International VAT / GST Guidelines, Draft Consolidated Version, Invitation for Comments (February 2013)* pgs 15, 18. Available at www.**oecd**.org/tax/consumption/**ConsolidatedGuidelines**20130131.pdf *[Accessed 26 August 013]*

The OECD guidelines with respect to "'registration"' as a 'tax collection mechanisms provide that:

> "A registration system would oblige non-resident businesses to register in a jurisdiction and to charge, collect and remit the consumption tax to that country. From an administrative point of view, for the most part this option is feasible, effective and would promote neutrality. Difficulties arise in terms of identifying non-resident suppliers, as well as in imposing registration requirements and enforcing obligations on non-residents… registration would also impose significant compliance costs on non-resident suppliers, particularly for those making supplies in multiple jurisdictions with relatively few sales in each jurisdiction*…*

The Working Party studied the advantages and disadvantages of registration thresholds for B2C transactions on the basis of competitive equity between domestic and non-domestic suppliers, and the compliance burden imposed on private-sector stakeholders. It concluded that thresholds ensure that the compliance burden is eliminated where it would reduce or negate the incentive to carry on business activity. The principal disadvantage of registration thresholds, however, is the risk to neutrality/competitive equity between taxpayers below and above the threshold (although this is not a new problem for those revenue authorities that already operate a registration threshold for indirect taxation)

The OECD Working Party recognised that the threshold model is fairly well established internationally. It is likely that tax administrations will choose to take a similar approach to e-commerce. In light of this, the Working Party recommends that Member countries accept the principle that registration thresholds should apply in a non-discriminatory manner. The Taxation Framework Conditions recommend that revenue authorities should minimise compliance costs for taxpayers and administrative costs for revenue authorities as far as possible.[115]

7.2.2 International trends on indirect taxes and the digital economy

The European Union (EU)

The EU VAT Directive[116] provides a very clear list of items and supplies which constitute electronically supplied services. The EU VAT Directive, furthermore, makes a distinction between electronically supplied services and "telecommunications services". Supplies made by electronic means are categorised as either, the supply of services, supply of intangible personal property or supply of telecommunication services (depending on what is being supplied).

Even though the OECD recommends the harmonization of VAT systems, and often the EU VAT system is looked at as demonstration of how harmonisation can be

115 OECD *Taxation and Electronic Commerce, Implementing the Ottawa Taxation Framework Conditions* (2001) pgs 30 -31, 36.

116 Directive 2006/112/EC.

effectively applied, the EU has recently come up with a VAT Directive[117] that would not fit in the South African context and should not be followed. The previous EU VAT legislation required registration in the individual EU Member States subject to the registration requirements and thresholds applicable in each EU Member State. However the EU has amended its provisions relating to VAT administration and compliance in order to address administration and compliance of e-Commerce supplies by non-EU Member residents to EU residents as a whole and not on an individual EU Member State basis. In terms of the changes, a non-EU supplier will have to register for VAT in the EU with respect to e-commerce supplies made to EU Member residents, regardless of turnover, but will only have to register for VAT in one EU jurisdiction and account for all VAT imposed and collected for all supplies made to all EU Member States to the one EU Member State in which the non-EU supplier has registered. Thus, the administrative burden of requiring non-EU Member suppliers to register for VAT in multiple countries has been eliminated and the need to impose a VAT registration threshold to limit or reduce such administrative burden is no longer necessary. If the e-commerce supplies made to all EU Member states was examined as a whole, they would most likely be substantial thereby justifying the administrative burden of requiring registration.

South Africa differs from the EU in this regard and the administrative and compliance aspects of South Africa may be more closely associated with other non-EU VAT jurisdictions. South Africa should not follow the recent administrative changes made in the EU with respect to non-EU Member resident e-Commerce suppliers ("non-EU supplier") and the requirement to register for VAT in the EU regardless of turnover. South Africa should follow the OECD principle of neutrality and the OECD recommendations to apply a VAT registration threshold in such circumstances. To ensure VAT neutrality the VAT registration requirements which apply to South African e-commerce suppliers should also apply to non-resident e-commerce suppliers. The registration requirements which apply to local residents (the registration thresholds) should also apply to foreign e-commerce suppliers.

Canada

Like the EU, Canada has a definition of "telecommunication services" in its legislation; which is distinct from electronically supplied services. The term "telecommunication services" is defined as "the transmission of any information by means of a system for telecommunication or any part thereof and includes the making available of such a system or part for that use, whether or not it is so used."[118]

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117 **Directive 2013**/42/**EU** and **Directive 2013**/43/**EU.**

118 Canadian Revenue Authority "GST/HST Technical Information" Bulletin *GST / HST and Electronic Commerce* (July 2002) at 3

VAT registration is required in Canada if the non-resident supplier has a permanent establishment in Canada and is not a "small supplier"; or does not have a permanent establishment in Canada but make taxable supplies in Canada in the course of a business carried on in Canada (subject to requirements). [119] The registration requirement may be summarised as follows:

> "Every non-resident person, other than a small supplier, who is carrying on business in Canada and is making taxable supplies in Canada, including supplies made by electronic means, is required to register for GST/HST purposes and to charge GST/HST on its taxable (other than zero-rated) supplies made in Canada. As well, a non-resident person who has a permanent establishment in Canada (which could include a server) is treated as a resident of Canada, and is subject to the same GST/HST obligations as a domestic supplier in respect of activities carried on through that permanent establishment."[120] [Emphasis added].

A "Small supplier" is effectively any supplier, other than a public service body, that has taxable supplies of CA $30,000 or less (CA $50,000 for a public service body). Thus, Canada also supports a VAT registration threshold for non-resident suppliers of electronic commerce. [121]

New Zealand

Like in the EU and in Canada, New Zealand has a definition of "telecommunication services" in its legislation. Subject to exceptions, a non-New Zealand supplier of telecommunications services (subject to different place of supply rules) is required to register for VAT in New Zealand as such services are treated as being supplied in New Zealand where the value of such supplies exceeds NZ $40,000 in a 12 month period. Electronically supplied services, which constitute 'content of telecommunication services' and subject to the general place of supply rules, are generally subject to VAT in terms of the reverse charge mechanism, but only with respect to Business-to-Business supplies. However, the reverse charge mechanism may require the recipient to register for VAT in New Zealand where the supplies received exceed NZ $60,000 in a 12 month period. While New Zealand applies slightly different rules with respect to imposing and collecting VAT on such supplies (i.e. the administrative aspect is different to that of the EU), VAT registration thresholds are nevertheless applied regardless of who must register and account for VAT on such supplies.

