TAXATION OF NON-RESIDENT DIGITAL COMPANIES PROVIDING SERVICES IN SOUTH AFRICA

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Abstract

The role played by electronic commerce has increased in recent years and continues to increase. Due to this increase in the buying and selling of digital goods and services, revenue authorities have had to recognise that the existing taxation laws do not adequately tax the digital economy. The goal of this research was to establish how South Africa could amend its fiscal legislation in order to adequately tax the digital economy. The Organisation for Economic Co-Operation and Development (OECD) has been the leader in addressing the challenges posed by the digital economy. The thesis therefore focused on the recommendations by the OECD on how to tax the digital economy and relevant recommendations for South were adopted in this thesis, based on the work of the OECD. The main focus of these recommendations was on implementing the International VAT/GST Guidelines that were drafted by the OECD. The thesis also focused on the progress made by New Zealand with regard to taxing of the digital economy. New Zealand has a similar taxation system to South Africa so that the progress made there was relevant in the South African context. Recommendations were also made, based on the proposals by the New Zealand revenue authority that South Africa could adopt in taxing the digital economy. The main focus of these recommendations was lowering the Value-Added Tax (VAT) registration threshold for non-resident suppliers of electronic services and enacting legislation to provide for registration of an electronic marketplace for VAT purposes, instead of an individual supplier.

KEY WORDS: taxation; digital economy; value-added tax; electronic marketplace

Declaration

I, Marilyn Tatenda Shumba, declare that the work presented in this thesis is original. It has never been presented to any other University or Institution. Where other people's works have been used, references have been provided. It is in this regard that I declare this work as originally mine. It is hereby presented in partial fulfilment of the requirements for the award of the Master of Commerce (Taxation).

Signed..

Date...

Acknowledgments

This thesis is dedicated to my parents, Elisabeth and Wilbert without whose support I would never have accomplished my goals. I would like to thank my siblings Chikomborero, Petronella and Tanaka for acting as my guiding lights when things became difficult. I would also like to thank my cousin Rumbidzai and her husband Ernest who have been pillars of strength and offered me an escape whenever I needed it. To Shamiso, Samantha, Fredy, Tinatsei and Wadzanai thank you for being my cheerleaders.

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Table of Contents

Abstract 2

Declaration 3

Acknowledgments 4

CHAPTER 1: INTRODUCTION

1.1 CONTEXT 9

1.2 GOALS OF THE RESEARCH 13

1.3 METHODS, PROCEDURES AND TECHNIQUES 13

1.4 OVERVIEW OF THE THESIS 14

CHAPTER 2: THE EVOLUTION OF DIGITAL TAXATION IN SOUTH AFRICA

2.1 INTRODUCTION 16

2.2 THE KATZ COMMISSION REPORT 17

2.3 INCOME TAX APPLYING TO NON-RESIDENT DIGITAL COMPANIES 18

- **2.3.1 The Common Law Source Principles** 19
- **2.3.2 Taxation Where a Double Taxation Agreement is in Place** 20
- **2.3.3 The Permanent Establishment Concept** 21
- **2.3.4 The Source Provisions in Section 9** 25

2.4 VALUE-ADDED TAX IN RELATION TO DIGITAL COMPANIES 25

- **2.4.1 Value-Added Tax** 26
- **2.4.2 Value-Added Tax on Electronic Services** 26

2.4.3 Problems Associated with Electronic Services Regulations 31

2.5 CONCLUSION 32

CHAPTER 3: THE APPROACH OF THE OECD AND NEW ZEALAND ON THE TAXATION OF THE DIGITAL ECONOMY

3.1 INTRODUCTION 34

3.2 THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT 35

3.2.1 Background to the Work Performed by the OECD 35

3.2.2 The Action Plan on Base Erosion and Profit Shifting 38

3.2.3 The Final Report of the Taskforce on the Digital Economy 42

3.2.4 Conclusion on the Work of the OECD 49

3.3 THE APPROACH OF NEW ZEALAND TO THE DIGITAL ECONOMY 50

3.3.1 Background of the Discussion Paper 50

3.3.2 The New Zealand GST System Prior to the Proposals 51

3.3.3 The Proposed Rules 54

3.3.3.1 Services and intangibles supplied remotely by offshore suppliers to be subjected to GST 54

3.3.3.2 Registration of non-resident suppliers and registering an intermediary in place of supplier 56

3.3.3.3 The registration threshold 58

3.3.3.4 The definition of services should be widened to include digital and traditional services. 59

3.3.4 Enforcement of the Rules 61

3.3.5 Conclusion Regarding the New Zealand Approach 61

3.4 CONCLUSION 62

CHAPTER 4: RECOMMENDATIONS FOR TAXING THE DIGITAL ECONOMY IN SOUTH AFRICA

4.1 INTRODUCTION 64

4.2 THE RECOMMENDATIONS MADE BY THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT 64

4.2.1 The Relevance of the Ottawa Principles to the South African Context 66

4.2.2 Application of the Ottawa Principles in South Africa 71

4.2.3 The Action Plan on Base Erosion and Profit Shifting 73

4.2.3.1 Relevance of amendment of Article 5 of the OECD Model Tax Convention to South Africa 75

4.2.4 Recommendations Made by the Taskforce on the Digital Economy 75

4.2.5 The Impact of the International VAT/GST Guidelines on South Africa 76

4.2.5.1 Guideline 2.2 78

4.2.5.2 Guideline 2.3 78

4.2.5.3 Guideline 2.4 79

4.2.5.4 Guideline 2.6 80

4.2.6 Further Recommendations Made by the OECD 81

4.3 NEW ZEALAND AND ITS APPROACH TO THE DIGITAL ECONOMY 82

4.3.1 The Proposed Rules 83

4.3.2 Relevance of the Proposed Rules in the South African Context 84

4.3.2.1 Registration threshold 84

4.3.2.2 Registration of an intermediary to represent an offshore supplier 85

4.4 FINAL RECOMMENDATIONS FOR SOUTH AFRICA 87

4.5 CONCLUSION 87

CHAPTER 5: CONCLUSION

5.1 INTRODUCTION......89

5.2 GOALS OF THE RESEARCH......89

5.3 CONCLUSION......93

BIBLIOGRAPHY......94

Chapter 1: Introduction

1.1 CONTEXT

Electronic commerce (e-commerce) is one of the fastest growing retail sectors in the global economy.[1] South Africa is also part of this economy and E-Commerce has a substantial effect on the country's economy. According to a study conducted by *World Wide Worx* in 2012, the internet economy contributes 2% to South Africa's gross domestic product.[2] This figure was expected to rise to 2.5% by the year 2016.[3] Based on these statistics it is evident that a substantial amount of revenue can be earned from this industry. Owing to the lucrative nature of this industry, more and more companies are venturing into the digital space. Among these companies are foreign entities that render services within South Africa. In a recent report PricewaterhouseCoopers pointed out that the current legislative framework is inadequate to impose and collect taxes from non-resident digital companies and it is important to begin considering amending the legislation to ensure that revenue losses are decreased and to ensure that local companies have a competitive advantage.[4] It is submitted that this assertion is correct and the current legislation should be amended to ensure that revenue is taxed accordingly and that resident digital companies are able to compete with the non-resident digital companies.

Currently the only tax that directly affects non-resident digital companies in South Africa is Value-Added Tax which is regulated by the Value-Added Tax Act[5] (hereafter referred to as the VAT Act). The VAT Act includes electronic services as part of the definition of an "enterprise." According to the definition, an enterprise includes,

> ... the supply of electronic services by a person from a place in an export country where at least two of the following circumstances are present:
>
> (aa) the recipient of those electronic services is a resident of the Republic

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[1] E Fryer *The VAT Implications of e-commerce goods and services imported to South Africa* (Mini Dissertation Potchefstroom University (2014) 10.

[2] A Goldstuck "Internet Matters: The Quiet Engine of the South African Economy" *World Wide Worx* (2012) 8.

[3] Goldstuck "Internet Matters" 8.

[4] PwC Pressroom "Online Services in digital space" (2015) http://www.pwc.co.za/en/press-room/broadband-tax.html [Accessed 22 August 2016].

[5] 89 of 1991.

(bb) any payment to that person in respect of such electronic services originates from a bank registered or authorised in terms of the Banks Act, 1990 (Act No. 94 of 1990);

(cc) the recipient of those electronic services has a business address, residential address or postal address in the Republic...[6]

The definition as it stands does not expand on which services will be regarded as electronic services. In order to provide clarity, the Minister of Finance enacted the "Regulations Prescribing Electronic Services for the Purpose of the Definition of 'Electronic Services' in section 1 of the Value-Added Tax Act, 1991".[7] According to section 2(1) of these regulations, the purpose is to define the services that would be regarded as electronic services. These services include educational services (regulation 3), games and games of chance (regulation 4), internet-based auctions (regulation 5), miscellaneous services (regulation 6) and subscription services (regulation 7). This does not include other services that could be defined as electronic services and therefore the scope of taxable electronic services is narrow. Non-resident digital companies providing these electronic services are required to register as VAT vendors and charge the requisite VAT in terms of section 7(1) of the VAT Act, provided these companies make taxable supplies exceeding R50 000 in terms of section 23(1A) of the Act. This provision places these digital companies in the same position as local companies and therefore it is submitted that this could assist to protect the South African tax base.

From an Income Tax perspective, as South Africa applies a residence-based system of taxation in terms of the "gross income" definition[8] in the Income Tax Act[9], the only possible section that may subject the income from the digital economy to normal tax is section 9[10], where section 9(1)(3) and 9(1)(f) may include the provision of scientific and commercial knowledge and assistance in connection with that knowledge provided to residents as being from a South African source.

[6] S1.
[7] GN R. 221Government Gazette 37489 28 March 2014.
[8] S1.
[9] Act 58 of 1962, as amended.
[10] *Ibid.*

South Africa is behind in taxing the digital economy and it is necessary for the relevant taxation laws to be amended to prevent base erosion.[11] It is evident that South Africa currently has made progress in taxing non-resident digital companies by amending the VAT Act to include electronic services, but further measures need to be implemented for the growing digital economy to be effectively taxed. Since taxation is a global issue it would be helpful to investigate how other jurisdictions have amended their taxation laws to accommodate the advent of the digital economy. According to PricewaterhouseCoopers the Organisation for Economic Co-Operation and Development (the OECD) is at the forefront of addressing the challenges posed by the digital economy.[12] A report entitled "Action Plan on Base Erosion and Profit Shifting" was released by the OECD, highlighting various tax challenges.[13] Base erosion refers to "tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations".[14] The Action Plan initially highlights the various stakeholders being affected by the increasing prominence of the digital economy. The stakeholders identified were government, local and multinational businesses and individual taxpayers.[15] The report goes on to list the actions that need to be implemented and each target an area to be addressed. In the present research the most important of the action plans would address the challenges posed by the digital economy. This action has received much attention and the OECD Task Force on the Digital Economy[16] was formed to focus on the challenges referred to in Action 1, which deals with the digital economy. In the final report the task force made recommendations to address the challenges posed by the digital economy.

The first recommendation was that the definition of a permanent establishment should be modified to ensure that only activities that were preparatory or auxiliary in nature would be excluded. This definition was to be applied across all tax treaty networks.[17] This modification would ensure that digital companies that have a permanent establishment status can be taxed

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[11] I Lamprecht "South African tax laws have not kept pace with digital economy" (2015) http://www.moneyweb.co.za/mymoney/moneyweb-tax/sa-tax-laws-have-not-kept-pace-with-digital-economy/ [Accessed 21 August 2016].

[12] BusinessTech "Online Tax laws holding South African Companies back" (2015) http://www.businesstech.co.za/news/internet/87020/online-tax-laws-holding-sa-companies-back/ [Accessed 21 August 2016].

[13] OECD *Action Plan on Base Erosion and Profit* Shifting (2013) http://dx.doi.org/10.1787/9789264202719-en [Accessed 21 August 2016].

[14] OECD "Base Erosion and Profit Shifting" http://www.oecd.org/tax/beps/ [Accessed 21 August 2016].

[15] OECD *Action Plan* 8.

[16] OECD, "Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report" (2015) 106 http://dx.doi.org/10.1787/9789264241046-en [Accessed 21 August 2016].

[17] *Ibid*.

accordingly. The second recommendation was that there should be increased focus on VAT charged on cross-border transactions.[18] In this regard, the Task Force recommended that the principles of the *International VAT/GST Guidelines* should be applied and that the collection methods that were identified should be applied. These recommendations are important in the South African context, even though South Africa is not a member of the OECD. This is because several of South Africa's trading partners are members of the OECD and applying the same principles applied by these member states would ensure fairness and neutrality in cross-border digital trade.

Other countries have also made progress regarding the taxation of the digital economy and New Zealand is one such country. New legislation dealing with a Goods and Services Tax (hereafter GST), which is similar to VAT, was promulgated on the 1st of October 2016.[19] This Act requires that GST at the rate of 15% be paid on all sales of 60 000 New Zealand Dollars or more during a 12-month period. In addition to this, businesses that earn 60 000 New Zealand Dollars or more in sales are required to register for GST. The revenue authority requires non-resident digital companies providing services to New Zealand residents to collect two pieces of non-conflicting evidence to be used to prove where the service was provided, these being the IP address or the bank account of the customer.[20] This measure was adopted from the European Union, where this is a requirement for non-resident digital companies providing services to residents within the Union.[21]

The current VAT legislation in South Africa could be amended to require non-resident digital suppliers to provide evidence to show where supplies are made, or services provided, to enable tax authorities to identify when these supplies or services are provided to consumers in South Africa. This does not guarantee that the suppliers will comply with this and it would be necessary to propose anti-avoidance measures to ensure that this is done accordingly. One such measure may be to require the clearing house (for example the bank) to provide the information.

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[18] OECD "Addressing Tax Challenges" 136.

[19] Inside Quaderno "Digital Taxes Around the World: What to know about new tax rules" (2015) https://quaderno.io/blog/digital-taxes-around-world-know-new-tax-rules/ [Accessed 23 October 2016].

[20] *Ibid*.

[21] *Ibid*.

The aim of this research was therefore to establish the current taxation mechanisms applied to non-resident digital companies in South Africa and investigate how other jurisdictions have addressed the taxation of digital companies, with a view to making possible recommendations to amend the South African legislation.

1.2 GOALS OF THE RESEARCH

The main goal of the research is to establish how South Africa could amend the current tax legislation to tax non-resident digital companies adequately. To achieve this, the following sub-goals are addressed:

1. Establish the current South African legislation in place to tax non-resident digital companies.
2. Establish how the OECD has proposed to address taxation of the digital economy.
3. Establish how New Zealand has addressed the taxation of digital companies.
4. Provide recommendations for South Africa, based on the OECD's work on the digital economy and New Zealand's legislation.

1.3 METHODS, PROCEDURES AND TECHNIQUES

An interpretative research approach was adopted for the present research as it seeks to understand and describe.[22] The research methodology applied can be described as a *doctrinal* research methodology. This methodology provides a systematic exposition of the rules governing a specific legal category (in the present case the legal rules relating to the taxation of digital companies in South Africa), analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data.[23]

The documentary data used for the research consisted of:

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[22] E Babbie & J Mouton *The Practice of Social Research* (2009).

[23] M McKerchar "Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation", (2014) *eJournal of Tax Research* 5-22 https://www.business.unsw.edu.au/research-site/publications-site/ejournaloftaxresearch-site/Documents/paper1_v6n1.pdf [Accessed 10 May 2014].

- legislation, namely the Value-Added Tax Act 89 of 1991, the Income Tax Act 58 of 1962 and the Goods and Services Act 141 of 1985 (New Zealand);
- South African Revenue Service "Regulations Prescribing Electronic Services for the Purpose of the Definition of 'Electronic Services' in section 1 of the Value Added Tax Act, 1991", Notice No. R. 221 and similar regulations in New Zealand;
- articles in accredited journals; and
- textbooks and other writings.

The research was conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and the conclusions was promoted by:

- adhering to the rules of the statutory interpretation, as established in terms of statute and common law;
- placing greater evidential weight on legislation, case law which creates precedent, or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and concluding, based on a preponderance of credible evidence; and
- the rigour of the arguments.

As all the data were publicly available, no ethical considerations arose in relation to their use. Interviews were not conducted; opinions were considered in their written form.

1.4 OVERVIEW OF THE THESIS

Chapter Two outlines the evolution of digital taxation in South Africa. The chapter starts by focusing on the work performed by the Katz Commission in 1996 and the comments made regarding a possible future digital taxation. The chapter then explores the possibility of charging income tax on the profits of non-resident digital companies. The aim of this exploration is to highlight how non-resident digital companies have failed to meet the requirements of the current income tax legislation. The chapter then focuses on the Value-Added Tax Act as this is the only legislation that has currently been amended to include digital companies. The relevant provisions of the Act are discussed in detail to establish

whether and what goods or services provided by non-resident digital companies will attract Value-Added Tax. In the conclusion the problems associated with the present legislation are discussed.

Chapter Three explores the work carried out by the OECD regarding the digital economy, this Organisation being the forerunner in addressing the digital economy. Although South Africa is not a member, many of the country's trading partners are members and therefore it would be important to amend legislation to align it with recommendations made by the Organisation. In addition to this, the chapter also focuses on the work carried out in New Zealand regarding the digital economy. New Zealand has a tax model that is considered the best in its class and in addition New Zealand has a tax model that is similar to the South African model. Significant progress has been made in New Zealand regarding amending legislation dealing with the digital economy and therefore it would be helpful to examine this legislation.

