ANNEXURE 1

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA

SUMMARY OF DTC REPORT ON ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY

The digital economy is the result of a transformative process 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.

Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. The digital economy and its business models present however some key features which are potentially relevant from a tax perspective. These features include mobility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations.

BEPS issues in the digital economy

While the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks. These BEPS risks were identified and the work on the relevant actions of the BEPS Project was informed by these findings and took these issues into account to ensure that the proposed solutions fully address BEPS in the digital economy. Accordingly,

- It was agreed to modify the list of exceptions to the definition of permanent establishment (PE) to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a “preparatory or auxiliary” character, and to introduce a new anti-fragmentation rule to ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities among closely related enterprises. For example, the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a PE for that seller under the new standard.

- It was also agreed to modify the definition of PE 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 the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company, this activity would result in a PE for the parent company.
- The revised transfer pricing guidance makes it clear that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible, but that the group companies performing the important functions, contributing the important assets and controlling economically significant risks, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return. Specific guidance will also ensure that the transfer pricing analysis is not weakened by information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement.
- The recommendations on the design of effective CFC include definitions of CFC income that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent company.

It is expected that the implementation of these measures, as well as the other measures developed in the BEPS Project (e.g. minimum standard to address treaty shopping arrangements, best practices in the design of domestic rules on interest and other deductible financial payments, application to IP regimes of a substantial activity requirement with a “nexus approach”), will substantially address the BEPS issues exacerbated by the digital economy at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income.

Broader tax challenges raised by the digital economy

The digital economy also raises broader tax challenges for policy makers. For the direct taxes, these challenges relate in particular to nexus, data, and characterisation for direct tax purposes, which often overlap with each other. The OECD discussed and analysed a number of potential options to address these challenges, including through an analysis of their economic incidence, and concluded that:

- The option to modify the exceptions to PE status in order to ensure that they are available only for activities that are in fact preparatory or auxiliary in nature that was adopted as a result of the work on Action 7 of the BEPS

Project is expected to be implemented across the existing tax treaty network in a synchronised and efficient manner via the conclusion of the multilateral instrument that modifies bilateral tax treaties under Action 15.

- The OECD considered some options to determine nexus for the digital economy namely (i) a new nexus in the form of a significant economic presence, (ii) a withholding tax on certain types of digital transactions, and (iii) an equalisation levy, were recommended at this stage. It is expected that the measures developed in the BEPS Project will have a substantial impact on BEPS issues previously identified in the digital economy that certain BEPS measures will mitigate some aspects of the broader tax challenges.
- Countries could, introduce any of these three options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties. Adoption as domestic law measures would require further calibration of the options in order to provide additional clarity about the details, as well as some adaptation to ensure consistency with existing international legal commitments.

For indirect taxes the digital economy also creates challenges particularly where goods, services and intangibles are acquired by private consumers from suppliers abroad. The OECD noted that:

- The collection of VAT/GST on cross-border transactions, particularly those between businesses and consumers, is an important issue. Countries are thus recommended to apply the principles of the International VAT/GST Guidelines and consider the introduction of the collection mechanisms included therein. It is expected that as a result of the measures developed in the BEPS Project, consumption taxes will be levied effectively in the market country.

Next steps

Given that these conclusions may evolve as the digital economy continues to develop, it is important to continue working on these issues and to monitor developments over time. To these aims, the work will continue following the completion of the other follow-up work on the BEPS Project. This future work will be done in consultation with a broad range of stakeholders, and on the basis of a detailed mandate to be developed during 2016 in the context of designing an inclusive post-BEPS monitoring process. A report reflecting the outcome of the continued work in relation to the digital economy should be produced by 2020.

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 adopts the OECD recommendations.

- The proposals by the OECD to change the definition of a PE in double tax treaties will help to address this matter. 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 payor principle (like a royalty). The rules could for instance provide that digital goods or services are sourced where the recipient who pays for the digital goods or services is based,[1] 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.
- The recommended new source rules for non-resident suppliers of goods and services via e-commerce to South African customers should cover the situation where physical goods and services are delivered or rendered in South Africa and for which payment is made electronically to a non-resident (consider, for example, where payment is made to a non-resident, but where the service is rendered in South Africa, or where goods are delivered in South Africa, but payment is made to a non-resident). This would create the foundation for South Africa to tax non-residents on such goods and services, subject to the application of any tax treaty and the revised nexus rules contained therein, and provide for a level playing field between foreign and domestic suppliers of similar goods and services. However any such services should be deemed to not be from a South Africa source where they do not

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[1] SAIT: Comment on DTC First Interim BEPS Report (March 2015) Slide 14 of the Power Point Presentation.

meet the South Africa sourced rule. This is crucial in order to provide double tax relief to South African resident providers of such services and create a level playing field.[2]

- Apart from the gap in the source rules, there are also administrative concerns. Currently non-residents are 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.
- To alleviate the compliance burden on non-residents having to submit comprehensive tax returns, notwithstanding that they may not be liable to tax in South Africa, an alternative measure would be introduce a self-assessment system for income tax purposes. A further possibility would be for a non-resident to be able to apply for a ruling to the effect that it is not liable to tax in South Africa on its specific facts and circumstances and to be relieved of the obligation to submit tax returns for so long as there is no change in the circumstance (including the law).[3]
- 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.
- 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

2 PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.
3 PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.

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.[4] 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.

Addressing administrative challenges in the digital economy in South Africa

The OECD Final Report on the digital economy points out 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.[5] These issues are outlined below paragraph 10 of the report attached. The recommendations for South Africa regarding the administrative challenges of the digital economy are as follows:

- 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.
- 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 25 of 2002 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.
- SARS can also obtain information for purposes of identifying digital businesses carrying on activities in South Africa using the exchange of information tools provided for in treaties. While the major players such as Google and Amazon are well known, the nature of the digital economy is such that new players appear on a continuous basis. Other avenues of obtaining third party information from domestic sources in relation to digital transactions should be explored. In this regard, consultations should be held with the financial institutions to investigate the feasibility of providing information

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

[5] OECD/G20 2015 Final Report on Action 1 per Box 7.1 at 105.

related to electronic transactions with non-residents and which could be provided to SARS through the IT3 mechanism. However, any such mechanism should not impose an excessive compliance burden on the financial institutions relative to the benefit to SARS.[6]

ADRESSING BEPS IN THE DIGITAL ECONOMY WITH RESPECT TO INDIRECT TAXES

With respect to indirect taxes, the OECD called on countries to ensure the effective collection of VAT/GST with respect to cross-border supply of digital goods and services. The 2015 OECD 2015 Final Report on the digital economy explains how the digital economy can be used to circumvent indirect taxes and it provides recommendations to curb base erosion. The report notes that if the OECD's "Guidelines on place of taxation for B2B supplies of services and intangibles" are not implemented, opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT may arise with respect to:

- remote digital supplies to exempt businesses, and
- remote digital supplies acquired by enterprises that have establishments (branches) in more than one jurisdiction (MLE) that are engaged in exempt activities. [7]

Recommendations for South Africa

Currently 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 Income Tax Act. These provisions should be in line with the OECD principles on the harmonisation of global VAT/GST rules.
- ➢ Regulations should be refined further in order to allow for a comprehensive understanding and appreciation of the ambit of thereof.

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6 PWC Comments on "DTC BEPS First Interim Report" (30 March 2015) at 10.
7 OECD/G20 2015 Final Report on Action 1 in para 197.

- 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.
- It is recommended that the Regulations be refined further to allow for a comprehensive understanding and appreciation of the ambit thereof.

With respect to the place of supply rules, 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 came into operation in the EU on 1 January 2015.[8]

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

The OECD recommends that B2B and B2C transactions should be treated differently.

- In South Africa 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. It is our understanding that the Regulations follows National Treasury's (NT) intention that B2C transactions are captured by the special provisions and that B2B transactions will be captured by the 'imported services' provisions. For this purpose, the Regulations must accurately define what is included in the scope of 'electronic services' so as to clearly distinguish between B2B and B2C transactions.
- 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

8 Article 59a of Council Directive 2008/8/EC.

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). Note however that there are instances where VAT implications are dependent on who the recipient is, for example with respect to zero-rated exports.

The reverse-charge mechanism, which is essentially self-assessment mechanism, 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.

- 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.

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.

- 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 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.

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.

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.[9] 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. 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.*[10]

Although the concessions made by SARS to streamline the VAT registration of foreign suppliers of electronic services is in line with the OECD guidelines, 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. Despite the simplified registration process afforded by SARS, many foreign suppliers are still unaware of their obligations in terms of the Act.

The OECD recommends that in addition to a simplified registration process, a simplified electronic self-assessment procedure should be available to non-resident suppliers of cross-border intangibles.[11] 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 be submitted electronically on the e-file system, the difficulty and administrative burden associated therewith is not diminished. It must be noted that Treasury has announced

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

[10] 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

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

concessions to reduce compliance costs for foreign businesses to prevent these business from withdrawing from South Africa.

- 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 option of payment or collection agents (whether acting as agents or third party services providers) to be appointed and registered as VAT vendors for and on behalf of foreign businesses must be considered.

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. Some concessions have been announced. The foreign supplier of 'electronic services' is allowed to submit an abridged invoice (the details of the recipient is not required. However, the invoice must still be issued in ZAR currency. In most instances the cost and payment of the 'electronic services' is made in foreign currency. The supplier is, accordingly, required to calculate and express the amount in ZAR. In terms of the Binding General Ruling on electronic services, the ZAR amount must be calculated in accordance with the Bloomberg or European Central Bank rate on the day that the tax invoice is issued. This can result in accounting differences where the supplier's system has a set exchange rate or where the system operates on monthly averages.

- 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 (on their website or online shopping portal) 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 (on the website or shopping portal) in South African Rand inclusive of VAT should be reconsidered.

- Clause 103 of the TLAB 2014 and the Explanatory memorandum is addressing this matter.
- Foreign suppliers of ‘electronic services’ must account for VAT on the payment basis. This creates accounting problems where the supplier’s accounting system is set up to account on the invoice basis.

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 extremely 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 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 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.

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. 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. This, however, goes to the basic design of the VAT system and the impact of the extent to which the principles of the OECD VAT/GST Guidelines can be achieved.

With respect to alternative collection models:

- 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 revenue 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.
- 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.

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.

ADDRESSING BASE EROSION AND PROFIT SHIFTING IN SOUTH AFRICA
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1 BACKGROUND

Long before the OECD, released its 2013 BEPS Action 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 ignore 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 the following 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]

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.

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 commenced 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:[12]

Neutrality*:* Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic 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.
Efficiency*:* Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.
Certainty and Simplicity*:* The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.
Effectiveness and Fairness: Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.
Flexibility: The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments. [13]

Equity is also an important consideration within a tax policy framework. Equity has two main elements; horizontal equity and vertical equity. Horizontal equity suggests that taxpayers in similar circumstances should bear a similar tax burden. Vertical equity suggests that taxpayers in better circumstances should bear a larger part of the tax burden as a proportion of their income. Equity may also refer to inter-nation equity which is concerned with the allocation of national gain and loss in the international context and aims to ensure that each country receives an equitable share of tax revenues from cross border transactions.

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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" in para 9.

13 OECD "Electronic Commerce: Taxation Framework Conditions" in para 9.

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.[14]

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:[15]

> "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 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:[16]

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14 OECD "Electronic Commerce: Taxation Framework Conditions" in para 11.

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

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

- 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; and
- supplying information.

The OECD Commentary points out that:[17]

> "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."

3 CHALLENGES ENCOUNTERED IN APPLYING THE OECD GUIDELINES ON PES IN THE E-COMMERCE ERA

Generally servers are highly mobile and flexible in nature.[18] The location of a server can be easily moved (without affecting any underlying transaction) between different countries. Servers can transfer their programs almost instantaneously to a server in a different jurisdiction if necessary.[19] Servers can be shifted to a location outside a 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 purchased.[20] 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 with respect to the OECD's view that the existence of a PE has to be determined using the traditional approach of the location of the server. This view 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

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

18 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.

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

20 Ibid.

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 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.[21] Digital Companies 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.[22]

4 OECD BEPS ACTION ON THE DIGITAL ECONOMY

In its 2013 BEPS Action Plan, the OECD noted that

> "the spread of the digital economy poses challenges for international taxation. The digital economy is characterised by an unparalleled reliance on intangibles, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes. At the same time, the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation is not per se an indicator of defects in the existing system. The OECD noted that it is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS."[23]

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[24] and it called on countries:

- to develop rules to address the tax challenges of the digital economy; and
- 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.

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21 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.

22 SS Jonstone "News Analysis: Chasing Google -- The Global Struggle to Tax Ecommerce" 10 February 2014.

23 OECD/G20 2015 Final Report on Action 1 at 2.

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

Action 1 required that a holistic approach be taken that considers both direct and indirect taxation of the digital economy. Examining in particular issues relating but 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.

The work required a thorough analysis of the various business models in the digital economy.

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.

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:[25]

> "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 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).**

5 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

[25] 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.

mobile income.[26] 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 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. [27]

In response to these strongly worded comments, the OECD shifted its stance of referring to digital companies to reference to the digitalization of the economy.[28] 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.[29]

6 APPROACHES ADOPTED BY SOME 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.[30] This is 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. [31]

6.1 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 authority (HMRC) has confirmed that this is the case regardless of whether the server is owned, rented or otherwise at the disposal of the business.[32] In March 2014, the UK Treasury (HM Treasury)

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26 M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" *Tax Analysts* 3 February 2014.
27 Ibid.
28 Ibid.
29 L A Sheppard "News Analysis: OECD BEPS Hybrid Developments" Tax Analysts 29 January 2014.
30 Para 45.5 – 45.11 of the Commentary on art 5 of the OECD Model Convention.
31 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.
32 See HMRC International Manual INTM266100.

and the HMRC released a joint report entitled: "Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting (UK Report on BEPS)".[33] The Report observes that:[34]

> "…. 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:[35]

> "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.[36] 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.[37] 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.

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33 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).

34 UK Report on BEPS at 15 in para 2.4.

35 UK Report on BEPS in para 2.5.

36 UK Report on BEPS in para 2.6.

37 UK Report on BEPS in para 2.9.

6.2 AUSTRALIA

Following a request from National Government, the Australian Treasury released a scoping paper (Paper) in June 2013 which analysed the exposure to the Australian corporate tax system resulting from BEPS.[38] 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.[39] 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).[40] 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.[41]

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.[42] 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.[43] The Paper

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38 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.

39 Australian Treasury's Scoping Paper at 45.

40 Australian Treasury's Scoping Paper in para 19.

41 Australian Treasury's Scoping Paper in para 20.

42 Australian Treasury's Scoping Paper in para 54.

43 Australian Treasury's Scoping Paper in para 55.

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. [44]

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.[45]

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 BEPS will inevitably require effective multilateral action.[46]

6.3 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.[47] 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. [48] 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.[49] On 19 January 2013 the French Ministry for the Economy and Finance published the Colin-Collin report (predating the BEPS Report), in which it

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

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. [50] French proposals to enact the Google tax were however stopped because of lobbying pressure. [51]

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. [52]

7 OECD BEPS PROJECT WORK ON THE DIGITAL ECONOMY

In September 2013, the OECD formed the Task Force on Digital Economy, a subsidiary body of the OECD Committee on Fiscal Affairs, 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”. [53] The matters addressed in this Discussion Draft culminated in September 2014 entitled “Address the Challenges of The Digital Economy”. The Final Report on the Digital economy was issued in October 2015, the gist of which is summarised below.