7.2.4 Indirect Taxation and the digital economy in South Africa

The principal deficiency in modern VAT systems is their inability to levy VAT on affected transactions through a simplified collection mechanism that does not overburden taxable entities charged with VAT collection, or is not inefficient from an economic point of view. VAT systems operate based on tax policy, tax

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119 Ibid.
120 Ibid.
121 Ibid.

administration, and the law. If any of these are inadequate, difficult technical issues will not be manageable. As a result, VAT systems that do not specifically provide for, or which have not been adapted to cope with, technology-driven advances, generally do not provide for the adequate levying and collection of VAT on cross-border digital trade. The South African VAT system is no exception.

Most VAT systems, including that of South Africa, are based on the principle of consumption. Consequently, the person who consumes the goods and services is the person who ultimately carries the burden of paying the tax due on them. Although the South African VAT system levies VAT on production, it is still the final consumer who carries the burden of tax as intermediaries (wholesalers, distributors, and retailers) receive tax credits on the VAT paid on input. In other words, VAT is levied on goods and services that are utilised and consumed within the borders of the Republic, irrespective of the taxpayer's residence status.

If VAT is not appropriately levied and recovered at each level of the production chain, it will no longer be a consumption tax.[122] Breaks in the tax chain can lead to the failure to collect VAT by revenue authorities. Breaks in the tax chain can also lead to the failure to recover VAT paid by intermediaries, which would ultimately lead to double taxation.[123] The following should *inter alia* be considered to determine the VAT treatment of online cross-border transactions:

- Is there a supply of goods or services?
- Where is the place of supply?
- Is it made in the course or furtherance of an enterprise? In other words, should B2B (business-to-business) transactions be treated differently from B2C (business-to-consumer) transactions?
- How is VAT on the transaction collected?

Is there a Supply of goods or services?

In line with the OECD guidelines,[124] Treasury has resolved that digital goods should be treated as services for VAT purposes. To echo this view, section165(*d*) of the Taxation Laws Amendment Act 31 of 2013 introduced the definition of "electronic service" which is defined as:

> "Those electronic services prescribed by the Minister by regulation in terms of this Act"

The Electronic Services Regulations,[125] which came into effect 1 June 2014, contain a list of definitions of different types of digital goods that are capable of being transferred/supplied over the internet. This list of electronic services is similar to the

122 Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 18.
123 Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 18; Cnossen S (1996) "VAT Treatment of Immovable Property" in Thuronyi (ed) (1996) *Tax Law Design and Drafting* vol 1 at 231-232.
124 OECD (2006) International VAT/GST Guidelines http://www.oecd.org/ctp/36177871.pdf
125 http://www.treasury.gov.za/public%20comments/E-services%20Regulation.pdf.

list of “electronically supplied services” in terms of Annexure 1 to the Council Regulation of 17 October 2005 in the EU. Further changes to the South African rules are proposed in the Taxation Laws Amendment Bill (TLAB) 2014, which is expected to come into effect 01 April 2015.

As is the position in the EU, there is uncertainty with the scope of the services listed in the Electronic Services Regulations. For example, it is not clear what is meant by ‘subscription service’. Where the ordinary dictionary meaning is applied, it could be construed to mean that payment must be made to access a certain service. Where, for example, a subscription fee is paid to enable the user to carry out transactions on a website, the service is subject to VAT. However, where no such subscription fee is payable but a service is fee is charged on individual transactions carried out on the website, the transaction would escape VAT. Similarly, the meaning of “web application”, “web series”, “webcast”, and “webinar” under item 9 of the Regulations is uncertain. Should the ordinary dictionary meaning be applied? Furthermore, certain supplies of electronic services, for example computer software, are excluded from the Regulations despite the fact that the services are capable of being utilised and consumed by consumers other than VAT vendors. It is uncertain whether, if at all, computer software, cell phone software, or applications fall under “information system services” of item 5 of the Regulations or “software” under item 8(*e*) of the Regulations. The Regulations also do not provide for the supply of online advertising. It is uncertain whether, if at all, online advertising could resort under “images”, “film”, “music”, or a combination thereof under item 8(*e*) of the Regulations.

Although the VAT Act does not provide for variable VAT rates for the supply of different types of services, the place of supply of services and electronic services differ (see below). As a result, uncertainty exists as to the treatment of services that are capable of being delivered electronically but that are not specifically provided for in the Regulations. For example, there is no clear distinction between telecommunication services and electronic services. Some overlap is possible. Such a clear distinction between electronic services and telecommunication services, each with its own place-of-supply rules can be found in modern VAT systems such as Canada and New Zealand as well as established VAT systems in the EU.

- There are generally no place of supply rules in South Africa. Suppliers providing services to SA consumers are subject to the registration threshold. This has been extended to include services supplied electronically.
- It is recommended that “telecommunication services” should be specifically defined, and clear and specific place-of-supply rules for telecommunication services should be incorporated in the Act. These provisions should be in line with the OECD principles on the harmonisation of global VAT/GST rules.

The EU guidelines, despite their extensive nature, are already obsolete in certain cases, and cannot be applied to correctly classify the type of service rendered.[126] As a result of the dynamic evolution of the Internet and e-commerce, many transactions that should in principle be taxed, escape the application of VAT as a direct consequence of the unsatisfactory list of electronically supplied services. It has been suggested that further guidance in the form of definitions and classifications, is required on a regular basis to guarantee clarity and certainty.[127] Whether this approach is desirable may be questioned given the fast pace at which e-commerce and technology evolve.[128] A less than definitive list in itself allows for alternative interpretation once e-commerce evolves beyond the scope it offers.[129] Greater certainty is not achieved through extensive legislation, but rather through explanatory guidelines.[130] These guidelines are not subject to the long and complex legislative process and can be amended with greater ease.

