AN EXAMINATION OF THE CHALLENGES POSED BY THE INTERNET ECONOMY FOR THE SOUTH AFRICAN INCOME TAX REGIME

by

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DEDICATION

This thesis is dedicated to my mother Philister Achieng' and my lovely wife Lavender Adhiambo, to whom I owe everything.

DECLARATION

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AN EXAMINATION OF THE CHALLENGES POSED BY THE INTERNET ECONOMY FOR THE SOUTH AFRICAN INCOME TAX REGIME

I declare that the above thesis is my own work and that all the sources I have used or quoted have been indicated and acknowledged by means of complete references.

I further declare that I have not previously submitted this work, or part of it, for examination at Unisa for another qualification or at any other higher education institution.

I further declare that I submitted the thesis to originality checking software and that it falls within the accepted requirements for originality.

Signature: Date: 15th May 2022

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KEY TERMS

Base, cyberization, Base erosion, Cryptocurrency, Cyberspace, Digital economy, Digital tax, E- signature, E-commerce, Formulary Apportionment, GloBe, Nexus, Physical presence, Pillar one, Pillar two, Republic, Residency, Significant economic presence, Simplifying Conventions, Specified service, Taxable presence, Taxpayer, The Income Tax Act, Transfer pricing, Unified Approach, Virtual currency.

ABSTRACT

The way of doing business has changed significantly since the turn of this century due to the growth of internet technology and the global digital economy. This growth has reduced the importance traditionally attached to tangible assets and physical location in both commerce and taxation. This implies that any country that relies on physical presence to trigger tax liability in today's digital economy may be forced to reconsider the relevance, effectiveness, and efficiency of its income tax legislation.

This thesis postulates that South Africa's income tax law and the international taxation principles it relies on in taxing cross-border and digital transactions have not grown in tandem with the changing landscape of today's digital economy. The thesis contends that South Africa will not receive its fair share of tax from giant multinational enterprises such as Google, Facebook, and Amazon which operate and trade in the country, if it does not amend its income tax laws to address the challenges posed by the internet economy.

In examining the challenges posed by the internet economy to South Africa's income tax regime, the thesis commences in Chapter 2 by discussing the growth of the digital economy and its implications for South Africa's income tax system. Chapter 3 offers a critical analysis of South Africa's income tax laws and the international principles on which they rely in taxing the digital economy. Chapter 4 discusses the measures that South Africa's government has taken to tax its digital economy, while Chapter 5 compares how the Organization for Economic Cooperation and Development (OECD), the European Union (EU), Kenya, India, and New Zealand have dealt with the issue of taxing the digital economy and the lessons to be learned from these jurisdictions. The thesis concludes in Chapter 6 by proposing recommendations that South Africa could consider to make its income tax regime more efficient and effective in taxing transactions that take place in today's digitised economy.

LIST OF ACRONYMS

ATAF	African Tax Administration Forum
BEPS	Base Erosion and Profit Shifting
CBDC	Central Bank Digital Currency
CFC	Controlled Foreign Company
CGT	Capital Gains Tax
CIR	Commissioner of Inland Revenue
CSARS	Commissioner of the South African Revenue Service
DST	Digital Service Tax
ECTA	Electronic Communications and Transactions Act
EL	Equalization Levy
EU	European Union
FIC	Financial Intelligence Centre
FSCA	Financial Sector Conduct Authority
G-20	Group of Twenty countries comprising 19 countries and the EU
GDP	Gross Domestic Product
GILTI	Global Intangible Low-taxed Income
IFWG	Intergovernmental Fintech Working Group
IN	Interpretation Note
ICT	Information and Communication Technology
IoT	Internet of Things
IRC	Internal Revenue Code
ISP	Internet service provider
KRA	Kenya Revenue Authority
MNE	Multinational Enterprise
NZIR	New Zealand Inland Revenue
OECD	Organisation for Economic Cooperation and Development
OEEC	European Economic Cooperation
PE	Permanent Establishment
PEM	Place of Effective Management
POPI	Protection of Personal Information
SARB	South African Reserve Bank
SARS	South African Revenue Service

SEP	Significant Economic Presence
TFDE	Task Force on Digital Economy
UA	Unified Approach
UK	United Kingdom
USA	United States of America
VAT	Value Added Tax
VCs	Virtual currencies

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CHAPTER 1
GENERAL INTRODUCTION

1.1 Introduction and Background

Internet technology has radically transformed the world and the way people do business. This technological revolution,[1] has altered the way we live, trade, and collect tax from business enterprises and individual taxpayers. It has also posed questions on the relevance of geographical boundaries in determining the tax liability of persons. To survive this phenomenon, South Africa may require creativity and intense innovation in the way it models its tax laws and policy. If this does not happen the country's ability to collect tax and realise its tax targets may be greatly hampered or diminished.

The internet[2] has continued to drive innovation and business enterprises to new levels where almost every product or service available for sale or purchase is digitised. According to a survey carried out by the consultancy firm, Accenture, to understand the impact of internet technology on today's business enterprise,[3] it emerged that 62% of business enterprises and industries intend investing in digital technologies, while 35% have already comprehensively invested in digital technology.[4] This is a clear pointer to tax authorities that the future of doing business in most countries, South Africa included, lies in the internet. The government must,

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[1] This is the current trend of automation and digital development characterised by a range of technologies that have fused the physical and digital worlds to improve commercial trade through the use of mobile phones, artificial intelligence, robotics, nanotechnology, and related technological developments. It depends on the internet as its pivot of operation. It is also known as the industrial internet, digital technology, or digital economy. See definition in Valenduc G 'Technological revolutions and societal transitions' (2018) *Foresight Briefs* <file:///C:/Users/user/Downloads/Foresight-Brief_04_EN.pdf> 1 accessed 10 September 2022.

[2] Internet is shorthand for interconnected networks which form an international aggregation of computers and communication networks. See definition in Kahn ER and Vinton GC 'What Is the Internet (And What Makes It Work)?' <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/http://www.policyscience.net/cerf.pdf> 2 accessed 10 September 2022.

[3] Accenture Technology Vision 'Digital Business Era: Stretch Your Boundaries' *(*2015) <www.accenture.com> accessed 18 September 16.