Chapter Four focuses on the recommendations made by the OECD to address the challenges posed by the digital economy. The chapter establishes whether these recommendations are relevant in the South African context and, if so, the steps that should be taken by South Africa legislature to apply them. The chapter also focuses on the proposals made by the New Zealand revenue authority (Inland Revenue) to address the challenges posed by the digital economy. It is also established whether there are any recommendations that can be made to tax digital commerce in South Africa, based on the New Zealand proposals.

Chapter Five provides the conclusion and establishes the extent to which the research question has been answered and the goals of the research have been adequately achieved. In doing so, the findings flowing from the research are presented.

Chapter 2: The Evolution of Digital Taxation in South Africa

2.1 INTRODUCTION

Electronic commerce (e-commerce) has been defined as "the wide array of commercial activities carried out by electronic means that enable trade without the confines of geographical boundaries."[24] E-commerce has become one of the fastest growing retail sectors in the global economy.[25] South Africa is part of this economy and as such e-commerce has had a significant effect on the economy of the country. According to a study conducted by *World Wide Worx* in 2012, the digital economy contributed 2% to the country's overall Gross Domestic Product (GDP)[26] and was expected to increase its contribution to 2.5% in the year 2016. As can be seen from the study, e-commerce contributes substantially to the South African economy. Consequently, it is necessary that the government puts appropriate taxation measures in place.

The purpose of this chapter is to establish the progress that has been made so far in terms of the taxation of the digital economy in South Africa, as well as to highlight the problems that have occurred due to the current taxation system. The chapter first discusses the background of the taxation measures applying to the digital economy in South Africa and thereafter focuses on the current system being applied to tax non-resident digital companies. Finally, the problems associated with taxing digital services in terms of the Value-Added Tax Act[27] are also discussed.

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[24] AW Oguttu & S Tladi "The Challenges that E-Commerce Poses to the Determination of a Taxable Presence: The "Permanent Establishment" Concept Analyzed from a South African Perspective" (2009) *JCILT* 4 (3) 213 at 216.

[25] E Fryer *The VAT Implications of e-commerce goods and services imported to South Africa* (Mini Dissertation Potchefstroom University, 2014) 10.

[26] A Goldstuck "Internet Matters: "The Quiet Engine of the South African Economy" (2012) *World Wide Worx* (2012) 39.

[27] 89 of 1991.

2.2 THE KATZ COMMISSION REPORT

In 1994, when South Africa became a democracy, the objective of the newly elected government was to achieve transformation in all sectors to enable it to thrive within the global economy.[28] Various complex changes had to be made and task forces had to be set up to effectively tackle the challenges being faced by South Africa at the beginning of its democratic era. One such example of these task forces was the Katz Commission, which was a team put together to make recommendations for tax reform in the newly democratic South Africa.[29] The Commission had to decide on various issues and make recommendations that would then be discussed in Parliament and would also be made available to the public for discussion and debate.

In the 5th report compiled by the Commission, the possibility of a time where trade would take place on the Internet was also contemplated. The report states:

> The Commission received much evidence regarding a not too distant future where international trade investment will increasingly become a function of global electronic communication such as through the Internet. There is no doubt that these developments will greatly impact on some of the basic tenets of international taxation as they exist today.[30]

From this report it is clear that the Commission was already aware of the possibility of e-commerce occurring in the near future. The Commission proceeded to cite the example of how the physical presence aspect of the permanent establishment concept would become redundant due to trading on the Internet.[31] As there were no existing international precedents dealing with such scenarios or possibilities, however, the Commission could not make recommendations with regard to the prospective digital economy.[32]The Commission did indicate that, despite there being no point in introducing a new tax regime prematurely, it was

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[28] T Manuel "The South African Tax Reform Experience Since 1994" (2002) National Treasury www.treasury.gov.za/comm_media/speeches/2002/2002102501.pdf [Accessed 11 April 2017].

[29] "What the Katz report actually did say" *Mail & Guardian* 17 February 1995 http://mg.co.za/article/1995-02-17-what-the-katz-report-actually-did-say [Accessed 27 March 2017].

[30] Katz Commission "Basing the South African Income Tax System on the Source or Residence Principle-Options and Recommendations" (1996) 53 www.treasury.gov.za/publications/other/katz/5.pdf [Accessed 4 January 2017].

[31] *Ibid.*

[32] Katz Commission "South African Income Tax" 53.

necessary to be aware of any changes that were being made by South Africa's trading partners so as to remain relevant to these partners.[33]

At the time that the Katz Commission submitted its report, there had been no significant activity in the e-commerce sector and there was therefore no need for the introduction of a new tax regime to tax e-commerce accordingly. As time progressed the digital economy gained momentum and the need to tax the sector has become apparent.

2.3 INCOME TAX APPLYING TO NON-RESIDENT DIGITAL COMPANIES

South Africa applies two different types of taxes, namely direct taxes and indirect taxes. The most important direct tax is income tax, and this is levied on both residents and non-residents, provided they meet the criteria for taxation.

South Africa has a residence-based taxation system and applies source principles for non-residents who have earned income within the Republic.[34] The definition of "gross income" in section 1 of the Income Tax Act is as follows:

> "gross income", in relation to any year or period of assessment, means –
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature . . .

According to the definition of a "resident" in section 1 of the Income Tax Act[35], resident persons other than natural persons (thus including companies) are those which are incorporated, established or formed in the Republic of South Africa, or have their place of effective management in South Africa. The definition of a "resident" excludes "any person

[33] Katz Commission "South African Income Tax" 54.
[34] M Stiglingh *et al SILKE: South African Income Tax* (2015) 59.
[35] 58 of 1962.

who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation"[36]. Non-resident companies are subject to the source principles applied in South Africa and these are a combination of the common law principles found in case law, statutory law, including the source principles in terms of section 9, and any applicable tax treaty principles.[37] Where there is no tax treaty in place between South Africa and the jurisdiction of a non-resident, the common law source principles are applied. It is important to determine whether digital companies are subject to income tax in South Africa.

2.3.1 The Common Law Source Principles

In a situation where a non-resident earns income in South Africa and the jurisdiction of the non-resident does not have a tax treaty with South Africa, the common law source principles will be applied. The issue of the source of income was dealt with in the matter of *Commissioner for Inland Revenue v Lever Brothers and Unilever Ltd*[38]. The court in this matter held

> The word source has several possible meanings. In this section it is used figuratively and when so used in relation to the receipt of money one possible meaning is the originating cause of the receipt of the money, another possible is the quarter from which it is received. A series of decisions of this Court and of the Judicial Committee of the Privy Council upon our Income Tax Acts and upon similar Acts elsewhere have dealt with the meaning of the word 'source' and the inference, which, I think, should be drawn from those decisions is that the source of receipts, received as income is not the quarter whence they come, but the originating cause of their being received as income **and that this originating cause is the work which the taxpayer does to earn them, the *quid quo pro* which he gives in return for which he receives them.** The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages, and it may take the form of

[36] S1.
[37] Stiglingh *et al SILKE* 71.
[38] 14 SATC 1.

personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these.[39] (own emphasis)

From this excerpt from the judgment it can be concluded that the source of the income is the originating cause and to establish the originating cause, a two-fold inquiry is made:

1. What is the originating cause of the income?
2. Where is the originating cause of the income situated?[40]

The first question would be what has been done by the non-resident person to create the income generated. The second question would be where the non-resident performs the work that generated the income. It was established that determining the source of the income should be done on a case by case basis. In the matter of *Liquidator, Rhodesian Metals Ltd v Commissioner of Tax*[41] it was held that "source means not a legal concept but something which the practical man would regard as a real source of income. The ascertaining of the actual source is a practical hard matter of fact."[42] Therefore it is important to focus on the facts of each case to determine what the originating cause is and where this is located.

2.3.2 Taxation Where a Double Taxation Agreement is in Place

South Africa is privy to various Double Taxation Agreements with other jurisdictions. According to section 108 (1) of the Income Tax Act:

> The National Executive may enter into an agreement with the government of any other country whereby arrangements are made with such government with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the Republic and of such other country of tax in respect of the same income, profits or gains, or tax imposed in respect of the same donation or to the

[39] 8.
[40] Stiglingh *et al SILKE* 73.
[41] 9 SATC 363.
[42] 379.

rendering of reciprocal assistance in the administration of and the collection of taxes under the said laws of the Republic and of such other country.[43]

This provision means that the National Executive may enter into agreements with other jurisdictions, which results in the provisions of the agreement superseding the South African taxation legislation.[44] Once a double taxation agreement has been properly adopted and in force, South Africa must abide by the provisions of that agreement and in certain instances will not be entitled to levy tax on a certain portion, or all of the income earned in the Republic.[45] Therefore where a double taxation agreement is in place, reliance will be placed on that agreement instead of the South African taxation laws.

2.3.3 The Permanent Establishment Concept

The source rules applying in South Africa are subject to the tax treaty provisions. One of these is the permanent establishment concept, which is a common feature in Double Tax Agreements between South Africa and various countries. This is an important principle in relation to digital companies and their capability of being charged income tax in South Africa.

A "permanent establishment" is defined in section 1 of the Income Tax Act as " a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and Capital of the Organisation for Economic Co-Operation and Development".[46] South Africa is not a member of the Organisation for Economic Co-Operation and Development (the OECD), but the court in *Secretary for Inland Revenue v Downing*[47] held that South Africa is bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Tax Convention.[48] Many of the Double Tax Treaties entered into by South Africa are based on the OECD Model Tax Convention. In addition to this, section 232 of the Constitution of the Republic of South

[43] S108 (1).
[44] The South African Institute of Chartered Accountants "Residence Basis of Taxation: 935 Double taxation agreements" October 2001 https://www.saica.co.za/integritax/2001/935_Double_taxation_agreements.htm [Accessed 01 November 2017].
[45] *Ibid.*
[46] S1.
[47] 1975 (4) SA 518 (A).
[48] 524.

Africa[49] states that "customary international law is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament."

The OECD Model Tax Convention is considered customary international law, so that the definition contained in Article 5 is binding on taxpayers. The Article states that a permanent establishment is "a fixed place of business through which the business of an enterprise is wholly or partly carried on."[50] The concept is based on the principle that there must be a physical presence of the business before the source country can tax its profits.[51] The OECD definition highlights three elements which must exist for a permanent establishment to be proved namely:

1. There must be a place of business.
2. This place of business must be fixed.
3. The business of the enterprise must be wholly or partly carried out at the place of business.

Element 1: There must be a place of business

The non-resident company must have a physical presence in the source country to be liable for income tax. A digital company may have a physical presence in its country of origin, but it may lack a physical presence in the source country. This is because the company may operate from a website or web page in the source country and therefore it becomes problematic to meet the requirement of the existence of a place of business. The OECD Commentaries address the question whether a website constitutes a place of business:

> …an Internet website, 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 website is concerned'.[52]

[49] 1996.
[50] Article 5(1).
[51] Oguttu & Tladi 2009 *JICLT* 213.
[52] OECD "Commentaries on the Articles of the Model Tax Convention" (2010) par 42.2.

The OECD Commentaries indicate that it is not readily acceptable to consider a website a place of business as it is not considered to be tangible property. This makes it difficult to apply the first element of the permanent establishment concept.

It has been argued that a server that is “automated equipment on which an Internet web site is stored and through which the website is accessible”[53] can be considered a place of business. The location of the server would be the place of business of the non-resident and this would therefore satisfy the element of a place of business. There is currently no legal precedent, however, that has established that a server will be accepted as a place of business. Therefore, digital companies may still not satisfy the “place of business” component of the permanent establishment definition.

Element 2: This place of business must be fixed

For a permanent establishment to exist, the place of business referred to in element one, must be fixed. This element includes two characteristics, which must both exist to satisfy the requirement, namely:

1. a specific geographic location; and
2. a degree of permanence.

Specific geographic location

The place of business must have a certain geographic location which it occupies in the source country. This characteristic focuses on the physical presence of a place of business, which would be where the business is geographically located from which it conducts business in the source country.[54] A digital company would not satisfy this requirement as the location from which it conducts its business is an address that only exists on the Internet. It follows that there would be no physical presence of the company in the source country and therefore this requirement would not be satisfied.

[53] Oguttu & Tladi 2009 *JICLT* 217. See further R Buys & F Cronjé *Cyber Law: The Law of the Internet in South Africa* 2 ed (2004) 303.
[54] Oguttu & Tladi 2009 *JICLT* 214.

Degree of permanence

The place of business must have a permanent nature which calls for continuity of operations in the source country. This does not mean that some interruption of operations is prohibited;[55] it simply means that regular operations must occur in the source country. The problem with this requirement when it comes to digital companies is that, since the first requirement has already failed to be met, the second cannot logically be met as there is no physical location to speak of. If the first characteristic cannot be met, the second will automatically not be fulfilled, and the second element of the permanent establishment definition therefore cannot be satisfied when it comes to digital companies.

Element 3: The business of the enterprise must be wholly or partly carried out at the place of business

The operations of the company must be wholly or partly carried out through the place of business. This phrase "carried out through", "infers that the business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose."[56] This means that to qualify to as a permanent establishment there must be a location that is designated by the enterprise from which the business is carried out. It is submitted that for this element to be fulfilled, the first element must first be met. It follows that if there is no place of business to speak of the last element has already failed. Digital companies have no specific location in the source country and therefore the operations cannot be carried out through a place of business.

From this discussion it is evident that non-resident digital companies fail to meet the permanent establishment requirement and therefore they cannot be liable for income tax in terms of the definition of a "permanent establishment" in a Double Tax Agreement.

[55] Oguttu & Tladi 2009 *JICLT* 214.
[56] Oguttu & Tladi 2009 *JICLT* 215 see further R Doernberg *et al Electronic Commerce and Multijurisdictional Taxation* 2001 206.

2.3.4 The Source Provisions in Section 9 of the Income Tax Act

Section 9 of the Income Tax Act provides that certain amounts are received by or accrue to a person from a source within the Republic. No specific provision is made in the section for e-commerce. Certain of the provisions may also apply in the digital economy, such as:

- an amount incurred by a resident in respect of the imparting or undertaking to impart any scientific, technical, industrial or commercial knowledge or information or a service or assistance in connection with its application, unless the amount is attributable to a permanent establishment situated outside the Republic;[57] or

- an amount that is received or accrues in respect of the imparting or undertaking to impart any scientific, technical, industrial or commercial knowledge or information for use in the Republic, or a service or assistance in connection with its application.[58]

Such knowledge or information, which could be of a commercial or educational nature, that is provided digitally and either paid for by a South African resident or used or applied in the Republic would fall within the provisions of section 9 of the Income Tax Act and therefore subjected to tax in South Africa.

Possibly, the ambit of section 9 of the Income Tax Act could be extended to include in the source provisions goods and services paid for or consumed or used in South Africa, that are provided through digital means.

2.4 VALUE-ADDED TAX IN RELATION TO DIGITAL COMPANIES

The digital economy and e-commerce have grown over the years and because of this South Africa has had to take steps to tax this economy to protect the tax base. The former Minister of Finance, Pravin Gordhan, introduced amendments to the Value-Added Tax Act[59] (the Value-Added Tax Act) to include certain digital services. It is necessary to provide a brief

[57] S9(1)(e).
[58] S9(1)(f).
[59] 89 of 1991.

discussion of value-added tax (VAT) to establish the nature of the tax and how it operates, before exploring the amendments which were made to the Act in respect of e-commerce.

2.4.1 Value-Added Tax

VAT is regarded as an indirect tax, which is regulated by the Value-Added Tax Act. An indirect tax is one which is not assessed directly by the South African Revenue Service (SARS), but assessed through the taxation of transactions.[60] The supplier pays the tax to SARS while the consumer pays the tax to the supplier as part of the purchase price.[61] This type of taxation therefore places a burden on the supplier to pay tax to SARS and thus it is necessary that SARS puts measures in place to ensure that the suppliers or the clearing houses comply with this requirement.

2.4.2 Value-Added Tax on Electronic Services

Section 7 (1) of the Value-Added Tax Act states:

> Subject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value-added tax-
>
> (a) On the supply by any **vendor** of any goods or services supplied by him on or after the commencement date in the course or furtherance of any **enterprise** carried on by him …[62] (emphasis added)

The definition states that a vendor will be subject to VAT on the supply of goods or services supplied by him in the course of an enterprise he carries on. A "vendor" is defined as:

> any person who is required to be registered under this Act: Provided that where the Commissioner has under section 23 or section 50A determined the date from

[60] Stiglingh *et al* *SILKE* 1030.
[61] *Ibid.*
[62] S 7(1)(a).

> which a person is a vendor that person shall be deemed to be a vendor from that date.[63]

This means that all taxpayers who are defined as vendors are liable to pay VAT on any supply of goods or services made in the course of an enterprise. The definition of "enterprise" in section 1 of the Act was amended by section 95(1) of the Taxation Laws Amendment Act[64] and now states that an enterprise is:

> …the supply of electronic services by a person from a place in an export country, where at least two of the following circumstances are present:
> (aa) the recipient of those electronic services is a resident of the Republic;
> (bb) any payment to that person in respect of such electronic services originates from a bank registered or authorised in terms of the Banks Act (Act No. 94 of 1990);
> (cc) the recipient of those electronic services has a business address, residential address or postal address in the Republic.[65]

This amendment has included electronic services as part of the definition of an enterprise and therefore aims to cater for the lack of a mechanism to subject digital services to VAT in South Africa. The pre-requisite for these electronic services being taxed is that they must be supplied by a person in an export country. An export country is defined in section 1 of the Value-Added Tax Act as:

> any country other than the Republic and includes any place which is not situated within the Republic: Provided that the President may by notice in the *Gazette* determine that a specific country or territory shall from a date and to the extent indicated in the notice, be deemed not to be an export country.[66]

It is clear from the definition that export countries would be all those countries that are not the Republic of South Africa and it would only be by way of notice that a country would be excluded from the definition of export country. This definition therefore casts a wide net and

[63] S1.
[64] 2014.
[65] S1.
[66] *Ibid*.

ensures that all suppliers of digital services from any export country would be liable to pay VAT, unless the country has been excluded by the President.

