2016 Southern African Accounting Association (SAAA) National Teaching and Learning and Regional Conference Proceedings

ISBN number: 978-0-620-74761-5

TAX 03: The effect of electronic commerce on the erosion of tax bases – Developing appropriate taxation laws in South Africa

Authors:
Amy Wilson, Shaun Parsons and Riley Carpenter
University of Cape Town
E-mail: riley.carpenter@uct.ac.za

Abstract:

In response to concerns about the erosion of tax bases caused by a lack of adequate taxation laws to govern the digital economy, this paper considers the issues that have arisen around the taxation of electronic commerce.

Significant issues relating to classification, residency, permanent establishment and source of income that arise from the presence of technology and electronic commerce are identified and explored, though analysis of the considerations, discussions and actions of the Organisation of Economic Co-operation and Development as well as countries around the world. The relevance of issues are then applied to a South African context.

This study recommends that South Africa continue to follow the actions of the Organisation of Economic Co-operation and Development, along with those of the United Kingdom, the United States, New Zealand and Australia, in order to appropriately respond to this growing sector of the economy.

ISBN 978-0-620-74761-5

1. Introduction

In the past two decades, the world has seen massive growth in electronic commerce (e-commerce). Not only has e-commerce become a useful tool through which to conduct business, for some businesses it has become an essential part of their income earning structure. E-commerce has created a new trading platform and has introduced an entirely new economy, the digital economy. Some industries have been forced to completely transform the way they conduct business. For example, the magazine and newspaper industry has seen a trend towards the discontinuation of traditional print media and the launch of digital versions of these products online.

Tax authorities around the world have considered the issues that have arisen from the introduction of e-commerce that have been caused by the unfamiliarity of e-commerce transactions. Since these transactions do not fit perfectly into the current tax regimes, they challenge certain concepts and sometimes fall outside the reach of laws, causing transactions to go untaxed by any jurisdiction (Cox, Doernberg, & Hinnekens, 2013).

Not only does this issue have the potential to significantly erode the tax bases of countries all around the globe, but it also could have the effect of causing inequality within industries, thus challenging the concept of a free market. This arises when transactions over the internet offer the same products as ‘traditional bricks and mortar’ stores. If the online transactions are not taxed, but the traditional traders are, there is an opportunity for price differentiation between these two businesses as online retailers could charge a price proportionately lower than their competitors since they do not have to incorporate tax into the price. This unfair competitive advantage contradicts the concept of tax neutrality, which implies that all substantially similar transactions should be taxed equally (Chan, 2000).

In 1998, the US government signed a law introducing the Internet Tax Freedom Act (ITFA), which placed a temporary moratorium on the introduction of new taxes on e-commerce transactions. The rationale behind this was to promote the endless potential that the internet offered and encourage growth in this industry (Bruce, Fox, & Murray, 2003). Since then the digital economy has grown to a size where continuing to allow these transactions to remain untaxed could lead to a large opportunity cost of lost tax revenue. The Davis Committee, an advisory tax panel in South Africa, recently released an article identifying the fact that South Africa needs to create policies around the taxation of e-commerce in order to seize the opportunity to increase tax revenue in the Republic (Estor, 2014). These policies are necessary to ‘level the playing field between local and international companies dealing with electronic goods and services’ (Estor, 2014).

ISBN 978-0-620-74761-5

2. Literature Review

E-commerce presents a unique problem to tax authorities for many different reasons. These challenges arise because the nature of e-commerce transactions differs significantly from traditional transactions around which tax authorities have based their rules (Lau & Halkyard, 2003). Beyond the administrative and technical problems of taxing e-commerce, there are also several other issues around the current tax rules upon which the tax laws are based, namely, issues around income classification, residency, permanent establishment and source (Azam, 2007). These issues are discussed below.

2.1 Why electronic commerce presents a unique problem

According to the Organisation for Economic Co-operation and Development (OECD), e-commerce is defined as 'the sale or purchase of goods or services, conducted over computer mediated networks', narrowly defined as 'internet transactions', with the main network being the internet (OECD, 2002). These transactions can occur between any two parties that have access to the internet, regardless of their location around the globe, thereby transcending territorial boundaries (Azam, 2013). This ability to trade without the confines of geographical borders creates a world that undermines the legitimacy and feasibility of the tax laws that were created around the concept of the physical separation of countries (Cox et al., 2013). The internet creates a mobility of capital and almost real-time availability of information that causes volatile changes in taxable resources (Lau & Halkyard, 2003). This, along with the increasing mobility of intangible assets, users and business functions, has posed challenges to tax authorities all around the world (Cox et al., 2013). The taxation of these cross border transactions is becoming increasingly difficult, especially if state and country tax laws are not uniform (Mclure, 2015).

E-commerce has fundamentally changed the way business is conducted on a national and international level. The presence of a virtual business platform has allowed businesses to create innovative ways to streamline core business functions over the internet and to obtain resources in a manner that is more efficient (Lau & Halkyard, 2003). The growth in the digital economy has caused a convergence of resources making technologies cheaper, more powerful and widely standardised. This enhances innovation across many business sectors. For example, retailers can gather and analyse customer information from online sales in order to improve their reach to the target markets, the financial services industry can provide its customers with the ability to manage and track returns online, and the news and media industry has had to adapt to the rapid expansion of non-traditional mediums through which to communicate news while user participation has increased through the use of social networks and user-generated content (Cox et al., 2013). These innovations, together with the high mobility of capital through e-commerce, could see resident companies migrating to low tax jurisdictions by incorporating offshore companies through which business is performed (Cox et al., 2013).