[4] This grand network of connections and its transformative power is also known as the digital ecosystem. See definition in USAID 'Digital Ecosystem Framework' <file:///C:/Users/user/Downloads/Digital_Strategy_Digital_Ecosystem_Final.pdf> 2 accessed 10 September 2022.

therefore, ensure that its tax laws and policies are reviewed to keep up with this trend. It should also be able to tax all transactions in an internet economy.[5]

To show how the internet economy has grown, it is reported that in the 2012/2013 financial year income from the provision of internet services in South Africa rose by 8.6% to 35.1 billion Rand.[6] This figure grew eight-fold to 238 billion Rand in 2019.[7] Related studies in 2020 show that at least 70% of South African consumers shop online at least once a month.[8] This has brought the value of South Africa's e-commerce economy to some 3 billion United States (US) dollars. This increased online trade has been facilitated by smartphones which have made access to and the purchase of goods online far easier. Indeed, a study conducted in South Africa by the global research company, Ipsos, on behalf of PayPal, revealed that 70% of South Africa's internet users shop online or are expecting to shop online in future.[9] This explains why the value of goods transacted over the internet in South Africa has moved from 2.8 billion Rands in 2011 to 238 billion Rands in 2019. This figure was expected to grow at an average rate of between 13% and 20% annually.[10]

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[5] The Internet economy is an economy based on digital computing technologies. It enables people to conduct trade in goods and services through electronic commerce on the internet. It is also referred to as the digital economy, digital transactions, new economy, or web economy. This thesis uses the terms internet economy, digital transaction, digital economy, and digital economy interchangeably to mean the same thing. See Kahn ER and Vinton GC 'What Is the Internet (And What Makes It Work)?' <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/http://www.policyscience.net/cerf.pdf> 3-4 accessed 10 of September 2002.

[6] Evans J 'Income from Internet Services on the Rise' (2015) http://www.news24.com/SouthAfrica/News/Income-from-internet-services-on-the-rise-Stats-SA-20151005> accessed 28 September 2016.

[7] Independent Communications Authority of South Africa 'The State of the ICT Sector Report in South Africa' (2020) <https://www.icasa.org.za/uploads/files/State-of-the-ICT-Sector-Report-March-2020.pdf> accessed 4 December 2021.

[8] Deloitte 'Digital Commerce Acceleration Increased Online Purchases Present New Opportunities for Digital Commerce Players' (2021) <https://www2.deloitte.com/content/dam/Deloitte/za/Documents/strategy/za-Digital-Commerce-Acceleration-2021-Digital.pdf> accessed 14 December 2021.

[9] Study available at <www.itnewsafrica.com> accessed 17 May 2016.

[10] SARS 'Review Report E-commerce, Cybercrime and Cybersecurity – Status, Gaps and the Road Ahead' (2013) <www.sars.gov.za> accessed 12 August 2016. See also Deloitte 'Digital Commerce Acceleration Increased Online Purchases Present New Opportunities for Digital Commerce Players' (2021) <https://www2.deloitte.com/content/dam/Deloitte/za/Documents/strategy/za-Digital-Commerce-Acceleration-2021-Digital.pdf> accessed 14 December 2021.

In 2020 South Africa's internet economy contributed some 2.6% to the country's GDP.[11] This meant that the country's internet economy contribution to the GDP was marginally greater than that of the agricultural sector which, in 2020, stood at some 2.53%.[12] The fact that the internet economy has overtaken conventional sectors such as agriculture, which have been major contributors to the South African economy over the past years, is a wake-up call to the government to pay greater attention to the taxation issues of this sector.

Looking ahead, there is more to come from the internet which is still in its infancy. While it accounts for 6% of GDP in countries like the United Kingdom,[13] it contributes only some 2.5% to South Africa's GDP. This has left tremendous space for growth which could impact positively on the country's tax base once the potential of this 21st century phenomenon is fully realised. Therefore, it is clear that the growth and spread of the internet is a force that is likely to transform the South African economy by providing it with an engine for economic growth. This anticipated ~~disruptive~~ growth is put into perspective by reports that the internet economy would be worth 103 billion Rand by 2020.[14] In reality, however, the South African economy has seen a decline in GDP growth since 2010, with the economy growing by only 1.3% in 2015 as compared to the country's inflated growth target of 5.4%.[15] This flat growth

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[11] UNCTAD 'Digital Economy Report:2021' (2021) <der2021_en.pdf> accessed 30 May 2022. E

[12] Data obtained from <https://www.statista.com/statistics/371233/south-africa-gdp-distribution-across-economic-sectors/> accessed 30 April 2022. See also Arthur G 'Internet Matters: A Quiet Engine of the South African' <https://admin.hsf.org.za/publications/focus/focus-66/AGoldstuck.pdf> accessed 10 May 2017.

[13] McKinsey Global Institute 'The Great Transformer: Impact of the Internet on Economic Growth and Prosperity' <https://www.mckinsey.com/~/media/McKinsey/Industries/High%20Tech/Our%20Insights/The%20great%20transformer/MGI_Impact_of_Internet_on_economic_growth.ashx> accessed 28 May 2018.

[14] Business Report 'The Internet of Things: SA Opportunity on a Knife Edge' <https://www.iol.co.za/business-report/opinion-the-internet-of-things-sa-opportunity-on-a-knife-edge-11115046> accessed 2 June 2018. This growth projection was not realised because of the disruptions that were caused by the Covid-19 pandemic. The value of South Africa's e-commerce market stood at 30 billion Rand in 2020 and increased phenomenally to 72 billion Rand in 2021. Data obtained from <https://ecommercedb.com/en/markets/za/all> accessed 31 March 2022. The country's failure to realise the projected e-commerce growth was attributed to unemployment and the contraction in the country's economy resulting from the government's decision to offer 383 billion Rand Covid-19 rescue packages to support the country's weakest households and enterprises to weather the Covid-19 pandemic.

[15] Gordon Institute of Business Science 'Transforming South African' <https://www.gibs.co.za/news-events/news/PublishingImages/Pages/Transforming-South-African-Industry/17031%20Internet%20White%20Paper%203_Fweb(TSA).pdf> accessed 2 June 2018.

of 1.3% continued in 2017[16] but improved from one of its worst contractions (-6.4%) in 2020 to reach 4.9% in 2021.[17] The National Treasury projects that the economy will slow down and that GDP will grow by only 2.1% in 2022 and an average of 1.8% over the medium term.[18]

At the continental level, estimates of participation in trade through digital channels are low when compared to the rest of the world. This trend is, however, changing fast with recent studies showing that internet trade in Africa contributed 5.5% to the continent's GDP in 2020.[19] This is expected to grow to 5.2% and contribute some 180 billion USD to the continent's economy by 2025, and 712 billion USD by 2050.[20] From this it is clear that the internet economy is so huge that it could be the next engine to drive both South African and the global economies.[21] This unprecedented trajectory in the growth of the internet has led leading scholars like Gershenfied of the Massachusetts Institute of Technology to state that:[22]

> [T]he rapid growth of the World Wide Web may have been just the trigger charge that is now setting off the real explosion, as things start to use the Net.