8 SUMMARY OF OECD 2015 FINAL REPORT ON ACTION 1 - TAX CHALLENGES OF THE DIGITAL ECONOMY

8.1 FUNDAMENTAL PRINCIPLES OF TAXATION TO APPLY TO THE DIGITAL ECONOMY

The OECD 2015 Final Report on the digital economy, affirmed the outcomes of the (above discussed) 1998 Ottawa Ministerial Conference on Electronic Commerce and 2001 OECD Report “Electronic Commerce: Taxation Framework Conditions” which set out the taxation principles that should apply to electronic commerce (neutrality; efficiency; certainty and simplicity; effectiveness and fairness; flexibility). The OECD notes that these principles are still relevant today and, supplemented as necessary,

50 Ibid.
51 Ibid.
52 SS Jonstone “News Analysis: Chasing Google -- The Global Struggle to Tax Ecommerce” 10 February 2014.
53 The full report can be found at: http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf

can constitute the basis to evaluate options to address the tax challenges of the digital economy.[54]

8.2 INFORMATION AND COMMUNICATION TECHNOLOGY AND ITS IMPACT ON THE ECONOMY

The OECD notes that the development of ICT has been characterised by rapid technological progress that has brought prices of ICT products down rapidly, ensuring that technology can be applied throughout the economy at low cost.[55] Examples for such technological developments include:

- **Personal computing devices:** This covers innovative integrated packages of hardware and software, such as smartphones and tablets (and increasingly, connected wearable devices).[56]
- **Telecommunications networks:** This entails the development network component providers, infrastructure intermediaries, and Internet service providers (ISPs) that powered and operated the infrastructure of the telecommunications networks which have become central to the digital economy.[57]
- **Software:** The World Wide Web, initially made of websites and webpages, marked the emergence of Internet-powered software applications.[58]
- **Content:** Today, many major players in the digital economy are content providers. The definition of content in that regard is quite large: it includes both copyrighted content produced by professionals, enterprise-generated content, and non-copyrighted user-generated content (such as consumer reviews or comments in online forums).[59]
- **Use of data:** Users of applications provide businesses with access to substantial amounts of data, which are often personal and are used in a variety of ways that continue to be developed.[60]
- **Cloud-based processes:** These are processes whose resources can only be stored and executed in the cloud. As a result of the standardisation and commoditisation of different individual resources, such as hardware, network infrastructure, and software, some businesses have been able to combine those resources and make them available through the Internet as services.[61]

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54 OECD/G20 2015 Final Report on Action 1 at 2.
55 OECD/G20 2015 Final Report on Action 1 in para 64.
56 OECD/G20 2015 Final Report on Action 1 in para 67.
57 OECD/G20 2015 Final Report on Action 1 in para 69.
58 OECD/G20 2015 Final Report on Action 1 in para 72.
59 OECD/G20 2015 Final Report on Action 1 in para 75.
60 OECD/G20 2015 Final Report on Action 1 in para 77.
61 OECD/G20 2015 Final Report on Action 1 in para 78.

8.3 EMERGING AND POTENTIAL FUTURE DEVELOPMENTS OF THE DIGITAL ECONOMY

The rapid technological progress has led to a number of emerging trends and potential developments that may prove influential in the near future. These rapid changes make it difficult to predict future developments with any degree of reliability.[62] The developments include:

- **Internet of Things:** The ability to connect any smart device or object over time to a network of networks is enabling the "Internet of Things". The term refers to a series of components of equal importance including machine-to-machine communication, cloud computing, big data analysis, sensors and actuators, the combination of which leads to further developments in machine learning and remote control.[63]
- **Virtual currencies:** These are digital units of exchange that are not backed by government-issued legal tender. 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. Other virtual currencies were developed primarily to allow the purchase of real goods and services. The most prominent example are "cryptocurrencies", which rely on cryptography and peer-to-peer verification to secure and verify transactions. For example, with bitcoins, transactions can be made on an entirely anonymous basis, since no personally identifying information is required to be provided to acquire or transact in bitcoins.[64]
- **Advanced robotics:** The development of new connected and smart robots is changing manufacturing profoundly. With the increased productivity of new automated factories some multinational enterprises that had previously moved manufacturing offshore to take advantage of lower labour costs are considering moving their manufacturing activities back to where most of their customers are.[65]
- **3D Printing:** Advances in 3D printing have resulted in manufacturing gradually moving away from mass production of standardized products to shorter product lifecycle. In the healthcare industry, 3D printing of custom health products such as hearing aid earpieces is already heavily used. 3D printing has the potential to reduce the number of steps involved in production, transportation, assembly, and distribution, and can reduce the amount of material wasted as well.[66]
- **The sharing economy and collaborative production:** This refers to peer-to-peer sharing of goods and services. Recent years have seen the emergence of numerous innovative sharing applications using different business models and focusing on one particular service or product, such as cars, spare rooms, food, clothes, and private jets.[67]

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[62] OECD/G20 2015 Final Report on Action 1 in para 83.
[63] OECD/G20 2015 Final Report on Action 1 in para 84.
[64] OECD/G20 2015 Final Report on Action 1 in para 87-88.
[65] OECD/G20 2015 Final Report on Action 1 in para 90.
[66] OECD/G20 2015 Final Report on Action 1 in para 93.
[67] OECD/G20 2015 Final Report on Action 1 in para 94.

- **Access to government data:** Governments are making progress at making machine-readable resources, notably data, publicly available in what has been alternatively labelled as open data policy, open government or government as a platform. The three main goals are to ensure accountability, better performance and participation of third parties in government business. [68]
- **Reinforced protection of personal data:** As individuals become more sensitive to the use of their personal data and expect their privacy to be protected, discussions are ongoing in a number of countries to strengthen applicable laws and regulate data collection and exploitation by organisations.[69]

8.4 THE DIGITAL ECONOMY AND ITS IMPACT ACROSS BUSINESS SECTORS

Many sectors of the economy have adopted ICT to enhance productivity, enlarge market reach, and reduce operational costs. [70]

- **Retail**: The digital economy has enabled retailers to allow customers to place online orders (often fulfilled from a local store) and has made it easier for retailers to gather and analyse data on customers, to provide personalised service and advertising; as well as to manage logistics and increase productivity.
- **Transport and Logistics**: This sector has been transformed by digital economy, which enables the tracking of both vehicles and cargo across continents, the provision of information to customers and facilitates the development of new operational processes such as “Just-In-Time” delivery in the manufacturing sector.
- **Financial Services**: Banks, insurance providers and other companies, including non-traditional payment service providers, increasingly enable customers to manage their finances, conduct transactions and access new products on line, although they still continue to support branch networks for operations. The digital economy has also made it easier to track indices and manage investment portfolios and has enabled specialist businesses such as high-frequency trading.
- **Manufacturing and Agriculture**: The digital economy has enhanced design and development, as well as the ability to monitor production processes in factories and control robots, which has enabled greater precision in design and development and ongoing product refinement. In the automobile industry, for example, it is estimated that 90% of new features in cars have a significant software component. On farms, systems can monitor crops and animals, and soil/environmental quality. Increasingly, routine processes and agricultural equipment can be managed through automated systems.

[68] OECD/G20 2015 Final Report on Action 1 in para 96.
[69] OECD/G20 2015 Final Report on Action 1 in para 98.
[70] OECD/G20 2015 Final Report on Action 1 in para at 109.

- **Education:** Universities, tutor services and other education service providers are able to provide courses remotely without the need for face to face interaction through technologies such as video conferencing and streaming and online collaboration portals, which enables them to tap into global demand and leverage brands in a way not previously possible.
- **Healthcare:** The digital economy is revolutionising the healthcare sector, from enabling remote diagnosis to enhancing system efficiencies and patient experience through electronic health records. It also allows opportunities for advertising, for example of drugs and other treatments.
- **Broadcasting and Media:** The digital economy has dramatically changed the broadcasting and media industry, with increasing broadband access in particular opening new avenues for delivery of content for traditional media players, while also enabling the participation in the news media of non-traditional news sources, and expanding user participation in media through user-generated content and social networking. The digital economy has also enhanced the ability of companies to collect and use information about the viewing habits and preferences of customers, to enable them to better target programming. [71]

As digital technology is adopted across the economy, segmenting the digital economy has become increasingly difficult. The digital economy is increasingly becoming the economy itself, it is increasingly impossible to ring-fence the digital economy from the rest of the economy. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analyzing existing structures adopted by 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, and developing approaches to address those challenges or concerns. [72]

8.5 THE DIGITAL ECONOMY AND THE EMERGENCE OF NEW BUSINESS MODELS

The digital economy has given rise to a number of new business models. [73]

(a) Electronic commerce: Electronic commerce, or e-commerce, has been defined broadly by the OECD as “the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered by those methods, but the payment and the ultimate delivery of the goods or service do not

[71] OECD/G20 2015 Final Report on Action 1 in para 114.
[72] OECD/G20 2015 Final Report on Action 1 in para 115.
[73] OECD/G20 2015 Final Report on Action 1 in para 116.

have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organisations”. [74] Although e-commerce covers a broad array of businesses, the more prominent types are:

- *Business-to-business models:* transactions in which a business sells products or services to another business (so-called business-to-business (B2B)
- *Business-to-consumer models: This* business model sells goods or services to individuals acting outside the scope of their profession.
- *Consumer-to-consumer models:* Businesses involved in C2C e-commerce play the role of intermediaries, helping individual consumers to sell or rent their assets (such as residential property, cars, motorcycles, etc.) by publishing their information on the website and facilitating transactions.

(b) Payment services: Online payment service providers provide a secure way to enable payments online without requiring the parties to the transaction to share financial information with each other. [75]

- Cash payment solutions: A customer buys online, and pays in cash with a barcode or payment code at participating shops or settlement agencies.
- E-wallets or cyber-wallets: These are often used for micropayments because the use of a credit card for frequent small payments is not economical.
- Mobile payment solutions: These encompass all types of technologies that enable payment using a mobile phone or smartphone. [76]
- Virtual currencies: These can be used to purchase goods and services from businesses that agree to accept them, acting as an alternative to payment services.

(c) App stores: Application stores, are a type of digital distribution platform for software, often provided as a component of an operating system. Application stores typically take the form of central retail platforms, accessible through the consumer’s electronic device, through which the consumer can browse, view information and reviews, purchase and automatically download and install the application on his/her device. [77]

(d) Online advertising: This entails the using the Internet as a medium to target and deliver marketing messages to customers. Internet advertisers have developed sophisticated methods for segmenting consumers in order to allow more precise targeting of ads. Internet advertising publishers have also developed ways for clients to monitor performance of ads, tracking how users interact with their brands and learning what is of interest to current and prospective customers. [78]

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[74] OECD/G20 2015 Final Report on Action 1 in para 117.
[75] OECD/G20 2015 Final Report on Action 1 in para 126.
[76] OECD/G20 2015 Final Report on Action 1 in para 128.
[77] OECD/G20 2015 Final Report on Action 1 in para 130.
[78] OECD/G20 2015 Final Report on Action 1 in para 136.

(e) Cloud computing: Cloud computing is the provision of standardised, configurable, on-demand, online computer services, which can include computing, storage, software, and data management, using shared physical and virtual resources (including networks, servers, and applications). Since the service is provided online using the provider's hardware, users can access the service using their devices wherever they are located, provided they have a suitable Internet connection. [79]

(f) High frequency trading: High frequency trading uses sophisticated technology, including complex computer algorithms, to trade securities at high speed. Large numbers of orders which are typically fairly small in size are sent into the markets at high speed, on powerful computers that analyse huge volumes of market data and exploit small price movements or opportunities for market arbitrage that may occur for only milliseconds. [80]

(g) Participative networked platforms: A participative networked platform is an intermediary that enables users to collaborate and contribute to developing, extending, rating, commenting on and distributing user-created content (UCC) which comprises various forms of media and creative works (written, audio, visual, and combined) created by users. Examples of distribution platforms that have been created, including text-based collaboration formats such as blogs or wikis, group-based aggregation and social bookmarking sites, social networking sites, podcasting, and virtual worlds. The participative platform featuring the UCC, may monetise the UCC in a variety of ways, including through voluntary contributions, charging viewers for access on a per item or subscription basis, advertising-based models, licensing of content and technology to third parties, selling goods and services to the community, and selling user data to market research or other firms. [81]

8.6 KEY FEATURES OF THE DIGITAL ECONOMIES WHICH ARE RELEVANT FROM A TAX PERSPECTIVE

The key features of the digital economy which are increasingly potentially relevant from a tax perspective include the following:

(a) **Mobility**

- <u>Mobility of intangibles:</u> The investment in and development of intangibles is a core contributor to value creation and economic growth for companies in the digital economy. Digital companies often rely heavily on software, and will expend substantial resources on research and development to upgrade existing software or to develop new software products. Under existing tax rules, the rights to those

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[79] OECD/G20 2015 Final Report on Action 1 in para 140.
[80] OECD/G20 2015 Final Report on Action 1 in para 147.
[81] OECD/G20 2015 Final Report on Action 1 in para 149-150.

intangibles can often be easily assigned and transferred among associated enterprises, with the result that the legal ownership of the assets may be separated from the activities that resulted in the development of those assets.[82]

- Mobility of users and customers: Users are increasingly able to carry on commercial activities remotely while traveling across borders. An individual can, for example, reside in one country, purchase an application while in a second country, and use the application from a third country. Consumers can use virtual personal networks or proxy servers, whether intentionally or unintentionally, to disguise the location at which the ultimate sale took place. The fact that many interactions on the internet remain anonymous may add to the difficulty of the identity and location of users.[83]
- Mobility of business functions: Businesses are increasingly able to manage their global operations on an integrated basis from a central location that may be removed geographically from both the locations in which the operations are carried out and the locations in which their suppliers or customers are located. This has increased the ability to provide those goods and services across borders.[84] Technological advances can make it possible for businesses to carry on economic activity with minimal need for personnel to be present (so-called "scale without mass").[85] Technological advances have also permitted greater integration of worldwide businesses, which has made it easier for business to adopt global business models that centralise functions at a regional or global level, rather than at a country-by-country level.[86]

(b) Reliance on data and user participation

The digital economy allows businesses to collect data about their customers, users, suppliers, and operations and to leverage and monetise such activities. In certain social networking focused business models, for instance, the active collaboration of their users is a key value-driver of the business.[87]

(c) Network effects

Networks effects refer to the fact that decisions of users may have a direct impact on the benefit received by other users. This is especially so with the "Internet of Things", in which companies deploy software in many devices and objects, and leverage this web off infrastructure to sell goods or services either to the owners of those devices or to advertisers. In this model, hardware and software infrastructure becomes a privileged channel to get in touch with end users and to create value by

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[82] OECD/G20 2015 Final Report on Action 1 in para 152-153.
[83] OECD/G20 2015 Final Report on Action 1 in para 154.
[84] OECD/G20 2015 Final Report on Action 1 in para 155-156.
[85] OECD/G20 2015 Final Report on Action 1 in para 158.
[86] OECD/G20 2015 Final Report on Action 1 in para 159-160.
[87] OECD/G20 2015 Final Report on Action 1 in para 164.

monetising their attention (advertising-based business models), the data that flows from them, or the externalities generated through network effects, or through selling them goods or services. [88]

(d) Multi-sided business models

A multi-sided business model is one that is based on a market in which multiple distinct groups of persons interact through an intermediary or platform, and the decisions of each group of persons affects the outcome for the other groups of persons through a positive or negative externality. An example of a multi-sided business model involving positive externalities for different sides of the market is a payment card system, which will be more valuable to merchants if more consumers use the card, and more valuable to consumers if more merchants accept the card. [89]

(d) Tendency toward monopoly or oligopoly

In some markets, particularly where a company is the first actor to gain traction on an immature market, network effects combined with low incremental costs may enable the company to achieve a dominant position in a very short time. This ability to gain traction can be enhanced where a patent or other intellectual property right grants one competitor the exclusive power to exploit a particular innovation in a particular market. Ease of adoption of a new platform means that some players, as a result of customer choices compounded by network effects, have been able to rise to a dominant market position extremely quickly.[90]

(e) Volatility

Technological progress has led to progress in miniaturisation and a downward trend in the cost of computing power. This has increased performance reduced barriers to entry for new internet-based businesses which has fostered innovation and the constant development of new business models. As a result, in short periods of time, companies that appeared to control a substantial part of the market and enjoyed a dominant position have found themselves rapidly losing market share to challengers that manage to build their businesses on more powerful technology, a more attractive value proposal, or a more sustainable business model. The few companies that have managed long-term success typically have done so by investing substantial resources in research and development and in acquiring start-ups with innovative ideas, launching new features and new products, and continually evaluating and modifying business models in order to leverage their market position and maintain dominance in the market. [91]

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[88] OECD/G20 2015 Final Report on Action 1 in para 169-172.
[89] OECD/G20 2015 Final Report on Action 1 in para 173-174.
[90] OECD/G20 2015 Final Report on Action 1 in para 178.
[91] OECD/G20 2015 Final Report on Action 1 in para 179.