ISBN 978-0-620-74761-5

The matters presented above create challenges around the administration and enforcement of tax on e-commerce transactions. The ability of tax authorities to collect tax is dependent on the identification, location, and verification of taxpayers and their corresponding taxable transactions (Young, 2012). The increasing level of anonymity created by the internet has caused complexities to arise around merely identifying the appropriate taxpayer (Azam, 2013). Furthermore, with the global increase in information security and confidentiality, tax authorities may need to find a balance between the various privacy laws and regulations and the need to ensure tax compliance (Lau & Halkyard, 2003). However, the virtual nature of online transactions makes monitoring and controlling e-commerce transactions across borders difficult. Additionally, tax authorities need to consider the appropriate country in which certain taxpayers will be taxed. This may pose a problem when companies lack substantial physical presence in any country but are virtually present in multiple countries (Azam, 2007).

Another administrative challenge would be developing an efficient mechanism for tax collection from sellers, in particular remote sellers and non-residents (Lau & Halkyard, 2003). Some remote sellers may be burdened by the administrative cost of registering for tax and may not be able to meet the tax burden on top of other costs such as shipping and handling costs and time costs due to delivery lags (Bruce et al., 2003). Although compliance costs may seem to be disproportionately higher for smaller businesses, Bruce et al. (2003), discuss how the difference between local and remote sellers should continuously erode as the internet grows and online transactions become an increasingly important component of consumer life.

A further issue arises from the creation of different payment methods such as the use of e-wallets or cyber-wallets that are charged in advance with credits and used online as an alternative to a credit card (OECD, 2014). This is enhanced by the creation of virtual currencies, such as Bitcoin (Cox et al., 2013). Bitcoin is defined as the use of ‘peer-to-peer technology to operate with no central authority or banks’ (Bitcoin Foundation, 2015). The lack of a central authority makes it seemingly impossible to track every transaction made by each individual owner of the currency in order to impose tax on these (Cox et al., 2013). Furthermore, individual taxpayers may abuse the anonymity of Bitcoin ownership and transactions by not declaring related income (Parsons, 2014).

In order to approach these challenges tax authorities should consider the benefits that have been created from the internet and the administrative advantages that can be extracted from this medium. An opportunity has arisen where a new range of tools is available to be used in order to ensure compliance with legislation and other tax rules as well as assist with the collection of taxes and improve taxpayer services (Lau & Halkyard, 2003).

ISBN 978-0-620-74761-5

2.2 Important issues identified around the taxation of e-commerce

The unique problem e-commerce presents to tax authorities arises because the nature of these transactions creates room for warped interpretations of certain areas of current tax legislation. Transactions of a virtual nature put pressure on certain tax concepts that require physical presence for distinct classification (Azam, 2007). The main areas of concern are income classification, residency, permanent establishment and source rules.

2.2.1 Income Classification

The introduction of information technology has created numerous new products, services and methods of doing business. These products and services can sometimes blur the lines of income classification (Azam, 2007). Traditionally tax authorities have imposed different types of tax regimes on different classes of cross-border income. The transmission of digital goods and services, however, may not provide a clear indication as to what is actually being transferred, whether a good has been delivered, a service performed or an intangible asset licensed (Cockfield, 2006). The digital revolution has made it possible to record multimedia forms of interactive sounds and images that are of a high quality. This has created an opportunity to sell the same item in both tangible and intangible forms. For example, instead of purchasing a physical CD, one can purchase the mp3 version and download it from the internet (Mclure, 2015). Additionally, new business models, such as cloud computing, have arisen relying on the new digital economy and these models have made the ability to classify certain income even more challenging (Cox et al., 2013).

2.2.2 Residency

Many countries worldwide use a residence-based tax system where, if a taxpayer is a resident of the country, the taxpayer will be taxed on worldwide income regardless of its source. Generally, a universal perspective is taken that for a company to be classified as a resident, generally, there are two tests, namely, the ‘place of incorporation’ test and the ‘place of effective management’ test (OECD, 2001).

Under the ‘place of incorporation test’, if a company is incorporated in a country, it is considered a resident of that country, regardless of where the major economic activities take place (Cockfield, 2006). The justification for this system is that the company should compensate the country in which it was incorporated as this country contributes to the abilities of the company to produce income through providing resources and services (Azam, 2013). Since this test does not require the company to maintain economic presence within the country of incorporation, residency can change simply by changing the country of incorporation (OECD, 2001). The mobility and flexibility of the internet and other computer-mediated networks has removed most of the challenges around managing a company’s operations from an offshore

ISBN 978-0-620-74761-5

country (Lee, 2006). As a consequence, the 'place of incorporation test' could be used as a tax avoidance opportunity if internet companies were to incorporate in low tax jurisdictions, such as Ireland, or in tax havens, such as Bermuda, and escape taxation altogether (Cockfield, 2006).

Under the 'place of central/effective management and control test', the place where a company's major economic decisions are made is deemed to be that company's country of residence. This generally involves analysing where the company's board of directors meet on a regular basis and where the head office of the company is situated (Cockfield, 2006). However, the internet has created the ability for directors, employees and business partners to communicate seamlessly while maintaining physical presence in their various countries of personal residence (Lau & Halkyard, 2003). This gives rise to a possible manipulation of the residence-based taxation system in order to achieve tax avoidance (Azam, 2007).

2.2.3 Permanent Establishment

A company could be a non-resident of a country but may still have to pay tax in that country on a portion of its income. This is required if the company establishes and operates through a permanent establishment in the country. The tax payable would be imposed on the income attributable to that permanent establishment (Chan, 2000). The permanent establishment concept has been the basis on which to determine whether a particular country has the right to tax the profits made by a non-resident transacting in the country. The digital economy, however, is placing pressure on the concept of a permanent establishment, dependent as it is on a substantial physical presence in the country (Cox et al., 2013).