These figures have also reinforced the author's argument that digital transactions could constitute a significant source of tax revenue for South Africa. It is, therefore, vital for the South Africa Revenue Service (SARS) and the government to ensure

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[16] Fin21 'GDP Growth in 2017 Better than Expected- Stats SA' (6 March 2018 edn) <https://www.fin24.com/Economy/gdp-growth-in-2017-better-than-expected-stats-sa-20180306> accessed 2 June 2018.

[17] Statistics South Africa 'The South African Economy Records a Positive Fourth Quarter' (2022) <http://www.statssa.gov.za/?p=15214> accessed 30 March 2022. See also Deloitte Insights 'South Africa: Betting on Foundational Changes for Higher Growth' (16 March 2022) <https://www2.deloitte.com/xe/en/insights/economy/emea/africa-economic-outlook.html> accessed 30 March 2022.

[18] National Treasury 'RSA 2022 Budget Highlights' <http://www.treasury.gov.za/documents/national%20budget/2022/review/FullBR.pdf> accessed 31 March 2022.

[19] McKinsey 'Lions Go Digital: The Internet's Transformative Potential in Africa' (2013) <http://www.mckinsey.com/insights/high_tech_telecoms_internet/lions_go_digital_the_internets_transformative_potential_in_afric> accessed 30 May 2018.

[20] International Finance Corporation 'e-Conomy Africa 2020: Africa's $180 billion Internet Economy Future' <file:///C:/Users/Admin/Desktop/e-Conomy-Africa-2020-Exe-Summary.pdf> accessed 31 March 2022.

[21] Boston Consulting Group 'The $4.2 Trillion Opportunity: The Internet Economy in the G-20' (2012) <http://www.impactoftheinternet.com/pdf/> accessed 16 May 2017.

[22] Post Capes 'History of the Internet of Things' <http://postscapes.com/2017> accessed 15 June 2018.

that South Africa’s income tax regime is sufficiently effective to tax internet-based transactions.[23] This would, in turn, ensure that no segment of the economy or taxpayers are permitted an unfair tax advantage over the rest of the economy or other taxpayers.[24]

This thesis examines how taxpayers can use the internet to limit their tax liability. A typical example is a current practice where taxpayers use the internet to create a virtual presence, residency, or fixed place of business [25] so making it difficult for SARS to identify them and determine their residency or physical location for tax purposes.[26] Taxpayers have also used the internet to create new routes to exchange goods and services without relying on or using physical shops. The country's income tax regime had, however, largely anticipated that the sale and purchase of goods and/or services would in the main take place through or with the aid of physical shops. The internet has, therefore, created a trading concept that allows taxpayers to move their residency to the low-tax jurisdiction of their choice.[27] These opportunities afforded to taxpayers by the internet to manipulate their residency or physical location have the potential of destabilising ability of SARS to levy tax on such transactions.[28] Whereas these tax avoidance practices[29] are frowned upon by civic minded citizens, the reality is that they are not illegal. This

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[23] OECD ‘Explanatory Statement, OECD/G20 Base Erosion and Profit Sharing’ (2015) <www.oecd.org/tax/beps-explanatory-statements-2015.pdf> accessed 23 May 2016.

[24] Accenture Technology Vision ‘Digital Business Era: Stretch Your Boundaries’ (2015) <www.accenture.com> accessed 18 September 2016. Failure to effectively tax the transactions of persons who trade over the internet would give those taxpayers an undue and undeserved advantage over other taxpayers who are diligently paying tax on all their transactions.

[25] Virtual presence, residency, or fixed place of business is defined as the place were an enterprise creates a presence through a website, a server, or by the adoption and application of internet technology in its transactions. See Tipmar *International Taxation of Electronic Commerce* 74.

[26] OECD ‘Request for Input Regarding Input on Work Challenges of The Digital Economy’ (2013) <www.oecd.org> accessed 23 February 2016.

[27] Cox ‘The Regulation of Cyberspace and Loss of National Sovereignty’ (2002) 11 *Information and Communication Technology Law* 241.

[28] Doernberg and Hinnekens *Electronic Commerce* 3.

[29] Tax avoidance refers to the practice by taxpayers of arranging their affairs within the provisions of the law to limit their tax liability. Tax avoidance involves utilising loopholes in tax laws and exploiting them within legal parameters. This is contrasted with tax evasion which is illegal and usually involves the non-disclosure of income, the rendering of false returns, and the claiming of unwarranted deductions. See Oguttu *Base Erosion* 17. See also Oguttu (2008) 20 *SA Merc LJ* 1.

was emphasised in the classic case of *Duke of Westminster v IRC,*[30] where the court stated that:

> Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Act is less than it would otherwise be. If he succeeds in ordering them to secure this result, then, however, inappropriate to the Commissioner of Inland Revenue or his fellow taxpayers, such a person cannot be compelled to pay an increased tax resulting from his ingenuity in limiting his tax exposure.

This decision of the court in *Duke of Westminster v IRC* makes it clear that a taxpayer is at liberty to use or take advantage of the internet to limit his or her tax liability.[31] The state can, however, control these tax avoidance practices by constantly updating and remodelling its income tax laws to deal with the challenges posed by the digital economy. This thesis examines some of the challenges that SARS is likely to face when taxing digital transactions under the Income Tax Act 58 of 1962 (as amended) (the Act). The discusses starts by analysing the specific taxation challenges that the digital economy has posed for the country's income tax regime. It then makes recommendations that the state could consider in improving its income tax regime to enable it tax digital transactions more effectively and efficiently.

1.2 History and Development of the Internet

The first computer network was developed by the USA Defence Department in the 1960s to enable the Department's computers to share data.[32] The success of the use of computers in the USA Defence Department persuaded the government to make internet usage available to researchers in academic institutions and research centres. The continued use and escalation in the usage of the internet over the years resulted in the development of rules and protocols that made it possible for

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[30] 51 TLR 467, 19 TC 490, 520. It is also reported in (1935) AII ER 259, 267. This view which legitimises tax avoidance was also adopted by Justice Centreville in his minority judgment in *CIR v Estate Kohler* 1953 (2) SA 584 (A).