8.7 IDENTIFYING OPPORTUNITIES FOR BEPS IN THE DIGITAL ECONOMY

BEPS concerns in the digital economy are raised by:

- situations in which taxable income can be artificially segregated from the activities that generate it, or
- in the case of value-added tax (VAT), situations in which no or an inappropriately low amount of tax is collected on remote digital supplies to exempt businesses or multi-location enterprises (MLEs) that are engaged in exempt activities. [92]

Consequences:

- These situations undermine the integrity of the tax system and potentially increase the difficulty of reaching revenue goals.
- In addition, when certain taxpayers are able to shift taxable income away from the jurisdiction in which income producing activities are conducted, other taxpayers may ultimately bear a greater share of the burden.
- BEPS activities also distort competition, as corporations operating only in domestic markets or refraining from BEPS activities may face a competitive disadvantage relative to multinational enterprises (MNEs) that are able to avoid or reduce tax by shifting their profits across borders. [93]

In many cases, the nature of the strategies used to achieve BEPS in digital businesses is similar to the nature of strategies used to achieve BEPS in more traditional businesses. Some of the key characteristics of the digital economy may, however, exacerbate risks of BEPS in some circumstances, in the context of both direct and indirect taxation. [94]

8.8 BEPS IN THE CONTEXT OF DIRECT TAXATION

8.8.1 MINIMISATION OF TAXATION IN THE MARKET COUNTRY BY AVOIDING A TAXABLE PRESENCE EITHER BY SHIFTING GROSS PROFITS VIA TRADING STRUCTURES OR BY REDUCING NET PROFIT BY MAXIMISING DEDUCTIONS AT THE LEVEL OF THE PAYER

<u>Minimising taxation by avoiding a taxable presence</u>

In many digital economy business models, a non-resident company may interact with customers in a country remotely through a website or other digital means (e.g. an application on a mobile device) without maintaining a physical presence in the country. Increasing reliance on automated processes may further decrease reliance

[92] OECD/G20 2015 Final Report on Action 1 in para 180.
[93] OECD/G20 2015 Final Report on Action 1 in para 180.
[94] OECD/G20 2015 Final Report on Action 1 in para 181.

on local physical presence. However, the domestic laws of most countries require some degree of physical presence before business profits are subject to taxation. In addition, under Articles 5 and 7 of the OECD Model Tax Convention, a company is subject to tax on its business profits in a country of which it is a non-resident only if it has a PE in that country. Thus, such non-resident company may not be subject to tax in the country in which it has customers. [95]

- Companies in many industries have customers in a country without a PE in that country, and yet they can communicate with those customers via phone, mail, fax and through independent agents.
- The use of the digital economy to earn revenue from customers in a country without having a PE in that country coupled with strategies that eliminate taxation in the State of residence, results in such revenue not being taxed anywhere, BEPS concerns are raised. [96]
- In addition, under some circumstances, tax in a market jurisdiction can be artificially avoided by fragmenting operations among multiple group entities in order to qualify for the exceptions to PE status for preparatory and auxiliary activities, or by otherwise ensuring that each location through which business is conducted falls below the PE threshold.[97]

<u>Minimising the income allocable to functions, assets and risks in market jurisdictions</u>

Although MNEs do maintain a degree of presence in countries that represents significant markets for its products, in the context of the digital economy, an enterprise may establish a local subsidiary or a PE, with the local activities structured in a way that generates little taxable profit.

- MNEs can allocate functions, assets and risks in a way that minimises taxation by for example, contractually allocate them in a way that does not fully reflect the actual conduct of the parties, and that would not be chosen in the absence of tax considerations. For example, assets, in particular intangibles, and risks related to the activities carried out at the local level may be allocated via contractual arrangements to other group members operating in a low-tax environment in a way that minimises the overall tax burden of the MNE group.[98]
- Under these structures, the affiliate in the low-tax environment could to undervalue (typically at the time of the transfer) the transferred intangibles or other hard to-value income-producing assets, while claiming that it is entitled to have large portions of the MNE group's income allocated to it on the basis of its legal ownership of the undervalued intangibles, as well as on the basis of the risks assumed and the financing it provides. Operations in higher tax jurisdictions can then be contractually stripped of risk, and can avoid claiming

[95] OECD/G20 2015 Final Report on Action 1 in para 184.
[96] OECD/G20 2015 Final Report on Action 1 in para 185.
[97] OECD/G20 2015 Final Report on Action 1 in para 185.
[98] OECD/G20 2015 Final Report on Action 1 in para 186.

ownership of intangibles or other valuable assets or holding the capital that funds the core profit making activities of the group. Economic returns are thus reduced and income is shifted into low-tax environments. [99]

Examples of digital economy structures that can be used to minimise the tax burden in market jurisdictions through contractual allocation of assets and risks include:

- Using a subsidiary or PE to perform marketing or technical support, or to maintain a mirrored server to enable faster customer access to the digital products sold by the group, with a principal company contractually bearing the risks and claiming ownership of intangibles generated by these activities. A company may, for example, limit risk at the local company level by limiting capitalisation of that entity so that it is financially unable to bear risk.
- In the case of businesses selling tangible products online, a local subsidiary or PE may maintain a warehouse and assist in the fulfilment of orders. These subsidiaries or PEs will be taxable in their jurisdiction on the profits attributable to services they provide, but the amount they earn may be limited.
- Alternatively, functions allocated to local staff under contractual arrangements may not correspond with the substantive functions performed by the staff. For example, staff may not have formal authority to conclude contracts on behalf of a non-resident enterprise, but may perform functions that indicate effective authority to conclude those contracts. If the allocations of functions, assets, and risks do not correspond to actual allocations, or if less-than-arm's length compensation is provided for intangibles of a principal company, these structures may present BEPS concerns. [100]

Maximising deductions in market jurisdictions

Once a taxable presence in the market country has been established, another common technique to reduce taxable income in a source country is to maximise the amount of deductible payments made to affiliates other jurisdictions in the form of interest, royalties, service fees, etc. [101] For example, an affiliate in a low-tax jurisdiction may, due to a favourable credit rating, be able to borrow money at a low rate. It may then lend money to its subsidiaries in high-tax jurisdictions at a higher rate, thereby reducing the income of those subsidiaries by the amount of the deductible interest payments.

Alternatively, an affiliate may use hybrid instruments to create deductible payments for a subsidiary in a source country that result in no inclusion in the country of residence of the affiliate. Payments (including underpayments) for the use of intangibles held by low-tax group companies or for services rendered by other group companies can also be used to reduce taxable income in the market country. [102]

99 OECD/G20 2015 Final Report on Action 1 in para 187.
100 OECD/G20 2015 Final Report on Action 1 in para 188.
101 OECD/G20 2015 Final Report on Action 1 in para 189.
102 OECD/G20 2015 Final Report on Action 1 in para 189.

8.8.2 AVOIDING WITHHOLDING TAX

A company may be subject to withholding tax in a country in which it is not a resident if it receives certain payments, such as interest or royalties, from payers in that country. If allowed under a treaty between the jurisdictions of the payer and recipient, however, a company in the digital economy may be entitled to reduced withholding or exemption from withholding on payments of profits to a lower-tax jurisdiction in the form of royalties or interest. They may also make use of structures that involve treaty shopping by interposing shell companies located in countries with favourable treaty networks that contain insufficient protections against treaty abuse.[103]

8.8.3 ELIMINATING OR REDUCING TAX IN THE INTERMEDIATE COUNTRY

Eliminating or reducing tax in an intermediate country can be accomplished through the application of preferential domestic tax regimes, the use of hybrid mismatch arrangements, or through excessive deductible payments made to related entities in low or no-tax jurisdictions.

- Companies may locate functions, assets, or risks in low-tax jurisdictions or countries with preferential regimes, and thereby allocate income to those locations. [104]
- In the context of the digital economy, for example, the rights in intangibles and their related returns can be assigned and transferred among associated enterprises, and may be transferred, sometimes for a less-than-arm's length price, to an affiliate in a jurisdiction where income subsequently earned from those intangibles is subject to unduly low or no-tax due to the application of a preferential regime.[105]
- Companies may also reduce tax in an intermediate country by generating excessive deductible payments to related entities that are themselves located in low or no-tax jurisdictions or otherwise entitled to a low rate of taxation on the income from those payments. [106]
- Companies may also avoid taxes in an intermediate country by using hybrid mismatch arrangements to generate deductible payments with no corresponding inclusion in the country of the payee. Companies may also use arbitrage between the residence rules of the intermediate country and the ultimate residence country to create stateless income. [107]

[103] OECD/G20 2015 Final Report on Action 1 in para 190.
[104] OECD/G20 2015 Final Report on Action 1 in para 192.
[105] OECD/G20 2015 Final Report on Action 1 in para 193.
[106] OECD/G20 2015 Final Report on Action 1 in para 194.
[107] OECD/G20 2015 Final Report on Action 1 in para 194.

8.8.4 ELIMINATING OR REDUCING TAX IN THE COUNTRY OF RESIDENCE OF THE ULTIMATE PARENT

The same techniques that are used to reduce taxation in the market country can also be used to reduce taxation in the country of the ultimate parent company of the group or where the headquarters are located.

This can involve contractually allocating risk and legal ownership of mobile assets like intangibles to group entities in low-tax jurisdictions, while group members in the jurisdiction of the headquarters are undercompensated for the important functions relating to these risks and intangibles that continue to be performed in the jurisdiction of the headquarters.[108]In addition, companies may avoid tax in the residence country of their ultimate parent if that country has an exemption or deferral system for foreign-source income and either does not have a controlled foreign company (CFC) regime that applies to income earned by controlled foreign corporations of the parent, or has a regime with inadequate coverage of certain categories of passive or highly mobile income, including in particular certain income with respect to intangibles. [109]

8.9 TACKLING BEPS IN THE DIGITAL ECONOMY

Many of the key features of the digital economy, particularly those related to mobility, generate BEPS concerns in relation to both direct and indirect taxes.

- For example, 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 mobility of users creates substantial challenges and risks in the context of the imposition of VAT.
- The ability to centralise infrastructure at a distance from a market jurisdiction and conduct substantial sales into that market from a remote location, combined with increasing ability to conduct substantial activity with minimal use of personnel, generates potential opportunities to achieve BEPS by fragmenting physical operations to avoid taxation.

Work on the actions of the BEPS Action Plan (OECD, 2013) has taken into account these key features in order to ensure that the proposed solutions fully address BEPS in the digital economy.

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[108] OECD/G20 2015 Final Report on Action 1 in para 195.
[109] OECD/G20 2015 Final Report on Action 1 in para 196.

8.10 TACKLING BEPS IN THE DIGITAL ECONOMY – DIRECT TAXES

8.10.1 RESTORING TAXATION ON STATELESS INCOME

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 the work carried out in the context of the BEPS Project. At the same time, the work on BEPS will increase transparency between taxpayers and tax administrations and among tax administrations themselves.

- Risk assessment processes at the level of the competent tax administration will be enhanced by measures such as the mandatory disclosure of aggressive tax planning arrangements and uniform transfer pricing documentation requirements, coupled with a template for country-by-country (CBC) reporting. [110]
- The comprehensiveness of the BEPS Action Plan will ensure that, once the different measures have been implemented in a co-ordinated manner, taxation is more aligned with the location in which economic activities take place. This will address BEPS issues at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income.
- BEPS issues in the market jurisdiction should be addressed by preventing treaty abuse (Action 6) and preventing the artificial avoidance of PE status (Action 7).
- BEPS issues in the ultimate residence jurisdiction should be addressed by strengthening controlled foreign company (CFC) rules (Action 3).
- Both market and residence BEPS issues should be addressed 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 ensuring that transfer pricing outcomes are in line with value creation (Actions 8-10). [111]

Although all of the elements of the BEPS Action Plan will have an impact on BEPS in the digital economy; Actions 3 (strengthen CFC rules), 7 (prevent the artificial avoidance of PE status), and 8-10 (assure that transfer pricing outcomes are in line with value creation) were identified as particularly relevant to the digital economy. [112]

- In Action 3, it was noted that income from digital goods and services may be particularly mobile due to the importance of intangibles in the provision of such goods and services.[113]
- Action 7 considered that where activities that were previously considered preparatory or auxiliary for the purposes of these exceptions are increasingly

[110] OECD/G20 2015 Final Report on Action 1 in para 206.
[111] OECD/G20 2015 Final Report on Action 1 in para 207.
[112] OECD/G20 2015 Final Report on Action 1 in para 208.
[113] OECD/G20 2015 Final Report on Action 1 in para 209.

significant components of businesses in the digital economy, such activities may be considered core activities and subject to the PE rules.

  - The work on article 7 also considered how the definition of PE will 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. [114]

- Under Actions 8-10, it was noted that companies in the digital economy rely heavily on intangibles in creating value and producing income, and that many BEPS structures adopted by participants in the digital economy involve the transfer of intangibles or rights in intangibles to tax-advantaged locations, coupled with the position 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. BEPS work in the area of transfer pricing takes these issues in account as well as 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. This work provides simpler and clearer guidance on the application of transfer pricing methods, including profit splits in the context of global value chains. [115]

8.10.2 MEASURES THAT WILL ADDRESS BEPS ISSUES IN THE MARKET JURISDICTION

A number of measures of the BEPS Action Plan will have the primary effect of restoring source taxation, in particular with respect to treaty abuse (Action 6) and artificial avoidance of PE status (Action 7).

<u>Prevent treaty abuse (Action 6):</u> The Report on Action 6 provides model rules to tackle the abuse of tax treaties.

- The denial of treaty benefits in cases that could otherwise inappropriately result in double non-taxation will ensure that the market country will be able to apply its domestic law unconstrained by treaty rules aimed at preventing double taxation. This is of relevance both in cases where the foreign company has claimed not to have a taxable presence in that country in the form of a PE or when there is indeed a taxable presence in the form of a PE or a group company, but the relevant taxable income is reduced by deductible payments. In cases where such deductible payments would be subject to a withholding tax under domestic law, the market country will be able to apply such a withholding tax without any treaty limitation. [116]

[114] OECD/G20 2015 Final Report on Action 1 in para 210.
[115] OECD/G20 2015 Final Report on Action 1 in para 211.
[116] OECD/G20 2015 Final Report on Action 1 in para 214.

Prevent the artificial avoidance of PE status (Action 7): The treaty definition of PE may limit the application of domestic law rules applicable to the taxation of the business profits of non-resident companies derived from sources in the market country.