Article 5 of the OECD Model Tax Convention addresses the concept of permanent establishment and provides a definition on which many tax laws rely when considering this concept (Laursen, 2010). Article 5 states that 'the term permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on' (OECD, 2003). The word 'permanent' does not require the company's presence in a country to be forever. Laursen (2009) discusses how in most cases, a period of six months is usually sufficient to constitute a permanent nature in terms of the permanent establishment concept. The definition alludes to the fact that to be considered a permanent establishment, the place must be a 'fixed' place and must be a place through which business is carried on. Paragraph 2 includes especially a place of management, a branch, an office, a factory, workshop or a mine (OECD, 2003). This supports the court-determined definition of 'nexus', which requires substantial physical presence by a company before being defined as a permanent establishment or being obligated to pay tax on a portion of its profit (Bruce et al., 2003).

ISBN 978-0-620-74761-5

E-commerce challenges the concept of a permanent establishment because it gives a company the potential ability to have digital presence in a country without having the burden of paying tax because of the lack of substantial nexus (Cadesky, Rinninsland, & Lobo, 2014). This is because internet transactions and other digital platforms reduce the need for physical presence in a country in order to transact and conduct business in that jurisdiction. This places questions around the assumption of the need for physical presence in order carry out value-generating economic activities within a country and suggests that the digital economy has caused this concept to become outdated (Cox et al., 2013). A company could potentially be present in hundreds of different countries around the world at one time in a purely virtual manner (Azam, 2013).

This concept can be demonstrated further by using as an example. Google's mission is to 'to organize the world's information and make it universally accessible and useful' (Google, 2015). In pursuit of this, Google maintains more than 180 domains in countries around the world but only operate offices in 40 of these countries. While more than half of Google's revenue is generated outside of the United States of America, the ability to classify the proportion of revenue generated in each individual country in order to share fairly all pieces of the tax pie, is almost impossible. This process is made more challenging in the countries where Google has no physical office or presence of any type, other than in the computer servers that feed the domains within each country (Azam, 2013).

From this, one can see that the introduction of internet transactions, there may be an opportunity for a company to achieve double non-taxation due to the lack of nexus in the source country together with the lack of taxation in the resident country arising from a double taxation agreement (Cox et al., 2013).

The lack of physical presence needed for generating income in any economy and the rise in the ease of cross-border commercial transactions has been enabled by the use of computer servers. A computer server is a computer that has been networked to the internet and, in some cases, eliminates the need for traditional business intermediaries such as retail stores (Cockfield, 2006). The current legislation does not adequately consider the issues around the virtual and independent nature of a server. A server has the potential to perform integral economic activities within the business without requiring any human involvement (OECD Committee on Fiscal Affairs, 2000). Furthermore, since virtual distance is not proportional to physical distance, the actual location of each server could be challenging to pinpoint. This shows the challenges that arise from the digital economy and may indicate that the concept of a permanent establishment may be outdated and in need of revision (Lau & Halkyard, 2003).

ISBN 978-0-620-74761-5

2.2.4 Source

If a company is a non-resident, the general rule is that the company will be taxed in a jurisdiction on income that is derived from a source within that specific jurisdiction. The rationale behind source-based taxation is that the source country provides the company with infrastructure and other facilities that contribute to the income-generating ability of the business (Azam, 2007). The source country usually takes precedent over the resident country and although both countries may impose tax on the company, generally, double taxation agreements lead to a credit being issued by the resident country, leaving the final tax benefit with the source country (Chan, 2000).

E-commerce makes the identification of 'what is done in which country' and the original cause of the income significantly more challenging and exposes a potential weakness of the current source-based rules (Lau & Halkyard, 2003). All types of e-commerce transactions have some sort of virtual aspect to them, as physical existence outside the internet may be limited or non-existent. This makes it difficult to identify the specific geographical location of an e-commerce transaction as the technical location of the transaction could be 'on the internet', making the identification of the source of the income more challenging (Azam, 2007).

Additionally, determining the source of e-commerce transactions is made more challenging as the existence of a virtual trading platform causes certain income to be linked with several countries, with no clear indication of a country that provides a dominant contribution (Azam, 2013). As the internet has provided almost instantaneous access to a large volume of information, companies can use this to gather information and generate data on consumers, competitors and target markets within the industry. This causes the attribution of taxable profits to a particular source country to become particularly challenging as the value is derived from the generation of information that is collected from digital goods and services from sources around the world. The ability to separate each bit of information and determine a value attached to that specific piece of information may prove to be nearly impossible (Cox et al., 2013).

These challenges around the enforcement of source rules cause a number of possible tax avoidance opportunities to arise and may lead to avoidance becoming widespread and easy for many companies participating in information generation and other trades (Azam, 2013). This suggests that special attention toward source-based rules may be required by tax authorities before the growth in e-commerce causes a significant erosion of tax bases around the world (Azam, 2013).

ISBN 978-0-620-74761-5

2.3 Current considerations and responses by the OECD and other countries on the taxation of electronic commerce

The issues discussed above has been cause for consideration for the past two decades by authorities such as the OECD, the US National Treasury and other tax authorities around the globe (Cox et al., 2013).

2.3.1 The OECD actions and recommendations

Throughout the last few decades, the OECD has considered the issues around the taxation of e-commerce. The Ottawa Ministerial Conference on Electronic Commerce was held in 1998, where leaders from both member and non-member countries participated in a discussion around the promotion and development of e-commerce around the world. At this conference, a set of tax principles was established on which the OECD and other tax authorities would base their considerations around the taxation of the digital economy (OECD, 2014). This framework provided that taxation between different forms of commerce must be neutral and equitable, achieving effectiveness and fairness while remaining simple and certain. The compliance and collection costs must be efficiently minimised as far as possible as well as have the ability to keep up with the flexible and continuously evolving technologies in the digital economy (Cockfield, 2006).