The definition of electronic services is wide, and the persons are only required to meet two of the three requirements in the definition to be required to register. The requirements are all based on the recipient complying with the destination basis of VAT. VAT is a destination-based tax, which means that it is levied where the good or service is consumed, rather than from where it has originated.[67] This assists in the taxation of digital companies as the issue of the taxing jurisdiction is based on where the consumer is located, rather than where the supplier is located or whether the supplier has a physical presence in the taxing country.

Although the definition of an enterprise was amended, there initially was no clarity on what would be defined as electronic services in terms of section 1. Because of this lack of clarity, the former Minister of Finance, Pravin Gordhan, promulgated the "Regulations Prescribing Electronic Services for the Purpose of the Definition of 'Electronic Services' in Section 1 of the Value-Added Tax Act 89 of 1991"[68] to clarify which services could be regarded as electronic services.[69] These services include:

1. Educational services[70]
2. Games and games of chance[71]
3. Internet based auctions[72]
4. Miscellaneous services[73]
5. Subscription services.[74]

<u>Educational services</u>

According to section 3 of the Regulations, educational services include Internet-based courses, distance teaching programmes, webinars, education programmes or webcasts.[75]

[67] K Siliafis *Consumption Taxation & Electronic Commerce: Issues, Approaches, a Way Forward* (PhD Thesis in Law University of Aberystwyth, 2015) 90.
[68] GN R. 221Government Gazette 37489 28 March 2014.
[69] S2(1).
[70] S3.
[71] S4.
[72] S5.
[73] S6.
[74] S7.

These services are only defined as educational services where the person making the supply of the services is not regulated by an educational authority in the export country.[76] This means that the person making the supply must be a private entity. Any persons making supplies that are regulated by the educational authority are therefore excluded from this definition.

Games and games of chance

The supply of electronic games, which are either Internet based, or multiplayer role-playing games will be included as electronic services. This means that any games which require the use of the Internet to be played, such as Tom Clancy's *The Division* (an online-only multiplayer role-playing game available on leading gaming platforms such as *Sony PlayStation* 4),[77] will attract VAT due to the nature of the game. Interactive games, such as games which involve chance, skill or a combination of both, will be included in the definition. In addition to this any betting or wagering that involves gambling on the outcome of a race or another event, will also be included in the definition and therefore taxed. In terms of games and games of chance, the Regulations have clearly cast a wide net and as such there may be an opportunity for increased VAT collections.

Internet-based auctions

Section 5 states that, "the supply of an internet-based auction service facility" will be included in electronic services. The Regulation does not expand on what will be defined as an internet-based auction service facility and therefore it is assumed that the plain language definition of an auction will be applied. An auction is defined as, "a public sale in which goods or property are sold to the highest bidder"[78] and an auction service facility would be an online platform which allows auctions to take place. It is submitted that a service like *BidorBuy* would be considered an internet-based auction service facility if it was based in an export country. However, *BidorBuy* is a South African company and therefore excluded from

[75] S3(a-e).
[76] S3(a-e).
[77]Tom Clancy. The Division https://tomclancy-thedivision.ubisoft.com/game/en-us/home/(Undated) [Accessed 6 April 2017].
[78] https://en.oxforddictionaries.com/definition/auction [Accessed 6 April 2017].

this definition. Companies like *eBay,* which are similar in concept, could be included in this definition.

Miscellaneous services

This part of the Regulation focuses on all the other services not dealt with in the previous sections. Miscellaneous services include e-books, music, audio-visual content and still images. This also includes the rights to listen to music and to view audio visual content and still images. The Regulation is quite straightforward and explains what would be included under each of the categories.

Subscription Services

According to this regulation any subscription to the following will be considered an electronic service:

a. Blog
b. Journal
c. Magazine
d. Newspaper
e. Games
f. Internet-based auctions
g. Periodical
h. Publication
i. Social networking service
j. Webcast
k. Webinar
l. Web site
m. Web application
n. Web series.[79]

This list includes many categories, clearly to ensure that taxation would apply.

[79] S7.

The Regulations have provided the clarity that was needed regarding electronic services. The Regulations do not cover all electronic services, however. There are services that have been excluded from the list, such as software supplies, which could attract a substantial amount of VAT. In a Press Release by National Treasury, it was pointed out that the scope was purposefully narrowed as it would reduce the problems of taxing business-to-business, supplies as opposed to taxing business-to-consumer supplies, which were mostly what the Regulations provided for.[80] The Press Release also emphasised that imported services not included in the Regulations would still be subject to VAT in terms of section 14 of the Act.[81]

The introduction of the Regulations has provided a measure of protection for the tax base in terms of e-commerce, but there are problems that may arise resulting from their enactment.

2.4.3 Problems Associated with Electronic Services Regulations

The burden of compliance has shifted from the resident recipient to the foreign supplier and one of the main reasons for this is that there had been a low level of compliance on the payment of VAT by resident recipients of imported services.[82] As a result of this shift, the administrative compliance burden on the foreign supplier is quite onerous. The foreign supplier is required to register as a VAT vendor[83] and with this there may be other requirements that may arise in respect of this registration. This could include opening a South African bank account.[84]

In addition to this, the foreign supplier may need to devise a system which tracks where customers are located who are purchasing the products.[85] Where such a system is not already in existence, the costs may be high, and this may be problematic for the supplier in question.

[80] National Treasury "Press Release Final Electronic Services Regulations Published" (2014) 1.
[81] *Ibid*.
[82] H Louw & D Botha "Value-added tax on electronic services supplied by persons outside South Africa" (2014) http://www.thesait.org.za/news/168149/Value-added-Tax-on-electronic-services-supplied-by-persons-outside-South-Africa.htm [Accessed 07 April 2017].
[83] S23 (1) A.
[84] Louw &Botha "Value-added tax".
[85] *Ibid.*

The supplier may also be unaware that the services are being provided to a resident and as a result will also be unaware of the duty to pay the required VAT to SARS.[86]

To date there has been no indication of how SARS plans to address these issues and it is necessary that recommendations be made to assist in addressing the problems.

2.5 CONCLUSION

This chapter has focused on the development of the taxation provisions relating to digital companies. The initial discussion referred to the recommendations made by the Katz Commission regarding a future that would possibly involve e-commerce and whether creating legislation to deal with such a future would be feasible. The chapter then discussed the source principles of taxation in terms of the Income Tax Act applying in South Africa in relation to non-resident persons, including the definition of a "resident". It was noted that the provisions of a Double Tax Treaty between South Africa and another country would override the source principles. It was found that non-resident digital companies in countries with which South Africa had entered into a Double Tax Agreement are unlikely to have a permanent establishment in South Africa due to the lack of a physical presence and would therefore not meet the source requirements and would not be subject to income tax in South Africa. The possible application of the source principles introduced by section 9 of the Income Tax Act, dealing with the imparting of knowledge, or assistance in relation to the knowledge, may apply to include digitally provided commercial or educational knowledge provided by a non-resident within the ambit of the Income Tax Act, as being from a source in South Africa.

The chapter lastly focused on the progress made to include electronic services within the ambit of the VAT Act, by an amendment to the definition of an "enterprise" in section 1 of the VAT Act. In the discussion, the various services to be included as electronic services were discussed in terms of the Regulations prescribing which services constituted the electronic services included in the definition of an "enterprise". During this discussion it was also indicated that there were various problems that could arise in terms of these Regulations.

[86] Louw & Botha "Value-added tax".

These problems will be discussed in more detail the following chapters, where recommendations will be made.

In the next chapter the focus will be on the progress that the OECD has made regarding addressing the challenges of taxing the digital economy. In addition to this, the approach that New Zealand has taken to taxing the digital economy will also be dealt with.

Chapter 3: The Approach of the OECD and New Zealand on the taxation of the digital economy

3.1 INTRODUCTION

The previous chapter discussed the taxation of the digital economy in South Africa. It was shown that most non-resident digital services provided by non-resident persons could not be subject to income tax in South Africa. It was also established that currently the only type of tax which can be applied to these digital companies is value-added tax (VAT). In order for vendors to be liable for VAT they must supply goods or services in the course of any enterprise that they carry on.[87] The definition of "enterprise" in the Value-Added Tax Act[88] was amended by the Taxation Amendment Laws Act,[89] to include electronic services supplied by vendors in export countries.[90] There was no clarity on which services would be included in the definition, and the former Minister of Finance, Pravin Gordhan, published the "Regulations Prescribing Electronic Services for the Purpose of the Definition of 'Electronic Services' in section 1 of the Value-Added Tax Act, 1991"[91] that highlighted those services that would be included as electronic services. It was also established that there are various problems with the current digital taxation system as implemented in South Africa, and it was therefore important to examine how other jurisdictions have dealt with the problem of taxing the digital economy.

The aim of this chapter is to focus on the work performed by the Organisation for Economic Co-Operation and Development (OECD) regarding the digital economy. A brief discussion on the OECD will be provided to explain the work the organisation performs. Thereafter the past work of the organisation will be examined, and finally the current report dealing with taxing the digital economy will be discussed. In addition to this, the chapter will also focus on the approach adopted in New Zealand to tax the digital economy. This country has a similar taxation system to South Africa's and therefore it would be helpful to identify progress made

[87] S 7(1)(a).
[88] 1991.
[89] 2014.
[90] S1.
[91] GN R. 221Government Gazette 37489 28 March 2014.

in taxing the digital economy in New Zealand, with a view to possible adopting similar measures in South Africa.

3.2 THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a global forum comprised of 34 member states that all share market economies.[92] The Organisation promotes economic growth, prosperity and sustainable development, and acts as an innovation hub through extensive economic research and peer-to-peer reviews that are undertaken regularly.[93] This allows many member, and non-member states to assist in developing the global economy, and enables governments to compare policy experiences and solve common problems.[94] The mission of the OECD is to promote policies that will improve the economic and social well-being of the world population.[95]

There are over 70 countries that are not members of the OECD but contribute to the work of the Organisation and benefit from the policies formulated resulting from this work. South Africa is not a member of the OECD, but policies implemented by the forum are important because many of South Africa's trading partners belong to the Organisation. In addition, decisions made by the Organisation will affect South Africa and it would therefore be useful to adopt the tax principles that have been established by the OECD.

The OECD has been at the forefront in addressing the issue of taxing the digital economy. It is important therefore to focus on the work done by the organisation to date.

3.2.1 Background to the Work Performed by the OECD

The OECD began work on addressing the digital economy in 1996 when the Committee on Fiscal Affairs had a discussion on the taxation implications of the development of

[92] U.S Mission to the Organization for Economic Co-Operation and Development "What is the OECD?" https://usoecd.usmission.gov/our-relationship/about-the-oecd/what-is-the-oecd/ [Accessed 10 May 2017].
[93] *Ibid.*
[94] *Ibid.*
[95] OECD "About the OECD" www.oecd.org/about [Accessed 5 May 2017].

communication technologies.[96] A conference that was held on the issue of electronic commerce formed the basis of a series of proposals to be made at a Ministerial conference in Ottawa in 1998.[97] At this meeting the Committee on Fiscal Affairs concluded that existing taxation principles should also be applied in relation to electronic commerce. In addition it was agreed that new legislative measures could be introduced, provided they were introduced in conjunction with the existing taxation principles so as not to create discriminatory taxation of electronic commerce.[98] The Committee on Fiscal Affairs also agreed that double taxation should be avoided and the fiscal sovereignty of states should be maintained.[99] Concerned stakeholders, such as non-member states and businesses, were expected to be included in a dialogue regarding implementation of these principles.

At the Ottawa Conference, the proposals of the Committee on Fiscal Affairs were discussed, and it was agreed that they should be adopted. In addition, it was decided to apply certain principles to electronic commerce. These were neutrality, certainty and simplicity, effectiveness and fairness and flexibility.[100]

Neutrality

It was agreed that taxation systems should maintain neutrality and equitability between conventional and electronic forms of commerce.[101] This means that there should be no differentiation between the taxation of the two types of commerce. The rationale behind this was that if taxation principles were applied differently to conventional and electronic commerce, business decisions could be affected based on whichever taxation system was more favourable. It was concluded that business decisions should be based on economic rather than tax considerations.[102] In addition it was also agreed that taxpayers performing similar transactions should be taxed similarly.[103] This would mean that regardless of whether the transaction was carried out in a conventional manner, or using electronic means, it would be taxed in the same way.

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[96] OECD/G20 Base Erosion and Profit Shifting Project "Addressing the Tax Challenges of the Digital Economy, Action 1 2015 Final Report" (2015) 152 http://dx.doi.org/10.1787/9789264241046.en [Accessed 1 May 2017].
[97] *Ibid*.
[98] *Ibid*.
[99] *Ibid*.
[100] *Ibid*.
[101] OECD "Electronic Commerce: Taxation Framework Conditions" (1998) 4.
[102] *Ibid*.
[103] *Ibid*.

Efficiency

It was agreed that the introduction of electronic commerce should remain efficient. The compliance costs for taxpayers involved in electronic commerce were to be kept low, and the administrative costs for the tax authorities were also to be kept low.[104]

Effectiveness and Fairness

It was established that with the introduction of electronic commerce there could be potential tax evasion and avoidance.[105] It was therefore important for tax authorities to put relevant counter measures in place that were proportionate to the risks involved.[106] An example of such a measure would be where the tax authority ensures that tax legislation is amended to tax services provided by digital companies in the same way that services provided by conventional suppliers are taxed.

Flexibility

The advent of electronic commerce would call for taxation systems to be more flexible.[107] This would mean that these systems would have to be kept updated with technology and developments in the commercial sphere to charge tax accordingly.

Certainty and simplicity

Electronic commerce would require that the laws which were promulgated would be simple and certain which would mean there would be no ambiguity which would be experienced by taxpayers involved in the industry. This would mean that the taxpayers would be able to anticipate any tax consequences arising from electronic commerce.[108]

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[104] OECD "Electronic Commerce" 4.
[105] *Ibid.*
[106] *Ibid.*
[107] *Ibid.*
[108] *Ibid.*

3.2.2 The Action Plan on Base Erosion and Profit Shifting

The OECD continued its work on issues raised by the increasing prominence of electronic commerce in the global economy. There were various taxation issues that became apparent regarding globalisation, and it was established that measures should be put into place to ensure that tax authorities would impose the correct tax on companies earning profits in their countries. With this in mind, the organisation began working on the "Action Plan on Base Erosion and Profit Shifting". Base Erosion and Profit Shifting (BEPS) has been defined as, "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity."[109] This was identified by the OECD as a problem as it meant that corporations could exploit low tax jurisdictions and therefore avoid being taxed in the countries where they earned their profits.

Background of the Action Plan

The OECD acknowledged that there had been an increase in globalisation and this meant that there would be greater movement of capital, labour, and developments in telecommunications. As a result of this trade barriers had been removed.[110] In addition there were opportunities for job creation, foreign direct investment and the alleviation of poverty.[111] As globalisation increased, states realized that there could be the possibility of double taxation as a result of companies earning profits in various countries and being taxed in their country of residence as well as the country where the profit was earned. To prevent this, countries began to enter into Double Taxation Agreements to ensure that taxpayers would not be greatly disadvantaged. The OECD concluded that international taxation that included these Double Taxation Agreements was therefore a key player in the growth of the global economy.[112]

The digital economy gained prominence because of globalisation and the enhancement of technology. Companies were therefore able to provide products and services to customers in

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[109] OECD "About the Inclusive Framework on BEPS" (2016) http://www.oecd.org/tax/beps-about.htm [Accessed 16 May 2017].

[110] OECD *Action Plan on Base Erosion and Profit Shifting* (2013) 7 http://dx.doi.org/10.1787/9789264202719-en [Accessed 21 August 2016].

[111] *Ibid.*

[112] *Ibid.*

different states without being physically present in these jurisdictions.[113] This, in turn, reduced the tax burdens of many multi-national companies as they were not liable for income tax on profits earned in jurisdictions where they had no physical presence. It was established that this practice affected various stakeholders, including governments, individuals and businesses.

Governments

The OECD found that with multi-national companies not paying income tax in jurisdictions where they had no physical presence, the integrity of the tax systems of governments was jeopardized.[114] As a result of the digital economy, revenue earned by the governments was drastically decreased and this forced governments to ensure compliance at an increased cost.[115] Developing countries were at a great disadvantage because decreased revenue would result in underfunding of public investments, and this would therefore stunt economic growth.[116]

Individuals

To compensate for less tax revenue earned from companies, the OECD concluded that governments would end up increasing the rate of individual income tax.[117] This meant that individual taxpayers would therefore bear the brunt of the tax burden that would negatively impact on them.