- The work done with respect to Action 7 was aimed at preventing the artificial avoidance of the treaty threshold below which the market country may not tax.
- This work is a key area of focus in order to ensure that BEPS risks in the digital economy could be addressed. Work on Action 7 took into account the key features of the digital economy in developing changes to the definition of PE to ensure that artificial arrangements cannot be used to circumvent the threshold for exercising taxing rights. [117]
- The work involved modifying the definition of PE 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 the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company, it will result in a PE for the parent company even though the subsidiary does not formally conclude those contracts, and even though the contracts may be standard form contracts. Once the outcome of this work is implemented, such strategies will no longer be effective. [118]
- The work also ensures that where essential business activities of an enterprise are carried on at a given location in a country, the enterprise cannot benefit from the list of exceptions usually found in the definition of PE. It was therefore agreed to modify Article 5(4) of the OECD Model Tax Convention to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a “preparatory or auxiliary” character.
- In addition, a new anti-fragmentation rule was introduced to ensure that it is not possible to benefit from the PE exceptions through the fragmentation of business activities among closely related enterprises. Where certain activities that were previously granted the benefit of these exceptions have become increasingly significant components of businesses in the digital economy, such that they are not preparatory or auxiliary in character, those activities will no longer be entitled to an exception from PE status. For example, the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model

[117] OECD/G20 2015 Final Report on Action 1 in para 216.
[118] OECD/G20 2015 Final Report on Action 1 in para 216.

relies on the proximity to customers and the need for quick delivery to clients) would constitute a PE for that seller.[119]

8.10.3 MEASURES THAT WILL ADDRESS BEPS ISSUES IN BOTH MARKET AND ULTIMATE PARENT JURISDICTIONS

<u>Neutralise the effects of hybrid mismatch arrangements (Action 2):</u> The BEPS Action Plan notes that hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for example, creating two deductions for a single expense, generating deductions in one jurisdiction without corresponding income inclusions in another, or misusing foreign tax credit or participation exemption regimes.

- The 2015 Report on *Neutralising the Effects of Hybrid Mismatch Arrangements* (OECD, 2015) sets out recommendations regarding the design of domestic rules and the development of model treaty provisions to neutralise the effect of hybrid instruments and entities, and includes detailed commentary explaining how the recommendations are intended to operate in practice. [120]

<u>Limit base erosion via interest deductions and other financial payments (Action 4):</u> The innovation that is essential to success in the digital economy must be financed. Many large and well-established digital economy players are cash rich and they often finance new ventures, the acquisition of start-ups, or other assets with intra-group debt.

- It is often the case that taxpayers will establish and capitalise entities in low-tax environments that are then able to engage in transactions with associated enterprises that have the effect of eroding the tax base. For example, an affiliate in a low-tax environment might be established to lend to high-tax operating entities. Interest deductions on loans from such low-tax entities can present BEPS concerns in countries where business operations actually take place. [121]
- The work done with respect to Action 4 provides an agreed framework for best practices in the design of domestic rules, in order to reduce opportunities for BEPS via interest and other deductible financial payments. This work addresses BEPS in respect of interest paid to both related parties and third parties and addresses both inbound and outbound investment scenarios.
- The framework is based on a fixed ratio rule that limits an entity's net deductions for interest (and payments economically equivalent to interest) to a specified percentage of its earnings before interest, taxes, depreciation and

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119 OECD/G20 2015 Final Report on Action 1 in para 217.

120 OECD/G20 2015 Final Report on Action 1 in para 219.

121 OECD/G20 2015 Final Report on Action 1 in para 220.

amortization (EBITDA). To ensure that countries apply a fixed ratio that is low enough to tackle BEPS, while recognising that not all countries are in the same position, the recommended approach includes a corridor of possible ratios of between 10 and 30% along with factors that countries should take into account in setting their fixed ratio within this corridor.

- Recognising that some groups are highly leveraged with third party debt for non-tax reasons, the recommended approach allows the fixed ratio rule to be supplemented by a group ratio rule that allows an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group.
- Alternatively the fixed ratio rule based on net interest/EBITDA can be supplemented by an "equity test", whereby the fixed ratio rule does not apply if an entity can show that its equity/total assets ratio is equal to or exceeds that of its group (within a small tolerance). The framework also recommends that countries introduce targeted rules to address specific risks.[122]

<u>Counter harmful tax practices more effectively (Action 5):</u> Digital economy companies heavily rely on intangibles to create value and produce income. Intangibles, and income arising from the exploitation of intangibles, are by definition geographically mobile. Over the last decade, a number of OECD and non-OECD countries have introduced regimes which provide for a preferential tax treatment for certain income arising from the exploitation of intellectual property (IP), generally through a 50% to 80 % deduction or exemption of qualified IP income. [123]

- The work undertaken under Action 5 has therefore included an examination of intangible regimes to determine whether they constitute harmful preferential tax regimes within the meaning of the OECD's 1998 Report "Harmful Tax Competition: An Emerging Global Issue".
- Action 5 of the BEPS Action Plan also requires there to be substantial activity for any preferential regime and as a result the existing substance factor has been elaborated and elevated in importance.
- In the context of IP regimes, agreement was reached on the "nexus approach" which uses expenditures as a proxy for substantial activity, ensuring that taxpayers can only benefit from IP regimes where they engaged in research and development and incurred actual expenditures on such activities.
- In the context of other preferential regimes, the same principle can be applied, so that such regimes would be found to meet the substantial activities requirement where the taxpayer undertook the core income generating activities required to produce the type of business income covered by the preferential regime.[124]

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[122] OECD/G20 2015 Final Report on Action 1 in para 222.
[123] OECD/G20 2015 Final Report on Action 1 in para 223.
[124] OECD/G20 2015 Final Report on Action 1 in para 224.

Assure that transfer pricing outcomes are in line with value creation (Actions 8-10): The BEPS work on transfer pricing addresses BEPS issues that commonly arise among companies active in the digital economy as well as other taxpayers. Taken together, the overall objective of the transfer pricing actions is to bring the allocation of income within a multinational group of companies more directly in line with the location of the economic activity that gives rise to that income (*Aligning Transfer Pricing Outcomes with Value Creation*, OECD, 2015). This objective is pursued by focusing on key transfer pricing issues including issues related to:

- the transfer and use of intangibles including hard-to-value intangibles, and cost contribution arrangements,
- delineating the actual transaction and business risks, and
- global value chains and transactional profit split methods. [125]

(i) The transfer and use of intangibles including hard-to-value intangibles, and cost contribution arrangements

A key feature of many BEPS structures adopted by participants in the digital economy involves the transfer of intangibles or rights in intangibles to tax advantaged locations. Digital economy companies rely heavily on intangibles in creating value and producing income. Depending on the local law, transfers of intangibles and rights in intangibles at non-arm's length prices can occur in connection with licensing arrangements, cost contribution arrangements or tax structures that separate deductions relevant to the development of the intangible from the income associated with it. [126] Transfers of intangibles at non-arm's length prices can occur *(i)* because of difficulties in valuing transferred intangibles at the time they are transferred; *(ii)* because of unequal access to information relating to value between taxpayers and tax administrations; and *(iii)* because some arrangements result in the transfer of hidden or unidentified intangibles without payment.

The BEPS work on intangibles addresses these issues by taking several steps.

- First, the work provides a broad but clear definition of intangibles for transfer pricing purposes, and makes clear that any intangible item for which unrelated parties would provide compensation upon transfer must be compensated in transfers between associated enterprises. This will help ensure that transfers of hidden intangibles are not used to shift income.
- Second, the work ensures that entities within an MNE group that contribute value to intangibles either by performing or managing development functions or by bearing and controlling risks are appropriately rewarded for doing so. Specifically, the revised guidance ensures that legal ownership alone does not entitle the owner to premium profits, but that the group companies

125 OECD/G20 2015 Final Report on Action 1 in para 225.
126 OECD/G20 2015 Final Report on Action 1 in para 226.

performing the important functions, contributing assets or assuming risks related to the development, enhancement, maintenance, protection and exploitation of intangibles will receive an appropriate return.

- The work also makes clear that valuation techniques can be used to determine arm's length transfer prices when comparable transfers of intangibles cannot be identified. In situations where hard-to-value intangibles are transferred, the work ensures that post transfer profitability of an intangible can be taken into account in the valuation in specified circumstances in order to balance the availability of information between taxpayers and tax administrations. [127]
- Revised guidance on cost contribution agreements (CCA) ensures that such arrangements are appropriately analysed and produce outcomes that are consistent with how and where value is created. Specifically, it ensures that the same guidance for valuing and pricing intangibles, including hard-to-value intangibles, is applicable to CCA as to other kinds of contractual arrangements. It ensures also that contributions made to CCA, with specific focus on intangibles, should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of participants, since this may lead to non-arm's length results. [128]

(ii) Delineating the actual transaction and allocating business risks

BEPS structures aimed at shifting income into low-tax environments often feature a contractual allocation of business risk into a low-tax affiliate. It then may be argued that these contractual risk allocations justify large allocations of income to the entity allocated the risk. The argument entails the assertion that other entities in the group are contractually insulated from risk so that a low-tax affiliate is entitled to substantial amounts of income after compensating other low risk group members for their functions.

- The revised guidance challenges such assertions by determining that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, and does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and have the financial capacity to assume the risk.
- This revision is part of the requirement to accurately delineate the actual transaction between the associated enterprises by supplementing, where necessary, the terms of any contract with the evidence of the actual conduct of the parties. In combination with the proper application of transfer pricing methods in a way that prevents the allocation of profits to locations where no contributions are made to these profits, this revised guidance will lead to the allocation of an appropriate return to group companies performing the

[127] OECD/G20 2015 Final Report on Action 1 in para 228.
[128] OECD/G20 2015 Final Report on Action 1 in para 229.

important functions, contributing important assets and controlling economically significant risks, as determined through the accurate delineation of the actual transaction. [129]

(iii) Global value chains and transactional profit split methods

When the arm's length principle was initially devised, it was common that each country in which an MNE group did business had its own subsidiary with full functionality and carrying out a broad range of activities reflecting the group's business as a whole. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties, and relatively high transportation costs that made integrated global supply chains difficult to operate. With the advent of improvements in information and communication technology (ICT), reductions in many currency and custom barriers, and the move to digital products and a service based economy, these barriers to integration broke down and MNE groups began to operate much more as single global firms.

Developments in ICT have thus accelerated and changed the spread of global value chains in which corporate legal structures and individual legal entities become less important and MNE groups move closer to the economist's conception of a single firm operating in a co-ordinated fashion to maximise opportunities in a global economy. Attention will therefore be devoted to the implications of this increased integration in MNEs and will evaluate the need for greater reliance on value chain analyses and transactional profit split methods. [130]

The consultation process on the transactional profit split method in the course of the BEPS Project confirmed that this method can be useful when properly applied to align profits with value creation in certain circumstances. The further work on the transactional profit split method will examine their application to highly integrated business operations and develop profit splitting factors that show strong correlation with value creation. This work should also address situations where comparables are not available because of the structures designed by taxpayers and could include revised guidance on the use of profit methods. This work will be carried out in 2016 and 2017 and may be relevant for highly integrated MNE groups in the digital economy. [131]

8.10.4 MEASURES THAT WILL ADDRESS BEPS ISSUES IN THE JURISDICTION OF THE ULTIMATE PARENT

The work on designing effective CFC rules may also contribute to restoring taxation in the jurisdiction of the ultimate parent company. As noted in the BEPS Action Plan,

[129] OECD/G20 2015 Final Report on Action 1 in para 230.
[130] OECD/G20 2015 Final Report on Action 1 in para 232.
[131] OECD/G20 2015 Final Report on Action 1 in para 233.

one source of BEPS concerns is the possibility of creating affiliated non-resident taxpayers and routing income of resident enterprises through that non-resident affiliate. Although CFC rules have been introduced in many countries to address this, there remain many jurisdictions that lack CFC rules. Where CFC rules do exist, they do not always address BEPS in a comprehensive manner. However, effective CFC rules can reduce the incentive to shift profits from a source country into a low-tax jurisdiction. The report on Action 3, *Designing Effective Controlled Foreign Company Rules* (OECD, 2015) provides recommendations in the form of six building blocks, including a definition of CFC income which sets out a non-exhaustive list of approaches or combination of approaches that CFC rules could use for such a definition. These approaches include categorical, substance, and excess profits analyses which could be applied on their own or combined with each other. The recommendations are designed to ensure that jurisdictions that choose to implement them will have effective CFC rules.[132]

To address BEPS issues within the digital economy, CFC rules must effectively address the taxation of mobile income typically earned in the digital economy. Although CFC rules vary significantly from jurisdiction to jurisdiction, income from digital goods and services provided remotely is frequently not subject to current taxation under CFC rules. Accordingly, a MNE 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 without the CFC itself performing significant activities in its jurisdiction. As a result, a digital economy company may pay little or no tax in the CFC jurisdiction while also avoiding tax in the source country and the country of ultimate residence.[133]

To address this situation, consideration was given to a number of approaches for CFC rules that could target income typically earned in the digital economy, such as IP income and income earned from the remote sale of digital goods and services. 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. Countries can implement these approaches to design CFC rules that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent company.

- For instance, countries could use the categorical analyses to define CFC income to include types of revenue typically generated in digital economy transactions such as license fees and certain types of income from sales of digital goods and services.

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132 OECD/G20 2015 Final Report on Action 1 in para 234.
133 OECD/G20 2015 Final Report on Action 1 in para 236.