After the Ottawa conference, the Committee on Fiscal Affairs created Technical Advisory Groups, consisting of business, scientific and governmental representatives from around the globe, to discuss further the issues surrounding the digital economy and present possible recommendations (OECD, 2014). In 2013, the OECD launched an Action Plan on Base Erosion and Profit Shifting, followed by a discussion draft on Action 1: Address the tax challenges of the digital economy, released in April 2014. Some of the considerations and recommendations that have arisen are discussed below.

Residency: There was a proposal to amend the determination of residency under the 'place of central/effective management and control test'. If the taxpayer's activities indicate more than one country, or indicate no clear country of residence, the place of effective management would be determined by considering three options. The place of effective management would be either the country in which the taxpayer substantially makes use of the economic, financial, physical and legal resources of the country; that in which the activities performed by the taxpayer are the most substantial and relevant; or the country in which the clear majority of decisions by the Board of Directors are made and the location of the head offices of the corporation (OECD, 2002). This amendment would eliminate the challenges around identifying the resident country of a taxpayer through the 'place of central/effective management and control test', thereby decreasing the opportunity to escape the imposition of taxation.

ISBN 978-0-620-74761-5

Permanent Establishment: The OECD established certain guidelines around the definition of a permanent establishment, including an amendment of the commentary on Article 5 of the Model Tax Convention (OECD Committee on Fiscal Affairs, 2000). The clarification on the application of the permanent establishment definition in e-commerce considers separately whether computer equipment, websites and servers could constitute permanent establishments. It also considers the issues around Internet Service Providers (ISPs). The responses around these issues are as follows:

- *Computer equipment:* A permanent establishment may exist in a location where computer equipment is used regardless of whether the location requires human presence or not. If the equipment carries out core functions of the business that are substantial and significant, a permanent establishment will exist. However, if the activities carried out by the computer equipment are preparatory or auxiliary, further evidence would be needed in order to determine whether the equipment constitutes a permanent establishment (OECD Committee on Fiscal Affairs, 2000).

- *Websites:* The commentary on Article 5 states that a website, in itself, does not constitute a permanent establishment. This is because the website is an intangible item that cannot be classified as 'computer equipment' and therefore does not fall into the above category (OECD Committee on Fiscal Affairs, 2000).

- *Servers:* According to the OECD Committee on Fiscal Affairs (2000), a server, if owned or leased by a non-resident company, could classify as a permanent establishment as it is equipment with a physical location. The server will constitute a permanent establishment if it performs an integral part of the cross-border transactions of an enterprise and is in a fixed location for an adequate period of time (Cockfield, 2006).

- *ISPs:* If an enterprise's website, through which business is conducted, is hosted on the server of an ISP, the enterprise usually does not have control over where the server is located. Therefore the only presence the enterprise has in a country is through its website, which, as seen above, will not constitute a permanent establishment (OECD Committee on Fiscal Affairs, 2000).

- *Nexus:* A new nexus rule was proposed where a resident transacting with a non-resident would be required to withhold tax from the payment that has been made from the resident bank to the non-resident company (OECD, 2014).

- *Virtual Permanent Establishment:* As an alternative to the new nexus rule, a proposal was made to amend or extend the definition of a permanent

ISBN 978-0-620-74761-5

establishment. This would allow for servers and specific virtual presence of a company to be considered a permanent establishment, thus eliminating the possible avoidance of tax imposition through a lack of substantial physical presence (OECD, 2014).

Countries around the world, both members and non-members of the OECD, have been following the OECD's commentaries, and implementing reactions in order to adequately deal with this taxation issue (Cockfield, 2006). The responses of the United States (US), Australia, New Zealand, Canada and the UK have been considered and analysed below. The analysis will occur on these specific countries because of the sophisticated taxation systems along with the presence of a fair amount of e-commerce in each of these developed economies.

2.3.2 The United States

The US established the Digital Economic Task Force (DETF) in September 2013, which seeks to promote a balanced analysis of the taxation of the digital economy. Although there was little support from the DETF on the implementation of a 'virtual permanent establishment' definition, the task force does recognize the complexities around the taxation of e-commerce. Along with an organisation of worldwide in-house corporate tax executives (the Tax Executive Institute), the DETF suggests inequitable taxation implications could occur from an improper application of tax initiatives. This could lead to multiple tax impositions on the same transaction. The groups suggest that the appropriate response to these issues may be achieved through the proper application of the existing taxation rules (Cadesky et al., 2014). Although very little action seems to have taken place in addressing this issue, the US, in all its agreements with various countries, maintains that taxation of e-commerce should be clear, consistent and non-discriminatory (Cockfield, 2006).

2.3.3 Canada

Initially, the Canada Revenue Agency maintained a status quo on both the direct and indirect taxation of e-commerce transactions. Canada used an approach that consisted of examining the place of contracting and the location of physical assets of a business (Ault & Arnold, 2004). The country's tax authority did not deal with issues around service providers and servers and deemed these not to be permanent establishments as they were not physically located within Canada. Therefore no tax was imposed on these transactions on a physical presence basis.

However, from 2013 onwards, the Canada Revenue Agency has issued tax and reporting requirements for corporations, partnerships and self-employed individuals who earn income from one or more internet webpages or websites. Corporations are required to submit a 'Schedule 88, Internet Business Activities' report along with their corporate tax returns. Partnerships are not yet required to report the above income

ISBN 978-0-620-74761-5

and self-employed individuals are required to report an 'Internet Business Section' of a specific tax form and submit it with their income tax and benefit returns (Canada Revenue Agency, 2015).