[31] Lord Denning observed in *Re Weston's Settlements* [1968) All ER 338, 342 that tax avoidance may be lawful but it is not yet a virtue.

[32] Internet Society 'Brief History of the Internet' at 3 <https://www.internetsociety.org/wp-content/uploads/2017/09/ISOC-History-of-the-Internet_1997.pdf> accessed 2 June 2018.

computers in the USA to be connected to any computer in the world.[33] This phenomenal breakthrough, which resulted in an explosion in the expansion of the web of networks available, is what is today known as the internet. It has revolutionised how business is done in the world and made communication fast, cheap, simple, and reliable.

In the early 1990s, the rudimentary internet was improved by the introduction of a graphic interface termed a browse. This made it possible for one computer to be added to another computer in a different location.[34] This technological improvement resulted in a myriad of networks which made it possible for the internet to be used as a platform for e-commerce, distance learning, video conferencing, transfer of money, internet banking, and other related actions. Once the internet became available to the public, it took only four years to realise a global audience of 50 million users.[35]

In 2011 South Africa had approximately 8.5 million internet users who contributed some 2% to its GDP.[36] The number of internet users grew to about 19.9 million by 2016 of whom some 8.3 million were active e-shoppers.[37] It is impossible to quantify the value of the entire internet economy in South Africa – there is no reliable data on this trading platform. However, available data indicates that the value of e-commerce trade in South Africa was about 12 billion Rand in 2015[38] which grew to 43 billion Rand in 2019[39] before hitting an all-time high of 42 billion Rands in 2021.[40]

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[33] A protocol is a standard used to define a method of exchanging data over a computer network such as a local area network, internet, or intranet. It uses a set of rules to send and receive a message at the internet address level.
[34] Internet Society 'Brief History of the Internet' at 3-4 <https://www.internetsociety.org/wp-content/uploads/2017/09/ISOC-History-of-the-Internet_1997.pdf> accessed 2 June 2018.
[35]Information available at <www.ecommerce.gov> accessed 29 April 2017.
[36]Boston Consulting Group 'The Connected World: The 4.2 Trillion opportunity' <http://image-src.bcg.com/Images/The_Internet_Economy_G-20_tcm9-106842.pdf> accessed 30 May 2018.
[37] Adheesh B 'E-Commerce Country Case Study: South Africa' (2017) Global Economic Governance Discussion Paper 7.
[38] UNCTAD 'Information Economy Report 2015 – Unlocking the Potential of E-commerce for Developing Countries' (2015) Geneva: UNCTAD.
[39] Policy Action Network 'South Africa's Digital Economy: The Changing Nature of Competition & Data Regulation' (2020) <https://policyaction.org.za/sites/default/files/PAN_TopicalGuide_AIData7_DigEco_Elec.pdf> accessed 31 March 2022.
[40] WorldWide Worx 'SA Online Retail Leaps to R 30 Billion' (12 May 2021) <http://www.worldwideworx.com/online-retail-in-sa-2021/> accessed 1 April 2022.

South Africa's e-commerce market could go much higher if business-to-business e-commerce and other forms of online presence are included in the available data. It is predicted that the internet economy in the country will grow to some 114 billion Rand by the year 2027.[41] This represents a compound annual growth of 9.83%.[42] This phenomenal growth in the e-commerce sector in South Africa is consistent with the Boston Consulting Group's predictions which indicated that the internet economy of the G20 countries, , would grow at an average rate of 8% thereby outpacing the traditional economic sectors such as construction and agriculture.[43] This clearly illustrates that the internet economy has transcended into the main economy where it will continue to have an impact on South Africa's GDP and the rate of its growth. It cannot, therefore, be ignored by government as a potential rich source of tax revenue.

Today, unlike in the recent past when one needed a personal computer, a phone, a modem, a telephone connection, and access to the browser[44] of a service provider[45] in order to share, buy, or sell one's products or services over the internet, a person today needs only a mobile telephone to access and use the internet.[46] This significant level of internet penetration and use is largely attributed to the availability and use of cellular phones (or mobile phones) in the country, which had reached 22.5 million users by 2017 when internet penetration in the country had reached the 40% mark and was growing.[47] The country's overall internet penetration and use

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[41] Research and Markets 'South Africa E-commerce Market (2022 to 2027) - Impact Analysis of Covid-19' (30 December 2021) <https://www.globenewswire.com/news-release/2021/12/30/2359147/28124/en/South-Africa-E-Commerce-Market-2022-to-2027-Impact-Analysis-of-COVID-19.html> accessed 31 March 2022.
[42] ibid.
[43] Boston Consulting Group 'The Connected World: The 4.2 Trillion Opportunity' (May 2018) <https://eizba.pl/wp-content/uploads/2018/07/BCG_3._Internet_Economy_G20.pdf> accessed 30 May 2018. See also Goldstuck ''Internet Matters: The Quiet Engine of the South African Economy' at 38-50 <AGoldstuck.pdf> accessed 30 May 2018. FIX BIB.
[44] A browser is a programme with a graphic user interface for displaying files used to navigate the World Wide Web.
[45] Doernberg and Hinnekens *Electronic Commerce* 3.
[46] ibid.
[47] World Wide Worx 'Internet Access in South Africa 2017' <http://www.worldwideworx.com/wp-content/uploads/2017/07/Exec-Summary-Internet-Access-in-SA-2017.pdf> accessed 28 May 2018.

was expected to hit the 60% mark by the year 2021.[48] Large retail traders in South Africa like Pick n Pay, Makro, and Mr Price encourage customers to purchase goods from their stores over the internet which are then delivered to the customers..[49] This saw the overall value of internet trade hit 7.5 billion Rand and shifted the expected value of online retail in South Africa from 12 billion Rand recorded in 2015 to 18 billion Rand by 2021.[50] The growth in the e-commerce sector is, therefore, a potential revenue stream that cannot be ignored by SARS if it wants to protect and grow the country's revenue base.[51]

1.3 Tax Challenges Posed by the Digital Economy

The following are some of the tax challenges in today's digital economy.