- If countries adopted the excess profits approach this could characterise any “excess profits” generated in low tax jurisdictions, which may include profits attributable to IP-related assets, as CFC income.
- This approach could potentially limit the use of offshore deferral structures popular with digital economy MNEs that indefinitely defer foreign income from taxation in the residence jurisdiction. Both approaches may be combined with a substance analysis aimed at verifying whether the CFC is engaged in substantial activities in order to accurately identify and quantify shifted income. [134]

8.11 BROADER DIRECT TAX CHALLENGES FOR POLICY MAKERS RAISED BY THE DIGITAL ECONOMY AND THE OPTIONS TO ADDRESS THEM

Although the spread of the digital economy brings about many benefits, for example in terms of growth, employment and well-being more generally, it gives rise to a number of challenges for policy makers. The development of digital technologies has the potential to enable economic actors to operate in ways that avoid, remove, or significantly reduce, their tax liability. This highlights the importance of designing corporate income and consumption tax systems that promote growth and investment, while reducing inequality and establishing a level playing field among economic actors.[135] In general terms, in the area of direct taxation, the main policy challenges raised by the digital economy fall into three broad categories:

- Nexus and the ability to have a significant presence without being liable to tax;
- Characterisation of income derived from new business models; and
- Data and the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services.[136]

8.11.1 NEXUS AND THE ABILITY TO HAVE A SIGNIFICANT PRESENCE WITHOUT BEING LIABLE TO TAX

To generate income, businesses still need to source and acquire inputs, create or add value, and sell to customers. To support their sales activities, businesses have always needed to carry out activities such as market research, marketing and advertising, and customer support. Digital technology has, however, had significant impact on how these activities are carried out. Activities can for example be carried out remotely, increasing the speed at which information can be processed, analysed and utilized. Because distance forms less of a barrier to trade, it can be quite easy to expand the number of potential customers that can be targeted and reached. As a result, certain processes previously carried out by local personnel can now be performed cross-border by automated equipment, changing the nature and scope of activities to be performed by staff. Thus, the growth of a customer base in a country

134 OECD/G20 2015 Final Report on Action 1 in para 236.
135 OECD/G20 2015 Final Report on Action 1 in para 244.
136 OECD/G20 2015 Final Report on Action 1 in para 248.

does not always need the level of local infrastructure and personnel that would have been needed in a “pre-digital” age. [137]

This increases the flexibility of businesses to choose where substantial business activities take place, or to move existing functions to a new location, even if those locations may be removed both from the ultimate market jurisdiction and from the jurisdictions in which other related business functions may take place. As a result, it is increasingly possible for a business’s personnel, IT infrastructure (e.g. servers), and customers each to be spread among multiple jurisdictions, away from the market jurisdiction. Advances in computing power have also meant that certain functions, including decision-making capabilities, can now be carried out by increasingly sophisticated software programmes and algorithms. For example, contracts can in some cases be automatically accepted by software programmes, so that no intervention of local staff is necessary.[138] It is thus possible to generate a large quantity of sales without a taxable presence which raises questions about whether the current rules continue to be appropriate in the digital economy.[139]

These questions relate in particular to the definition of PE for treaty purposes, and the related profit attribution rules. The concept of PE refers not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carried on business in the country concerned via a dependent agent. [140] Nowadays it is possible to be heavily involved in the economic life of another country without having a fixed place of business or a dependent agent therein. Concerns are raised regarding whether the existing definition of PE remains consistent with the underlying principles on which it was based. For example, the ability to conclude contracts remotely through technological means, with no involvement of individual employees or dependent agents, raises questions about whether the focus of the existing rules on conclusion of contracts by persons other than agents of an independent status remains appropriate in all cases. Another specific issue raised by the changing ways in which businesses are conducted is whether certain activities that were previously considered preparatory or auxiliary (and hence benefit from the exceptions to the definition of PE) may be increasingly significant components of businesses in the digital economy. [141]

8.11.2 DATA AND THE ATTRIBUTION OF VALUE CREATED FROM THE GENERATION OF MARKETABLE LOCATION-RELEVANT DATA THROUGH THE USE OF DIGITAL PRODUCTS AND SERVICES

Digital technologies enable the collection, storage and use of data, and also enable data to be gathered remotely and from a greater distance from the market than

[137] OECD/G20 2015 Final Report on Action 1 in para 253.
[138] OECD/G20 2015 Final Report on Action 1 in para 254.
[139] OECD/G20 2015 Final Report on Action 1 in para 255.
[140] OECD/G20 2015 Final Report on Action 1 in para 256.
[141] OECD/G20 2015 Final Report on Action 1 in para 260.

previously. Data can be gathered directly from users, consumers or other sources of information, or indirectly via third parties. Data can also be gathered through a range of transactional relationships with users, or based on other explicit or implicit forms of agreement with users. Data gathered from various sources is often a primary input into the process of value creation in the digital economy. Leveraging data can create value for businesses in a variety of ways, including by allowing businesses to segment populations in order to tailor offerings, to improve the development of products and services, to better understand variability in performance, and to improve decision making.

The expanding role of data raises questions about whether current nexus rules continue to be appropriate or whether any profits attributable to the remote gathering of data by an enterprise should be taxable in the State from which the data is gathered, as well as questions about whether data is being appropriately characterised and valued for tax purposes. Although data collection is not new, the ability to collect and categorise data has increased exponentially in large part due to computing power and the growth of the internet. [142]

As with other user contributions, the value of data may be reflected in the value of the business itself, and may be monetised when the business is sold. Even where data itself is sold, the value of that data may vary widely depending on the capacity of the purchaser to analyse and make use of that data. The issue of valuing data as an asset is further complicated by existing legal questions about the ownership of personal data, and the ability of users to control whether businesses can access and utilise user data by using digital services anonymously, or by deleting data stored in local caches. Many jurisdictions have passed data protection and privacy legislation to ensure that the personal data of consumers is closely protected. [143]

The value of data, and the difficulties associated with determining that value, is also relevant for tax purposes in the cross-border context and triggers questions regarding whether:

- The remote collection of data should give rise to nexus for tax purposes even in the absence of a physical presence, and if so (or in the case of an existing taxable presence); and
- What impact this would have on the application of transfer pricing and profit attribution principles, which in turn require an analysis of the functions performed, assets used and risks assumed.

The fact that the value of data can impact tax results places pressure on the valuation of data. Further, the fact that the value of data can impact tax results if attributable to a PE or if held by a local subsidiary and sold to a foreign enterprise,

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[142] OECD/G20 2015 Final Report on Action 1 in para 262.
[143] OECD/G20 2015 Final Report on Action 1 in para 263.

but not if collected directly by a foreign enterprise with no PE, places pressure on the nexus issues and raises questions regarding the location of data collection.[144]

In addition, data, including location-specific data, may be collected from customers or devices in one country using technology developed in a second country. It may then be processed in the second country and used to improve product offerings or target advertisements to customers in the first country. Determining whether profit is attributable to each of these functions and the appropriate allocation of that profit between the first country and the second country raises tax challenges. These challenges may be exacerbated by the fact that in practice a range of data may be gathered from different sources and for different purposes by businesses and combined in various ways to create value, making tracing the source of data challenging. This data may be stored and processed using cloud computing, making the determination of the location where the processing takes place similarly challenging. [145]

8.11.3 CHARACTERISATION OF INCOME DERIVED FROM NEW BUSINESS MODELS

Products and services can be provided to customers in new ways through digital technology. This raises questions regarding both the rationale behind existing categorisations of income and consistency of treatment of similar types of transactions. New business models raise new questions about how to characterise certain transactions and payments for domestic and tax treaty law purposes. The question for tax treaty purposes is often whether such payments should be treated as royalties (particularly under treaties in which the definition of royalties includes payments for rentals of commercial, industrial, or scientific equipment), fees for technical services (under treaties that contain specific provisions in that respect), or business profits. More specifically, questions arise regarding whether infrastructure-as-a-service transactions should be treated as services (and hence payments characterised as business profits for treaty purposes), as rentals of space on the cloud service provider's servers by others (and hence be characterised as royalties for purposes of treaties that include in the definition of royalties payments for rentals of commercial, industrial, or scientific equipment), or as the provision of technical services.[146]

The development and increasing use of 3D printing may also raise character questions. For example, if direct manufacturing for delivery evolves into a license of designs for remote printing directly by purchasers, questions may arise as to whether and under what circumstances payments by purchasers may be classified as

144 OECD/G20 2015 Final Report on Action 1 in para 264.
145 OECD/G20 2015 Final Report on Action 1 in para 265.
146 OECD/G20 2015 Final Report on Action 1 in para 269.

royalties rather than as business profits, or may be treated as fees for technical services. [147]

Under most tax treaties, business profits would be taxable in a country only if attributable to a PE located therein. In contrast, certain other types of income, such as royalties, may be subject to withholding tax in the country of the payer, depending on the terms of any applicable treaty. The characterisation of income arising from a transaction as business profits or as another type of income, can result in a different treatment for tax treaty purposes. There is therefore a need to clarify the application of existing rules to some new business models. [148]

At the same time, when considering questions regarding the characterisation of income derived from new business models, it may be necessary to examine the rationale behind existing rules, in order to determine whether those rules produce appropriate results in the digital economy and whether differences in treatment of substantially similar transactions are justified in policy terms. These developments imply that further clarity may be needed regarding the tax treaty characterisation of certain payments under new business models, especially cloud computing payments (including payments for infrastructure-as-a-service, software-as-a-service, and platform-as-a-service transactions). [149] In addition, issues of characterisation have broader implications for the allocation of taxing rights for direct tax purposes. For example, if a new type of business is able to interact extensively with customers in a market jurisdiction and generate business profits without physical presence that would rise to the level of a PE, and it were determined that the market jurisdiction should be able to tax such income on a net basis, modifying the PE threshold and associated profit attribution rules could permit such taxation. Source taxation could also be ensured by creating a new category of income that is subject to withholding tax. As a result, the issue of characterisation has significant implications for the issue of nexus. [150]

8.12 DEVELOPING OPTIONS TO ADDRESS THE BROADER DIRECT TAX CHALLENGES OF THE DIGITAL ECONOMY

The OECD discussed some options to address the broader direct tax challenges raised by the digital economy, as there is a substantial overlap between the challenges related to nexus, data, and characterisation, it was considered that rather than attempting to individually target them, any potential option should instead focus more generally on the ability of businesses in the digital economy to *(i)* derive sales income from a country without a physical presence, and *(ii)* use the contributions of users in the value chain (including through collection and monitoring of data), and

[147] OECD/G20 2015 Final Report on Action 1 in para 270.
[148] OECD/G20 2015 Final Report on Action 1 in para 271.
[149] OECD/G20 2015 Final Report on Action 1 in para 272.
[150] OECD/G20 2015 Final Report on Action 1 in para 272.

monetise these contributions by selling the data to third parties, by selling targeted ads, by selling the business itself, or in any other way.[151] The options analysed included:

- modifications to the exceptions from PE status;
- alternatives to the existing PE threshold;
- the imposition of a withholding tax on certain types of digital transactions; and
- the introduction of a tax on bandwidth use.[152]

8.12.1 MODIFICATIONS TO THE EXCEPTIONS FROM PE STATUS

With respect to the exceptions from PE status (contained in Article 5(4) of the OECD Model Tax Convention), work in the context of Action 7 of the BEPS Project will result in the modification of these exceptions to ensure that they are available only for activities that are of a preparatory or auxiliary nature.[153]

8.12.2 A NEW NEXUS BASED ON THE CONCEPT OF SIGNIFICANT ECONOMIC PRESENCE

This option would create a taxable presence in a country when a non-resident enterprise has a significant economic presence in a country on the basis of factors that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools. These factors would ensure that only cases of significant economic presence are covered, limit compliance costs of the taxpayers, and provide certainty for cross-border activities.[154] The factors to be considered are:

- <u>The revenue-based factor:</u> Revenue that is generated on a sustained basis from a country could be considered to be one of the clearest potential indicators of the existence of a significant economic presence.[155]
- <u>Digital factors:</u> The test for significant economic presence in the digital economy could be determined through the ability to establish and maintain a purposeful and sustained interaction with users or customers in a specific country via an online presence depends on a range of digital factors, including: a local domain name, a local digital platform; and local payment options.[156]
- <u>User-based factors:</u> Given the importance of network effects in the digital economy, the user base and the associated data input may also be important indicators of a purposeful and sustained interaction with the economy of that another country. Examples of user based factors that reflect the level of

151 OECD/G20 2015 Final Report on Action 1 in para 273.
152 OECD/G20 2015 Final Report on Action 1 in para 274.
153 OECD/G20 2015 Final Report on Action 1 in para 275.
154 OECD/G20 2015 Final Report on Action 1 in para 277.
155 OECD/G20 2015 Final Report on Action 1 in para 278.
156 OECD/G20 2015 Final Report on Action 1 in para 279.

participation in the economic life of a country are: monthly active users, online contract conclusion and data collected. [157]

Determining the income attributable to the significant economic presence

Attribution of profits is a key consideration in developing a nexus based on significant economic presence in cases where an enterprise has no physical presence in the country concerned. If the significant economic presence is adopted, consideration must be given changing profit attribution rules while ensuring parity to the extent possible between enterprises that are subject to tax due to physical presence in the market country (i.e. local subsidiary or traditional PE) and those that would be taxable using the significant economic presence test.[158] Where significant economic presence nexus is adopted, the OECD has considered the following options for attributing profits to PE:[159]

- Methods based on fractional apportionment: The OECD considered the apportionment of the profits of the whole enterprise to the digital presence either on the basis of a predetermined formula, or on the basis of variable allocation factors determined on a case-by-case basis. However it found that in the context of a significant economic presence, effective implementation of a method based on fractional apportionment would require overcoming challenges of *(1)* the definition of the tax base to be divided, *(2)* the determination of the allocation keys to divide that tax base, and *(3)* the weighting of these allocation keys. Since domestic laws of most countries use profit attribution methods based on the separate accounts of the PE, rather than fractional apportionment (which would be a departure from current international standards), fractional apportionment methods were not pursued further. [160]
- Modified deemed profit methods: In the context of a nexus based on significant economic presence, one possible approach would be to regard the presence to be equivalent to a physical presence from which the non-resident enterprise is operating a commercial business and determine the deemed net income by applying a ratio of presumed expenses to the non-resident enterprise's revenue derived from transactions concluded with in-country customers. Determining an appropriate ratio would depend on a number of factors, including the industry concerned, the degree of integration of the particular enterprise, and the type of product and service provided. [161]

[157] OECD/G20 2015 Final Report on Action 1 in para 280.
[158] OECD/G20 2015 Final Report on Action 1 in para 284.
[159] OECD/G20 2015 Final Report on Action 1 in para 285.
[160] OECD/G20 2015 Final Report on Action 1 in para 287.
[161] OECD/G20 2015 Final Report on Action 1 in para 290-291.

8.12.3 A WITHHOLDING TAX ON DIGITAL TRANSACTIONS

A withholding tax could be levied on payments by residents (and local PEs) of a country for goods and services purchased online from non-resident providers. This withholding tax could in theory be imposed as a standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online or, alternatively, as a primary collection mechanism and enforcement tool to support the application of the nexus option described above, i.e. net-basis taxation.[162]

8.12.4 AN "EQUALISATION LEVY"

To avoid some of the difficulties arising from creating new profit attribution rules for purposes of a nexus based on significant economic presence, an "equalisation levy" could be considered as an alternative way to address the broader direct tax challenges of the digital economy. This approach has been used by some countries in order to ensure equal treatment of foreign and domestic suppliers. An equalisation levy would be intended to serve as a way to tax a non-resident enterprise's significant economic presence in a country. In order to provide clarity, certainty and equity to all stakeholders, and to avoid undue burden on small and medium-sized businesses, therefore, the equalisation levy would be applied only in cases where it is determined that a non-resident enterprise has a significant economic presence.[163]

NOTE: The above three options i.e., the new nexus based on the concept of significant economic presence, withholding tax on digital transactions and the equalisation levy; have been conceived in a way that allows them to be either combined into a single option or chosen individually. [164]

9 ADDRESSING THE DIRECT TAX CHALLENGES OF THE DIGITAL ECONOMY IN SOUTH AFRICA

In South Africa, the 1997 Katz Commission Report[165] 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.[166] 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

[162] OECD/G20 2015 Final Report on Action 1 in para 292.
[163] OECD/G20 2015 Final Report on Action 1 in para 302.
[164] OECD/G20 2015 Final Report on Action 1 in para 276.
[165] 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)").
[166] Ibid.

changes brought about by e-commerce, but that it should internationalise its laws affecting international trade and investment.[167]

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.[168] This culminated into the Green Paper on E-commerce released in 2000[169] 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,[170] 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.[171] 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.[172] As a result of the green/white paper process that forged an e-commerce policy for South Africa,[173] in 2002, the Electronic Communications and Transactions Act[174] was enacted. This Act repealed the Computer Evidence Act of 1983.[175] The preamble to the Electronic Communications and Transactions Act[176] *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

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167 Ibid.

168 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.

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

170 Ibid.

171 Ibid.

172 Ibid.

173 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.

174 Act 25 of 2002.

175 57 of 1983.

176 Act 25 of 2002.

identification problems posed by e-commerce.[177] On the whole, however, the Electronic Communications and Transactions Act does not provide for taxation issues in respect of e-commerce transactions.

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.[178] Electronic recording keeping is now provided for in section 30(1)(b) of the Tax Administration Act. However, the TAA 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.[179]

The drag in coming up with legislation on the taxation of the digital economy in South Africa can be explained from the fact that as a developing country, taxing the digital is has not been an urgent concern in South African as such measures would stifle the development of badly needed electronic advancements. Focusing on taxing the digital economy has also not been an urgent concern since the economy of South Africa has not reached the likes of US and European levels. Most digital companies in Africa are generally small and relatively unprofitable. South Africa is yet to see the rise of local e-commerce businesses from abroad (other than Amazon).[180]

9.1 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.