- While the list of services in the Regulations does not provide for adequate definitions, which causes some confusion, the definitions in the Regulations, as they stand, may not necessarily require further amendments. However, further guidelines providing clarification should accompany the Regulations. These guidelines should be updated regularly to ensure that new technology cannot escape the VAT fold.
- It remains uncertain if the list of electronic services in the Regulations can be interpreted so as to include the supply of online advertising. It is recommended that the guidelines referred to above should clarify this issue.

Where is the place of supply?

The VAT Act does not provide for specific place-of-supply rules. Where these rules have been incorporated in the Act, this has been couched in vague general terms not designed to meet the requirements of an electronic era. The definition of "enterprise", and the provisions in section 7(1) of the VAT Act, should be read in conjunction to determine the place of supply. It can generally be accepted that the place of supply is the place where the goods or services are utilised and consumed in the Republic. The reliance on the "utilised and consumed in the Republic" principle

126 Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 71.

127 Fridensköld E (2004) "VAT and the Internet: The Application of Consumption Taxes to E-commerce Transactions" *Information & Communications Technology Law* vol 13 no 2 at 184-185.

128 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 142.

129 Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 76.

130 Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 76; also see Value Added Tax Committee, EC, VAT Information Sheet 04/03, *Electronically Supplied Services: A Guide to Interpretation* http://webarchive.nationalarchives.gov.uk/20120128212010/http:/customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_CL_000907.

adds to confusion in determining the place of supply or consumption. This is particularly evident where intangible products or services have been physically delivered (downloaded) outside of the Republic, but where the benefit of the service or product is experienced in the Republic.

Instead of providing for specific place-of-supply rules in the case of electronically supplied services, Treasury, in the Taxation Laws Amendment Act 31 of 2013, attempted to achieve the incorporation of deemed place-of-supply rules by the insertion of the definition of “electronic services” and the amendment of the definition of “enterprise”. Although the place-of-supply proxies in the case of electronic services are not clearly set out in the amendments, it can be deduced with a certain amount of certainty by the reading together of the definition of “electronic services” and the definition of “enterprise.”

Based on these definitions, a foreign supplier of e-commerce services to a recipient that is resident to South Africa, or where payment originates from a bank registered in South Africa, must register as VAT vendor under the VAT Act. However, this would only be the case where the taxable supplies, that is the supply of electronic services to South African residents, exceeds the annual threshold of R50 000. In other words, the place of supply proxy is the Republic where-

- the recipient resides in South Africa; or
- payment was made from a South African Bank account.

This place-of-supply proxy is in line with the provisions in the Council Directive 2008/8/EC in the EU and the OECD *VAT/GST Guidelines*. It should be noted that the reverse-charge mechanism will remain as backstop to the new foreign VAT registration rules. However, it remains uncertain if the use and enjoyment principle will remain as backstop for the place-of-supply proxies in the case of electronic services. The OECD recommends that the use and enjoyment principle may be applied in cases where the special place-of-supply rules (applicable to electronically supplied services) lead to double or non-taxation, or market distortions. In other words, the use and enjoyment principle should only be applied in exceptional circumstances. A provision to this effect will come into operation in the EU on 1 January 2015.[131]

- ➢ While the reverse-charge mechanism applies as a backstop to the registration mechanism, it remains uncertain under what circumstances the reverse-charge mechanism will apply. It further remains uncertain under what circumstances the use-and-enjoyment principle will take precedence over the place-of-supply proxies in the case of the supply of electronic services. It is recommended that clarity should to given on whether the use-and enjoyment principle should apply as a backstop where the place-supply-proxies lead to double or non-taxation, or market distortions. It is recommended that the VAT

[131] Article 59a of Council Directive 2008/8/EC

Act be amended in line with the OECD proposals and Article 59a Council Directive 2008/8/EC.

As a result of the new place-of-supply rules, additional duties are imposed on foreign suppliers that supply electronic services to consumers who reside in South Africa or consumers who pay for these services from a South African bank account. These duties *inter alia* entail that the foreign supplier must identify and locate the consumer, register for VAT in South Africa, levy VAT on the transaction and remit VAT to SARS, and comply with the duties associated with VAT vendor registration status. These issues are discussed below.

Is the supply made in the course or furtherance of an enterprise?

The OECD recommends that B2B and B2C transactions should be treated differently. In terms of the OECD's principal rule, once the supplier has identified the customer as a business entity and has located the place of the customer's establishment in a foreign jurisdiction, the supplier is relieved from the VAT burden on the transaction.[132] The transaction will be taxed in the customer's country of jurisdiction in terms of the reverse-charge mechanism.[133] Put simply, the tax burden is shifted to the business customer who is deemed to be the taxable entity.[134]

The OECD recommends that the burden of VAT should not lie on taxable businesses unless specifically provided for in legislation.[135] In other words, the business, as taxable entity, should be able to recover the taxes from its customers when it makes subsequent supplies for final home consumption. Where the business customer would be entitled to recover output VAT for which it must account on imports in terms of the reverse-charge mechanism, the OECD recommends that jurisdictions should consider dispensing with the self-assessment method.[136] Simply put, where the business customer applies the imported intangibles in the course and furtherance of an enterprise (in the making of taxable supplies), it should not be required to account for output VAT upon import, and simultaneously recover VAT as inputs. The supplier will only account for output VAT when it makes further taxable supplies to consumers (from whom VAT will be collected) or where the supplies acquired are not applied to make further taxable supplies. This position is also followed by the majority of the EU member states. The South African position is in line with the OECD proposal. In the case of imported services in terms of the use-and-consumption principle, the recipient vendor of imported services has to account

132 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf.

133 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf.

134 OECD (2010) OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location at 8 http://www.oecd.org/ctp/consumptiontax/44559751.pdf.

135 OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 4 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf.

136 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf.

only for VAT on the imported services that are not applied by it in the course and furtherance of an enterprise. However, some of the items listed in the Regulations are generally utilised by businesses in the making of taxable supplies. As a result, confusion arises as to whether the duty to levy VAT on B2B transactions for the services so listed would be shifted to the business recipient resident in South Africa when that business makes further taxable supplies.