2.3.4 The United Kingdom

In 2000, after considering the OECD's release of the Clarification of Article 5 of the Model

Tax Convention and the discussion within that indicated when servers, computer equipment and websites could be considered a permanent establishment, Her Majesty's Treasury (HM Treasury) issued a press release on the matter. The stance that the HM Treasury took was that servers in themselves will never constitute a permanent establishment of a non-resident (HM Treasury & HM Revenue & Customs, 2014) .

In March 2014, the HM Treasury issued a report showing its support of the OECD's Task Force on the Digital Economy. The HM Treasury's view is that fair and consistent tax treatment must be applied to digital enterprises as well as traditional enterprises that have incorporated digital technology into their business operations. The HM Treasury has considered the revised definition of permanent establishments and states that it will need to be applied to all companies, not just those that are digital.

The ultimate approach of the HM Treasury is to continuously follow the work done by the OECD and 'propose supplementary rules to tackle specific issues raised by digitisation if progress on updating the existing international framework fails to materialise' (HM Treasury & HM Revenue & Customs, 2014).

2.3.5 Australia

Australia's tax jurisdiction usually revolves around two doctrines, namely, the benefit doctrine and the economic allegiance doctrine. The benefit doctrine places taxation rights based of the benefits derived, by residents and non-residents, from Australia, whereas the economic allegiance doctrine uses the relationship between the income generating ability of the taxpayer and the country. The Australian Treasury notes that these doctrines may be inadequate to determine taxation rights relating to the digital economy, and is considering the concepts of source, residence and permanent establishment (The Australian Government Treasury, 2013).

The Australian Treasury has identified a number of different responses to the risk of base erosion and profit shifting caused by the digital economy. One response is to improve the enforcement of existing tax laws by increasing the exchange of information through expanded networks and providing the necessary training for tax auditors. Another response is to improve tax transparency by requiring large

ISBN 978-0-620-74761-5

corporate entities to disclose certain tax information. However, a cost-benefit analysis may be necessary before this takes place. Furthermore, the Treasury recommends that a review of Australia's bilateral and multilateral agreements with other countries should be performed at least once a decade to ensure that the terms of the agreements continue to be for the national benefit and fairness to the taxpayer (The Australian Government Treasury, 2013).

2.3.6 New Zealand

New Zealand has continuously provided guidance on the issue of cross border taxation and internet transactions. The Inland Revenue Department of New Zealand (Te Tari Taake, referred to as the 'Inland Revenue') has stated that e-commerce transactions will be treated within the current laws and interpretations of New Zealand (Inland Revenue, 2004).

According to the Inland Revenue (2004), New Zealand has followed the OECD's recommendations of determining whether a server is a permanent establishment, as discussed earlier, provided all the facts and circumstances are assessed on a case-by-case basis. This shows how the Inland Revenue has taken the OECD's comments and recommendations into account and applied some of these responses to their local tax laws.

2.4. Identification of arguments opposing the taxation of the digital economy

In 1998, the US government signed a law introducing the Internet Tax Freedom Act (ITFA). This ITFA was created, and extended until 2003, in order to promote and preserve the commercial, educational and informational potential that the internet provided by placing a moratorium on taxing internet transactions. States were allowed to apply current tax laws to e-commerce transactions but were prohibited from created any new or discriminatory laws explicitly targeted at internet sales (Bruce et al., 2003). In 2003, the ITFA Coalition proposed the introduction of a permanent ITFA, stating that it would 'benefit America's consumers and innovators and ultimately lead to higher economic growth and job creation'. This argument was based on the premise of tax neutrality and suggested that this would protect the internet from unfair taxation (ITFA Coalition, 2015).

The ITFA was developed when most online sales were by remote sellers in the US and therefore fueled the argument that a tax differential between remote and local sellers would be an incentive to purchase remotely, thereby fostering the growth and development of remote purchasing mechanisms such as the internet (Bruce et al., 2003). This argument, however, has gradually become less sound as internet transactions and globalisation has become a large part of the business world today (Bruce et al., 2003).

Zodrow (2003) explains how the implementation and development of separate tax laws dealing with the internet may have compliance and cost issues. The costs of

ISBN 978-0-620-74761-5

developing sound laws, communicating them to all companies, including remote sellers and collecting the tax may prove more costly than the benefit arising from the extra tax revenue received from these transactions (Zodrow, 2003). A cost-benefit analysis may need to be performed on the issues mentioned above in order to ensure that the costs do not outweigh the benefits. This may be an area for further research.

Many countries are in co-operation to develop a fair and efficient method of taxing the digital economy. Some countries may be slightly more hesitant or less equipped to implement changes at the moment but should still be participating in the discussions and suggestions of the OECD (Cockfield, 2006). There are many different approaches that have been implemented by different countries around the world and these are continuously monitored alongside the actions of the OECD.

3. Research Methodology

Analysis of the literature has identified issues relating to income classification, residency, permanent establishments and source of income as well as compliance and administration concerns and costs. The reactions of the United States of America (US), the United Kingdom (UK), Australia, Canada and New Zealand, along with that of the OECD were explored. These issues will be applied to a South African context and a recommendation will be developed from the findings.

4. Research Question: How should South Africa approach the taxing of e-commerce?

While South Africa is not a member of the OECD, it is one of the many non-member countries with which the OECD has a working relationship. South Africa has generally recognised and adopted the OECD Commentary on its Model Tax Convention (Jardine, Owens, & Sanger, 2014). In 2007, the OECD adopted a resolution to strengthen its relationship with South Africa among other non-member countries. This brings about a relationship of mutual advantage as ‘South Africa is Africa’s largest economy, and typically the ‘prime mover’ for OECD activities… especially on taxation, investment and competition policy’ (OECD, 2015).