Businesses

Multinational companies managed to lower their tax burdens due to the effect of the digital economy and this was seen as problematic by the OECD. This is because a low effective tax rate could affect the reputation of the business.[118] Businesses that did not act in the form of multinational companies and failed to take advantage of the lower tax opportunities were at a

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[113] *Ibid.*
[114] OECD *Action Plan* 7.
[115] OECD *Action Plan* 8.
[116] *Ibid.*
[117] *Ibid.*
[118] *Ibid.*

competitive disadvantage. In addition, smaller companies that only operated in one country and did not make use of the Internet to conduct business, were at a disadvantage as they could not maintain their competitive edge over multinationals and reduce their tax burdens.[119]

Once it was established that the digital economy was contributing to multinationals shifting their profits, reducing their tax burden, and therefore affecting various stakeholders, the OECD acknowledged the need to amend the current taxation legislation in order to curb this problem.[120] It was also agreed that states needed to maintain their tax sovereignty and as a result there could still be conflicting tax rules causing gaps and frictions.[121] These gaps could still allow multinationals to exploit this and reduce their tax burden. The OECD therefore proposed that the global economy should collaborate on tax matters so that the tax sovereignty of the countries would be maintained.[122]

The digital economy posed a great difficulty in relation to taxation, as it was not easy to establish where value creation occurred, and as a result, companies that earned profits in foreign jurisdictions were not liable to pay income tax.[123] It was proposed that companies that operated in the digital economy had to be scrutinised to establish how they created value and made profit.[124] This would be done in order to decide to what extent the current tax rules had to be amended to cater to the different features of the digital economy, and therefore reduce base erosion and profit shifting.[125]

To reduce base erosion and profit shifting the OECD formulated an Action Plan which dealt with the different issues of base erosion and profit shifting. There were fifteen actions in total and these included Action Plan 1 – to address the tax challenges of the digital economy.[126]

The focus of this thesis is on the First Action Plan, which was to "Address the tax challenges of the digital economy".[127]

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[119] *Ibid*.
[120] OECD *Action Plan* 9.
[121] *Ibid*.
[122] OECD *Action Plan* 9.
[123] OECD *Action Plan* 10.
[124] *Ibid*.
[125] *Ibid*.
[126] OECD *Action Plan* 14.
[127] *Ibid*.

Action 1: Addressing the tax challenges of the digital economy

The aim of this action was to:

> identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation.[128]

Various issues were identified by the OECD that needed to be considered. These included:

- the inability of companies with a digital presence in other countries to pay income tax because of a lack of nexus in terms of international tax rules;
- the application of source rules;
- ensuring the effective collection of Value-Added Tax or Goods and Sales Tax on cross-border supplies of digital goods and services;
- income characterisation based on new business models; and
- value attribution created from marketable location-relevant data through using digital products and services.[129]

The Action Plan was endorsed by the leaders of the G20 because of its importance in tackling the challenges in the digital economy. It was emphasised by the leaders that it is imperative that all taxpayers be liable to pay their fair share of tax.[130] In order to fulfil the Action Plan, a panel, *The Taskforce on the Digital Economy,* was formed, whose core mandate was to address Action 1 of the Plan.[131] The taskforce discussed the scope of work to be done, and in order to gain clarity, past efforts of the OECD were considered.[132] The principles that were set out at the 1998 Ottawa Ministerial Conference on Electronic Commerce were considered to be important, and relevant to the work that would be completed by the Taskforce on the

[128] OECD *Action Plan* 14.
[129] *Ibid.*
[130] OECD "Addressing Tax Challenges" 16.
[131] OECD "Addressing Tax Challenges" 17.
[132] *Ibid.*

Digital Economy.[133] It was concluded that these principles were useful in determining options to address the challenges posed by the digital economy.[134] The Taskforce also focused on the work that was done after the Ottawa Conference, with particular reference to the Technical Advisory Group on Business Profits.[135] This related to profit attribution to permanent establishments, the place of effective management concept and tax treaty rules in the context of e-commerce.[136]

The Taskforce was also of the opinion that, to progress, it was important to receive stakeholder input. They engaged with public input and issues on hand, which led to the drafting of the final report on Action 1 in 2015.[137]

3.2.3 The Final Report of the Taskforce on the Digital Economy

There were various issues that had to be discussed regarding challenges posed by the digital economy. The Taskforce established that, although the problems observed in Action 1 were mainly centred on the digital economy, the features of this economy exacerbated the risk of BEPS occurring.[138]

The panel concluded that there were three features of the digital economy that posed a risk to BEPS, namely:

1. the intangibles used in the digital economy;
2. centralising infrastructure remotely; and
3. the ability of the digital economy to avoid PE status in source countries.

Intangibles used in the digital economy

It was observed that the main feature of the digital economy was the intangibles used in providing goods and services to consumers in different jurisdictions. Coupled with the

[133] *Ibid.*
[134] OECD "Addressing Tax Challenges" 17.
[135] *Ibid.*
[136] *Ibid.*
[137] OECD "Addressing Tax Challenges" 18.
[138] OECD "Addressing Tax Challenges" 144.

mobility of the entire economy, the Taskforce on the Digital Economy highlighted that this gave taxpayers in the digital economy the opportunity to avoid direct taxes. This is because there was an opportunity for taxpayers to move their profits to lower tax jurisdictions.[139]

Centralising infrastructure remotely

It was established by the panel that it was possible for businesses operating in the digital economy to conduct sales of goods and services from a remote location. In addition, these businesses could structure their operations in such a way as to limit the number of personnel involved, resulting in a fragmentation of physical operations, which could lead to avoiding taxation.[140]

Avoiding permanent establishment status

The BEPS Project, which was put together by the OECD in order to confront the challenges raised by BEPS in the global economy, found that a danger posed by the digital economy is that core activities that take place may escape Permanent Establishment status, and be claimed as auxiliary or preparatory in nature.[141] In addition, these digital companies could use artificial arrangements relating to the sale of goods and services as a means to avoid Permanent Establishment status.[142]

This observation by the BEPS Project prompted the Taskforce on the Digital Economy to also focus on Action 7 of the Action Plan which addressed the avoidance of Permanent Establishment status, as it was evident that there were findings relevant to the digital economy.

Work carried out on Action 7: Avoiding Permanent Establishment Status

The taskforce working on Action 7 established that activities previously considered to be preparatory or auxiliary in nature could in fact be considered core in nature where the digital

[139] OECD "Addressing Tax Challenges" 144.
[140] *Ibid.*
[141] *Ibid.*
[142] *Ibid.*

economy was concerned.[143] The taskforce agreed that in order to curb this problem the list of exceptions to Permanent Establishment status should be restricted to activities that were preparatory or auxiliary in nature.[144] In addition to this modification of Permanent Establishment status exceptions, an anti-fragmentation rule was put in place to prevent businesses from dividing key business functions among closely related enterprises.[145] An example was given in the report to illustrate what the rule would translate to. It was explained that the rule would apply in situations where an online seller maintained a warehouse that had a significant workforce dedicated to storage and delivery of goods to customers of the online seller. The warehouse would be considered as a Permanent Establishment for the seller and therefore there would be liable for direct tax.[146]

In addition to this the taskforce agreed to modify the definition of a Permanent Establishment as contained in Article 5(5) and 5(6) of the OECD Model Tax Convention.[147] This would address situations where artificial arrangements relating to sales of goods or services by a subsidiary company in a multinational enterprise would effectively result in a contract being concluded, and sales would be regarded as having been made by that company.[148] In order to illustrate this modification, the example was cited of a subsidiary company that habitually acted as the principal and concluded contracts with little or no contribution by the parent company that would cause the creation of a Permanent Establishment for the parent company. This was used to illustrate a likely scenario of how the rule would be affected.[149]

The Taskforce on the Digital Economy found the work on Action 7 useful and it was thus included in the considerations that were to be made to address the challenges posed by the digital economy. Once the panel had focused on the work done on Action 7, it was considered necessary to examine the broader tax challenges posed by the digital economy.

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[143] OECD "Addressing Tax Challenges" 145.
[144] OECD "Addressing Tax Challenges" 145.
[145] *Ibid.*
[146] *Ibid.*
[147] OECD *Model Tax Convention on Income and on Capital 2014* (2015) http://dx.doi.org/10.1787/9789264239081-en [Accessed 18 May 2017].
[148] OECD "Addressing Tax Challenges" 145.
[149] *Ibid.*

Broader Tax Challenges Posed by the Digital Economy

The panel divided the challenges posed by the digital economy into two main categories namely:

1. challenges related to nexus, data and characterisation;[150] and
2. challenges related to cross-border trade in goods, services and intangibles and collection of VAT/GST.[151]

Challenges related to nexus, data and characterisation

These are three separate but overlapping issues and as such it is submitted that it would be prudent to discuss each separately, as laid out in the Final Report.

Nexus

The physical presence rule is one of considerable importance and as such the Taskforce on the Digital Economy found that it was necessary to establish whether this rule would remain appropriate. This is because there had been a decline in the need for a physical presence to conduct business.[152] According to statistics, the number of firms operating in the digital sphere had rapidly spiked in the past 10 years. In 2014 the business-to-consumer sector of e-commerce earned $US 1.4 trillion while in 2013 worldwide e-commerce totalled $US 16 trillion.[153] With these figures in mind, the Taskforce on the Digital Economy was of the opinion that it would be necessary to establish how relevant the physical presence rule remained in the modern digitised world.

Data

The Taskforce established that it was becoming more and more difficult to conclude how to properly allocate taxable income between locations where economic activities occurred and

[150]OECD "Addressing Tax Challenges" 147.
[151]*Ibid*.
[152]*Ibid*.
[153]*Ibid*.

where value was created.[154] It was pointed out that this became especially difficult where customers formed part of the value chain, such as in multi-sided business models and the sharing economy.[155] It was established that, with the improvement of technology and the utilisation of information technology, digital companies were able to obtain and use information. All these issues raised various questions, such as how to attribute the value created from data generation through digital products and services.[156] Another important question raised was whether the remote collection of data should be considered as giving rise to nexus for taxation purposes. The last question raised by these issues was regarding ownership and how to characterise a person or entity's supply of data in a transaction for taxation purposes,[157] and whether such supply would be considered as free supply of a good or, for example, a barter transaction.

Characterisation

With modern and innovative methods of delivering services and new digital products being manufactured, it has become increasingly difficult to characterise these in terms of the existing rules of payment made in the context of new business models.[158] In cloud computing this has especially been a problem. With 3D printing on the rise, it was submitted by the panel that characterisation issues may also arise, as the old method of direct manufacturing for delivery would now evolve into the licensing of designs for remote printing by customers.[159]

Challenges related to cross-border trade in goods, services and intangibles and collection of VAT/GST

Consumers in the recent past have begun to receive products from suppliers abroad and this has caused problems with the collection of VAT/GST. This problem has arisen partly because there is no effective international framework to ensure the VAT collection in respect of goods

[154] *Ibid.*
[155] OECD "Addressing Tax Challenges" 147.
[156] *Ibid.*
[157] *Ibid.*
[158] *Ibid.*
[159] *Ibid.*

supplied.[160] The absence of this has proved costly to many tax authorities, as there is an increased risk of loss of revenue and trade distortions.[161] The lack of appropriate collection methods has increased tax liabilities incurred through a high volume of low value transactions, leading to a significant administrative burden but producing only marginal revenues.[162]

The broad challenges, as well as other challenges raised by the Taskforce had to be given appropriate and workable solutions. To address this, the panel drew up a list of optional solutions to the challenges. These were:

1. modifications to the exceptions from Permanent Establishment status;
2. alternatives to the existing Permanent Establishment threshold;
3. imposition of a withholding tax on certain types of digital transactions;
4. introduction of an equalisation levy; and
5. collection of VAT in the country where the consumer is located according to the principles and mechanisms developed by Working Party 9 of the Committee on Fiscal Affairs.[163]

Conclusions reached by the Taskforce on the Digital Economy

After careful consideration the Taskforce decided to select only the first and fifth options. It was submitted that the option to modify exceptions to Permanent Establishment status was already under consideration by the BEPS in terms of the work done on Action 7, and therefore it should be adopted.[164] The modification would be implemented altogether with the existing tax treaty networks.

The collection of VAT/GST was considered of importance and therefore it was imperative to consider the fifth option. It was recommended that countries abide by the principles contained

[160] *Ibid.*
[161] *Ibid.*
[162] OECD "Addressing Tax Challenges" 147.
[163] *Ibid.*
[164] OECD "Addressing Tax Challenges" 148.

in the International VAT/GST Guidelines[165] for collection of VAT on cross-border business-to-consumer supplies of services and intangibles.[166] The aim of these guidelines was to ensure certainty with regard to international VAT transactions, so as to avoid double taxation, as well as any other risks that could be posed due to cross-border trading.[167] The guidelines did not supersede a country's tax sovereignty; they simply acted as a guide for countries to follow in order to avoid uncertainty.[168] The principle of neutrality was emphasised in the guidelines and states were encouraged to treat cross-border transactions as similar to domestic transactions.[169] This would mean that where foreign businesses made supplies in a country, they would not be unfairly disadvantaged or advantaged on the basis of their foreign status.[170]

It was also suggested that countries adopt the collection mechanisms as described in the International VAT/GST Guidelines. According to the Guidelines, the traditional approach regarding collection of VAT was one where the supplier would be liable to pay the VAT incurred.[171] This approach was seen as cumbersome and complex for the suppliers as the supplier has no physical presence in the jurisdiction.[172] The tax authorities would also be burdened because it would be difficult to enforce and administer the traditional rules.[173] The OECD established that there was one effective collection method where business-to-business suppliers were concerned, namely the reverse charge mechanism.[174] This would only be applicable where it was consistent with the particular jurisdiction's VAT system. The mechanism would ensure that off-shore suppliers do not have to go through the process of registering for VAT.[175] This method would not be appropriate for business-to-consumer supplies as there is the possibility of low levels of compliance on the part of the consumer to pay the VAT to the revenue authorities.[176] The most appropriate method therefore would be the traditional method where off-shore suppliers are required to register for VAT, and

[165] OECD *International VAT/GST Guidelines* (2015) http://dx.doi.org/10.1787/9789264271401-en [Accessed 18 May 2017].
[166] OECD "Addressing Tax Challenges" 148.
[167] OECD *International Guidelines* 9.
[168] *Ibid.*
[169] OECD *International Guidelines* 24.
[170] *Ibid.*
[171] OECD *International Guidelines* 49.
[172] *Ibid.*
[173] *Ibid.*
[174] OECD *International Guidelines* 50.
[175] OECD *International Guidelines* 48.
[176] *Ibid.*

therefore pay the requisite tax to the revenue authorities. The recommendations regarding this approach will be discussed in the following chapter of the present thesis.

The panel also made a suggestion that the VAT exemption threshold should be lowered or totally removed.[177] The panel was of the opinion that any other challenges considered would be mitigated once BEPS measures had been put in place.[178] The Taskforce decided not to implement the other three options but indicated that this did not mean that countries were prohibited from implementing the options if it was deemed necessary.[179]

3.2.4 Conclusion on the Work of the OECD

The work of the OECD in addressing the challenges posed by the digital economy has been discussed above. It is clear that rigorous consideration has been given by the OECD to the issues and it could be helpful for the South African revenue authorities to take note of the progress made. The authorities should take cognizance of the five options in response to Action 1. It would be necessary to conclude which of the options will be regarded as relevant for the South African economy, and recommendations regarding this will be provided in the next chapter. In addition, the VAT considerations made in the chapter will also be focused on to see whether the current method applied in South Africa is in line with the recommendations made by the OECD.

Based on the discussion in the previous chapter of the thesis, where the source principles for income tax and the VAT provisions were discussed, it would appear that the amendment to the requirements for meeting the Permanent Establishment status would assist in relation to income tax and the digital economy, and specifically determining the source of amounts arising from the provision of digital goods and services, while the OECD recommendations relating to VAT would be relevant to the levying of VAT.

[177] OECD "Addressing Tax Challenges" 148.
[178] OECD "Addressing Tax Challenges" 148.
[179] *Ibid.*

3.3 THE APPROACH OF NEW ZEALAND TO THE DIGITAL ECONOMY

New Zealand has a VAT system that is similar to the South African system and because of this it is important to focus on how the New Zealand government has approached the challenges posed by the digital economy. New Zealand applies a Goods and Services Tax (GST), which is a similar tax to the South African VAT. New Zealand considers itself as having a GST model that is "best in its class."[180] With that in mind it is important to focus on the approach taken by the New Zealand revenue authority, Inland Revenue, to see how the challenge of the digital economy was addressed.

In light of the growing digital economy, the Minister of Revenue, the Honourable Todd McClay, with the aid of Inland Revenue, drafted a discussion paper entitled "GST: Cross-border services, intangibles and goods: a government discussion document."[181] The aim of the paper was to seek submissions on the rules that would apply to GST on cross-border services.[182] The proposed rules would require that off-shore suppliers would be obligated to register for GST when supplying consumers in New Zealand.[183] The proposed rules were taken into consideration in order to ensure that the country was aligned with the guidelines that had been presented by the OECD.[184]

3.3.1 Background of the Discussion Paper

GST was previously not charged on cross-border services or intangibles from off-shore suppliers. This was because there was a low demand for off-shore services or intangibles by New Zealand consumers and digital products did not exist at the time when GST was

[180] PricewaterhouseCoopers "Tax by the megabyte: New Zealand's GST in our digital economy" (2015).
[181] Inland Revenue Policy & Strategy (2015).
[182] Inland Revenue "Cross-border services" 1.
[183] *Ibid.*
[184] *Ibid.*

introduced in 1986.[185] Inland Revenue decided to forego the taxation of imported services because the compliance costs would be considerably higher than the benefit.[186]

Problems with non-collection of GST

As E-commerce became more prevalent, the revenue authority contemplated whether it was necessary for the then current tax rules to be amended, or to maintain the rules as they were.[187] Inland Revenue was particularly concerned with how the economy would be affected by the unequal taxation system.[188] This inequality existed as cross-border services remained untaxed while domestic companies that provided the same service were taxed due to their geographical location.[189] The domestic suppliers were unfairly disadvantaged as the off-shore products could be cheaper without GST to consider in the price of the services.[190] This would result in consumers opting for the cheaper off-shore services, and therefore becoming biased towards them and foregoing the domestic services.[191] As GST had not previously been collected on off-shore services, Inland Revenue was losing approximately $NZ 80 million (per annum) on uncollected taxes.[192] It was therefore imperative for the existing New Zealand legislation to be amended to ensure that these problems would be avoided.