- The differentiation between B2B and B2C transactions are, in principle, in line with the OECD recommendations. However, the existing rules do not make a clear distinction between B2B and B2C transactions. Clearer rules should be developed to distinguish between B2B and B2C transactions more effectively.
- NT is of the view that not having the distinction actually broadens the SA VAT net since the onus is now on the supplier to levy VAT. B2C transactions will lead to no input tax claim if the recipient is not registered for VAT. B2B transactions are subject to the normal input tax provisions of the VAT Act.
- South African VAT legislation generally only deals with who the supplier is and what the supply is. The VAT implications usually flow from that rather than from who the recipient is (i.e. business or consumer)

It should, however, be noted that while this method reduces the risk of businesses carrying the burden of VAT, the reliance on the taxpayer's interpretation of what constitutes "in the furtherance of an enterprise" could increase the risk of VAT fraud or under-taxation. This was illustrated in *CSARS v De Beers Consolidated Mines Ltd*[137] and *Metropolitan Life Ltd v CSARS.*[138] In both these cases the taxpayer imported services and failed to account for VAT in terms of the reverse-charge mechanism because it believed the services to be utilised in the making of taxable supplies. During an audit it was revealed that the services so imported were not utilised in the making of taxable supplies, but that it was utilised for purposes ancillary to the main business of the taxpayer. The self-assessment mechanism, therefore, relies on the integrity of the taxable entity to account for output VAT on the import of intangibles in so far as they are acquired to make exempt supplies or for final consumption. It would generally be difficult for revenue authorities to verify the accuracy of the taxpayer's self-assessed tax return in the absence of practical evidence reflecting the actual use of the intangibles. To eliminate VAT fraud, the European Commission proposed that in the case of cross-border trade, the reverse-charge mechanism as currently applied in the Netherlands, should find general application. Under this system, the recipient vendor of imported services must account for VAT on the supplies, irrespective of whether or not the supplies are applied in the furtherance of the enterprise. The supplier will immediately be entitled to an input VAT deduction. Under this model, the administrative burden on taxpayers to account for VAT and claim an input VAT deduction on imports is no different from the administrative burden of reporting domestic transactions.[139]

137 (503/2011) [2012] ZASCA 103 (1 June 2012)
138 2009 (3) SA 484 (C).
139 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 166.

- In the case of B2B transactions, the recipient vendor can only account for VAT on the imported electronic services in so far as the services are not used in the making of taxable supplies (in other words, when the recipient vendor is the final consumer). This relies heavily on the vendor's interpretation of what constitutes "in the making of taxable supplies". It is recommended that, in the case of B2B transactions, the recipient vendor must, in terms of the reverse-charge mechanism account for VAT on all imported services irrespective of it being applied in the making of taxable supplies. The recipient vendor should claim an input VAT deduction in cases where such a deduction is allowed.
- It is however acknowledged that the new changes (TLAB 2014) to the VAT Act that require the foreign supplier to register for VAT in SA eliminates this problem to a large extent. The supplier levies VAT on the supply and the recipient is subject to the normal input tax provisions of the VAT Act.

It should further be noted that the differentiation between B2C and B2B transactions create an additional administrative burden on foreign suppliers. The foreign supplier burdened with the duty to register, collect, and remit South African VAT on affected transactions must verify the VAT vendor status of the customer. This is virtually impossible. Verifying the customer's identity and VAT registration status requires costly technology which is not widely accessible and which most suppliers simply cannot afford to implement. In the EU, where the supplier cannot verify the VAT registration number because it has not been correctly supplied, or not supplied at all, and no other reasonable proof exists indicating the VAT registration status of the customer, the supplier may assume that the customer is a non-taxable person.[140] When the customer is established outside of the EU, the supplier may treat the customer as a business entity or VAT vendor if:

a) the customer has issued the supplier with a certificate issued by the tax authority in the country where the customer is established, in terms of which it can be deduced that the customer is entitled to obtain a VAT refund;[141]
b) the customer has provided any number that would identify it as a business for tax purposes, or any other proof evidencing its taxable status.[142]

- Foreign suppliers of electronic services are burdened with the task of identifying the recipient's VAT vendor status. No guidelines exist and foreign suppliers of electronic services run the risk of penalties being imposed on unintended non-taxation. It is recommended that guidelines similar to the EU guidelines must be drafted. However, provision must be made that where the foreign supplier is unable to determine the VAT status of the recipient, the

140 Article 18(2) of Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF.
141 Article 18(3)a) of Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF.
142 Article 18(3)b) of Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF.

supplier may deem the recipient a non-vendor. Furthermore, where the foreign supplier has followed the guidelines, no penalty should be imposed where the supplier incorrectly identified the recipient's VAT status.

VAT collection mechanisms

The OECD recognises four essential VAT collection mechanisms: registration; collection through a reverse-charge mechanism; taxing at source and remittance; and collection by collecting agents.[143] Since registration and the reverse-charge mechanism are commonly applied in most jurisdictions, the OECD suggests that, as an *interim* approach, it should be adapted (where required) and applied as the collection mechanism of choice in the case of cross-border trade in intangibles.[144] Despite the rise of modern technology that can be applied to develop collection mechanisms, OECD member countries are of the opinion that the traditional collection mechanisms remain the most effective.[145]

As the lack in the current VAT rules to levy and collect VAT on imported digital goods adequately negatively affects domestic suppliers of digital products, the new registration rules for foreign suppliers of electronic services is aimed, not only at raising revenue, but also to protect the domestic market. However, it remains uncertain whether registration as a VAT collection mechanism would serve this purpose without overburdening taxable entities charged with VAT collection, or is not inefficient from an economic point of view. The administrative and cost burden to suppliers could be significant. In many cases, the cost of compliance in the case of nominal value supplies, would outweigh the benefit of international establishment. The OECD recommends that where registration of non-resident vendors is required, the burden on these vendors should be minimised. Discrimination created by specific rules applicable to foreign vendors should therefore not be disguised as compliance with these specific rules. This can be achieved by developing a simplified registration regime for foreign vendors which includes electronic registration and declaration procedures.

Thresholds

The effectiveness of a registration system is greatly affected by the design and application of a threshold system. The OECD recommends that, to further minimise the burden on small and micro businesses, thresholds that apply to resident vendors should be applied equally to non-resident suppliers.[146] In other words, the simplified registration dispensation should not create alternative registration thresholds for non-resident suppliers. This is not the case under the new rules. Domestic suppliers must

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143 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012]; OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 5 http://www.oecd.org/tax/consumptiontax/1923240.pdf.