4.1 South Africa’s reactions to date

In 2000, the Department of Communications of the Republic of South Africa issued a report titled ‘The National Green Paper on Electronic Commerce’. This was neither academic literature nor a government policy statement but was a platform on which to translate topical issues around e-commerce into government policy. The paper was of a discursive nature and dealt with many of the unconventional issues that e-commerce brought into the marketplace (Department of Communications Republic of South Africa, 2000).

The paper established the underlying principles towards the development of e-commerce policy, which were similar to those established by the OECD in 1998.

ISBN 978-0-620-74761-5

These goals supported the principles of flexibility of regulation and governance, technological neutrality and international benchmarking. The paper continues to analyse certain issues that needed to be considered by the policy makers, including how to recognize e-commerce transactions, the threats that arise from the existence of cyber cash and multilateral trading systems. The ultimate objective of the green paper was to develop a policy that equitably imposed tax on e-commerce transactions, considering administration and compliance issues, as well as ensuring the citizens of South Africa's rights to privacy (Department of Communications Republic of South Africa, 2000).

Since then, the Value Added Tax (VAT) Act has recently been amended to incorporate the compulsory registration for VAT of foreign suppliers of e-commerce. The South African Revenue Service (SARS) has amended the VAT Act in order to account for the lack of VAT levied on e-commerce between foreign suppliers and South African customers (Strydom & Hare, 2014).

4.2 Analysis of the Income Tax Act and other legislation

A revision of the Income Tax Act No. 58 of 1962 (The Income Tax Act) dealing with the taxation of e-commerce transactions and the digital economy has yet to be implemented. The current income tax laws in South Africa show that South Africa's current approach is similar to that of the OECD. An analysis of the Act should indicate whether it is currently adequate to deal with the issues of taxing e-commerce.

Presently, e-commerce transactions between two residents of South Africa do not pose a unique threat to SARS' tax collection on these revenues. This is because if a taxpayer is a resident, the taxpayer is taxed on worldwide income, which will incorporate all income, regardless of the source. However, when a South African resident transacts with a non-resident, several issues arise. These concerns are similar to those already identified, being residency, permanent establishment and source of the income arising from e-commerce transactions.

Residency:

A resident is defined in section 1 of the Income Tax Act as any natural person who is ordinarily resident in the Republic or, if not, meets specific requirements of a 'physical presence test'. For a company, the Income Tax Act defines a resident as 'any person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic (Income Tax Act, 2015).

The term 'place of effective management' is not defined in the Income Tax Act therefore SARS looks to the ordinary meaning of the words, while considering international precedent and interpretation. The term 'effective management' does not

ISBN 978-0-620-74761-5

have a universal meaning and countries around the world, as well as the OECD, attach different interpretations to the word. SARS has issued an interpretation clarifying that, while considering all the relevant facts and circumstances on a case-to-case basis, the general approach will be that 'the place of effective management is the place where the company is managed on a regular or day-to-day basis by the directors or senior management of the company, irrespective of where the overriding control is exercised, or where the board of directors meets' (South African Revenue Services, 2002).

Although the interpretation of the place of effective management differs slightly from that of the OECD and other international interpretations, some of the underlying issues that arise from e-commerce are still present in both interpretations. However, the ability to avoid being defined as a place of effective management, by using technologies such as video conferencing, has been hindered by this interpretation (Cox et al., 2013). This is because the day-to-day, routine transactions generally need to be made where the operations of the business are occurring. However, the virtual nature of internet companies could still cause the artificial avoidance of being defined as a permanent establishment due to lack of physical presence in the Republic.

Permanent establishment:

The issues around establishing a permanent establishment are identical to those identified by the OECD. This is because a permanent establishment is defined in section 1 of the Income Tax Act (2014/2015) as 'a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation of Economic Co-operation and Development'.

Source:

Section 9 of the Income Tax Act (2015) determines which receipts and accruals are derived from a source within South Africa as well as stipulating those derived from a source outside South Africa. Section 9(2)(a)-(l) describes amounts received by or accrued to the taxpayer that are from a source within South Africa. These define the source relating to the income received in the form of: local dividends; interest; royalties; payments for imparting scientific, technical, industrial or commercial knowledge or information; payment for services rendered on behalf of certain resident employers; receipts of any lump sums, pensions or annuities in respect of services rendered within South Africa; sale of immovable property; sale of assets other than immoveable property and exchange differences (Income Tax Act, 2015).

If certain income does not fall within these sections in the Act, a taxpayer must look to case law in order to determine the source of the income. Under the case of CIR v Lever Brothers and Unilever Ltd 1946, in order to determine the source of income, the taxpayer must first establish the *quid pro quo* given in return for what the

ISBN 978-0-620-74761-5

taxpayer has supplied. The source of the income is then determined by identifying the originating cause of the income is and then determining where that originating cause is located (The Appellate Division, 1946). The Black v CIT case indicated that the source of the income is determined by considering where the dominant or main or substantial cause of income originated (Young, 2012).

When applying the principles established by these cases to e-commerce transactions, neither the issue around income classification nor around source is solved. This is because the originating cause of the income could be from a service provided over the internet or an intangible good supplied. Therefore determining the location of this cause may be a challenge, as the internet has no specific location.

There are no other interpretation notes to the Income Tax Act that reference the internet. There are also no cases regarding source or residency relating to the internet (South African Revenue Service, 2015). This suggests that South Africa needs to look towards developing an approach to this issue, either by adopting the views of the OECD or developing an independent approach.