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177 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 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.

178 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.

179 Oguttu & Van der Merwe at 321; see also RL Doernberg, L Hinnekens & W Hererstein 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.

180 SAIT: Comments on DTC First Interim BEPS Report (March 2015). Slide 14 of PowerPoint presentation.

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 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 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,[181] the originating cause would be where the server is located.

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

181 Paragraph 42.1 to 42.10 of the Commentary on article 5 of the OECD MTC.

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.

9.2 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 adopts the OECD recommendations.

- The proposals by the OECD to change the definition of a PE in double tax treaties will help to address this matter. 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 payor principle (like a royalty). The rules could for instance provide that digital goods or services are sourced where the recipient who pays for the digital goods or services is based,[182] which would be where the South African tax-resident; physically present in South Africa, is at the 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.
- The recommended new source rules for non-resident suppliers of goods and services via e-commerce to South African customers should cover the situation where physical goods and services are delivered or rendered in South Africa and for which payment is made electronically to a non-resident (consider, for example, where payment is made to a non-resident, but where the service is rendered in South Africa, or the case where goods are delivered in South Africa, but payment is made to a non-resident). This would create the foundation for South Africa to tax non-residents on such goods and services, subject to the application of any tax treaty and the revised nexus rules contained therein, and provide for a level playing field between foreign and

182 SAIT: Comment on DTC First Interim BEPS Report (March 2015) Slide 14 of the Power Point Presentation.

domestic suppliers of similar goods and services. However any such services should be deemed to not be from a South Africa source where they do not meet the South Africa sourced rule. This is crucial in order to provide double tax relief to South African resident providers of such services and create a level playing field.[183]

- Apart from the gap in the source rules, there are also administrative concerns. Currently non-residents are 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.
- The current rules that require non-resident companies with South African sourced income to submit income tax returns even if they do not have a PE in South Africa 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.
- To alleviate the compliance burden on non-residents having to submit comprehensive tax returns, notwithstanding that they may not be liable to tax in South Africa, an alternative measure would be for a non-resident to be able to apply for a ruling to the effect that it is not liable to tax in South Africa on its specific facts and circumstances and to be relieved of the obligation to submit tax returns for so long as there is no change in the circumstance (including the law).[184]
- 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.
- 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

183 PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.
184 PWC "Comment on DTC BEPS First Interim Report" (30 March 2015) at 9.

resident countries 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.[185] 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.

10 ADMINISTRATIVE CHALLENGES IN THE DIGITAL ECONOMY

Regarding the tax administration challenges of the digital economy, it is worth noting that the BEPS Action 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.[186] 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, the tax authorities of the source country may need to seek information from non-residents who have no operations in the source country.[187] 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.[188] 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."[189]

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

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

187 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.

188 OECD 2014 Discussion Draft Report on Action 1 at 62.

189 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.

There is a pressing need to consider how investment in skills, technologies and data management can help tax administrations keep up with the ways in which technology is transforming business operations. 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. These issues as explained in the OECD Final Report on the digital economy are outlined below:[190]

- **Identification:** While global business structures in the digital economy involve traditional identification challenges, these challenges are magnified in the digital economy. For example, the market jurisdiction may not require registration or other identification when overseas businesses sell remotely to customers in the jurisdiction, or may have issues with implementing registration requirements, as it is often difficult for tax authorities to know that activities are taking place, to identify remote sellers and to ensure compliance with domestic rules. Difficulties in identifying remote sellers may also make ultimate collection of tax difficult.
- **Determining the extent of activities:** Even if the identity and role of the parties involved can be determined, it may be impossible to ascertain the extent of sales or other activities without information from the offshore seller, as there may be no sales or other accounting records held in the local jurisdiction or otherwise accessible by the local revenue authority. It may be possible to obtain this information from third parties such as the customers or payment intermediaries, but this may be dependent on privacy or financial regulation laws.
- **Information collection and verification:** To verify local activity, the market jurisdiction's tax administration may need to seek information from parties that have no operations in the jurisdiction and are not subject to regulation therein. While exchange of information can be a very useful tool where the proper legal basis is 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. This can create challenges for a market jurisdiction revenue authority seeking to independently verify any information provided by the offshore entity.
- **Identification of customers:** There are in principle a number of ways in which a business can identify the country of residence of its client and/or the country in which consumption occurs. These could include freight forwarders or other customs documentation or tracking of Internet Protocol (IP) and card billing addresses. However, this could be burdensome for the business and would not work where customers are able to disguise their location.

Most of these administrative challenges can be dealt with from the various recommends discussed in the Report above. The OECD is carrying out operational

[190] OECD/G20 2015 Final Report on Action 1 per Box 7.1 at 105.

work within the Forum on Tax Administration to develop a strong voluntary compliance culture and expand the use of modern technology for self-service delivery purposes.[191]

10.1 RECOMMENDATIONS FOR SOUTH AFRICA REGARDING THE ADMINISTRATIVE CHALLENGES OF THE DIGITAL ECONOMY

- 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.
- 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.
- SARS can also obtain information for purposes of identifying digital businesses carrying on activities in South Africa using the exchange of information tools provided for in treaties. While the major players such as Google and Amazon are well known, the nature of the digital economy is such that new players appear on a continuous basis. Other avenues of obtaining third party information from domestic sources in relation to digital transactions should be explored. In this regard, consultations should be held with the financial institutions to investigate the feasibility of providing information related to electronic transactions with non-residents and which could be provided to SARS through the IT3 mechanism. However, any such mechanism should not impose an excessive compliance burden on the financial institutions relative to the benefit to SARS.[192]

11 INDIRECT TAXES AND THE DIGITAL ECONOMY

191 OECD/G20 2015 Final Report on Action 1 per Box 7.1 at 105.

192 PWC Comments on “DTC BEPS First Interim Report” (30 March 2015) at 10.

Given the difficulties that countries face in asserting direct income taxes on e-commerce, assessing indirect taxes on the transactions has proven much easier.[193] The argument is that when companies 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 sharing. The presence of the immobile local consumer and the economic activity of the non-resident business should be the focus.[194]

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.[195] 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.[196] There is a case to be made that getting the VAT determinations correct "is more important than figuring out if a PE exists.[197]

11.1 PREVIOUS OECD WORK ON APPLYING INDIRECT TAXES TO THE DIGITAL ECONOMY

At the 1999 Ottawa Ministerial Conference on Electronic Commerce,[198] 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",[199] and endorsed the set of taxation principles which should apply to electronic commerce.[200] In the field of consumption

[193] 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.

[194] L Shepperd "What should the OECD do about Base Erosion?" Copenhagen precise of 2013 International Fiscal Association annual Congress" 9/9/2013.

[195] 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.

[196] Ibid.

[197] Ibid.

[198] OECD "Forum Background: The Ottawa Conference" (October 1999). Available at http://www.oecd.org/sti/ieconomy/forumbackgroundtheottawaconference.htm accessed 5 May 2014.

[199] 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.

[200] OECD 2014 Discussion Draft Report on Action 1 in Annex 1.

taxes, the core elements of the Taxation Framework Conditions can be summarised as follows:[201]

- 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.
- 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 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."[202]

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.[203]

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201 OECD 2014 Discussion Draft Report on Action 1 in para 3.3 of Annex 1.
202 OECD 2014 Discussion Draft Report on Action 1 in para 242.
203 OECD "International VAT/GST Guidelines: Draft Consolidated Version" (February 2013) http://www.oecd.org/ctp/consumption/ConsolidatedGuidelines20130131.pdf accessed 6 May 2014.

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 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".[204] 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."[205]

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.[206]

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.

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204 OECD Consumption Tax Trends, VAT / GST and Excise Rates, Trends and Administration Issues.

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

206 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 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.

The OECD guidelines with respect to "'registration"' as a tax collection mechanism 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.[207]

12 INTERNATIONAL TRENDS ON INDIRECT TAXES AND THE DIGITAL ECONOMY

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

12.1 THE EUROPEAN UNION (EU)

The EU VAT Directive[208] 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 effectively applied, the EU has recently come up with a VAT Directive[209] 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. (It should

208 Directive 2006/112/EC.
209 Directive 2013/42/EU and Directive 2013/43/EU.

be noted though that the compliance by the non-resident suppliers would still remain and issues and that this problem is not limited to e-commerce supplies).

12.2 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."[210]

VAT registration is required in Canada if the non-resident supplier has a PE in Canada and is not a "small supplier"; or does not have a PE in Canada but make taxable supplies in Canada in the course of a business carried; on in Canada (subject to requirements).[211] 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."[212] [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.[213]

12.3 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

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

211 Ibid.

212 Ibid.

213 Ibid.

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.

13 OECD BEPS ACTION ON THE DIGITAL ECONOMY: INDIRECT TAXES

In the 2013 OECD report on BEPS Action 1 points out the challenges the digital economy poses to international taxation.[214] With respect to indirect taxes, the OECD called on countries to ensure the effective collection of VAT/GST with respect to cross-border supply of digital goods and services. The 2015 Final Report on the digital economy exposes how the digital economy can be used to circumvent indirect taxes and it provides recommendations to curb base erosion

13.1 OPPORTUNITIES FOR BEPS IN THE DIGITAL ECONOMY WITH RESPECT TO INDIRECT TAXES

The OECD 2015 Final Report on the digital economy notes that if the OECD's "Guidelines on place of taxation for B2B supplies of services and intangibles" are not implemented, opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT may arise with respect to:

- remote digital supplies to exempt businesses, and
- remote digital supplies acquired by enterprises that have establishments (branches) in more than one jurisdiction (multiple location entities – MLE) that are engaged in exempt activities.[215]

13.1.1 REMOTE DIGITAL SUPPLIES TO EXEMPT BUSINESSES

VAT is generally not designed to be a tax on businesses as businesses are generally able to recover any tax they pay on their inputs. Many VAT jurisdictions using the destination principle for business-to-business (B2B) digital supplies will generally require a business customer in their jurisdiction to self-assess VAT on acquisitions of remotely delivered services and intangibles and then allow the business to claim a credit for this self-assessed VAT. The vast number of cross-border supplies made between businesses (other than businesses engaged in exempt activities) do not therefore, generally create BEPS concerns.[216]

BEPS concerns in a VAT context could arise however, with respect to offshore digital supplies made to exempt businesses (e.g. the financial services industry). Where a

214 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 14.
215 OECD/G20 2015 Final Report on Action 1 in para 197.
216 OECD/G20 2015 Final Report on Action 1 in para 198.

business is engaged in VAT-exempt activities, no VAT is levied on the exempt supplies made by the business, while VAT incurred by the business on the associated inputs is not deductible. For example, a business acquiring a data processing service from a non-resident supplier would be required to self-assess VAT according to the rules of the jurisdiction in which it is located and could claim an off-setting credit for this self-assessed VAT (some jurisdictions may not require the business to self-assess tax as it is entitled to an offsetting credit). If the business customer is an exempt business, it is still required to self-assess VAT in these jurisdictions but would not be able to claim a credit for the self-assessed tax. The exempt business is then “input taxed” in its residence jurisdiction, where it is assumed to use the service for making exempt supplies. [217]

However, some jurisdictions currently do not require the exempt business to self-assess VAT on the services and intangibles acquired from abroad. In such case, no VAT is levied on the transaction.

BEPS concerns also arise if the data processing services would be subject to VAT in the jurisdiction where the supplier is resident (established, located). The VAT would then accrue to the jurisdiction in which the supplier is situated and not the jurisdiction of the exempt business. This is likely to raise concerns particularly where this jurisdiction has no VAT or a VAT rate lower than the rate in the jurisdiction of the exempt business customer. In these cases, the exempt business customer would pay no VAT or an inappropriately low amount of VAT.

The above cases illustrate how an exempt business could pay no or an inappropriately low amount of VAT when acquiring digital supplies from suppliers abroad. They also illustrate how domestic suppliers of competing services could face potential competitive pressures from non-resident suppliers. Domestic suppliers are required to collect and remit VAT on their supplies of services to domestic businesses while non-resident suppliers could structure their affairs so that they collect no or an inappropriately low amount of VAT. [218]

13.1.2 REMOTE DIGITAL SUPPLIES TO A MULTI-LOCATION ENTERPRISE

BEPS concerns could also arise in cases where a digital supply is acquired by an MNE. It is common practice for multinational businesses to arrange for a wide scope of services to be acquired centrally to realise economies of scale.

- Typically, the cost of acquiring such a service or intangible is initially borne by the establishment that has acquired it and, in line with normal business practice, is subsequently recharged to the establishments using the service or intangible. The establishments are charged for their share of the service or

217 OECD/G20 2015 Final Report on Action 1 in para 199.
218 OECD/G20 2015 Final Report on Action 1 in para 203.

intangible on the basis of the internal recharge arrangements, in accordance with corporate tax, accounting and other regulatory requirements.

- However, many VAT jurisdictions do not currently apply VAT to transactions that occur between establishments of one single legal entity.[219] This means that where an establishment of an MLE acquires a service, for instance data processing services, for use by other establishments in other jurisdictions, no additional VAT would apply on any internal cost allocations or recharges made within the MLE for the use of these services by other establishments.
- On the other hand, the establishment that acquired the service will be generally entitled to recover any input VAT on the acquisition of these services if it is a taxable business. In other words, the other establishments using the data processing services are able to acquire their portion of these services without incurring any VAT. This is generally not a great concern from a VAT perspective if all of the establishments of the MLE using the service are taxable businesses. This is because in this case they have a right to recover any input VAT. However, where the establishments using the data processing services are exempt businesses, they are not normally entitled to recover VAT paid on their inputs. [220]

13.2 ADDRESSING BEPS ISSUES IN THE AREA OF CONSUMPTION TAXES

The digitisation of the economy has greatly facilitated the ability of businesses to acquire a wide range of services and intangibles from suppliers in other jurisdictions around the world and to structure their operations in a truly global manner. These developments have allowed exempt businesses to avoid and minimise the amount of unrecoverable VAT they pay on their inputs. Such 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.