144 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 217.

145 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf.

146 OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf.

register for VAT when their taxable supplies exceeds or is likely to exceed R1 million. However, foreign suppliers of electronic services must register as VAT vendors when their supply of electronic services “imported” to South Africa exceeds R50 000. This differentiation is justified by SARS in that is aimed at levelling the playing field between domestic and foreign suppliers of electronic services.

- The differentiation in thresholds that apply to domestic vendors and foreign suppliers of electronic services raises concerns. Although the differentiation can be justified in that it is aimed at the protection of domestic markets, further research is necessary to determine whether the differentiation, in fact, balances out the assumed market distortions. In the interim, it is recommended that the VAT registration threshold for foreign suppliers of electronic services should be reconsidered to give effect to tax neutrality.

Simplified registration process

The OECD recommends that the simplified registration regime for the cross-border supply of intangibles should not require the supplier to have a physical presence or fixed establishment in the country of supply.[147] Applicants should be allowed to complete an online registration application form that is accessible from the revenue authority’s home page.[148] The application form should further be available in the official language of the applicable country’s major trading partners.[149] In addition, the form should be standardised and the information requested should be limited to:

i) the registered name of the business and trading name;
ii) name and contact details of the person responsible for tax administration;
iii) postal/registered address of the business and name of contact person;
iv) telephone number of contact person;
v) electronic address of contact person;
vi) website URL of business;
vii) the national tax number in the jurisdiction of establishment.[150]

Confirmation of receipt of the application, and the final registration number should be communicated to the supplier by electronic means.[151]

The South African VAT registration system does not provide for a simplified registration process for suppliers of cross-border intangibles. Vendors must, amongst other requirements, have a fixed establishment with a physical presence in the Republic. The current vendor registration regime is inconsistent with the simplified registration proposal. It is trite that the strict VAT registration regime in

147 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf .

148 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

149 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

150 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

151 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

South Africa serves as a tax administration tool to combat VAT fraud and false VAT registrations. However, certain concessions were made in respect of foreign suppliers of electronic services. In terms of the *VAT Registration Guide for Foreign Suppliers of Electronic Services,*[152] the following concessions were made:

- The foreign supplier of electronic services is not required to have a physical presence in the Republic.
- The foreign supplier of electronic services is not required to have a South African ban account.
- The foreign supplier of electronic services is not required to appoint a representative vendor.
- The foreign supplier of electronic services will be registered on the payment basis
- Registration can be completed online.

➢ The concessions made by SARS to streamline the VAT registration of foreign suppliers of electronic services is in line with the OECD guidelines as well as similar provisions in the EU that will come into operation on 1 January 2015. The registration process should be closely monitored and reviewed on a regular basis to ensure that the process remains compliant with the OECD simple registration guidelines.

Assessment / invoicing

In addition to a simplified registration process, a simplified electronic self-assessment procedure should be available to non-resident suppliers of cross-border intangibles.[153] The OECD recommends that a standardised international declaration form and process should be developed for vendors who are registered under the simplified registration regime.[154] The VAT/GST declaration form should strike a balance between the need for simplicity, and the need for tax authorities to verify whether the tax obligations have been fulfilled.[155] The OECD suggests that further guidance should be given on the frequency of tax returns.[156] It is arguable whether the concession to register foreign suppliers of electronic services on the payment basis provides for a simplified assessment procedure. While the VAT201 form can

152 SARS (2014) *VAT Registration Guide for Foreign Suppliers of Electronic Services* http://www.sars.gov.za/AllDocs/OpsDocs/Guides/VAT-REG-01-G02%20-%20VAT%20Registration%20Guide%20for%20Foreign%20Suppliers%20of%20Electronic%20Services%20-%20External%20Guide.pdf

153 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf .

154 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

155 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

156 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

be submitted electronically on the e-file system, the difficulty and administrative burden associated therewith is not diminished.

- With regards to foreign suppliers, SARS has issued Guidelines for completing the VAT 201. SARS reports that to date 96 foreign taxpayers have registered with SARS. VAT returns are being submitted monthly and that the compliance rate of submitted returns is approximately 87%. To encourage increases registrations and to increase the rate of compliance, it is recommended that measures should be taken to lessen the administrative burdens of completing VAT 201. As foreign suppliers of electronic services are not eligible for a VAT refund, it is recommended that an abridged VAT 201 should be developed specifically for foreign suppliers of electronic services.

The frequency of the filing of returns and the actual transfer of VAT from a foreign bank account to SARS's South African Bank account will be frustrating and counterproductive. If the non-resident supplier operates from a jurisdiction that applies strict exchange control measures, the transfer of funds could result in a long process. This could further result in late payments and additional penalties or interest being levied on the late payment.

A non-resident supplier of electronic services will face various compliance challenges, *inter alia*, costly once-off changes in its invoicing system is required to ensure that invoices reflect a) the term 'tax invoice'; b) the name, address and VAT registration number of the supplier; c) an individual serialized number and date on which the invoice is issued; d) a description of the services supplied; and e) the consideration of the supply and the amount of VAT expressed as 14 per cent of the value of the supply.

- The foreign supplier of electronic services is required to issue an invoice compliant with the invoice requirements in the VAT Act. Although this SA requirement is in line with the EU VAT Directive, this requirement would require other non-EU suppliers to change their invoicing system. The requirement to issue an invoice, based on the requirements of an invoice in terms of the VAT Act, should be re-considered.
- The foreign supplier of electronic services is required to display prices in South African Rand and the price so displayed must include VAT at 14 per cent. This would require the supplier to change its accounting and invoicing system. It is recommended that the requirement to display prices in South African Rand inclusive of VAT should be reconsidered.
- Clause 103 of the TLAB 2014 and the Explanatory memorandum is addressing this matter.

Record keeping

The OECD proposes that an international standard for record keeping in the case of cross-border traders should be developed.[157] In developing record keeping guidelines that can ensure reliable and verifiable records that can be trusted to contain a full and accurate account of the electronic transaction concerned, cognisance should be taken of existing acceptable business practices.[158] In terms of the OECD guidelines, record keeping in jurisdictions other than the jurisdiction in which the documents are created, should not pose an adverse risk to tax authorities if a standardised record keeping format (as is required in the jurisdiction of establishment) is maintained and can be guaranteed.[159] Record keeping in a place other than the Republic of South Africa is, generally, prohibited unless strict requirements are adhered to. In contrast, the EU Directive allows for record keeping in the cloud, provided that online access can be guaranteed.