4.3. Davis Committee opinions and suggestions

The Davis Committee recognises the need for South Africa to address the issues of base erosion and profit shifting. The committee has issued an interim report regarding the OECD's action plan on Base Erosion and Profit Shifting (BEPS). The report does not specifically deal with the taxation of the digital economy, but rather considers the entire BEPS action plan in a South African context. The taxation of the digital economy is action one of fifteen actions in the plan (OECD, 2013). The committee identifies the challenges that arise around the amendment of taxation policies. This is because tax policy changes could produce unintentional distortions on cross-border trade, which could disadvantage domestic businesses (Jardine et al., 2014). The committee also recognizes the OECD's warning to be wary of taking unilateral action that may lead to multiple taxation, causing South Africa to become a less attractive country for foreign direct investment (Jardine et al., 2014).

The Davis Committee notes that although South Africa is not a member of the OECD, Section 233 of the Constitution states 'when interpreting legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law' (Jardine et al., 2014). This suggests that South African law should consider the views of the OECD and other international policies when creating policy regarding the issue of the taxation of the digital economy. The Davis committee emphasizes that South Africa needs to be aware of its position in the global market as an emerging economy and create tax policies that will allow the country to be a good platform for future economic growth, development and investment into South Africa and the rest of Africa (Jardine et al., 2014).

ISBN 978-0-620-74761-5

4.4 The total size and stage of development of the virtual economy in South Africa

Director of the International Telecommunication Union (ITU), Brahima Sanou, states that 'technological progress, infrastructure deployment, and falling prices have brought unexpected growth in ICT [information and communication technologies] access and connectivity to billions of people around the world' (International Telecommunications Union, 2015). According to the ITU world facts and figures of 2015, the number of internet users in developed countries has increased from 300 million users in 2005 to 1 billion in 2015, whereas the internet users in developing countries has increased from 100 million to 2.2 billion, respectively (International Telecommunications Union, 2015). This demonstrates the immense growth of the digital world and its infiltration into the world's population and business processes. Since 43% of the world's population has access to the internet, there is still potential for growth in the digital economy in the future (International Telecommunications Union, 2015).

According to Internet Live Statistics (2015), 46.88% of South Africa's population has access to the internet, representing growth of 14% from 2013. The largest growth in internet penetration in a country from the year 2013 to 2014 was 17% in countries such as Uganda, Angola and Zimbabwe and 16% in countries such as Kenya, Mozambique and Madagascar (Internet Live Statistics, 2014). This shows the degree of internet penetration that gives the South African population access to e-commerce transactions and the significant growth of this in developing countries in Africa. This suggests that the size of the e-commerce market in South Africa is continuing to grow and the digital economy is potentially becoming of greater importance to policymakers within South Africa. Therefore, even if e-commerce transactions have not eroded South Africa's tax base immensely in the past, there is great potential for this to become a large issue in South Africa, and may cause the country to forgo an opportunity to increase its tax revenue.

5. Area for future research

As stated above, implementing and developing separate tax laws could create a greater burden on compliance and an increase in costs (Zodrow, 2003). An analysis on the cost-benefit of developing the laws, communicating them to taxpayers, including remote sellers and collecting the tax could be performed.

6. Conclusion and recommendations

Some countries automatically adopt the OECD views, while others either adopt an independent view that parallels that of the OECD, intentionally elect an alternative route or believe their current system to be adequate to deal with the issues under consideration. The US, Australia and Canada have elected not to follow the view of the OECD. The US believes that more stringent enforcement of their current tax laws should be adequate to tackle the issue. Canada has not taken much action towards

ISBN 978-0-620-74761-5

solving the issues of digital taxation, its only action being an update of the legislation around declaring income from certain internet businesses. Australia intends to review its existing laws and improve enforcement of its current tax system. Both New Zealand and the UK have each chosen to implement systems that use the OECD as a guide, but are independent of the OECD's views, focusing on different aspects of both current and new laws.

South Africa's approach, to date, has been to follow that of the OECD, adjusting its approach to suit the SA environment more appropriately (Jardine et al., 2014). South Africa's green paper issued in 2000 shows its commitment to keep up with worldwide policymakers regarding this issue. South Africa's reactions to the issues around the taxation of the digital economy have been similar to those of other countries such as New Zealand and the UK. South Africa has followed the views and changes of the OECD, almost automatically adopting its views around some issues in the digital economy.

It is recommended that South Africa continue to follow the actions of the OECD, as well as those of the UK, US, New Zealand and Australia, in order to develop a sound understanding of the issues around the taxation of e-commerce, as well as to keep constantly updated with new developments. By closely following the actions of the OECD and constantly commenting on these developments, South Africa can slowly start to develop policies that will be consistent with the goals of the country's taxation policies. South Africa should not rush the development of these policies that could create a unilateral response to the issue, causing a strain on competition and a disadvantage for local businesses, but should rather consider the value that could be created by developing an internationally coordinated approach (Jardine et al., 2014).

In line with the OECD's Model Tax Convention, South Africa should continue to update its interpretation notes and other tax legislation in order to slowly integrate the taxation of the digital economy into tax policies. Although this may be a slow approach to tackling this issue, it will allow e-commerce to contribute to the tax base of the country in the medium to long term, as well as encourage entrepreneurship and development of industry.

If South Africa considers its options, in line with developments from the OECD, and creates an approach in cooperation with other international countries, the issue of taxing the digital economy can be addressed, while also creating new or strengthening old relationships with countries in the worldwide economy.

ISBN 978-0-620-74761-5

References

Ault, H. J., & Arnold, B. (2004). *Comparative Income Taxation: A Structural Analysis* (2nd ed.). The Hague: Kluwer Law International.

Azam, R. (2007). E-commerce taxation and cyberspace law: The integrative adaptation model. *Va. JL & Tech.*, 12, 1..

Azam, R. (2013). Global Taxation of Cross-Border Ecommerce Income. *Virginia Tax Review. 31*(4).