1.3.1. Jurisdiction to Tax Income of Natural Resident Persons

Income tax systems are often based on the taxpayer's country of residence. In a territorial system it is only income sourced from within the borders of a specific country that is subject to tax; while under a residential system (worldwide) the residents of a particular country are taxed on their worldwide (both local and foreign) income subject to the stipulated exemptions.[52] In line with the Steyn,[53] Margo,[54] and Katz Commissions' recommendations,[55] the government has retained the source basis of taxation to tax income derived by foreigners from a source within the

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[48] Ecommerce Foundation 'Global B2C E-commerce Report 2016' <https://www.ecommercewiki.org/wikis/www.ecommercewiki.org/images/5/56/Global_B2C_Ecommerce_Report_2016.pdf> accessed 8 August 2018.

[49] Adhesh B "E-commerce Country Case: South Africa" (August 2017) Discussion paper <file:///C:/Users/Admin/Downloads/GA_Th3_DP_Budhree_20170901.pdf> accessed 30 March 2022.

[50] United Nations Industrial Development Organisation 'National Report on E-commerce Development in South Africa' (2017) Department of Policy Research and Statistics Working Paper 18 <https://www.unido.org/sites/default/files/2017-10/WP_18_2017.pdf> accessed 30 March 2022.

[51] OECD 'BEPS Action 1: Address the Tax Challenges of the Digital Economy' (2014) <www.oecd.org> accessed 4 May 2017.

[52] Section 5 read with s 10 of Act 58 of 1962 as amended (the Act).

[53] Steyn Commission 'Report of the Commission of Inquiry into the Income Tax Act' (1951 Government Printer, Pretoria) para 68 at 19.

[54] Margo Commission "Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa" (1987 Government Printer Pretoria) para 26.3. See <www.sars.gov.za> accessed 27 April 2017.

[55] Katz Commission "Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa" (1997 Government Printer Pretoria) para 3.1.2.11. See <www.sars.org> accessed 27 April 2017.

country. South Africa has, therefore, adopted a hybrid tax system of taxation which adopts both the source and residential systems. This dual tax system has grown over the years through the introduction of the deeming provisions as to source, especially in regard to passive income.[56] Retention of this hybrid tax system has provided the country with an equitable and neutral tax system which ensures that non-residents operating in the South African economy pay tax at the same rate as their domestic counterparts.

The concept of 'a resident'[57] and the term 'residency' are the fulcrum around which a worldwide or residence-based system of taxation operates. This is because any person who is deemed or qualifies to be considered a resident is subject to tax in South Africa on all its receipts and accruals subject to certain exceptions.[58]
A resident is defined as a natural person who is ordinarily a resident in the Republic (South Africa), or an individual who meets the physical-presence test, or an individual who is ordinarily resident in South Africa under the South African common law.[59] A person is considered to have met the physical presence test if he or she is physically present in South Africa for a period or periods exceeding:[60]

a) 91 days in the aggregate during the year of assessment under consideration;

b) 91 days in the aggregate during each of the five years of assessment preceding the year of assessment under consideration; and

c) 915 days in the aggregate during the five preceding years of assessment.

A natural person who complies with all the requirements referred to above is a resident of the Republic for tax purposes for the year under consideration.

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56 Katz Commission 'Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1997 Government Printer Pretoria) para 2.1.5. <www.sars.org> accessed 27 April 2017.
57 Para (i) of the definition of 'gross income' in s 1 of the Act. As defined in s 1 of the Act.
58 Article 5 of SARS Interpretation Notes of 2014 (SARS-IN 4).
59 Section 1 of the Act.
60 Article 4.2 of SARS-IN 4.

The Act, however, does not define what constitutes an 'ordinary resident'. To fill this gap, the courts have stated that an individual shall be regarded as an ordinary resident of South Africa if his or her habitual and normal country of residence in which he or she resides with some degree of continuity.[61] Unlike an ordinary resident, the interpretation of a resident is provided for in section 1 of the Act. The court interpreted it *CIR v Kuttel,*[62] to mean the place to which a person would normally and as a matter of course return from his or her wanderings.[63] This has since become the benchmark for determining the residency of natural persons in South Africa. As much as the country generally applies a residence-based system of taxation, an element of the source principle has been retained in its tax practice. Section 5(1)(*c*) of the Act provides that any person shall pay tax in respect of any income received, or which accrues to him or her in any relevant year of assessment. The literal interpretation of this provision implies that even non-residents can be taxed on any income they may generate or be deemed to have generated within the country.[64]

The thesis argues that, while the definition of a resident and an ordinary resident is vital in determining tax liability, South Africa's decision to exclude the definition of these two terms in the Act may have contributed to the difficulties facing SARS in the taxation of internet-based transactions.[65] This is, in the main, because the there is a 'loophole' in the current income tax legal regime which allows taxpayers the opportunity to establish residency in low-tax jurisdictions by ensuring that they do not physically come to South Africa to meet the physical-presence test. For example, under the current law, taxpayers can limit their tax liability by visiting South Africa for a period of less than 91 days within a period of five consecutive years. They would instead keep in touch with their family members and business

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[61] The meaning of ordinary resident under s1(*a*)(*i*) of the Act was explained in *H v CoT* (1962) 24 SATC 738, where the court held that a person's ordinary residence is the taxpayer's real home where he or she has a permanent place of abode or where his or her belongings are stored. See William *Cases and Materials* 19.

[62] (1992) 54 SATC 298, 1992 (3) SA 242 (A).

[63] This was the *obiter dictum* of the court in an earlier case of *Cohen v CIR* (1946) AD 174, 13 SATC 362.

[64] Mosupa (2001) 9 *Juta's Business Law* 160.

[65] Parliamentary Budget Office 'Tax Brief: Digital Economy and Taxation Policy Considerations' (June 2020) <file:///C:/Users/Admin/Desktop/200609June_PBO_Brief_-_Digital_Economy_and_Taxation_Consideration-June_2020.pdf> accessed 29 August 2022.

associates in the country through video conferencing, e-mail communications, Skype, mobile telephone, and related digital resources. The business entity, which is the source of this individual's income, would also be physically retained in a low-tax jurisdiction and managed by digital technology from within the Republic. A literal reading of section 5(1) of the Act provides that such an individual would be deemed to be a non-resident of South Africa and the source of his or her income would also be regarded as a source outside the country. It would therefore not be possible for SARS to levy tax on such a transaction irrespective of the taxpayer concerned having been present in the country at various stages during the relevant year of assessment.