Another impractical administrative concern relates to VAT branch registration and the requirement to maintain a separate independent accounting system. To expect foreign suppliers of electronic services to maintain a separate independent accounting system with respect to supplies falling within the South African VAT net, so as to ensure that supplies occurring outside of South Africa do not fall within the South Africa VAT net, is not practical. This is an extreme burdensome requirement.

- ➢ It is recommended that legislation around VAT branch registration and the requirement to maintain a separate independent accounting system should be revised. Foreign suppliers of electronic services should be entitled to register a VAT branch but should not be required to maintain a separate independent accounting system. A proviso should be added to this requirement to apply to foreign suppliers of electronic services, whereby, instead of maintaining an independent accounting system, the foreign supplier or electronic services should merely be required to produce financial accounts which reflect the supplies made to residents in South Africa or where payment was made from a South African bank account.

Enforceability of compliance / administrative burden

Enforceability of registration remains the chief challenge. In the absence of definitive rules and international cooperation, tax collection from non-compliant offshore suppliers would be difficult to enforce. In addition, transparency in cases where registration can be enforced would be difficult to achieve. For example, does SARS have extra-territorial powers to conduct audits on non-resident suppliers to ensure

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157 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 14 http://www.oecd.org/ctp/consumptiontax/17851117.pdf.

158 OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 14 http://www.oecd.org/ctp/consumptiontax/17851117.pdf; OECD *Record Keeping Guidance* at 17 http://www.oecd.org/tax/taxadministration/31663114.pdf.

159 OECD *Record Keeping Guidance* at 14 http://www.oecd.org/tax/taxadministration/31663114.pdf.

the accuracy of tax returns? Furthermore, is SARS able to enforce penalties, interest, or other punitive measures against non-compliance in foreign jurisdictions?

- In the absence of international cooperation, the collection of VAT and enforcing the registration mechanism would be impossible. The negotiation of multilateral treaties, as opposed to bilateral treaties, must be undertaken to ensure greater international and regional cooperation.

Determining the place of supply

The levying and collection of VAT by non-resident suppliers of electronic supplies under both a proxy system and a system based on the "utilised and consumed" principle presupposes that the supplier can identify the customer's location. Place-of-supply proxies are founded on the premise that the supplier is able to determine the place where the consumer is established, or has a fixed address, or resides. In the case of tangible goods, the address of delivery is fairly indicative of the place of consumption. In the absence of guidelines, determining the place of supply/consumption for digital deliveries is cumbersome. Various methods of locating the customer's place of residence can be applied:

i) **Customer self-declaration:** This relies on the integrity of the customer. Taxpayers are known to manipulate information to best suit their taxing needs.

ii) **Billing information as supplied by the customer:** As the services are capable of electronic delivery, the customer can submit false billing information to escape VAT.

iii) **Tracking/Geo-location software:** This software is expensive and can be circumvented by anonymising software. Furthermore, accuracy levels are low.

iv) **IP address of the device on which the purchases are made:** Multiple devices can share the same IP address. The IP address can be hidden by use of anonymising software.

v) **Tracing the payment path:** Due to privacy protocol, financial institutions no longer reveal customer information to suppliers. Furthermore, credit card numbers can no longer be used to verify the country of issue with accuracy.

vi) **Digital certificates:** Very few countries issue taxpayers with individual digital tax certificates.

It would generally be onerous, if not impossible, to determine the actual place of consumption for tax purposes in the absence of a close relationship between the supplier and the non-taxable customer. Verification tests should not irritate customers, or significantly slow down the transaction process.

- The OECD recommends that the registration model should be applied as an interim measure to balance-out market distortions. In contrast, SARS is of the view that the registration model is the final/optimum solution. It is recommended that the registration model should be applied as an interim measure aimed at balancing out existing market distortions. Alternative VAT collection models should be explored.

Alternative VAT collection models[160]

Existing VAT collection mechanisms are in dire need of modernisation, in that they are inefficient and increasingly burdensome on revenue authorities and suppliers.[161] Some observers have proposed the use of financial institutions as VAT collectors and using technology to facilitate their task. The OECD conclusion that VAT collection by financial institutions is not a viable option is based on resistance and objections from financial institutions coupled with the general international perception of the banker-customer relationship in respect of customer privacy prevailing when the proposal was considered.[162] Recent technological advances and a shift in VAT collection trends at local level, warrant further research on the viability of VAT collection by financial institutions in the case of cross-border digital trade.

The basis of this model is to collect VAT on each transaction at the point at which it is traded through an electronic payment system – for example, a credit card system - based on the location of the customer and the VAT rules applicable in that jurisdiction. In other words, the customer is immediately assessed when the transaction is entered into, and the VAT payable is transferred to the relevant revenue authority without delay. This is typically achieved when the supplier submits the customer’s credit card or other payment details to the customer’s bank or credit card company, which then identifies and locates the customer’s place of residence or establishment. Details of the transaction, i.e. the purchase price and type of supply, are transmitted to the financial institution to enable it to correctly assess the transaction based on the VAT rules applicable in the customer’s jurisdiction where he resides, is established, or has a permanent address. The amount payable by the customer is the final amount inclusive of VAT. A split-payment system separates the payment in two: the purchase price is transferred into the supplier’s bank account; while VAT is transferred to the relevant revenue authority. This can be seen in the schematic explanation below adopted from Van Zyl’s doctoral thesis.[163]