Bitcoin Foundation. (2015). Bitcoin is an innovative payment network and a new kind of money. Retrieved May 29, 2015, from https://bitcoin.org/en/

Bruce, D., Fox, W., & Murray, M. (2003). To tax or not to tax? The case of electronic commerce. *Western Economic Association International*, *21*(1), 25–40.

Cadesky, M., Rinninsland, R., & Lobo, K. (2014). The U.S. View on BEPS. Presented to AOTCA 2014 Conference October 2014, (October).

Canada Revenue Agency. (2015). Reporting Internet business activities. Retrieved May 29, 2015, from http://www.cra-arc.gc.ca/tx/bsnss/tpcs/cmm/ncm/wbncm-eng.html

Chan, C. W. (2000). Taxation of Global E-Commerce on the Internet: The Underlying Issues and Proposed Plans. *Minn J Global Trade*, *9*, 233. http://doi.org/http://www.winthrop.com/Portals/0/PDF/claytonchan.pdf

Cockfield, A. J. (2006). The Rise of the OECD as informal “World Tax Organization” through national responses to e-commerce tax challenges. *Yale Journal of Law and Technology*, *8*(1), 137–187.

Commissioner for Inland revenue vs Lever Brothers & Unilever Ltd 1946 AD 441

Cox, N., Doernberg, R., & Hinnekens, L. (2013). Adressing Base Erosion and Profit Shifting in South Africa. *Davis Committee Interim Report*, (2001), 1–56.

Department of Communications Republic of South Africa. (2000). *Green paper on electronic commerce for South Africa*. Retrieved from http://www.info.gov.za/view/DownloadFileAction?id=68917

Estor, L. (2014). BDlive - SA must not miss out on e-commerce tax revenue, says Davis Committee.pdf. *BDlive - Print Article*, 1–2.

Google. (2015). About Google. Retrieved May 30, 2015, from http://www.google.com/about/

HM Treasury, & HM Revenue & Customs. (2014). *Tackling aggressive tax planning*

in the global economy : UK prorities for the G20-OECD project for countering Base Erosion and Profit Shifting.

Income Tax Act, No 58 of 1962, as amended. (2016). *SAICA Student Handbook 2015/2016*, Vol. 3. Cape Town: LexisNexis.

Inland Revenue. (2004). E-commerce and income tax. Retrieved May 29, 2015, from http://www.ird.govt.nz/ecommerce-tax/ecommerce-incometax/

International Telecommunications Union. (2015). *Facts & Figures*.

Internet Live Statistics. (2014). Internet users by country (2014). Retrieved July 18, 2015, from http://www.internetlivestats.com/internet-users-by-country/

ITFA Coalition. (2015). About the Internet Tax Freedom Act Coalition. Retrieved May 30, 2015, from http://itfacoalition.org/

Jardine, M., Owens, J., & Sanger, C. (2014). Addressing Base Erosion and Profit Shifting in South Africa. *Davis Committee Interim Report*, 1–39.

Lau, C., & Halkyard, A. (2003). From E-Commerce to E-Business Taxation. *Asia-Pacific Tax Bulletin*, (January 2003), 2–13.

Laursen, A. N. (2010). Permanent Establishment – an Analysis of Article 5 of the OECD Model Tax Convention, *94*(2009).

Lee, S.-H. (2006). Price Competition between online and offline firms in an electronic commerce market and discriminatory taxation. *Hitotsubashi Journal of Economics*, *47*, 37–49.

Mclure, C. E. (2015). National Tax Association. *National Tax Journal*, *50*(4), 731–749. Retrieved from http://www.jstor.org/stable/41789713

OECD. (2001). *The Impact of the Communications Revolution on the Application of “Place of Effective Management” As a Tie Breaker Rule*. Retrieved from http://www.oecd.org/ctp/treaties/1923328.pdf

OECD. (2002). *Measuring the Information Economy*. Retrieved from http://www.ingentaconnect.com/content/oecd/16080270/2002/00002002/00000014/9202151e

OECD. (2003). Articles of the model convention with respect to taxes on income and on capital. *OECD Model Tax Convention*, (January).

OECD. (2013). Action Plan on Base Erosion and Profit Shifting. *OECD Publishing*, 43. Retreived from http://doi.org/10.1787/9789264202719-en

OECD. (2014). Public Discussion Draft BEPS action 1: Address the tax challenges of

ISBN 978-0-620-74761-5

the digital economy. *Public Discussion Draft*, (April). Retreived from https://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf

OECD. (2015). South Africa and the OECD. Retrieved July 18, 2015, from http://www.oecd.org/southafrica/south-africa-and-oecd.htm

OECD Committee on Fiscal Affairs. (2000). *Clarification on the application of the Permanent Establishment definition in E-Commerce: Changes to the Commentary on the Model Conventin on Article 5*.

Parsons, S. (2014). What is Bitcoin? The potential tax consequences of transacting in virtual currency in South Africa. *Southern African Accounting Association 2014 annual conference*.

South African Revenue Service. (2002). *Interpretation Note: No.6: Resident: Place of effective management (persons other than natural)* (Vol. 1962).

Strydom, B., & Hare, R. (2014). South Africa's VAT changes: the impact on e-commerce, (February), 16.

The Australian Government Treasury. (2013). *Risks to the Sustainability of Australia ' s Corporate Tax Base*.

Young, N. (2012). The Effect of Global E Commerce on Taxation Legiuslation and The Permanent Establishment Concept in South Africa. *International Journal of Economics and Finance*, *3*, 10–12.

Zodrow, G. R. (2003). Network Externalities and Indirect Tax Preferences. *Kluwer Academic Publishers*, 79–97.