This thesis also argues that despite the prevalence of the internet in almost all facets of trade and service payments in South Africa, the definition of a resident under the Act has failed to prescribe what level of internet communication or interest in South Africa will lead to the user being deemed a resident of South Africa and so liable to be taxed on any income earned from such internet activities. If the Act has not provided for the possibility of taxing such transactions so allowing those who use internet-related services such as video conferencing and e-mail to avoid establishing a physical presence in the country, South Africa may already be experiencing severe income base erosion from digital transactions. This thesis examines this assertion and if found to be true, recommendations that the country could consider adopting to reverse this negative trend are proposed.

1.3.2. Jurisdiction to Tax Income of Non-Natural Persons

Persons other than natural persons[66] are taxed on any income earned in South Africa if they meet any of the following requirements:[67]

a) if the artificial entity is incorporated in South Africa;
b) if the artificial entity is formed or established in South Africa; or
c) if the artificial entity has its place of effective management (PEM) within the country.

[66] Also known as artificial or non-natural persons.
[67] This is consistent with the definition of a resident in s 1(*b*) of the Act.

Whereas it is easy to determine whether the artificial entity has been incorporated, formed, or established in South Africa, determining an artificial entity's PEM is a different matter. A company's PEM is the place where the key management and commercial decisions necessary for the conduct of its business as a whole are in substance made.[68] The situation is further complicated by the fact that the Act does not define what amounts to a PEM. This has compelled SARS to rely on the definition ascribed to the term in the Organisation for Economic Co-operation and Development Model Tax Convention on Income and Capital (OECD Model Tax Convention)[69] which defines PEM as the place where the most senior person or group of persons (e.g., a board of directors) makes its decisions, the place where the place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made.[70] South Africa's decision to align its definition of PEM with that of the OECD was affirmed by the decision of the Constitutional Court in *the Oceanic Trust Co Ltd NO v Commissioner for South African Revenue Service*,[71] where, as regards the meaning of the term PEM, the court concurred with the decision of the England and Wales Court of Appeal in *Commissioner for Her Majesty's Revenue and Customs v Smallwood and Another*[72] where it was held that the term PEM of a trust is where the key management and commercial decisions necessary for the conduct of the entity's business are in substance made.

This thesis argues that this definition of PEM has not necessarily kept pace with the reality of the digital economy. This is supported by the fact that internet technology has made it possible for globe-trotting directors to manage and give directions on the management of their companies from any part of the world. At the same time, most companies hold their board meetings via Skype, Zoom, Microsoft Teams,

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68 Article 4.1 of SARS-IN 6 of 2015.
69 OECD 'Commentaries on the Articles of The Model Tax Convention' Commentary on Article 4 para 3 s 24 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 20 September 2016.
70 Article 4(3) of the OECD Model Tax Convention read with Article 4.1 of SARS-IN 6.
71 (2012) 74 SATC 127 (WCC).
72 [2010] EWCA Civ. 778, 48.

Google Meet, or video conferencing to reduce travel expenses and save time.[73] Considering that these directors could be stationed in different countries all over the world, it would be difficult to determine the exact PEM for such a company.

In addition, Article 4.2.2 of the SARS IN 6 provides that:

> A company's board may delegate some or all of its authority to one or more committees such as an executive committee consisting of key members of senior management. In these situations, the location where the members of the executive committee are based and where that committee develops and formulates the key strategies and policies for formal approval by the full board will often be considered the company's place of effective management.

Whereas the objective of this Note was to provide guidance on the interpretation and application of the term 'PEM' in determining the tax residence of a company,[74] the reality of today's digital world has posed a serious challenge. This is attributed to the fact that the internet has made it possible for key senior members of a company's management to develop and formulate key strategy and policy decisions that affect the company while they are based in low-tax jurisdictions. If the company was not incorporated, established, or formed within the Republic,[75] SARS would have no jurisdiction to tax the profits of the company as it does not have its PEM within the country. This thesis explores ways through which the definition of a resident other than a natural person under the Act and the term 'PEM' in SARS IN 6 can be better constructed to control tax avoidance practices by taxpayers who are adept at manipulating internet technology to achieve their selfish goals.

From the preceding discussion it is clear that the current concept of PEM relies more on physical location than on virtual presence. It can, therefore, be easily manipulated by directors who opt to carry out most of their management work of an entity over the internet. The OECD has also acknowledged the weaknesses in its

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[73] Doodle 'State of Meetings 2021' (April 2021) 4 <https://assets.ctfassets.net/p24lh3qexxeo/3TarXcEbnPXd2waEzY3rIM/5b4111f7bcb99f1954a1575340c7d31f/SoM_2021.pdf> accessed 26 August 2022.
[74] Article 1 of SARS-IN 6.
[75] Section 1 of the Act defines a 'resident' as a 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 of South Africa.

interpretation of this term and argued that the current definition of a PEM is not sustainable in the current world communication and technological revolution.[76] The OECD has recommended that the interpretation of the term PEM should be refined or an alternative interpretation should be applied to deal with the various challenges posed by digital technology.[77]

The South African government, too, has acknowledged the shortcomings of relying on the current definition of PEM to tax digital transactions.[78] It has, instead, proposed that use of internet technology in commercial transactions should be included in the list of the relevant facts and circumstances to be considered when determining an entity's PEM.[79] It is hoped that this approach will make it possible for the country to tax digital transactions using the PEM principle. This would also limit directors of international digitally-based enterprises from making a convenient decision on when to use or apply the PEM principle in their transactions. A good tax principle ought to apply to all transactions as a yoke that is pre-determined and fixed by the law instead of the current situation where the PEM principle applies to taxpayers as a matter of choice.

This thesis offers proposals on how the PEM principle can be applied or reformed to incorporate the reality of today's internet-based economy.