3.3.2 The New Zealand GST System Prior to the Proposals

GST is a consumption tax that aims to tax consumer spending on goods and services and was introduced in New Zealand in 1986.[193] The tax is based on the destination principle which holds that tax is charged in the country where the goods or services are consumed.[194] The application of this principle could result in the decrease of double taxation. The New Zealand GST system has been well-respected globally as a consumption tax because it is broad-based, meaning that numerous goods and services are included in the tax net.[195] In addition, GST

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[185] *Ibid*.
[186] *Ibid*.
[187] *Ibid*.
[188] *Ibid*.
[189] Inland Revenue "Cross-border services" 5.
[190] *Ibid*.
[191] *Ibid*.
[192] Inland Revenue "Cross-border services" 5.
[193] Inland Revenue "Cross-border services" 1.
[194] Inland Revenue "Cross-border services" 5.
[195] Inland Revenue "Cross-border services" 6.

being broad-based would mean that consumers are not influenced by taxation considerations when making their purchasing decision.[196] Despite this advantage the revenue authority had not included the taxation of cross-border services. According to the Goods and Services Act[197] "services" are defined as "anything which is not goods or money."[198] This broad definition therefore could include intangibles such as digital content.[199] According to the Act, however, GST only applied to services performed by New Zealand tax residents[200] or those performed physically in New Zealand by a non-resident.[201] In light of the prevalence of the digital economy, the Act was amended in order to accommodate off-shore services that fall within the digital economy. According to section 8(2) of the Goods and Services Act, any goods provided, or services performed by a non-resident would be deemed to be provided or performed outside of New Zealand.[202] Section 8 (6) of the same Act, however, states that:

> . . . telecommunications services are treated as being supplied in New Zealand if the supplier is a non-resident and a person, physically in New Zealand, initiates the supply from a telecommunications supplier, whether or not the person initiates the supply on behalf of another person.

This means that off-shore suppliers of telecommunication services are required to register for GST on services initiated by New Zealand consumers. Telecommunication services are defined as:

> the transmission, emission or reception, and the transfer or assignment of the right to use capacity for the transmission, emission or reception, of signals, writing, images, sounds or information of any kind by wire, cable, radio, optical or other electromagnetic system, or by a similar technical system, and includes access to global information networks but does not include the content of the telecommunication.[203]

[196] Inland Revenue "Cross-border services" 5.
[197] 141 of 1985.
[198] S2.
[199] Inland Revenue "Cross-border services" 5.
[200] S8(2).
[201] S8(3)(b).
[202] S8(2).
[203] S2.

The definition clearly excludes the content of the telecommunication, which means that, for example, an internet download would be excluded from being charged with GST, since it is the content of a telecommunication service.[204] This amendment did not remedy the problem created by the digital economy and therefore it was deemed appropriate to establish new rules.

New Zealand at the time applied the "place of supply" principle. This principle dictates that GST is charged in the jurisdiction where the service was supplied, regardless of whether the service was supplied to a New Zealand resident.[205] This meant that no GST was charged regardless of where the service was consumed, provided that it was supplied by a supplier outside of New Zealand.[206] This principle was causing Inland Revenue to lose substantial amounts of revenue from untaxed services being supplied to New Zealand residents who consumed the service in New Zealand. To address the problem, Inland Revenue concluded that it was necessary to introduce new rules that would assist in taxing supplies from abroad that were being consumed by New Zealand residents. The decision to introduce the proposed rules was based on the need to improve competitiveness between domestic and off-shore companies.[207] In addition it was established that New Zealand had to remain aligned with International VAT/GST Guidelines as set by the OECD regarding GST on cross-border services.[208] The purpose of these Guidelines was to set international standards for when countries would have the right to tax supplies brought into their countries.[209]

The Guidelines were divided into two groups, namely, on-the-spot and remote services.[210] On-the-spot services were those where the supplier and the consumer were in the same place where the services were supplied,[211] while remote services were those which involved the supplier and the consumer being in different locations.[212] The guidelines suggested that, regarding remote services, the country with the right to tax would be the country where the consumer was located, not the country from which the service was supplied.[213] The European

[204] Inland Revenue "Cross-border services" 7.
[205] Inland Revenue "Cross-border services" 14.
[206] *Ibid*.
[207] Inland Revenue "Cross-border services" 24.
[208] Inland Revenue "Cross-border services" 1.
[209] Inland Revenue "Cross-border services" 2.
[210] *Ibid*.
[211] *Ibid*.
[212] *Ibid*.
[213] *Ibid*.

Union adopted a VAT registration model and this was given as a suggestion in the Guidelines for jurisdictions to consider applying.[214] This model required off-shore suppliers of services to register for VAT or GST in countries where those services were supplied. Inland Revenue acknowledged that this model had already been adopted in various jurisdictions, including South Korea, Norway, South Africa and Switzerland.[215] The countries that had adopted this model reported success in collecting GST from off-shore suppliers and therefore Inland Revenue in New Zealand considered applying it in the new rules.[216] After considering these Guidelines, Inland Revenue drafted a set of new rules for discussion by interested parties.

3.3.3 The Proposed Rules

The revenue authority proposed that services and intangibles provided remotely by offshore suppliers would be treated as if they were performed in New Zealand and would therefore be subject to GST.[217] Non-resident suppliers would be required to register for GST, but this would only apply if the supply of services to New Zealand consumers exceeded a certain threshold during a twelve month period.[218] At the time of the discussion paper being compiled, the threshold had not been set, but it was later established that this would be $NZ 60 000.[219] Inland Revenue also proposed that the definition of the term "services" should be expanded in order to include both digital and traditional services.[220] In order to ensure that all offshore suppliers were capable of registering for GST, it was proposed that in specific cases an intermediary would be requested to register in place of the offshore supplier.[221]

3.3.3.1 Services and intangibles supplied remotely by offshore suppliers to be subjected to GST

The revenue authority's first proposed rule was to make services and intangibles provided by offshore suppliers liable for GST. New Zealand had previously applied the "place of supply"

214 *Ibid.*
215 *Ibid.*
216 Inland Revenue "Cross-border services" 38.
217 Inland Revenue "Cross-border services" 2.
218 Inland Revenue "Cross-border services" 2.
219 Deloitte "GST on 'remote' services" 16 April 2015 https://www2.deloitte.com/nz/en/pages/tax-alerts/articles/gst-on-remote-services.html [Accessed 20 June 2017].
220 Inland Revenue "Cross-border services" 2.
221 *Ibid.*

principle, which determined that the jurisdiction from which the supply was made would have the right to tax regardless of where the service or good would be consumed.[222] If the service or good was supplied to a New Zealand resident by a non-resident, there would be no GST charged.[223] The OECD guidelines that had been drafted by the Taskforce on the Digital Economy suggested that countries should charge tax on cross-border services and intangibles.[224] With this proposal in mind Inland Revenue concluded that, in order to adapt to the increase in offshore supplies, GST had to be charged on supplies made to New Zealand residents. The revenue authority had to select the basis on which taxation would apply. Various options were considered, such as the residence of the consumer and the physical location of the consumer.[225] It was decided that the most appropriate basis would be the residence of the consumer as this was the international standard applied, and such a basis could help to prevent double taxation.[226] This decision meant that an amendment would be made to the "place of supply" principle and this amendment would have characteristics of the "destination" principle, which proposed that the jurisdiction where the services or goods would be consumed had the right to tax.[227]

Inland Revenue also had to decide which services would be subjected to GST and once again the OECD draft guidelines were consulted to enable it to make a decision.[228] The guidelines divided services into two groups, namely on-the-spot and remote services. To comply with the guidelines, the authority established that it was necessary to amend the "place of supply" rules and two options were considered to achieve this amendment:

1. All supplies made by a non-resident to a New Zealand consumer would be considered *prima facie* liable for GST, but on-the-spot services would be excluded by making them zero-rated.[229]
2. Imposing GST only on remote services from offshore suppliers and excluding any on-the-spot suppliers.[230]

[222] Inland Revenue "Cross-border services" 14.
[223] *Ibid.*
[224] *Ibid.*
[225] *Ibid.*
[226] Inland Revenue "Cross-border services" 14.
[227] Inland Revenue "Cross-border services" 6.
[228] Inland Revenue "Cross-border services" 16.
[229] Inland Revenue "Cross-border services" 17.
[230] *Ibid.*

Inland Revenue chose to apply the second option because it was more closely aligned with the European Union approach, and it would also remove the complication of including the zero-rating rule included in the first option.[231]

3.3.3.2 Registration of non-resident suppliers and registering an intermediary in place of supplier

An important rule proposed was the registration of non-resident suppliers or the clearing houses. This rule would ensure that the revenue authority was able to collect GST on supplies made to New Zealand consumers by offshore suppliers. This rule was closely related to the rule of requiring an intermediary to register in the place of supply, so both therefore had to be considered simultaneously. Inland Revenue established that there was an increasing trend by offshore suppliers of electronic services to make use of electronic marketplaces where the services would then be provided through an intermediary.[232] An example of this was where an application developer could make their application available through a mobile application store such as Google Play or the Apple App Store.[233] Inland Revenue proposed that where the offshore supplier used an electronic marketplace, the marketplace should be the one to register for GST.[234] This was because it was concluded that the electronic marketplace was better equipped to register than the individual offshore supplier.[235] It was also established that there could be a potential decrease in compliance costs as there would be fewer small suppliers required to register for GST.[236]

The decision to make intermediaries register for GST was considered after it was established that other jurisdictions, including Australia and Norway, had adopted this approach.[237] It was established that Australia had announced a proposed rule that required operators of electronic distribution services to register and return GST.[238] This rule would only be applied where an operator was in control of key elements of the supply of the service, such as the delivery,

[231] *Ibid.*
[232] Inland Revenue "Cross-border services" 25.
[233] Inland Revenue "Cross-border services" 25.
[234] *Ibid.*
[235] *Ibid.*
[236] *Ibid.*
[237] *Ibid.*
[238] *Ibid.*

charging of a fee, or the terms and conditions.[239] The efficacy of this rule was based on clearly defining the circumstances where either the electronic marketplace or the offshore supplier would be required to register. This had to be done to avoid a situation where either both would register for GST or where both would fail to register, and the revenue authority ended up losing the GST from both.[240]

Where the electronic marketplace is required to register

The electronic marketplace would be required to register in situations where the consumer considered the marketplace to be the supplier, and this would be indicated through the contractual agreement between the parties.[241] There are various situations where the consumer may consider the marketplace to be the supplier, such as where the marketplace authorizes the services charged to the consumer, where the marketplace authorizes the delivery of the service to the consumer, or where the marketplace sets the terms and conditions of the transaction.[242]

Where the offshore supplier is required to register

In a situation where an offshore supplier makes use of a payments service provider to organise payment from the consumer for the service, the supplier would be required to register for GST.[243] This is because the service provider has a limited role in the transaction and therefore cannot be required to register for GST.[244] However, where an offshore supplier utilises a third party website to list its services and this website has direct contact with consumers, the website would be required to register.[245]

[239] *Ibid.*
[240] *Ibid.*
[241] Inland Revenue "Cross-border services" 26.
[242] Inland Revenue "Cross-border services" 26.
[243] *Ibid.*
[244] *Ibid.*
[245] *Ibid.*

3.3.3.3 The registration threshold

Inland Revenue established that offshore suppliers would only be required to register for GST where supplies exceeding a certain threshold had been made to New Zealand consumers.[246] It was indicated that domestic suppliers were only required to register where a threshold of $60 000 had been exceeded. Suppliers whose sales were below $60 000 were permitted to voluntarily register for GST. This was because it was important to reduce compliance costs for small businesses supplying consumers in New Zealand.[247] The same line of reasoning was used for offshore suppliers and it was concluded that a threshold needed to be set in order to prevent smaller offshore suppliers from incurring high compliance costs.[248] Inland Revenue established that the registration threshold rules to be imposed had to have the effect of opening up trade channels between New Zealand and other jurisdictions.[249]

The revenue authority had to ensure that the threshold set was not too high as various disadvantages could occur. These included larger offshore suppliers spreading their supplies over various jurisdictions in order to remain below the threshold.[250] It was indicated that such a disadvantage would easily be detectable in a domestic context, but much harder to establish in the international context.[251] Another disadvantage that could occur due to a high threshold would be that large offshore suppliers would not need to register for GST in New Zealand or any other country with a high threshold, and therefore have a competitive advantage over domestic suppliers.[252] It was established that applying a threshold based on what domestic suppliers incurred would not necessarily encourage competition neutrality.[253] This is because there could be the possibility that offshore suppliers would not have to incur GST or claim

[246] Inland Revenue “Cross-border services” 1.
[247] Inland Revenue “Cross-border services” 24.
[248] *Ibid.*
[249] *Ibid.*
[250] Inland Revenue “Cross-border services” 24.
[251] *Ibid.*
[252] *Ibid.*
[253] *Ibid.*

back costs incurred in the process of exporting services to New Zealand residents.[254] Domestic suppliers below the threshold who did not register for GST would not be able to claim back their GST costs, while domestic suppliers who voluntarily registered for GST would be able to claim back GST costs, but would also be required to pay GST on any supplies made.[255]

The revenue authority therefore had to establish the appropriate threshold to be applied on offshore supplies. It was later established that this threshold would be NZ$60 000, which is the same as the domestic threshold.[256]

3.3.3.4 The definition of services should be widened to include digital and traditional services

According to the Goods and Services Tax Act, the definition of the term "services" in terms of the New Zealand GST system means anything other than goods or money.[257] The definition is broad and can include products like digital downloads, online music, or digital streaming.[258] It was established by Inland Revenue that other jurisdictions had chosen to limit their rules to digital services only. New Zealand chose to apply a broad definition for two main reasons. The first reason was that the authority did not want consumers to be influenced by taxation decisions, such as where the consumer would not utilise a digital service simply because it attracted GST.[259] The second reason the definition was kept broad was to reduce the complexity posed for suppliers who needed to establish whether their service would be regarded as digital, and therefore liable to incur GST.[260]

Inland Revenue had to decide whether the new rules would apply to business-to-business and business-to-consumer supplies, or business-to-consumer supplies alone. It was established that there were many advantages in applying the rules to business-to-consumer supplies only. The first advantage was that there was little value in applying the rules to business-to-business supplies as New Zealand businesses registered for GST would be able to claim back

[254] *Ibid.*
[255] *Ibid.*
[256] Deloitte "GST on 'remote' services" 16 April 2015 https://www2.deloitte.com/nz/en/pages/tax-alerts/articles/gst-on-remote-services.html [Accessed 20 June 2017].
[257] S2.
[258] Inland Revenue "Cross-border services" 19.
[259] Inland Revenue "Cross-border services" 19.
[260] *Ibid.*

the GST charged by an offshore supplier.[261] Another advantage in applying the rules to business-to-consumer supplies was that there would be lower compliance costs for offshore suppliers, as tax invoice requirements could be relaxed because New Zealand consumers who were charged GST would not be able to claim back the GST charged.[262] It was established that applying the rules to business-to-business supplies would result in certain offshore suppliers charging GST but failing to make a return, while businesses that were charged GST would claim GST on supplies received.[263] This would result in a potential loss for Inland Revenue. The last advantage noted was that of uniformity. If Inland Revenue applied the rules to business-to-consumer supplies, like Australia or the European Union, there would be an advantage for offshore suppliers who provide services to New Zealand.[264]

Despite the many advantages in applying the rules to business-to-consumer supplies only, one main disadvantage was noted by the revenue authority. It was argued that compliance costs could increase for offshore suppliers, as they would have to determine whether a supply was made to an individual consumer or a business.[265] Another disadvantage which could occur would be where an individual consumer presents themselves as a business and therefore avoids a GST charge on the supply.[266] In a situation where consumers knowingly represented themselves as a business, it was possible that they could be liable to pay knowledge offence fines.[267] Knowledge offences are defined as, "when a person knowingly provides altered, false, incomplete or misleading information to any person in respect of a tax law or a matter or thing relating to a tax law."[268] The fine for this would be up to $NZ 25 000 for a first offence and up to $NZ 50 000 for repeat offenders.[269]

If the revenue authority were to include business-to-business supplies, due consideration would be given to the invoice requirements placed on offshore suppliers, so that New Zealand businesses could claim back GST.[270] This meant there would have to be "a trade-off between the need to make requirements simple for offshore suppliers, but for sufficient

[261] Inland Revenue "Cross-border services" 20.
[262] *Ibid.*
[263] *Ibid.*
[264] *Ibid.*
[265] Inland Revenue "Cross-border services" 21.
[266] *Ibid.*
[267] Inland Revenue "Cross-border services" 29.
[268] *Ibid.*
[269] *Ibid.*
[270] Inland Revenue "Cross-border services" 21.

information to be available to domestic businesses to substantiate input tax claims."[271] If business-to-business supplies were to be excluded, they could possibly be made zero-rated which would mean that any GST incurred by the offshore supplier could be claimed back.[272] It was also proposed that where the services were exempt or zero-rated in the domestic context, the same should apply for the same services being supplied by offshore suppliers.[273]

3.3.4 Enforcement of the Rules

The New Zealand rules displayed a similarity to those used by other countries and as a result it was expected that offshore suppliers would generally comply with rules that had been set.[274] The same penalties that could be incurred by New Zealand suppliers could also be charged to offshore suppliers, and they would be liable to pay where offences were committed.[275] Due to the broad nature of the rules, it was expected that offshore suppliers would feel inclined to comply[276] and make for simple enforcement of the rules. Inland Revenue also took note of the approach suggested by the OECD to have jurisdictions share information widely with each other to decrease the likelihood of tax evasion and double taxation.[277] As New Zealand was party to many taxation agreements it was seen that there could be an opportunity to share taxation information with other countries and therefore improve compliance.[278]

3.3.5 Conclusion Regarding the New Zealand Approach

The focus of the section above was on the progress made by the New Zealand revenue authority (Inland Revenue) in addressing the challenges of the digital economy. A document entitled "GST: Cross-border services, intangibles and goods: a government discussion document"[279] was drafted in New Zealand to establish the progress that had to be made. This

[271] *Ibid.*
[272] *Ibid.*
[273] Inland Revenue "Cross-border services" 22.
[274] Inland Revenue "Cross-border services" 32.
[275] *Ibid.*
[276] *Ibid.*
[277] *Ibid.*
[278] Inland Revenue "Cross-border services" 32.
[279] Inland Revenue "Policy & Strategy" (2015).

document proposed four rules to tackle the challenges posed by the digital economy. These rules were:

1. services and intangibles supplied by offshore suppliers being treated as if they were performed in New Zealand;
2. offshore suppliers being required to register for GST and return GST, where applicable;
3. the definition of the term “services” being expanded to include digital and traditional services; and
4. an intermediary possibly being required to register in place of the supplier.