- The implementation of Guidelines 2 and 4 of the OECD's International VAT/GST Guidelines on place of taxation for business-to-business (B2B) supplies of services and intangibles will minimise BEPS opportunities for supplies of remotely delivered services and intangibles made to exempt businesses, including exempt entities that operate through establishments (branches) in multiple jurisdictions.[221]
- Guideline 2 recommends that the taxing rights on cross-border supplies of services and intangibles between businesses be allocated to the jurisdiction where the customer has located its business establishment and that business customers be required to self-assess VAT on remotely delivered services or

219 OECD/G20 2015 Final Report on Action 1 in para 201.
220 OECD/G20 2015 Final Report on Action 1 in para 201.
221 OECD/G20 2015 Final Report on Action 1 in para 238.

intangibles acquired from offshore suppliers according to the rules of the jurisdiction in which they are located.[222]

- Guideline 4 provides that when a supply is made to a business that is established in more than one jurisdiction, taxation should accrue to the jurisdiction where the customer's establishment (branch) using the service or intangible is located. These Guidelines set out the possible mechanisms for tax authorities to achieve the desired result in practice, which is allocation of the right to levy VAT on B2B services and intangibles to the jurisdiction where these services are used for business purposes irrespective of how the supply and acquisition of these services and intangibles were structured.[223]

13.3 BROADER INDIRECT TAX CHALLENGES RAISED BY THE DIGITAL ECONOMY AND THE OPTIONS TO ADDRESS THEM

13.3.1 CHALLENGES IN THE COLLECTION OF VAT IN THE DIGITAL ECONOMY

Cross-border trade in goods, services and intangibles (which include for VAT purposes digital downloads) create challenges for VAT systems, particularly where such products are acquired by private consumers from suppliers abroad. The digital economy magnifies these challenges, as the evolution of technology has dramatically increased the capability of private consumers to shop online and the capability of businesses to sell to consumers around the world without the need to be present physically or otherwise in the consumer's country. This often results in no or an inappropriately low amount of VAT being levied on these flows, with adverse effects on countries' VAT revenues and on the level playing field between resident and non-resident vendors.[224] The main tax challenges related to VAT in the digital economy relate to:

- imports of low value parcels from online sales which are treated as VAT-exempt in many jurisdictions, and
- the strong growth in the trade of services and intangibles, particularly sales to private consumers, on which often no or an inappropriately low amount of VAT is levied due to the complexity of enforcing VAT-payment on such supplies.[225]

(a) <u>Exemptions for imports of low valued goods:</u> The first challenge regarding collection of VAT arises from the growth that has occurred in e-commerce and in particular, online purchases of physical goods made by consumers from suppliers in another jurisdiction. Countries with VAT collect tax on imports of goods from the importer at the time the goods are imported using customs collection mechanisms. Many VAT jurisdictions apply an exemption from VAT for imports of low value goods

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222 OECD/G20 2015 Final Report on Action 1 in para 239.
223 OECD/G20 2015 Final Report on Action 1 in para 240.
224 OECD/G20 2015 Final Report on Action 1 in para 309.
225 OECD/G20 2015 Final Report on Action 1 in para 309.

as the administrative costs associated with collecting the VAT on the goods is likely to outweigh the VAT that would be collected on those goods. The value at which the exemption threshold is set varies considerably from country to country but regardless of the threshold value, many VAT countries have seen a significant growth in the volume of low value imports on which VAT is not collected.[226]

Challenges arise from the ability of businesses to deliberately structure their affairs to take advantage of a country's low value thresholds and sell goods to consumers without the payment of VAT. For example, a domestic business selling low value goods online to consumers in its jurisdiction would be required to collect and remit that jurisdiction's VAT on its sales. The business could restructure its affairs so that the low value goods are instead shipped to its consumers from an offshore jurisdiction and therefore qualify under that VAT jurisdiction's exemption for low value importations. Similarly, a business starting up could structure its operations to deliberately take advantage of the low value exemption and locate offshore rather than in the jurisdiction in which its customers are located. [227]

The exemption for low value imports results in decreased VAT revenues and the possibility of unfair competitive pressures on domestic retailers who are generally required, depending for instance on their size, to charge VAT on their sales to domestic consumers. As a consequence, the concern is not only this immediate loss of revenue and competitive pressures on domestic suppliers, but also the incentive that is created for domestic suppliers to locate or relocate to an offshore jurisdiction in order to sell their low value goods free of VAT. It should also be noted that such relocations by domestic businesses would have added negative impacts on domestic employment and direct tax revenues. [228]

The exemptions for low value imports have therefore become increasingly controversial in the context of the growing digital economy. The difficulty lies in finding the balance between the need for appropriate revenue protection and avoidance of distortions of competition, which tend to favour a lower threshold and the need to keep the cost of collection proportionate to the relatively small level of VAT collected, which favours a higher threshold. At the time when most current low value import reliefs were introduced, internet shopping did not exist and the level of imports benefitting from the relief was relatively small. Over recent years, many VAT countries have seen a significant and rapid growth in the volume of low value imports of physical goods on which VAT is not collected resulting in decreased VAT revenues and growing unfair competitive pressures on domestic retailers who are required to charge VAT on their sales to domestic consumers. [229]

[226] OECD/G20 2015 Final Report on Action 1 in para 310.
[227] OECD/G20 2015 Final Report on Action 1 in para 311.
[228] OECD/G20 2015 Final Report on Action 1 in para 312.
[229] OECD/G20 2015 Final Report on Action 1 in para 313.

(b) Remote digital supplies to consumers: The second challenge regarding collection of VAT arises from the strong growth in cross-border business-to-consumer (B2C) supplies of remotely delivered services and intangibles. The digital economy has increasingly allowed the delivery of such products by businesses from a remote location to consumers around the world without any direct or indirect physical presence of the supplier in the consumer's jurisdiction. Such remote supplies of services and intangibles present challenges to VAT systems, as they often result in no or an inappropriately low amount of VAT being collected and create potential competitive pressures on domestic suppliers. [230]

Consider an example of an online supplier of streaming digital content such as movies and television shows. The supplies are made mainly to consumers who can access the digital content through their computers, mobile devices and televisions that are connected to the internet. If the supplier is resident in the same jurisdiction as its customers, it would be required to collect and remit that jurisdiction's VAT on the supplies. However, if the supplier is a non-resident in the consumer's jurisdiction, issues may arise. [231]

Broadly two approaches are used by countries for applying VAT to such cross-border supplies of services or intangibles:

- the first approach allocates the taxing rights to the jurisdiction where the supplier is resident; whereas
- the second approach allocates the taxing rights to the jurisdiction where the customer is resident. [232]

If the first approach is applied to the supply of digital content in the example, then this supply will be subject to VAT in the supplier's jurisdiction at the rate that is applicable in that jurisdiction. If the jurisdiction of the supplier of the digital content in the example applies no VAT or a VAT with a lower rate than that of the consumer's jurisdiction, then no or an inappropriately low amount of VAT would be collected on this supply and none of the VAT revenue would accrue to the jurisdiction where the final consumption takes place. [233]

The second approach that allocates the taxing rights to the jurisdiction where the customer is resident would, in principle, result in taxation in the jurisdiction of consumption. However, under this approach, it is challenging for the private consumers' jurisdictions to ensure an effective collection of the VAT on services and intangibles acquired by such consumers abroad. One option is to require the private consumer to remit, or "self-assess", the VAT in its jurisdiction at the rate applicable in this jurisdiction. However, such consumer self-assessment mechanism has proven

230 OECD/G20 2015 Final Report on Action 1 in para 314.
231 OECD/G20 2015 Final Report on Action 1 in para 315.
232 OECD/G20 2015 Final Report on Action 1 in para 316.
233 OECD/G20 2015 Final Report on Action 1 in para 316.

to be largely ineffective and as result, it is highly likely that no VAT would be paid by the consumer in this scenario.[234]

The OECD's E-commerce Guidelines of 2003 therefore recommend a mechanism that requires the non-resident supplier to register, collect and remit VAT according to the rules of the jurisdiction in which the consumer is resident. This results in the correct amount of VAT being paid in the jurisdiction of consumption. This approach, however, is dependent on the non-resident supplier complying with the requirement to register, collect and remit the VAT. In other words, if taxing rights are allocated to the jurisdiction of consumer residence without implementing a suitable mechanism to collect the tax in this jurisdiction, it is unlikely that VAT would be paid. [235]

- The example above illustrates how domestic suppliers of competing services could face potential competitive pressures from non-resident suppliers. Domestic suppliers are required to collect and remit VAT on their supplies of services and intangibles to their domestic consumers while the non-resident supplier, depending on the scenario, could structure its affairs so that it collects and remits no or an inappropriately low amount of tax.
- The example also illustrates how an incentive could arise for domestic suppliers to restructure their affairs so that their supplies of services and intangibles are made from an offshore location, which could allow them to make the supplies with no or an inappropriately low amount of VAT. This incentive could arise as a response to competition from non-resident suppliers who are collecting no or an inappropriately low amount of VAT or as part of a strategy to gain a potential competitive advantage over domestic suppliers who are charging VAT. Such relocations by domestic businesses are likely to have a negative impact on domestic employment and direct tax revenues. [236]

Against this background, jurisdictions are increasingly looking at ways to ensure the effective collection of VAT on services and intangibles acquired by resident consumers from suppliers abroad through a digital platform, in line with the destination principle, relying primarily on a requirement for non-resident suppliers to register and collect and remit the tax.

- Compliance with these requirements is essentially voluntary as the consumers' jurisdictions have limited means to enforce compliance by non-resident non-established suppliers.
- The experience in countries that have implemented such an approach suggests that a significant number of suppliers comply by either registering in the VAT jurisdiction and collecting and remitting tax on their remotely delivered services, or by choosing to establish a physical presence in the jurisdiction and effectively becoming a "domestic" supplier.

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234 OECD/G20 2015 Final Report on Action 1 in para 317.
235 OECD/G20 2015 Final Report on Action 1 in para 317.
236 OECD/G20 2015 Final Report on Action 1 in para 318.

- It has been suggested that particularly the high-profile operators, which occupy a considerable part of the market, wish to be seen to be tax-compliant notably for reputational reasons.
- In the absence of a system that makes it easy for non-resident businesses to comply and without having well-functioning means of international co-operation between tax authorities, however, many non-resident suppliers are likely to fail to register and remit the VAT in the consumer's jurisdiction, without any real possibility for tax authorities to audit and sanction them. As a result, there is a loss of VAT revenue to these jurisdictions and potentially unfair competitive pressures on domestic suppliers. [237]

Some VAT regimes that allocate taxing rights to the jurisdiction of the residence or the actual location of the consumer, have not implemented a mechanism for collecting the VAT on services acquired by private consumers from non-resident suppliers. This has notably been based on the consideration that it would be overly burdensome on tax administrations to operate such a collection mechanism. As a result, no VAT is paid on digital supplies imported in these jurisdictions by private consumers. The strong growth of the digital economy, particularly the growing scale of B2C trade in digital products, may render this approach increasingly unsustainable. [238]

13.3.2 ADDRESSING THE BROADER INDIRECT TAX CHALLENGES OF THE DIGITAL ECONOMY

The OECD notes that collection of VAT on cross-border transactions concluded through digital media is a key issue that must be addressed urgently to level the playing field between foreign and domestic suppliers and to protect countries' VAT revenues.[239]

(a) The collection of VAT on imports of low value goods

When countries implement the VAT exemption thresholds for imports of low value goods, they generally attempt to find the appropriate balance between the administrative and compliance costs of taxing low value imports and the revenue loss and potential competitive distortions that the exemptions may create. However, these exemption thresholds were generally established before the advent and growth of the digital economy and a review may therefore be required to ensure that they are still appropriate. [240]

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237 OECD/G20 2015 Final Report on Action 1 in para 319.
238 OECD/G20 2015 Final Report on Action 1 in para 320.
239 OECD/G20 2015 Final Report on Action 1 in para 321.
240 OECD/G20 2015 Final Report on Action 1 in para 322.

If the efficiency of processing imports of low value goods and of collecting the VAT on such imports could be improved, governments may be in a position to lower these VAT exemption thresholds and address the issues associated with their operation. Against this background, the OECD came up with possible options or combinations of options for a more efficient collection of VAT on imports of low value goods, for governments to consider depending on their domestic situation and their exposure to imports of low value goods. [241]

The OECD Low Value Imports Report identifies four broad models for collecting VAT on low value imports and it assesses their likely performance. These models are:

- the traditional collection model
- the purchaser collection model
- the vendor collection model and
- the intermediary collection model.

The distinction between these collection models is essentially based on the person liable to account for the VAT. The traditional collection model is the model that is generally applied currently for the collection of duties and taxes at importation, and that is often combined with a VAT exemption for imports of low value goods. The other three models present possible alternative approaches for a more efficient collection of VAT on the importation of low value goods. The operation of these models and their likely performance are summarised below. [242]

<u>The traditional collection model:</u> The traditional collection model, where VAT is assessed at the border for each imported low value good individually, is generally found not to be an efficient model for collecting the VAT on imports of low value goods. This is certainly the case in the absence of electronic data transmission systems to replace the existing paper based and manual processes. The efficiency of the traditional collection model may improve over time, as and when electronic systems for pre-arrival declaration and electronic tax assessment and payment are implemented worldwide to replace paper based and manual verification processes. These new electronic processes are already prevalent in the express carrier environment where they have resulted in considerable efficiency gains. The consistent use of such electronic systems would improve the efficiency of the traditional collection model for both tax administrations and vendors. Their worldwide implementation might allow the removal of the current VAT exemption thresholds. The Low Value Import Report notes, however, that these systems are not yet available to process the import of the considerable numbers of low value goods that are moved by postal services. These electronic processes for the postal environment are still under development and may only be available in the medium term.[243]

[241] OECD/G20 2015 Final Report on Action 1 in para 323.
[242] OECD/G20 2015 Final Report on Action 1 in para 325.
[243] OECD/G20 2015 Final Report on Action 1 in para 327.

The purchaser collection model: A model relying on the purchaser to self-assess and pay the VAT on its imports of low value goods is not likely to provide a sufficiently robust solution for an efficient collection of the tax. Although the purchaser collection model is likely to involve only limited compliance burden for vendors, the level of compliance by purchasers is expected to be low and this model would be highly complex and costly for customs and tax administrations to implement and operate. [244]

The vendor collection model: A model requiring the non-resident vendors to charge, collect and remit the VAT in the country of importation could improve the efficiency of the collection of VAT on low value imports and thus create opportunities for governments to remove or reduce import exemption thresholds if they wish to do so. While a vendor collection model would create additional burden for non-resident vendors, these can be mitigated by complementing this model with a simplified VAT registration and compliance regime similar to the one suggested in the context of the OECD International VAT/GST Guidelines on B2C supplies of services and intangibles (B2C Guidelines). When a vendor supplies both goods and services into a particular jurisdiction, the registration system applied under the B2C Guidelines could be used for both kinds of supplies. This would reduce the administrative and compliance costs of the vendor registration. Implementation of such a model is likely to involve considerable changes to existing customs and tax collection processes and systems, and that enhanced international and inter-agency (tax and customs administrations) co−operation would be required to help ensure compliance by non-resident vendors under this model. [245]

The intermediary collection model: A model where VAT on imports of low value goods would be collected and remitted by intermediaries on behalf of non-resident vendors could improve the efficiency of the collection of VAT on such imports and thus create opportunities for governments to remove or reduce import exemption thresholds, assuming that such intermediaries would have the required information to assess and remit the right amount of taxes in the country of importation. The VAT collection by intermediaries would involve minimal compliance burdens on vendors. It may, however, come at an additional cost that may be passed on to the purchaser. This model may be particularly effective when the VAT is collected by intermediaries that have a presence in the country of importation. Four main types of intermediaries are identified: postal operators; express carriers; transparent e-commerce platforms and financial intermediaries. [246]

[244] OECD/G20 2015 Final Report on Action 1 in para 328.
[245] OECD/G20 2015 Final Report on Action 1 in para 329.

[246] OECD/G20 2015 Final Report on Action 1 in para 330.