1.3.3 Cloud Computing Transactions

Cloud computing is the practice of using a network of remote servers hosted on the internet to support the storage of data or the sale and purchase of goods or services over a virtual network (the internet), rather than a local server or a personal computer.[80] In cloud transactions, end-users are granted network access to cloud

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[76] OECD 'Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention' (2003) <www.oecd.org> accessed 25 September 2016.
[77] Ibid.
[78] SARS 'Discussion Paper on Interpretation Note 6: Place of Effective Management' (September 2011) <https://www.sars.gov.za/wp-content/uploads/Legal/DiscPapers/LAPD-LPrep-DP-2011-02-Discussion-Paper-POEM-on-IN6.pdf> accessed 25 September 2016.
[79] ibid.
[80] Price WaterhouseCoopers 'How Does One Tax the Cloud? (2012) <www.pwc.com> accessed 12 May 2016.

infrastructure which is made available by Cloud Service Providers (CSPs) to buy or sell goods and services.[81] Through the cloud, the internet has established a platform where cloud activities and services can be accessed and consumed from anywhere in the world.[82] The cloud computing transactions have supported multinational companies such as Mobile Telephone Network (MTN), Google, Napster, International Business Machines (IBM), and Orange. These transactions include infrastructure leasing, voice-over internet protocol services like Skype and Google voice, social applications like Facebook, Twitter, and LinkedIn, media services like YouTube, e-mail services, website hosting services, and online retailer services for goods and services to sell their goods and services all over the world relying on a permanent internet server of a single country.[83] These transactions have steadily increased the volumes of revenue moving through the cloud worldwide.[84]

As companies and individual taxpayers' race to embrace cloud-based business, the government must find ways of taxing these transactions. This is mainly because the cloud is virtual and borderless. It may, therefore, be difficult for SARS to pin down and tax any income earned from the cloud.[85] This difficulty arises because South Africa's tax system is largely based on the jurisdictional location or the physical presence of a taxpayer.

The OECD has argued that cloud transactions are not beyond the ambit of tax authorities because it is the server[86] which creates a permanent establishment[87] for

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[81] A cloud service provider provides information technology capabilities that determine the service model. See also PricewaterhouseCoopers, ibid.

[82] Bradshaw, Millard and Walden (2011) 19(3) *International Journal of Law and Information Technology* 187-223.

[83] Maaref 'Cloud Computing in Africa: Situations and Perspective' (2012) <https://www.itu.int/ ITU-D/treg/publications/Cloud_Computing_Afrique-e.pdf> accessed 18 August 2016.

[84] Ernst and Young 'Cloud Taxation Issues and Impacts' (2015) <file:///C:/Users/ Admin/Downloads/cloud-taxation-issues-and-impacts-ey-united.pdf> accessed 23 December 2016.

[85]Joubert B 'Tax Implications of Cloud Computing (2012) <http://deloitteblog.co.za> accessed 3 August 2016.

[86] A server is a computer programme or a device that provides functionality for other programmes or devices. It has also been defined as computer networked to the Internet which enables businesses, inter alia, to post websites and sell goods or services over the Internet. See Fei Hu *et al* (2011) 19(1) *Journal of Computing and Information Technology* 219-220 <hrcak.srce.hr/file/100837> 3 accessed 23 May 2016.

[87] A permanent establishment is generally defined as: "A fixed place of business through which the business of an enterprise is wholly or partly carried on and is required for a country subject to a treaty

cloud transactions.[88] Consequently, it is the country where the server is situated that has the right to tax cloud transactions that may arise from the use of that server. The evolving view of the OECD proffers that a server must be located at a particular place for a period of at least three years for it to be regarded as having created a place of establishment (PE) in a host jurisdiction.[89] This view ignores the fact that multinational enterprises can easily manipulate their tax jurisdictional location by ensuring that the servers on which they rely to carry out trade in South Africa are located in a preferred low-tax jurisdiction or in the cloud.

Similarly, a taxpayer can ensure that his server does not meet the three elements required of any server before it is deemed to be a permanent establishment in any transaction by constantly moving or changing the server that it uses for its commercial transactions.[90] This way no particular server used for its transactions in South Africa can be deemed to have been located in South Africa with some degree of permanence.

The OECD's proposal of identifying the location of a server to aid member countries in the taxation of cloud computing transactions did not consider the reality of the internet economy, and more so that cloud computing transactions do not require a local server or a person in its operations.

South Africa's Constitution dictates that courts should prefer an interpretation of the legislation that is consistent with international law like the OECD Model

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to tax the business profits of non-residents. To have a Permanent establishment, a non-resident has traditionally had to have a physical presence in the jurisdiction in question." This definition of permanent establishment as prescribed by the OECD has been adopted by South Africa in section 1 of the Act. See Chaffey A *Permanent Establishment Dilemma in the Digital Economy* (Minor Dissertation, Faculty of Economic and Financial Sciences, University of Johannesburg, March 2014 at 21).

[88] Articles 5(1) and 7(1) of the OECD Model Tax Convention.

[89] OECD 'OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment*)'* (2013) <http://www.oecd.org> accessed 24 December 2016.

[90] Article 5(1) of the OECD Model Tax Convention. These three elements as contained in the OECD Model Tax Convention are that there must be a place of business, the place of business must be fixed, and the business of the enterprise must be carried on through this fixed place of business.

Convention.[91] This means that whereas international law has a special place in South Africa's constitutional system as an interpretive aid, it does not give it the same status as that of its domestic laws. Nevertheless, courts would easily resort to international law to aid it in filling gaps that maybe present in domestic laws or to bring clarity to domestic laws that are ambiguous.[92] Any international law that is adopted to fill any gaps in the Act will be deemed to form part of the country's domestic laws.[93]

It is therefore possible that the absence of an express taxing provision for cloud-based transactions could lead a court to adopt the OECD's interpretation that the country of jurisdiction in such a transaction would be the place where the server is situated.[94] Consequently, South Africa would also end up adopting the inadequacies and challenges that the OECD's Model Tax Convention has faced in its attempt at taxing cloud-based transactions.

This thesis further posits that the OECD Model Tax Convention was not designed to provide adequately for the taxation of a modern-day digital development like cloud computing transactions. It, for example, did not anticipate that a time would come when a server would become a mobile instrument whose location could easily be moved by a taxpayer to manipulate his or her residency[95] thereby limiting his or her tax liability.[96]

The current OECD guidelines which provide that a server can be used to determine the residency of a digital enterprise also fail to address the following issues which are likely to create taxation loopholes:

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[91] Section 233 of the Constitution of the Republic of South Africa, 1996.
[92] *Glenister v President of the Republic of South Africa and Others* [2011] CCT 48/10 ZACC 6 paras 97, 98
[93] ibid para 102.
[94] Articles 5(1) and 7(1) of the OECD Model Tax Convention.
[95] OECD 'Dismantling the Barriers to Global Electronic Commerce' (1997) <http://www.oecd.org/LongAbstract/> accessed 26 September 2016.
[96] Fei Hu *et al* (2011) 19(1) *Journal of Computing and Information Technology* 219-220 <hrcak.srce.hr/file/100837> accessed 23 May 2016.

a) Coming up with a definite outline or guidance to SARS on when or at what point a cloud transaction could be deemed to have been concluded and so be taxable. Is it:
    i. at the point where the service is accessed by a taxpayer;
    ii. at the point when the transactions interact with the server; or
    iii. where the server is located irrespective of the location of the owners, directors or senior managers of the service provider?
b) Providing guidance on what happens if a taxpayer opens several similar websites to direct customers to different servers which are located out of the jurisdiction.[97] Which server would the tax authority rely on as the permanent establishment of that entity especially if the server catering for a South African business is established out of the jurisdiction?
c) Providing clarification on whether a server that is used to display products can constitute a PE if the server used to order products is located outside South Africa.
d) Giving better particulars on what it means by its assertion that a PE shall be created even if only some of the functions are performed through a server.[98] The clarification sought here is regarding what the threshold of the functions required to be carried through a server to create a PE would be.