These four rules were each discussed, and it was established that all four would be applicable, as they were helpful in addressing the digital economy and its various challenges.

The present section of the thesis concluded with a short discussion on the manner in which the revenue authority planned to enforce the rules. There was an indication that it would be prudent to make use of the OECD guidelines that called for co-operation between jurisdictions to share tax information which would decrease the prevalence of tax evasion and double taxation.

It would be useful for the South African revenue authorities to take note of the work performed by New Zealand’s tax authority, considering that the two taxation systems are similar. Based on the work discussed above, recommendations on how digital taxation should be addressed going forward will be made in the following chapter.

3.4 CONCLUSION

The focus of this chapter has been on the work performed by the OECD, which is the global forerunner in addressing the challenges of the digital economy, as well as the manner in which New Zealand has addressed the digital economy. The section on the OECD was centred around the work carried out by the Taskforce on the Digital Economy in terms of Action 1 of the Action Plan on Base Erosion and Profit Shifting. The section on New Zealand dealt with a document that had been drafted by the Minister of Revenue, Honourable Todd

McClay, and the revenue authority (Inland Revenue). This document proposed four new rules which would assist in addressing the challenges of the digital economy.

The aim of the following chapter is to make recommendations for South Africa, based on the OECD guidelines on the digital economy and the New Zealand approach to the digital economy. This chapter will determine the usefulness for South Africa of the OECD guidelines and the New Zealand rules for dealing with the digital economy, thus answering the research question.

Chapter 4: Recommendations for taxing the digital economy in South Africa

4.1 INTRODUCTION

The focus of the previous chapter was the work carried out by the Organisation for Economic Co-Operation and Development (OECD) to address the challenges posed by the digital economy. The Organisation is the forerunner in addressing the problems relating to the digital economy and, as such, it was essential to focus on the work performed by the organisation. South Africa is not a member of the OECD, but many of its trading partners are, and the recommendations made would therefore be useful for South Africa to adopt to remain in line with international standards. The previous chapter also examined progress made by New Zealand in addressing the digital economy. It was established that New Zealand has a GST system similar to the VAT system in South Africa and due to this similarity, the procedures adopted there would also be helpful in assisting South Africa to amend its taxation laws regarding the digital economy.

The aim of this chapter is to focus on recommendations made by both the OECD and New Zealand, and to examine the relevance of these recommendations in the South African context. The chapter will also establish whether South Africa has already adopted certain of the recommendations of the OECD and New Zealand.

4.2 THE RECOMMENDATIONS MADE BY THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD has been working on solutions with regard to the digital economy from as early as 1996.[280] It was established by the Committee on Fiscal Affairs that in order to address the taxation of electronic commerce, conventional taxation principles should be applied.[281] In

[280] OECD/G20 Base Erosion and Profit Shifting Project "Addressing the Tax Challenges of the Digital Economy, Action 1 2015 Final Report" (2015) 152 http://dx.doi.org/10.1787/9789264241046.en [Accessed 1 May 2017].
[281] OECD "Addressing Tax Challenges" 152.

addition to this, the Committee concluded that where legislation is to be introduced, it would be prudent for jurisdictions to promulgate legislation in line with existing taxation laws so as to ensure that there would be no discrimination against or in favour of electronic commerce.[282] The approach suggested by the OECD would be useful in the South African context because there should be uniformity of rules that are applied to different sectors in order to ensure that no disadvantage is experienced by any industry. Where the South African legislature introduces complicated laws that differ from existing taxation laws this might dissuade entities from supplying services to South Africa, as there is potential for numerous complex requirements that would need to be fulfilled by the taxpayers.

At the OECD's Ottawa Ministerial Conference in 1998, the Committee for Fiscal Affairs presented a set of principles to be used in guiding governments in the taxation of electronic commerce.[283] These principles were:

1. Neutrality[284]
2. Efficiency[285]
3. Effectiveness and fairness[286]
4. Certainty and simplicity[287]
5. Flexibility[288]

These principles were welcomed by the Ministers present as they were seen to be helpful in the prospective taxation of the digital economy.[289] It would be useful to apply these same principles in the South African context when considering taxation of the digital economy, as these principles have been widely adopted by other jurisdictions.

[282] *Ibid.*
[283] OECD "Electronic Commerce: Taxation Framework Conditions" (1998) 4.
[284] OECD "Electronic Commerce" 4.
[285] *Ibid.*
[286] *Ibid.*
[287] *Ibid.*
[288] *Ibid.*
[289] OECD "Electronic Commerce" 1.

4.2.1 The Relevance of the Ottawa Principles to the South African Context

The principles presented by the Committee on Fiscal Affairs were widely accepted by the Ministers present at the Ottawa Conference, and it was agreed that they would implement these principles in the taxation of the digital economy both in individual states, as well as in the international context.[290] It was concluded that the use of these principles should allow countries to maintain their fiscal sovereignty, while guaranteeing that double taxation would be avoided and there was fair sharing of the tax base between countries.[291] The approach taken by the Organisation is a feasible one and it would be helpful for South Africa to ensure that if the Ottawa principles are applied, the approach adopted at the Conference would be adhered to.

Neutrality

The first principle considered was that of neutrality. This principle calls for similarity between the taxation of conventional and electronic commerce.[292] This principle would help to ensure that business decisions made are based on economic and not taxation considerations.[293] If a revenue authority were to apply the principle of neutrality this would mean that any taxpayer, whether resident or non-resident, could make decisions based on economic conditions rather than the taxation provisions of a country.

In South Africa the legislation providing for the taxation of the digital economy is not neutral, as there are differences in the way conventional and electronic commerce are taxed. According to the Value-Added Tax Act:[294]

> Every person who on, or after the commencement date, carries on any enterprise and is not registered, becomes liable to be registered -

[290] OECD "Electronic Commerce" 3.
[291] *Ibid.*
[292] *Ibid.*
[293] *Ibid.*
[294] 89 of 1991.

(a) at the end of any month where the total value of taxable supplies made by that person in the period of 12 months ending at the end of that month in the course of carrying on all enterprises has exceeded R1 million...[295]

This means that only those people carrying on an enterprise and who have made taxable supplies that exceed R1 million are obliged to register for VAT. Where a non-resident supplier provides electronic services to South African recipients, however, the law is different. Section 23 (1A) of the Value-Added Tax Act states:

> Every person who carries on any enterprise as contemplated in paragraph (b)(vi) of the definition of "enterprise" in section 1 and is not registered becomes liable to registered at the end of any month where the total value of taxable supplies made by that person has exceeded R50 000.

Paragraph (b)(vi) of the definition of an "enterprise" refers to electronic services provided by suppliers from export countries.[296] This paragraph was introduced to provide clarity on whether electronic services are liable to incur VAT. It is clear that there is a considerable discrepancy between the requirements for registration by resident suppliers who are obliged to register once taxable supplies exceed R1 million in a period of 12 months, and non-resident suppliers who must register after making taxable supplies exceeding R50 000. This difference could discourage non-resident suppliers from providing services in South Africa, as the registration threshold is so much lower for non-resident suppliers of electronic services. The process of registering for VAT may prove cumbersome for such service providers and could result in minimal tax compliance. It is important for South Africa to apply the principle of neutrality in this case to ensure that electronic service suppliers are not at a considerable disadvantage compared to conventional suppliers.

Efficiency

The principle of efficiency refers to costs incurred by both the taxpayer and the revenue authority. According to the Committee on Fiscal Affairs, compliance costs of the taxpayer

[295] S23 (1)(a).
[296] S1.

and administrative costs of the revenue authority must be kept to a minimum.[297] This means that where a taxpayer plans to provide a service in a country other than their country of residence, the cost of complying with the taxation requirements of the foreign jurisdiction must be kept as low as possible. In addition, it would be necessary for revenue authorities to maintain lower administrative costs that might stem from non-resident taxpayers. With regard to this principle, the OECD emphasised the importance of co-operation between jurisdictions by sharing vital taxation information to reduce the administrative burden experienced by revenue authorities with insufficient taxation information.[298] It was suggested at the time that there should be mutual administrative assistance provided by revenue authorities, and in line with this the OECD intended making use of agreements to ensure this occurred.[299] One such agreement was the "Convention on Mutual Administrative Assistance in Tax Matters."[300] According to the OECD:

> 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.[301]

South Africa became a signatory to this Convention in 2011 and the Convention was applied in 2014[302] and as such will be able to make use of information provided by other jurisdictions that are signatories. The sharing of such information can therefore ease the administrative burden that may face SARS.

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[297] OECD "Electronic Commerce" 4.
[298] OECD "Electronic Commerce" 6.
[299] *Ibid.*
[300] OECD "Multilateral Convention on Mutual Administrative Assistance in Tax Matters" http://www.oecd.org/tax/exchange-of-tax-information/convention-onmutual-administrative-assistance-in-tax-matters.htm [Accessed 10 October 2017].
[301] *Ibid.*
[302] OECD "Jurisdictions participating in the Convention on Mutual Administrative Assistance in Tax Matters" (2017) http://www.oecd.org/tax/exchange-of-tax-information/convention-on-mutual-administrative-assistance-in-tax-matters.htm [Accessed 10 October 2017].

Effectiveness and fairness

The Committee on Fiscal Affairs also called for the principle of effectiveness and fairness to be applied. This principle ensures that there would be sufficient tax collected at the correct time.[303] This would mean a minimising of tax evasion and avoidance as a result of adequate taxation legislation implemented with regard to electronic commerce. The laws that would be promulgated would therefore have to ensure that there would be no occurrence of tax evasion.

In 1996 the Katz Commission, tasked with deciding whether to base the South African taxation system on a residence or sourced based system of taxation, found that it was important for South Africa to remain alert to any legislative changes made by any of its trading partners with regard to the digital economy.[304] This opinion is still valid currently and it is essential for South Africa to take note of the actions of its trading partners with regard to the digital economy. To address the issue of tax evasion it is important to make use of instruments such as the Convention on Mutual Administrative Assistance in Tax Matters and Double Tax Agreements. This ensures that those taxpayers liable to pay tax in South Africa would pay the appropriate amount of tax at the appropriate time. Co-operation among jurisdictions is therefore an important tool in combating tax evasion and avoidance among non-resident taxpayers, and as such South Africa should make use of it.

Certainty and Simplicity

It is important for the taxation laws relating to the digital economy to be simple enough for taxpayers to understand so as to foresee the consequences of certain transactions and therefore anticipate what type of tax is due, how much the tax is, and when it becomes due.[305] This means that the laws must be written in plain language, easily understood or translated where the need arises.

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[303] OECD "Electronic Commerce" 4.

[304] Katz Commission "Basing the South Africa Income Tax System on the Source or Residence Principle-Options and Recommendations" (1996) 54 www.treasury.gov.za/publications/other/katz/5.pdf [Accessed 10 October 2017].

[305] OECD "Electronic Commerce" 4.

In the current South African context, the only legislation that refers directly to and contains specific provisions dealing with the digital economy is the Value-Added Tax Act.[306] The legislation was amended by section 95(1) of the Taxation Laws Amendment Act[307] to amend the definition of an "enterprise" to include "electronic services". A set of Regulations entitled "Regulations Prescribing Electronic Services for the Purpose of the Definition of 'Electronic Services' in Section 1 of the Value-Added Tax Act, 1991"[308] was enacted by the former Minister of Finance, Pravin Gordhan, to provide clarity on services defined as "electronic services" in terms of section 1(1) of the Value-Added Tax Act.[309] It is evident that the Regulations were enacted to provide much needed clarity on which services would be included in the definition of "electronic services", and it can be seen that this was intended by the Minister of Finance to ensure that non-resident taxpayers would know whether their services fall within this category.

To guarantee that taxpayers are aware of taxation consequences they may face, it is important to create awareness of the implications. At the Ottawa Conference a suggestion was made by the Committee on Fiscal Affairs to ensure that jurisdictions could provide adequate services to taxpayers.[310] It stated that "revenue authorities should make use of the available technology and harness commercial developments in administering their tax system to continuously improve taxpayer service."[311] The Committee established that a feasible option in improving taxpayer service was to make use of technology at hand at the time.[312] This option is more relevant in the current context as technology has reached advanced stages. SARS has developed an online system (eFiling) that enables taxpayers to file their income tax returns online.[313] This system initially focused on VAT since its inception in 2001[314] and then expanded to include the filing of income tax returns in 2006.[315]

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[306] 89 of 1991.
[307] 43 of 2014.
[308] PJ Gordhan Notice No. R. 221of 2014.
[309] Para 2.
[310] OECD "Electronic Commerce" 5.
[311] *Ibid.*
[312] *Ibid.*
[313] SARS eFiling "About eFiling" http://www.sarsefiling.co.za/AboutPage.aspx [Accessed 11 October 2017].
[314] "SARS on the cutting edge" *South African Government News Agency* www.sanews.gov.za/features/sars-cutting-edge 25 October 2013 [Accessed 11 October 2017].
[315] *Ibid.*

A website created by SARS solely for non-residents would be useful in assisting these taxpayers to establish the taxation laws relating to services they might choose to provide to South African residents. A drawback of such a website is its inability to guarantee compliance. SARS may develop the website, but it is not guaranteed that non-resident taxpayers would utilize the website to establish their tax liabilities. In addition, there is no guarantee that once the taxpayers are aware of their liabilities they will pay the relevant tax. It is submitted that South Africa would therefore have to take further measures to ensure compliance, but at the same time make sure that all necessary steps have been taken to ensure that the taxation laws promulgated are simple enough to understand.

Flexibility

The purpose of this principle is to ensure that taxation laws enacted are capable of keeping up with the ever-changing face of technology.[316] This would ensure that there is adequate taxation of income received from the digital economy.

The Ottawa principles are a fundamental component in the approach that should be adopted by South Africa. This is because they act as a guide on how taxation should be applied to electronic commerce. Although it is a different sector, the principles also encourage similar treatment in conventional commerce. In addition, the Ottawa principles encourage flexibility to ensure that legislation promulgated will be flexible enough to be adjusted to address the ever-changing face of technology. It is therefore recommended that South Africa takes cognizance of the principles applied at the Ottawa conference to address the challenges of the digital economy and apply these principles in order to find sustainable solutions to problems brought about by electronic commerce.

4.2.2 Application of the Ottawa Principles in South Africa

The Katz Commission in its 1996 report on whether to apply a source or residence-based taxation system in South Africa warned against promulgating legislation specifically targeting the digital economy prematurely.[317] The report stated,

[316] OECD "Electronic Commerce" 4.

> the Commission is of the view that it would be premature now to introduce an entirely new regime of international taxation which seeks to cope with these developments; indeed, to seek a pioneering role here would be both arrogant and dangerous.[318]

Instead the Commission encouraged international co-operation and enacting legislation applicable in an international setting so as to ensure that the country could remain in line with its trading partners.[319] The Commission established that if South Africa were to model its international arrangements as closely to international conventions and concepts as possible, it would be possible to ensure that it could adjust to the evolution of taxation legislation.[320] It would be necessary therefore for South Africa to follow this suggestion so as to ensure it maintains international standards that have been set in conventions. This suggestion is in line with the principle of effectiveness and fairness as it encourages utilization of international conventions to model any international tax arrangements.

The Davis Tax Committee was formed in 2013 when the former Minister of Finance, Pravin Gordhan, tabled the 2013/2014 Budget and established that there was a need for government to institute a tax review to assess the tax policy framework and to establish its role in supporting the objectives of inclusive economic growth, employment, development and fiscal sustainability.[321] The Committee was responsible for policy reform and drafted an interim report based on the OECD Action Plan entitled "Addressing Base Erosion and Profit Shifting in South Africa: Action 1: Address the tax challenges of the digital economy."[322] This report urged that South Africa should wait on changes suggested by the OECD before enacting legislation that addressed the digital economy.[323] It urged that legislation enacted in the wake

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[317] Katz Commission "Basing the South African Income Tax System on the Source or Residence Principle- Options and Recommendations" (1996) 54 www.treasury.gov.za/publications/other/katz/5.pdf [Accessed 4 January 2017].
[318] Katz Commission "South African Income Tax" 54.
[319] *Ibid.*
[320] *Ibid.*
[321] Davis Tax Committee "Introduction" http://www.taxcom.org.za/ [Accessed 11 October 2017].
[322] Davis Tax Committee "Addressing Base Erosion and Profit Shifting in South Africa Davis Tax Committee Interim Report" http://www.taxcom.org.za/docs/New_Folder/2%20DTC%20BEPS%20Interim%20Report%20on%20Action%20Plan%201%20-%20Digital%20Economy,%202014%20deliverable.pdf [Accessed 11 October 2017].
[323] Davis Tax Committee "Interim Report" 54.

of the OECD suggestions should be internationally aligned.[324] This suggestion is in line with the principle of efficiency, requiring that jurisdictions are mutually aligned and able to share vital information. The recommendation to wait on the OECD indicates that the Davis Committee was convinced that applying the changes suggested by the OECD would be beneficial in addressing South Africa's tax challenges.