(b) The collection of VAT on cross-border business-to-consumer supplies of services and intangibles

The B2C Guidelines present a set of standards for determining the place of taxation for B2C supplies of services and intangibles, in accordance with the destination principle. They provide that the jurisdiction in which the customer has its usual residence has the right to collect VAT on remote supplies of services and intangibles, including digital supplies by offshore suppliers. This standard allows suppliers and tax administrations to predict with reasonable accuracy the place where the services or intangibles are likely to be consumed while taking into account practical constraints. The implementation of these standards aims at ensuring that VAT on such supplies in the market jurisdiction applies at the same rate as for domestic supplies. This ensures the even playing field between domestic and offshore suppliers, so that there is no tax advantage for foreign companies based in low or no tax jurisdictions selling to final consumers relative to domestic companies.[247]

Regarding the key issue of the collection of VAT in the destination country, the B2C Guidelines indicate that, at the present time, the most effective and efficient approach to ensure the appropriate collection of VAT on cross-border B2C supplies is to require the non-resident supplier to register and account for VAT in the jurisdiction of taxation. The B2C Guidelines recommend that jurisdictions consider establishing a simplified registration and compliance regime to facilitate compliance for non-resident suppliers. Appropriate simplification is particularly important to facilitate compliance for businesses faced with obligations in multiple jurisdictions. At the same time, in considering simplified registration for VAT purposes, it is important to underline that registration for VAT purposes is independent from the determination of whether there is a PE for income tax purposes. Recognising that a proper balance needs to be struck between simplification and the need of governments to safeguard the revenue, the B2C Guidelines indicate that it is necessary that jurisdictions take appropriate steps to strengthen international administrative co-operation, which is a key means to achieve the proper collection and remittance of the tax on cross-border supplies of services and intangibles by non-resident suppliers. [248]

Under the B2C Guidelines, the OECD recommends that:

- the jurisdiction of the usual residence of the customer will have the right to levy VAT on the supply of the digital content,
- the foreign seller will be required to register for VAT in that market jurisdiction under a simplified registration and compliance regime, and
- the foreign seller will be required to charge and collect the VAT in that jurisdiction at the same rate as for domestic supplies.

247 OECD/G20 2015 Final Report on Action 1 in para 336.
248 OECD/G20 2015 Final Report on Action 1 in para 337.

These Guidelines recognise explicitly that it is necessary to reinforce taxing authorities' enforcement capacity through enhanced international co-operation in tax administration in the field of indirect taxes. They recommend that such co-operation be enhanced through the development of a common standard for the exchange of information that is simple, minimises the costs for tax administrations and businesses by limiting the amount of data that is exchanged, and which can be implemented in a short timeframe.[249]

14 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 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.[250] 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.[251] 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?

249 OECD/G20 2015 Final Report on Action 1 in para 339.
250 Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 18.
251 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.

- 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,[252] 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: "[t]hose electronic services prescribed by the Minister by regulation in terms of this Act".

The Electronic Services Regulations (Government Gazette No. 37489),[253] 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 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 were effect in 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.

The rules for the place of supply of services and electronic services differ (see below) and 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

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

253 http://www.treasury.gov.za/public%20comments/E-services%20Regulation.pdf.

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 is 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.
- Regulations should be refined further in order to allow for a comprehensive understanding and appreciation of the ambit of thereof.

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.[254] 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.[255] Whether this approach is desirable may be questioned given the fast pace at which e-commerce and technology evolve.[256] A less than definitive list in itself allows for alternative interpretation once e-commerce evolves beyond the scope it offers.[257] Greater certainty is not achieved through extensive legislation, but rather through explanatory guidelines.[258] 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.

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254 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.

255 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.

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

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

258 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.

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.
- It is recommended that the Regulations be refined further to allow for a comprehensive understanding and appreciation of the ambit thereof.

Where is the place of supply?

As stated above, 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 adds to confusion in determining the place of supply or consumption. This is particularly evident where intangible products or services have been physically delivered (in this case 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, the National 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 (for voluntary registration). 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.[259]

- 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 be 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 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.[260] The transaction will be taxed in the customer's country of jurisdiction in terms of the reverse-charge mechanism.[261] Put simply, the tax burden is shifted to the business customer who is deemed to be the taxable entity.[262]

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259 Article 59a of Council Directive 2008/8/EC

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

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

262 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.

The OECD recommends that the burden of VAT should not lie on taxable businesses unless specifically provided for in legislation.[263] 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.[264] 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 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 is, in principle, in line with the OECD recommendations. However, the existing rules do not make a clear distinction between B2B and B2C transactions. It is our understanding that the Regulations follows Treasury's intention that B2C transactions are captured by the special provisions and that B2B transactions will be captured by the 'imported services' provisions. For this purpose, the Regulations must accurately define what is included in the scope of 'electronic services' so as to clearly distinguish between B2B and B2C transactions.
- National Treasury is of the view that not having the distinction actually broadens the South African 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 purposes. 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

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263 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.

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

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*[265] and *Metropolitan Life Ltd v CSARS.*[266] 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 were 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.[267]

- 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 2015 changes to the VAT Act that require the foreign supplier to register for VAT in SA eliminate 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

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265 (503/2011) [2012] ZASCA 103 (1 June 2012)

266 2009 (3) SA 484 (C).

267 Van Zyl SP (2013) The Collection of Value Added Tax on online cross-border trade in Digital Goods Unpublished LLD thesis (UNISA) at 166.

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.[268] 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;[269]
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.[270]

- 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 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.[271] Since registration and the reverse charge mechanism are commonly applied in most jurisdictions, the OECD recommends 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.[272] Despite the rise of modern technology that can be applied to develop collection

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268 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.

269 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.

270 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.

271 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.

272 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.

mechanisms, OECD member countries are of the opinion that the traditional collection mechanisms remain the most effective.[273]

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 are 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.[274] 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 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 applies 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.

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

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.[275] Applicants should be allowed to complete an online registration application form that is accessible from the revenue authority's home page.[276] The application form should further be available in the official language of the applicable country's major trading partners.[277] 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; and
- vii) the national tax number in the jurisdiction of establishment.[278]

Confirmation of receipt of the application, and the final registration number should be communicated to the supplier by electronic means.[279]

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 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,[280] 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;

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

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

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

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

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

[280] 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

- 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; and
- 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. Despite the simplified registration process afforded by SARS, many foreign suppliers are still unaware of their obligations in terms of the Act.

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.[281] The OECD recommends that a standardised international declaration form and process should be developed for vendors who are registered under the simplified registration regime.[282] The VAT 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.[283] The OECD suggests that further guidance should be given on the frequency of tax returns.[284] 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 be submitted electronically on the e-file system, the difficulty and administrative burden associated therewith is not diminished. It must be noted that National Treasury has come up with concessions to reduce compliance costs for foreign businesses to prevent these business from withdrawing from South Africa.

- 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

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

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

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

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

refund, it is recommended that an abridged VAT 201 should be developed specifically for foreign suppliers of electronic services.

- The option of payment or collection agents (whether acting as agents or third party services providers) to be appointed and registered as VAT vendors for and on behalf of foreign businesses must be considered.

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 would 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. Some concessions have been announced. The foreign supplier of 'electronic services' is allowed to submit an abridged invoice (the details of the recipient is not required. However, the invoice must still be issued in South African currency (the ZAR). In most instances the cost and payment of the 'electronic services' is made in foreign currency. The supplier is, accordingly, required to calculate and express the amount in ZAR. In terms of the Binding General Ruling on electronic services, the ZAR amount must be calculated in accordance with the Bloomberg or European Central Bank rate on the day that the tax invoice is issued. This can result in accounting differences where the supplier's system has a set exchange rate or where the system operates on monthly averages.

- 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 (on their website or online shopping portal) prices in ZAR 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 (on the website or shopping portal) in ZAR inclusive of VAT should be reconsidered.
- Clause 103 of the TLAB 2014 and the Explanatory memorandum is addresses this matter.
- Foreign suppliers of 'electronic services' must account for VAT on the payment basis. This creates accounting problems where the supplier's accounting system is set up to account on the invoice basis.

Record keeping

The OECD proposes that an international standard for record keeping in the case of cross-border traders should be developed.[285] 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.[286] 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.[287] Record keeping in a place other than 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 extremely 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

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

286 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.

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

registration can be enforced would be difficult to achieve. For example, it is not clear whether SARS has extra-territorial powers to conduct audits on non-resident suppliers to ensure the accuracy of tax returns. Furthermore, it is not clear whether SARS is 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 "used 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, 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 or consumption for digital deliveries is cumbersome. The following 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. It should, however, be noted that it has never been a priority to put the burden of identification of the recipient on the supplier. Transactions not covered by the 'electronic services' provisions will be taxed under the reverse-charge mechanism. The approach has been to keep the VAT system simple and easy to administer for all VAT vendors.

- 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. This, however, goes to the basic design of the VAT system and the impact of the extent to which the principles of the OECD VAT/GST Guidelines can be achieved.

Alternative VAT collection models[288]

Existing VAT collection mechanisms are in dire need of modernisation, in that they are inefficient and increasingly burdensome on revenue authorities and suppliers.[289] Some observers have proposed the use of financial institutions as VAT collectors and the use of technology to facilitate their task. The OECD's 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.[290] 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.

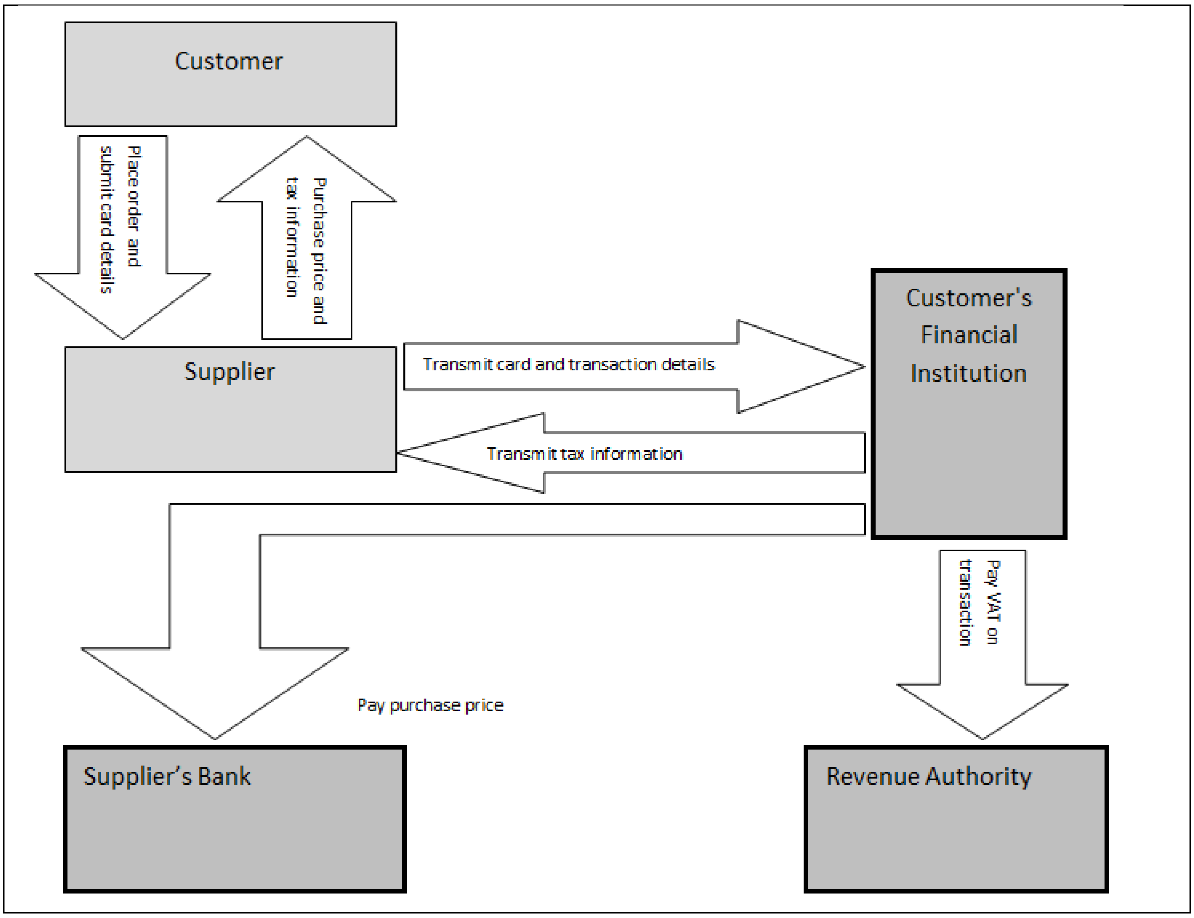
The basis of this model is to collect VAT on each transaction at the point at which it is traded through an electronic payment system – for example, a credit card system - based on the location of the customer and the VAT rules applicable in that jurisdiction. In other words, the customer is immediately 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

288 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).

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

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

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.[291]



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

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

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.[292] This is particularly evident in Latin American countries which increasingly apply withholding tax mechanisms as a VAT collection tool.[293] 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

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292 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.

293 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.

taxing trend among developing countries. Similar trends have recently been introduced in South Africa.[294]

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 its remains problematic. Although in terms of SARS records about 96 foreign supplies have registered to date, this number and the collected revenue 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.

There are for instance concerns from the Financial Institutions that:

- Financial institutions would have to make significant investments in IT/software systems that are capable of being integrated with the IT systems of suppliers in order to enable suppliers to submit customer credit or other payment details to the relevant financial institution I.e. the customer's bank or credit card provider
- The additional requirement for financial institutions to make split-payments (i.e. Payments of purchase price to the foreign supplier's bank account and the VAT payment to the relevant Revenue Authority) will place a further burden on the financial institutions' IT systems.
- Financial institutions would be required to perform additional tasks as identify verification and location identification of the related customers' place of residence or establishment, which may result in the transmission of information and efficiency in processing these digital transactions being compromised and/or slowed down.
- Financial institutions would have to correctly assess each customer's digital transactions and apply the relevant VAT legislation. The responsibility to levy

294 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.

and collect the correct amount of VAT therefore rests solely with the financial institutions.

- The sharing of customer information with suppliers and also the related sharing of supplier information with various revenue authorities, may compromise the privacy of customer and supplier information.
- Financial institutions would bear the burden of completing and sharing partial assessments to each of the suppliers for which VAT was paid into the relevant VAT blocked account.
- The additional costs to financial institutions completing these various allocation tasks would need to be recovered and will in all likelihood be passed onto customers by way of increased service fees.[295]

It is therefore recommended that before the RT-VAT system is implemented, a Steering Committee should be formed to determine its viability since it has not been tested anywhere in the world. The said Steering Committee should include relevant stakeholders such as representatives of Financial Institutions, legal, accounting and IT and payment systems professionals.

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.
- ➢ 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.

295 Comments submitted to the DTC by the Banking Association South Africa (BASA) on the "DTC First Interim Report on BEPS Action Plan 1" (25 March 2015) at 2.

- 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.

15 DEVELOPMENTS IN THE DIGITAL ECONOMY: VIRTUAL CURRENCIES

OECD 2015 Final 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.[296] 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.[297] According to the OECD Discussion Draft Report on Action 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 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.”[298]

The OECD Discussion Draft Report on Action 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.[299]

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

[296] OECD 2014 Discussion Draft Report on Action 1 at 15.
[297] Ibid.
[298] See “Bitcoin” https://en.bitcoin.it/wiki/Bitcoin; “Public Key cryptography” http://en.wikipedia.org/wiki/Public-key_cryptography. Accessed 2 October 2013.
[299] The OECD 2014 Discussion Draft Report on Action 1 at 15 in para 34.

15.1 BITCOIN TAXATION IN CANADA

The Canadian government has taken the position that Bitcoin is not legal tender[300]. The Canada Revenue Agency has stated that, when addressing the Canadian tax treatment of Bitcoin, taxpayers must look to the rules surrounding barter transactions[301] and must consider whether income or capital treatment arises on Bitcoin trading (*i.e.*, speculating on the changes in the value of Bitcoins**).**

15.2 BITCOIN TAXATION IN THE USA

In Notice 2014-21 (March 25, 2014),[302] 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.

15.3 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.[303]

15.4 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. South African legislators would be wise to consider the potential impact of virtual currencies on tax compliance and to monitor international developments to determine the most suitable approach for preventing abuse 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.

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300 http://www.canadiantaxlitigation.com/wp-content/uploads/2014/01/2013-0514701I7.txt.
301 http://www.cra-arc.gc.ca/E/pub/tp/it490/it490-e.html.
302 http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance.
303 Forbes, 17 Jan 2014.