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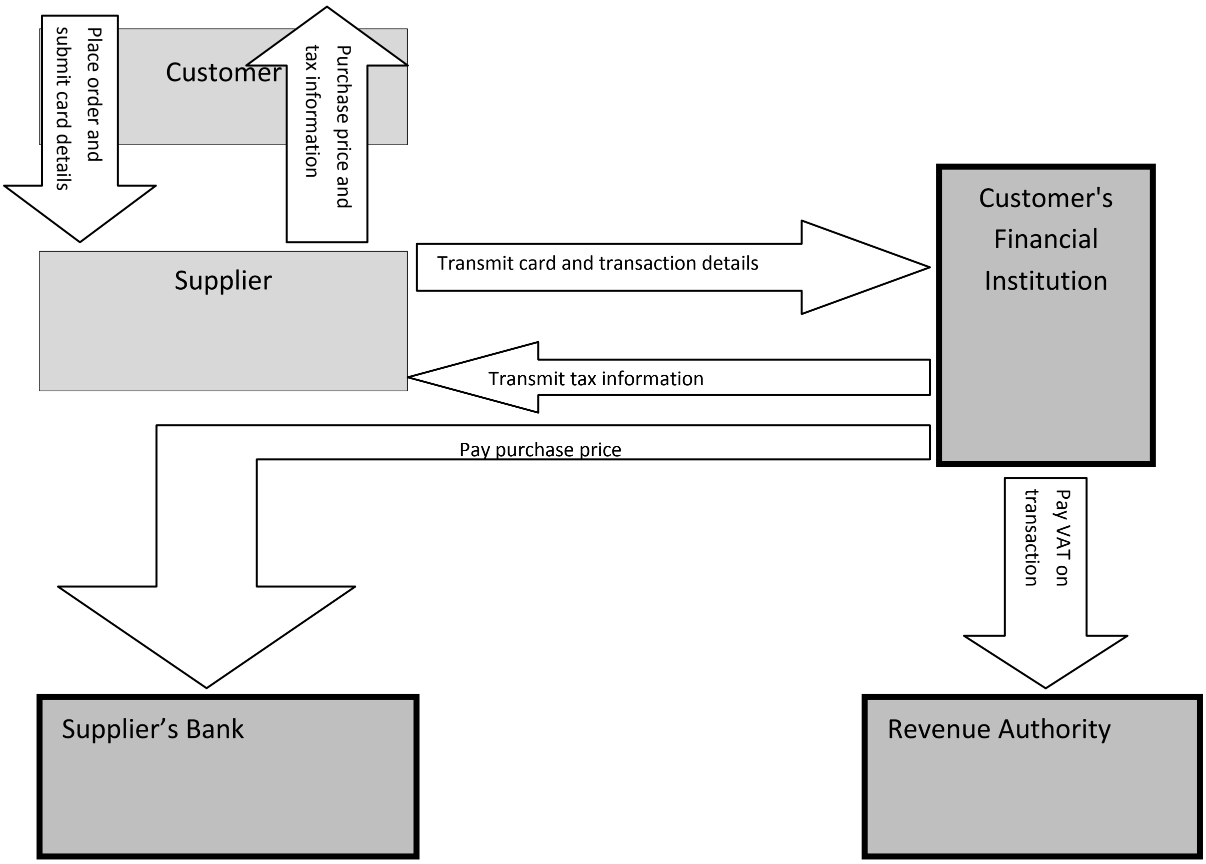
160 This section is a summary of Chapter 7 of Van Zyl SP (2013) *The Collection of Value Added Tax on online cross-border trade in Digital Goods* Unpublished LLD thesis (UNISA).

161 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 303.

162 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 303.

163 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 305.



Neither the supplier nor the customer is required to register with the relevant revenue authority. Currently, two models exist: a Blocked VAT Account system and a Real-time VAT system.

Blocked VAT Account system

The Blocked VAT Account system was developed by PricewaterhouseCoopers. A Blocked VAT Account system is essentially a split payment system in terms of which the financial institution that executes the payment, levies VAT on the transaction, and then pays it into a blocked VAT account. The blocked VAT account can be used for no purpose other than incoming and outgoing VAT payments, and for VAT settlements at the end of a VAT reporting period. The financial institution merely acts as an intermediary burdened with the task of splitting the payment. Since the VAT collected from the customer is not deposited into the supplier's private bank account, the risk of disappearing vendors is eliminated. The supplier is still burdened with filing tax returns at the end of a VAT reporting period. However, the supplier will receive a partially completed assessment form from the financial institution reflecting all the transactions effected by it for which VAT was paid into the blocked account. VAT payments and refunds will be effected from and to the blocked account. Despite the fact that VAT is collected in real-time, settlement with tax authorities is delayed until the supplier submits an assessment at the end of a reporting period. This system remains to be tested.

Real-time VAT

Real-time VAT (RT-VAT) collection is most consistent with the tax collection model by financial institutions outlined in the schematic model above. RT-VAT was put forward by Chris Williams, chairman of the RTpay® executive committee, a non-profit organisation the main aim of which is to promote RT-VAT as an alternative assessment method to the current registration and reverse-charge mechanisms. RT-VAT is a real-time VAT collection system that operates on the existing card and payment platforms. Once the supplier has submitted the customer's card details, purchase price, and transaction details to the financial institution, the financial institution will identify and locate the customer from its database and levy VAT on the transaction based on the VAT rate applicable in the customer's jurisdiction of residence. Payment is made directly from the customer's bank account and split into two separate payments. The purchase price is paid into the supplier's bank account, and VAT is paid to the relevant revenue authority. Payment of VAT is effected once every 24 hours, as opposed to the delayed payment system under the post-transaction assessment model. A dedicated server system (Tax Authority Settlement System (TASS)) tracks every transaction to ensure that allowable input VAT claims in the case of B2B transactions are paid automatically. The RT-VAT system remains to be tested.

International trends show that tax collection by third party intermediaries is increasingly being introduced in countries where cross-border trade and employment are on the rise.[164] This is particularly evident in Latin American countries which increasingly apply withholding tax mechanisms as a VAT collection tool.[165] The implementation of withholding tax mechanisms in terms of which a third party (financial institution) is burdened with the withholding duty, is a common modern taxing trend among developing countries. Similar trends have recently been introduced in South Africa.[166]

Cross-border digital trade is a fully fledged electronic trading, and often automated, phenomenon. The execution of these transactions requires no or minimal human intervention. It therefore follows that the taxation of cross-border digital transactions should preferably be done electronically and with minimal human intervention. A withholding tax mechanism by financial institutions through the implementation of an RT-VAT system, offers this possibility.