It was suggested by two Commissions that South Africa should adjust its legislation to address the digital economy. This amendment, however, must occur after considering how international forums like the OECD have addressed the digital economy. It is submitted that this approach is the best way for South Africa to address electronic commerce legislation as it gives guidance on how legislation should be structured and what aspects to focus on. It will also ensure that South Africa remains in line with international standards regarding the digital economy.

4.2.3 The Action Plan on Base Erosion and Profit Shifting

This plan was formulated to address the problems of companies that were taking advantage of loopholes in tax rules and artificially shifting their profits to low tax jurisdictions where they had performed little to no economic activity.[325] It was identified by the OECD that companies were taking advantage of low tax jurisdictions to avoid paying tax in the jurisdictions where they had gained their profits. It concluded that it was necessary to devise a plan to address these problems effectively. The Action Plan on Base Erosion and Profit Shifting was then drafted to make progress on the issues. There were fifteen actions identified that had to be addressed, and among them was an action regarding addressing challenges posed by the digital economy.[326] The aim of this action was to:

> identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these

[324] *Ibid.*
[325] OECD "About the Inclusive Framework on BEPS" (2016) http://www.oecd.org/tax/beps-about.htm [Accessed 16 May 2017].
[326] OECD *Action Plan on Base Erosion and Profit Shifting* (2013) 14 http://dx.doi.org/10.1787/9789264202719-en [Accessed 21 August 2016].

difficulties, taking a holistic approach and considering both direct and indirect taxation.[327]

To address this action adequately, a panel called the "Taskforce on the Digital Economy" was brought together. This panel established three features of the digital economy that were problematic, namely the use of intangibles, centralisation of infrastructure remotely, and the avoidance of permanent establishment status.[328]

In the South African context, the most relevant is the avoidance of permanent establishment status as this is a problem that affects South Africa because non-resident digital companies that are resident in jurisdictions that have Double Tax Agreements with South Africa, fail to meet the permanent establishment requirement and therefore are not liable to pay income tax. In order to address this problem, the Taskforce found it necessary to focus on the work carried out to address Action 7 of the Action Plan that focused on the avoidance of permanent establishment status.[329] The taskforce established that digital companies were avoiding permanent establishment status by claiming that core activities conducted were in fact preparatory or auxiliary in nature, and therefore were to be regarded as an exception to the permanent establishment rules.[330] In order to curb this problem it was established that a modified list of exceptions be drafted to ensure that only activities preparatory or auxiliary in nature would be exceptions to the permanent establishment definition.[331] This meant that Article 5(4) of the OECD Model Tax Convention would be modified to reflect the new list of exceptions. In addition, the taskforce also created an anti-fragmentation rule to ensure that companies would not benefit from the amended exceptions list, and fragment operations to avoid permanent establishment status.[332]

Modifications should also be made to Article 5(5) and 5(6) of the Model Tax Convention, to ensure that artificial arrangements between subsidiary and holding companies, where the subsidiary made sales on behalf of the parent company, would result in a permanent

[327] OECD *Action Plan* 14.
[328] OECD "Addressing Tax Challenges" 144.
[329] OECD "Addressing Tax Challenges" 144-145.
[330] OECD "Addressing Tax Challenges" 145.
[331] *Ibid.*
[332] *Ibid.*

establishment being created.[333] This would only occur where the subsidiary often acted as the principal and concluded contracts on behalf of the parent company.[334]

4.2.3.1 Relevance of amendment of Article 5 of the OECD Model Tax Convention to South Africa

South Africa is not a member of the OECD, but in terms of section 1 of the Income Tax Act[335] a permanent establishment is defined as "a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and Capital of the Organisation for Economic Co-Operation and Development." This means that the definition of permanent establishment in the South African context is the same as the OECD Model Tax Convention definition. Any amendments made by the OECD will therefore apply to South Africa as well. The modification of exceptions to the definition of a permanent establishment, as well as the anti-fragmentation rule will therefore apply in the South African context. It is important to continue to look to the OECD Commentaries for guidance on how to interpret the new rules. This rationale was supported by the court in the matter of *Secretary for Inland Revenue v Downing*,[336] where it was held that South Africa is bound to take cognizance of the guidelines on interpretation of the concepts in the Model Tax Convention by the OECD in its commentaries.[337] South Africa will benefit from the modifications to Article 5 as this helps to curb the number of digital companies that escape permanent establishment status.

4.2.4 Recommendations Made by the Taskforce on the Digital Economy

After careful consideration the Taskforce proposed five recommendations that could be applied to address challenges posed by the digital economy. These were:

1. modifications to the exceptions from Permanent Establishment status;[338]
2. alternatives to the existing Permanent Establishment threshold;[339]
3. imposition of a withholding tax on certain types of digital transactions;[340]

[333] *Ibid.*
[334] *Ibid.*
[335] 58 of 1962.
[336] 1975 (4) 518 (A) 37.
[337] 524.
[338] OECD "Addressing Tax Challenges" 136.
[339] *Ibid.*

4. introduction of an equalisation levy;[341] and
5. collection of VAT in the country where the consumer is located according to the principles and mechanisms developed by Working Party 9 of the Committee of Fiscal Affairs.[342]

The Taskforce decided to apply only two of the recommendations, namely the option to modify the exceptions from Permanent Establishment status, and collection of VAT in the country where the consumer was located.[343] The rationale behind this decision was that the amending of exceptions to Permanent Establishment status was already being addressed in Action 7 of the Action Plan and it would follow that the option would be adopted.[344] The collection of VAT was considered to be important and therefore also important to consider the fifth option.[345] The main recommendation made regarding collection of VAT was to apply the principles in the "International VAT/GST Guidelines" and therefore it is necessary to see how these Guidelines might apply in South Africa.

4.2.5 The Impact of the International VAT/GST Guidelines on South Africa

The Taskforce on the Digital Economy established that there were various issues surrounding the collection of VAT on cross-border goods and services. This was due to a lack of an effective international framework to collect VAT.[346] The absence of a framework meant that revenue authorities were incurring losses and there was a prevalence of trade distortions.[347] It was therefore considered that there should be a focus on the creation of an effective framework, as well as applying International VAT/GST Guidelines.[348] The aim of the guidelines is to:

> set forth a number of principles for the VAT treatment of the most common types of international transactions, focusing on trade in services and intangibles,

[340] *Ibid.*
[341] *Ibid.*
[342] OECD "Addressing Tax Challenges" 136.
[343] OECD "Addressing Tax Challenges" 136-137.
[344] OECD "Addressing Tax Challenges" 148.
[345] *Ibid.*
[346] OECD "Addressing Tax Challenges" 147.
[347] *Ibid.*
[348] OECD *International VAT/GST Guidelines* (2015) http://dx.doi.org/10.1787/9789264271401-en [Accessed 18 May 2017].

with the aim of reducing the uncertainty and risks of double taxation, and unintended non-taxation that result from inconsistencies in the application of VAT in a cross-border context.[349]

These guidelines are not intended to supersede a country's tax sovereignty, instead they aim to identify objectives and make suggestions on how to achieve them.[350] They were formulated to assist policy makers in the development of legal and administrative frameworks in their respective jurisdictions, taking note of economic, legal, institutional, cultural and social circumstances.[351]

The guidelines give a detailed explanation of what VAT is and how there are two principles which may be applied where VAT is concerned. These two principles are the origin and destination principle.[352] The most relevant in this context is the destination principle, as it is applied in South Africa. This principle dictates that VAT is levied where the final consumption takes place.[353] The total tax paid in relation to the supply is determined by the rules applicable in the jurisdiction of consumption, and all the revenue should accrue to the jurisdiction where the supply is made to the final consumer.[354] The application of the destination principle also facilitates the application of the principle of neutrality,[355] which is one of the key principles suggested at the Ottawa Conference when addressing electronic commerce. The application of the destination principle in VAT is widespread, but the practical means of applying such a principle vary in different jurisdictions, and as a result there are situations where double taxation or non-taxation may occur.[356] In order to ensure that such situations are minimised the OECD devised guidelines to assist tax authorities. In the present research, the most relevant guidelines are found in Chapter 2 and are discussed below.

[349] OECD *International Guidelines* 9.
[350] *Ibid.*
[351] *Ibid.*
[352] OECD *International Guidelines* 12.
[353] *Ibid.*
[354] *Ibid.*
[355] *Ibid.*
[356] OECD *International Guidelines* 13.

4.2.5.1 Guideline 2.2

This guideline states that "businesses in similar situations carrying out transactions should be subject to similar levels of taxation."[357] This guideline ensures uniformity in jurisdictions, and that the tax collected in a supply chain is proportional to the amount paid by the final consumer, regardless of various factors, including the nature of the supply, the structure of the distribution chain, the number of transactions or economic operators involved, or technical means used.[358] This would mean therefore that electronic transactions would have to be taxed at the same level as transactions that are conventional in nature, provided they are similar in nature. For example, where a consumer purchases a music CD from a store and is charged VAT on the purchase, the same VAT should be applied where a consumer purchases music from a digital music store as these are similar transactions. This type of uniformity ensures that suppliers in each industry are not unfairly disadvantaged.

4.2.5.2 Guideline 2.3

This guideline states that "VAT rules should be framed in such a way that they are not the primary influence on business decisions."[359] There are various considerations that businesses make when taking decisions. These can be financial, commercial, social, environmental or legal, all of which may influence where the business decides to conduct its operations.[360] The OECD is of the opinion that VAT considerations should not be the key determinant of whether a company will perform services in a jurisdiction.[361] This means that VAT rules that apply to certain services, such as electronic services, should not be discriminatory in nature to non-resident suppliers, to ensure that the decisions made are not solely focused on taxation aspects.

[357] OECD *International Guidelines* 16.
[358] *Ibid.*
[359] *Ibid.*
[360] *Ibid.*
[361] *Ibid.*

4.2.5.3 Guideline 2.4

This guideline states that, "with respect to the level of taxation, foreign businesses should not be disadvantaged or advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid."[362] This guideline is based on the principle of neutrality that calls for taxation systems to be equitable to both resident and non-resident suppliers so that businesses are not encouraged or discouraged to do business in a jurisdiction.[363] The legislation promulgated must therefore not be discriminatory in nature. South Africa has discriminatory legislation in place when it comes to the taxation of electronic services. In terms of section 23(1A) of the Value-Added Tax Act:

> Every person who carries on any enterprise as contemplated in paragraph (b)(vi) of the definition of "enterprise" in section 1, and is not registered, becomes liable to be registered at the end of any month where the total value of taxable supplies made by that person has exceeded **R50 000**. (emphasis added)

Section 1 of the Value-Added Tax Act defines an "enterprise" as "the supply of electronic services by a person from a place in an export country."[364] This means that non-resident suppliers who provide electronic services to residents in South Africa are liable to register for VAT when they make taxable supplies that exceed R50 000. In terms of section 23(1):

> Every person who, on or after the commencement date, carries on any enterprise and is not registered, becomes liable to be registered—
> (a) at the end of any month where the total value of taxable supplies made by that person in the period of 12 months ending at the end of that month in the course of carrying on all enterprises has exceeded **R1 million**; ... (emphasis added)

[362] OECD *International Guidelines* 17.
[363] *Ibid.*
[364] Para (b)(vi).

A person carrying on an enterprise in South Africa but not providing electronic services is liable to register for VAT once they have made taxable supplies exceeding R1 million, while a non-resident person supplying electronic services will be liable to register once they make taxable supplies of only R50 000. It is clear that there are different registration thresholds that apply and therefore the principle of neutrality is not applied. A lower registration threshold for electronic service providers can result in them being discouraged from providing services to South Africa. It is recommended that the legislature should consider amending the registration threshold for either resident persons or non-residents providers of electronic services.

Where the registration threshold is lowered for residents there may be an increase in the administrative and compliance burden faced by SARS, as there will now be more persons obliged to register for VAT. Where the registration threshold is increased for non-resident electronic service providers, there might be a smaller number of providers registering for VAT as they would not make enough taxable supplies to reach the threshold. South Africa therefore would need to strike a balance between the non-resident and resident persons to ensure that neutrality is achieved, as well as sufficient revenue collected and a decreased administrative and compliance burden.

4.2.5.4 Guideline 2.6

This guideline states that "where specific administrative requirements for foreign businesses are deemed necessary, they should not create a disproportionate or inappropriate compliance burden for the businesses."[365] The OECD acknowledges that tax administrations could possibly incur heavy administrative costs in relation to foreign businesses.[366] In order to ease this possible burden, tax administrations are encouraged to make use of available multilateral instruments at their disposal.[367] One such instrument is the "Multilateral Convention on Mutual Administrative Assistance in Tax Matters"[368] that can help with the exchange of information between contracting states in order to decrease tax evasion and double

[365] OECD *International Guidelines* 18.
[366] *Ibid.*
[367] *Ibid.*
[368] OECD http://www.oecd.org/tax/exchange-of-tax-information/convention-onmutual-administrative-assistance-in-tax-matters.htm [Accessed 10 October 2017].

taxation.[369] South Africa is a signatory to this Convention and could benefit from the exchange of relevant taxation information with other contracting states regarding their resident businesses that could be providing services in South Africa. The OECD also recommended that tax administrations should balance the use of multilateral instruments with the need to prevent unjustified discrimination.[370] Taxation rules dealing with foreign businesses must be non-discriminatory, specific, clear, consistent, and accessible to the businesses in question.[371]

4.2.6 Further Recommendations Made by the OECD

The OECD made certain recommendations regarding the collection of VAT that would be useful in the South African context. It was established that the most appropriate method of collection of VAT for business-to-consumer transactions was the registration method that requires the business to register as a VAT vendor.[372] It was acknowledged that such a method would often be considered as cumbersome and complex for a foreign business, and the key to achieving a high level of compliance would be simplified compliance requirements.[373]

It was suggested that the registration process should possibly be online to simplify the procedure.[374] South Africa has already implemented the SARS eFiling system that allows taxpayers to file their tax returns online instead of physically at a SARS office.[375] Foreign businesses should also be able to make use of this facility and be able to register for VAT. The OECD recommends that if an online platform were to be used, there should be provision for the translation of the website into the languages used by a country's major trading partners.[376] This would be a useful tool to add to the SARS eFiling website as this would provide ease of access for foreign businesses not using English as their main medium of exchange.

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[369]OECD International *Guidelines* 18.
[370] OECD *International Guidelines* 18.
[371] *Ibid.*
[372] OECD *International Guidelines* 50.
[373] *Ibid.*
[374]OECD *International Guidelines* 52.
[375] SARS on the cutting edge" *South African Government News Agency* www.sanews.gov.za/features/sars-cutting-edge 25 October 2013 [Accessed 11 October 2017].
[376]OECD *International Guidelines* 52.

In addition, the OECD also recommended the use of simplified returns for non-resident businesses in order to make the process easier.[377] Since the definition of an "enterprise" was amended to include electronic services, there has been no indication by South Africa whether simplified returns and registration processes would be offered for non-resident suppliers of electronic services.[378] Adopting a simplified returns and registration process would be useful in the South African context as it would ensure that non-resident businesses were able to fully comply timeously. The OECD warns that if a jurisdiction decides to adopt a simplified version for non-residents a balance should be struck between the need for simplicity and the needs of the tax administration to verify that tax obligations have been adequately fulfilled.[379]

The International VAT/GST Guidelines are a useful tool for jurisdictions that need to adjust their legislation to comply with international standards. South Africa would benefit greatly if it followed recommendations in the guidelines. Mutual administrative assistance is a key recommendation made by the Organization and it would be useful for South Africa to make use of multilateral instruments, such as the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. This allows for the mutual exchange of relevant tax information among signatories and therefore makes VAT collection simpler, as taxpayers can be identified. In addition, the recommendation to make the registration and returns processes simpler is also important to South Africa. Making use of the eFiling platform would also be helpful as registration can occur online and the process therefore expedited. SARS would have to modify the platform to include features such as a language option allowing ease of access for those non-residents not using English as their main medium of exchange, It is therefore recommended that South Africa should make use of the International VAT/GST Guidelines in order to amend the current VAT framework to ensure it is in line with international standards.

4.3 NEW ZEALAND AND ITS APPROACH TO THE DIGITAL ECONOMY

New Zealand applies Goods and Services Tax (GST) that is similar to South African VAT. This system was also affected by the growth of the digital economy. It was established by the

[377] *Ibid.*
[378] Ernst and Young "South Africa requires VAT registration for non-residents who supply electronic services" http://www.ey.com/gl/en/services/tax/international-tax/alert--south-africa-requires-vat-registration-for-nonresidents-who-supply-electronic-services 24 January 2014 [Accessed 23 October 2017].
[379] OECD *International Guidelines* 52.