- The reverse-charge mechanism is an ineffective tool to levy and collect VAT on cross-border trade in digital goods. The registration model, in theory, provides for a better VAT collection model. However, the registration model overly burdens the supplier and enforcement of the registration model remains problematic. Although in terms of SARS records about 96 foreign supplies have registered to date, this number and the collected could be increased if an alternative model is considered. The implementation of the RT-VAT system should be considered as an alternative VAT collection mechanism where the registration and reverse-charge mechanisms are found to be ineffective tax collection models. As the model remains to be tested, extensive further research into the viability of the RT-VAT system should be undertaken.

Further recommendations

- In its design of VAT legislation dealing with e-commerce, South Africa should ensure its laws are in line with international developments. It should not reinvent the wheel and draft provisions that are not internationally aligned.
- It is important that South Africa monitors the OECD recommendations and international developments and that it amends its legislation accordingly to ensure it is internationally aligned.

164 Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 11 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316.

165 Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 11 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316.

166 In terms of section 37I of the Income Tax Act 58 of 1962 any person who pays interest to or for the benefit of a foreign person must withhold the tax from that payment except in circumstances where the interest or the foreign person is exempted from tax. Section 37I will come into operation on 1 July 2013. Similarly, in terms of section 49E, any person making payment of any royalty to or for the benefit of a foreign person must withhold 15% tax from that payment. Section 49E will come into operation on 1 July 2013.

- There are concerns that the VAT amendments with respect to e-commerce do not comply with the principle of neutrality which requires that taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations, carrying out similar transactions, should be subject to similar levels of taxation.
- It is recommended that the administrative burden on foreign suppliers of electronic services, who do not otherwise have a presence in South Africa but who satisfy the compulsory requirements to register for VAT, need to be reviewed and reconsidered to ensure that the amendments addressing electronically supplied services are effectively and efficiently imposed and enforced. The administrative burden imposed on foreign suppliers of electronic services should minimise the administrative costs for both the taxpayer and SARS as far as possible.
- In a volatile economy, new tax rules should not be drafted so as to negatively impact on international trade or create additional market distortions. While we recommend that new tax rules should be in line with the OECD principles and international best practice, new tax rules should not merely slave-follow international trends in developed countries. Extensive research on the economic impact of new tax rules on the economy of developing countries should be undertaken and considered before these new rules are implemented.

8 DEVELOPMENTS IN THE DIGITAL ECONOMY: VIRTUAL CURRENCIES

OECD September 2014 Report on Action 1 identifies the recent developments of "virtual currencies", which are digital units of exchange that are not backed by government-issued legal tender.[167] Some virtual currencies are specific to a single virtual economy, such as an online game, where they are used to purchase in-game assets and services. In some cases, these economy-specific virtual currencies can be exchanged for real currencies or used to purchase real goods and services, through exchanges which may be operated by the creators of the game or by third parties.[168] According to the OECD Discussion Draft Report on Action Plan 1, virtual currencies have been developed to also allow the purchase of real goods and services. The most prominent are the various "cryptocurrencies", in particular so-called "Bitcoins".

"Bitcoin is a peer-to-peer payment system and digital currency introduced as open source software in 2009. It is a crypto currency, so-called because it uses cryptography to control the creation and transfer of money….. Bitcoins are created by a process called mining, in which participants verify and record payments into a

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167 OECD Discussion Draft Report on Action Plan 1 at 15.
168 Ibid.

public ledger in exchange for transaction fees and newly minted Bitcoins. Users send and receive Bitcoins using wallet software on a personal computer, mobile device, or a web application. Bitcoins can be obtained by mining or in exchange for products, services, or other currencies."[169]

The OECD Discussion Draft Report on Action Plan 1 expresses concern about the development of Bitcoins, in particular because transactions can be undertaken on an anonymous basis since no personally identifying information is required to acquire or transact Bitcoins.[170]

The only 3 countries that appear to have taken action in respect of the taxation of Bitcoin are Canada, the UK and the USA.

8.1 Bitcoin Taxation in Canada

The Canadian government has taken the position that Bitcoin is not legal tender[171]. The Canada Revenue Agency has stated that, when addressing the Canadian tax treatment of Bitcoin, taxpayers must look to the rules surrounding barter transactions[172] and must consider whether income or capital treatment arises on Bitcoin trading (*i.e.*, speculating on the changes in the value of Bitcoins**).**

8.2 Bitcoin Taxation in the USA

In Notice 2014-21 (March 25, 2014),[173] the IRS states that Bitcoin is property and not currency for tax purposes. According to the Notice, "general tax principles applicable to property transactions apply to transactions using virtual currency." Some of the U.S. tax implications of Bitcoin include the following: (1) taxpayers receiving Bitcoins as payment for goods or services must include in their gross income the fair market value of the Bitcoins; (2) taxpayers will have a gain or loss upon the exchange of Bitcoins for other property; and (3) taxpayers who "mine" Bitcoins must include the fair market value of the Bitcoins in their gross incomes. The IRS also confirmed in its statement that employment wages paid in Bitcoins are taxable.

8.3 Bitcoin Taxation in the UK

In the UK, Bitcoin is treated as a "money voucher" and attracts VAT. HMRC is considering changing its status to "private money". HMRC would tax any capital gain subject to an exemption for holding them for over a year[174].

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169 See "Bitcoin" https://en.bitcoin.it/wiki/Bitcoin; "Public Key cryptography" http://en.wikipedia.org/wiki/Public-key_cryptography. Accessed 2 October 2013.
170 The OECD Discussion Draft Report on Action Plan 1 at 15 in para 34.
171 http://www.canadiantaxlitigation.com/wp-content/uploads/2014/01/2013-0514701I7.txt
172 http://www.cra-arc.gc.ca/E/pub/tp/it490/it490-e.html
173 http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance
174 Forbes, Jan 17th 2014).

8.4 South Africa: Recommendations on Bitcoins and other crypto-currencies

- Whilst the use of virtual currencies such as Bitcoins is not yet widespread in South Africa, it is growing and South African legislators would be wise to consider the potential impact of virtual currencies like Bitcoins on tax compliance and to monitor international developments to determine the most suitable approach for in South Africa.
- Exchange controls seem at least in the short term - a major defence against BEPS in relation to e-commerce, digital products, virtual currencies, virtual currencies (e.g. Bitcoin), IP royalty payments and other forms of intangible related transfer functions. However statutory provisions will be needed in the long run.