Inland Revenue authority that a great disadvantage was being experienced by domestic suppliers of digital services as there was no tax liability for non-resident suppliers providing the same services.[380] This disadvantage meant that non-resident suppliers were able to provide their services at lower prices as they did not incur GST charges. New Zealand considered itself to have a "best in its class" GST model,[381] that was broad based and well-respected, but the model had not taken into consideration cross-border services and therefore was inadequate.[382] It was therefore important to introduce rules governing the taxation of cross-border services. In this regard the Minister of Revenue, the Honourable Todd McClay, with the assistance of Inland Revenue, drafted the document entitled "GST Cross-Border Services intangibles and goods: a government discussion document"[383] that contained a set of proposed rules aimed at addressing the digital economy. It was considered necessary to draft these rules as New Zealand was losing approximately $NZ 80 million in uncollected taxes.[384]

4.3.1 The Proposed Rules

The proposed rules were:

1. Remote services and intangibles would be treated as if they were performed in New Zealand and therefore subject to GST.[385]
2. Non-resident suppliers would be required to register for GST if a certain threshold was exceeded.[386]
3. The definition of the term "services" should be expanded to include both digital and traditional services.[387]
4. An intermediary would in certain situations be required to register in place of the offshore supplier.[388]

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[380] Inland Revenue Policy and Strategy "GST Cross-Border Services intangibles and goods: a government discussion document" (2015) 5.
[381] PricewaterhouseCoopers "Tax by the megabyte: New Zealand's GST in our digital economy" (2015).
[382] Inland Revenue "Cross-border services"5.
[383] Inland Revenue Policy and Strategy (2015).
[384] Inland Revenue "Cross-border services"5.
[385] Inland Revenue "Cross-border services"2.
[386] *Ibid.*
[387] *Ibid.*
[388] *Ibid.*

4.3.2 Relevance of the Proposed Rules in the South African Context

The rules proposed by Inland Revenue in New Zealand are similar to those introduced in South Africa, as there has been an amendment of the definition of the term "enterprise" to include electronic services. In addition, electronic services refer to those services that are provided by a supplier in an export country and those services are subject to VAT according to the Value-Added Tax Act.[389] The proposals most relevant to South Africa would be the rule regarding the registration threshold, and the use of an intermediary to register on behalf of the offshore supplier.

4.3.2.1 Registration threshold

Inland Revenue in New Zealand established that it was necessary to impose a registration threshold on cross-border services. To impose the correct threshold, various considerations were considered. On the one hand, imposing a very high registration threshold would mean that there would be a potential for larger offshore suppliers to spread their supplies over various jurisdictions and therefore escape GST in New Zealand.[390] It is submitted that this could be a reason why SARS set the threshold at R50 000 instead of R1 million, as is the case with the domestic threshold. New Zealand, however, set the registration threshold at $NZ 60 000, like their domestic threshold.[391] Inland Revenue argued against setting the thresholds at the same level as there was a danger that competition neutrality would not be achieved, as non-residents had the opportunity of escaping liability for GST on services exported to New Zealand.[392] Despite this argument the threshold was eventually set at the same level as the domestic threshold.

Unlike New Zealand, South Africa has a very low registration threshold for electronic services and this has been openly criticised by other jurisdictions.[393] It is submitted that it is necessary to revisit the issue of the registration threshold. The low threshold could also result

[389] S1.
[390] Inland Revenue "Cross-border services"24.
[391] Deloitte "GST on 'remote' services" 16 April 2015 https://www2.deloitte.com/nz/en/pages/tax-alerts/articles/gst-on-remote-services.html [Accessed 20 June 2017].
[392] Inland Revenue "Cross-border services"24.
[393] A Moyo "SA faces tighter cross-border transaction controls" 12 January 2016 http://www.itweb.co.za/index.php?option=com_content&view=article&id=149780 [Accessed 24 October 2017].

in higher compliance costs for SARS as there would be a greater number of suppliers required to register, as it is probable that many suppliers would reach the threshold. In addition, the principle of neutrality is not achieved as there is a disparity between resident and non-resident taxpayers, leaving the non-resident taxpayers at a disadvantage. South Africa therefore should follow the example of New Zealand and equalise the registration threshold. There is a danger that compliance could decrease as there would be fewer non-resident suppliers reaching the threshold, which could affect revenue earned on digital services. However, it is important to be in line with international standards set by other countries to ensure that potential trading is not diminished due to stringent legislation.

4.3.2.2 Registration of an intermediary to represent an offshore supplier

Inland Revenue recommended that in certain situations an intermediary registers on behalf of the offshore supplier.[394] The main proposal was that where the offshore supplier made use of an electronic marketplace like the Apple App Store or Google Play, the marketplace should register instead of the offshore supplier.[395] The reasoning behind this was that it was possible that the marketplace was better equipped to register for GST than the offshore supplier, and therefore making it simpler for the marketplace to register.[396] In addition, the revenue authority could keep compliance costs down as there would be fewer small suppliers registering for GST.[397]

It was established that there were certain situations where an electronic market place would be required to register, such as when the consumer considered the marketplace to be the supplier.[398] This would be reflected in the contractual agreement between the parties.[399] The marketplace could be considered the supplier in situations where:

1. the marketplace authorized the service charges to the consumer;[400]
2. the marketplace authorized delivery of the service to the consumer;[401] and

394 Inland Revenue "Cross-border services"2.
395 Inland Revenue "Cross-border services"25.
396 Inland Revenue "Cross-border services"25.
397 *Ibid.*
398 Inland Revenue "Cross-border services"26.
399 *Ibid.*
400 Inland Revenue "Cross-border services" 26.
401 *Ibid.*

3. the marketplace set the terms and conditions of service.[402]

Currently in South Africa, it has been acknowledged that electronic marketplaces like the Apple App Store have begun to pay VAT on the applications they sell on behalf of developers.[403] This is revealed by a notice sent to app developers using the Apple App Store regarding the price schedule changes due to the inclusion of the VAT charge.[404] Instead of individual app developers paying the requisite VAT, Apple made arrangements to charge and account for VAT.[405] It can therefore be seen that there are similarities between the New Zealand proposals and the actions of an electronic marketplace operating in South Africa. It is submitted that to ensure that this approach is applied across the board in South Africa, legislation must be enacted aimed at making this practice mandatory, where electronic marketplaces are concerned. An amendment can be made to the current VAT laws focusing on the digital economy to include this. Enacting legislation makes it simpler for suppliers to understand whether they meet the criteria for marketplaces to register on their behalf. Enacting this legislation may also help to decrease compliance costs, as was suggested by Inland Revenue in New Zealand.[406]

It is submitted that South Africa should take note of developments in jurisdictions like New Zealand, as there are certain relevant considerations that can be addressed. It is important for South Africa to address the issue of the registration threshold to ensure that offshore suppliers are not discouraged from providing services in the jurisdiction due to potential disadvantages. In addition, it is important to enact legislation that deals with a situation where an electronic marketplace is required to register instead of an individual offshore supplier. This is because electronic marketplaces are becoming more prevalent and numerous application developers prefer to use them when selling their services. In addition, these marketplaces are better equipped to register for GST and as such it would be useful to have legislation to govern them.

[402] *Ibid.*
[403] M Gurman "Apple notifies app developers of incoming VAT-influenced pricing changes to South African App Store" 8 June 2014 https://9to5mac.com/2014/06/08/apple-notifies-developers-of-incoming-vat-influenced-pricing-changes-to-south-african-app-store/ [Accessed 23 October 2017].
[404] *Ibid.*
[405] *Ibid.*
[406] Inland Revenue "Cross-border services"25.

The use of an electronic marketplace could also be used to argue in favour of increasing the registration threshold. This is because a marketplace would make higher taxable supplies than an individual supplier and as a result there would be an increased probability of meeting a higher threshold. According to a report made in 2014, Google was earning between R800 million and R1 billion in online advertising revenue.[407] With such statistics it is evident that an electronic marketplace is able to meet the registration threshold of R1 million set in South Africa.

4.4 FINAL RECOMMENDATIONS FOR SOUTH AFRICA

The work of the OECD and the New Zealand revenue authority are important for South Africa, as these developments can also assist South Africa in addressing challenges posed by the digital economy. The recommendations which are made for South Africa to consider are:

1. Make use of the International VAT/GST Guidelines in ensuring the VAT framework conforms to international standards.
2. Consider adjusting the registration threshold to create neutrality between domestic and non-resident suppliers of electronic services.
3. Enact legislation that focuses on electronic marketplaces registering for VAT, instead of individual non-resident suppliers

Possibly, the ambit of section 9 of the Income Tax Act could be extended to include in the source provisions goods and services paid for or consumed or used in South Africa, that are provided through digital means.

4.5 CONCLUSION

The aim of this chapter was to provide recommendations that will assist South Africa to address the digital economy, based on work carried out by the OECD and the New Zealand Inland Revenue authority. Various suggestions were made, but it was concluded that only a few of them would be relevant in the South African context. It was established that South Africa should make use of the International VAT/GST Guidelines as they offer adequate

[407] C Smith "Google 'avoids SA taxes'" 11 February 2014 http://www.fin24.com/Companies/ICT/Google-avoids-SA-taxes-20140211 [Accessed 23 October 2017].

assistance on how to shape VAT frameworks in line with international standards. In addition, it was recommended that South Africa should consider adjusting the registration threshold for non-resident suppliers, as there is a disparity between the domestic and non-resident thresholds. It was established that South Africa has been criticised by other countries for applying such a low threshold, and as such it was essential to adjust the threshold to discourage non-residents from not exporting services to the jurisdiction. The final recommendation made was to enact legislation that deals with situations where an electronic marketplace could register instead of an individual supplier. This was seen to be useful as there was a growing tendency by offshore suppliers of electronic services to utilize an electronic marketplace, instead of providing services individually. It was also suggested that the use of an electronic marketplace could be a factor to consider in increasing the registration threshold, as marketplaces are more capable of reaching a high threshold as opposed to individual suppliers.

The aim of the final chapter is to conclude the research and establish whether the research question has been adequately addressed.

Chapter 5: Conclusion

5.1 INTRODUCTION

The previous chapter focused on the recommendations that were made on how South Africa should tax the digital economy. These recommendations were based on the work carried out by the Organisation for Economic Co-Operation and Development (OECD) and the New Zealand revenue authority, Inland Revenue.

The aim of this final chapter is to establish whether the goals of the research have been achieved and whether the research question has been answered. The research question to be answered was to establish how South Africa could amend its legislation to adequately tax the digital economy.

5.2 GOALS OF THE RESEARCH

The main goal of the research was to establish how best South Africa could amend the current legislation to tax non-resident digital companies adequately. To achieve this goal, the sub-goals that had to be addressed were to:

1. establish the current South African legislation in place to tax non-resident digital companies;
2. establish how the OECD has proposed to address taxation of the digital economy;
3. establish how New Zealand has addressed the taxation of digital companies; and
4. provide recommendations for South Africa based on the OECD's work on the digital economy and New Zealand's legislation.

Chapter two focused on the current taxation legislation applied in South Africa and identified where this legislation was lacking with regard to taxing the digital economy. A key finding was that South Africa applies both direct and indirect taxes and as such it was necessary to establish whether digital taxation would be subject to both. The chapter firstly focused on

whether non-resident digital companies would be subject to income tax. South Africa applies a residence-based system of taxation, but when it comes to non-residents, source-based principles are applied to determine the income tax liability.[408] It was established that digital companies fail to meet the source requirements as they lack a physical presence in the Republic. As such it would be impossible to tax them on income earned in South Africa, except possibly regarding electronically provided scientific or commercial knowledge, or assistance in connection with this knowledge.[409]

Chapter two then continued by focusing on Value-Added Tax (VAT), which is the only tax that currently applies to non-resident digital companies. The Value-Added Tax Act[410] was amended by section 95(1) of the Taxation Laws Amendment Act[411] to include "electronic services" in the section 1 definition of an "enterprise." In order to provide further clarification regarding which services would be regarded as "electronic services", the former Minister of Finance, Pravin Gordhan, enacted the "Regulations Prescribing Electronic Services for the Purpose of the Definition of 'Electronic Services' in Section 1 of the Value-Added Tax Act 89 of 1991."[412] It was established that services that would be classified as electronic services would include, educational services,[413] games and games of chance,[414] internet-based auctions,[415] miscellaneous services,[416] and subscription services.[417] Foreign suppliers who provided electronic services were therefore obliged to register for VAT if they made taxable supplies that exceeded R50 000.[418] Despite the enactment of these regulations and the amendment of the Value-Added Tax Act, it was established that South Africa still lags behind other jurisdictions with regard to adequately taxing the digital economy and, as such, it would be necessary to make progress in order to prevent further base erosion.[419] In addition

[408] M Stiglingh *et al SILKE: South African Income Tax* (2015) 59.
[409] S9 of the Income Tax Act.
[410] 1991.
[411] 2014.
[412] GN R. 221Government Gazette 37489 28 March 2014.
[413] S3.
[414] S4.
[415] S5.
[416] S6.
[417] S7.
[418] S23(1A).
[419] I Lamprecht (2015) "South African tax laws have not kept pace with digital economy" http://www.moneyweb.co.za/mymoney/moneyweb-tax/sa-tax-laws-have-not-kept-pace-with-digital-economy/ [Accessed 21 August 2016].

to this it was established that there are probably low levels of compliance because of the onerous administrative burden placed on the foreign suppliers, and recommendations would be made in order to address this problem.

Chapter three dealt with the work that has been carried out by the OECD in addressing the challenges posed by the digital economy, as well as the measures taken by New Zealand to address the taxation of the digital economy. The OECD was selected as it is at the forefront in addressing the digital economy with work that began as early as 1996.[420] After observing that there had been an increase in base erosion and profit shifting due to globalisation, the OECD formulated an action plan entitled "Action Plan on Base Erosion and Profit Shifting". This was done to ensure that tax authorities would be able to tax companies on profits arising in their jurisdictions. The action plan had fifteen actions to be addressed and in the present research the most relevant action was the first action that was aimed at addressing the digital economy.[421] In order to adequately engage with the action, a taskforce called the "Taskforce on the Digital Economy" was formed. This panel had the duty to address the action and provide recommendations for the challenges posed by the digital economy.[422] Various challenges of the digital economy were identified, and these included the remote nature of the businesses, the ability of companies to avoid Permanent Establishment status, challenges to the collection of VAT on cross-border services and challenges that had to do with characterisation. The Taskforce then drafted a list of possible solutions to the challenges and these were:

1. modifications to the exceptions from Permanent Establishment status;
2. alternatives to the existing Permanent Establishment threshold;
3. imposition of a withholding tax on certain types of digital transactions;
4. introduction of an equalisation levy; and
5. collection of VAT in the country where the consumer is located, according to the principles and mechanisms developed by Working Party 9 of the Committee on Fiscal Affairs.[423]

[420] OECD/G20 Base Erosion and Profit Shifting Project "Addressing the Tax Challenges of the Digital Economy, Action 1 2015 Final Report" (2015) 152 http://dx.doi.org/10.1787/9789264241046.en [Accessed 1 May 2017].
[421] OECD *Action Plan on Base Erosion and Profit Shifting* (2013) 14 http://dx.doi.org/10.1787/9789264202719-en [Accessed 21 August 2016].
[422] *Ibid.*
[423] *Ibid.*

It was concluded by the Taskforce on the Digital Economy that focusing on the collection of VAT and the modification of the Permanent Establishment status exceptions were the most suitable proposals to be made to address the challenges that were posed by the digital economy.

The chapter proceeded to focus on the work that had been carried out by the New Zealand revenue authority, Inland Revenue, in conjunction with the Minister of Revenue, Honourable Todd McClay. New Zealand was selected because it has a similar taxation system to South Africa. A document entitled: "GST: Cross-border services, intangibles and goods: a government discussion document"[424] was drafted and proposals in the document were made with regard to addressing the digital economy. Four proposals were made:

1. Remote services and intangibles would be treated as if they were performed in New Zealand and therefore subject to GST.[425]
2. Non-resident suppliers would be required to register for GST if a certain threshold was exceeded.[426]
3. The definition of the term "services" should be expanded to include both digital and traditional services.[427]
4. An intermediary would in certain situations be required to register in place of the offshore supplier.[428]

Chapter four focused on the recommendations that could be made in the South African context, after considering the proposals that had been put forward by both the OECD and the New Zealand revenue authority. The recommendation by the OECD to modify the Permanent Establishment status exceptions list would automatically be implemented in South Africa as, in terms of the Income Tax Act, the definition of a Permanent Establishment in Article 5 of the OECD Model Tax Convention is the definition that applies in the South African Income Tax Act.[429] Any modifications made by the OECD would therefore apply in South Africa.

[424] Inland Revenue Policy & Strategy (2015).
[425] Inland Revenue "Cross-border services"2.
[426] *Ibid.*
[427] *Ibid.*
[428] *Ibid.*
[429] S1.

South Africa has already implemented three of the proposals made by the New Zealand revenue authority and it was therefore established that only one proposal would be relevant. These recommendations were firstly that remote services and intangibles would be treated as if they were performed in New Zealand and therefore subject to GST. In South Africa the same treatment of services from export countries was adopted by the Value-Added Tax Act where it was stated in section 1 that electronic services supplied by persons from an export country would be regarded as an enterprise. The second recommendation followed was the definition of "services" being expanded to include both digital and traditional services. In the South African context, the definition of an "enterprise" in terms of the Value-Added Tax Act was expanded to include "electronic services". The third recommendation that was followed was for non-resident suppliers to register for GST when a certain threshold was exceeded. This recommendation was implemented by the enactment of section 23(1A) of the Value-Added Tax Act which requires non-resident suppliers of electronic services to register for VAT when a threshold of R50 000 has been exceeded. The final recommendations that were made were:

1. South Africa should make use of the International VAT/GST Guidelines to ensure that the VAT legislation conforms to international standards.
2. The registration threshold for non-resident suppliers and domestic suppliers should be reconsidered to ensure that neutrality is achieved between resident and non-resident suppliers.
3. Legislation that focuses on electronic marketplaces registering for VAT, rather than individual non-resident suppliers, should be enacted.

Possibly, the ambit of section 9 of the Income Tax Act could be extended to include in the source provisions goods and services paid for or consumed or used in South Africa, that are provided through digital means.

5.3 CONCLUSION

The aim of the research was to provide recommendations on how South Africa could amend its current legislation to adequately tax the digital economy. Applying the recommendations and proposals of the OECD and the provisions introduced by the New Zealand revenue authority would address many of the problems identified.

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