The existing income tax regime is also unclear on whether a cloud computing transaction:

a) is a taxable or non-taxable service;

b) is a data processing or an information service;

c) is a transaction falling under the Act or whether it falls under other tax statutes such as the Value Added Tax Act (VAT Act);

d) is a lease of tangible personal property or is a lease of an intangible asset; or

e) can create a *nexus* in a specific state (preferably South Africa) for purposes of taxation of cloud income.

[97] Oguttu and Tladi (2009) 4(3) *Journal of International Commercial Law and Technology* 219-220.
[98] OECD 'Commentaries on the Articles of The Model Tax Convention' Article 5 para 42.6.

Clarification on these issues would help taxpayers and SARS easily to establish when, where, and how each portion or aspect of a cloud computing transaction would be taxed. The introduction of the Draft Cloud Policy in 2021 offers a ray of hope in this regard as it seeks to align the proposed South African developments with the Fourth Industrial Revolution **(**4IR**)** and global trends, particularly the OECD Framework and standards adopted in the European Union where data is viewed as a strategic asset.[99] Once it is finalised, the policy will also apply to foreign multinational companies investing in the digital marketplace. It is also proposing the review of the Electronic Communications and Transactions Act 25 of 2002 (ECTA) to align it with cybersecurity policy and legislation.

This thesis proposes ideas which could be included to eliminate the uncertainties which make it difficult for the South Africa's income tax framework to tax cloud computing transactions effectively.

1.3.4 E-Commerce

The Internet has made it possible for consumers to buy and sell goods or services from anywhere in the world regardless of where the seller or the buyer is located[100] through a process known as 'electronic commerce', or more colloquially, 'e-commerce'.[101] E-commerce[102] transactions are often efficient and instantaneous, which has made them attractive and lucrative for both the ordinary businessmen working from home and global companies. They have also provided the world with a platform where people can do business with little or no physical contact or activity.[103] Typical examples of e-commerce transactions include shopping for

[99] Department of Communications and Digital Technologies 'Draft National Policy on Data and Cloud' *Government Gazette* 44389 of 1 April 2021.
[100] OECD 'Report on Empowering E-consumers' (2009 Volume 6) <www.oecd.org> accessed 21 May 2016.
[101] Doernberg *et al Electronic Commerce* 3.
[102] 'E-commerce' is a term used to describe the wide array of commercial activities performed by electronic means which enable trade without the confines of geographical boundaries. It is defined as commercial activities which are conducted using computers interconnected by telecommunication lines and, more simply, as business transactions conducted over the Internet. See Oguttu and Tladi (2009) 20(1) *Stell LR* 80.
[103] ibid.

products and paying for them over the internet; accessing, paying, and downloading movies or music online, and making online bookings for accommodation and travel.

E-commerce grew rapidly in South Africa and by 2017 sales from online retail were estimated to be worth about 10 billion Rand.[104] This figure rose to 45 billion Rand in 2018[105] and it is projected to reach 128 billion in 2022.[106] This phenomenal growth in South Africa's e-commerce trade has placed it above Nigeria and Portugal as the 37th largest e-commerce market in the world.[107] Whereas this growth has created several opportunities for traditional businesses in the country, it has also created some challenges. This thesis examines the challenges that SARS faces as it levies tax on e-commerce transactions while relying on the well-established principle of permanent establishment, PEM, and the Controlled Foreign Companies provisions in the Act.

1.3.4.1 The principle of Permanent Establishment

The general principle is that before any country can levy an income tax, a connection or tax *nexus* must be established between that income and itself.[108] Tax *nexus* is established by the location of the property in the taxing state, residency of the taxpayer, nationality of the taxpayer or source of the income. It is an established principle of international law that the profits of any entity are only taxable in that state unless they are attributed to 'a permanent establishment' (PE) located in the source country.[109] The concept of PE is, therefore, significant because it is the only

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[104] Goga S, Paelo A and Nyamwena J 'Online Retailing in South Africa: An Overview' (March 2019) <https://static1.squarespace.com/static/52246331e4b0a46e5f1b8ce5/t/5cd008fcb208fc5e822f92c2/1557137668486/IDTT+2+eCommerce+1+Research+Report+2.pdf> accessed 2 February 2022.

[105] South African Institute of International Affairs 'The Digital Economy and Ecommerce in Africa – Drivers of the African Free Trade Area?' (Special Report 2019) <https://media.africaportal.org/documents/The-digital-economy-and-ecommerce-in-Africa_Special-Report.pdf> accessed 5 February 2022.

[106] Data obtained at <https://www.statista.com/outlook/dmo/ecommerce/south-africa> accessed 6 February 2022.

[107] eCommerce DB "The eCommerce Market in South Africa' <https://ecommercedb.com/en/markets/za/all> accessed 6 February 2022.

[108] Danziger *International Income Tax* 17-18 and 46.

[109] Oguttu (2009) 21 *SA Merc LJ 213-223.*

way through which a source country can tax income that is realised in a different jurisdiction.[110]

The concept of a PE is defined in section 1 of the Act to mean the definition that is ascribed to it under Article 5 of the OECD Model Tax Convention on Income and on Capital. The OECD Model Tax Convention defines it as:

> a fixed place of business through which the business of an enterprise is wholly or partly carried on.

The OECD definition of what constitutes a PE makes it clear that the following three elements must be in place for PE to be realised:

a) there must be a place of business;
b) that place of business must be fixed; and
c) the business of the entity must be carried out through this fixed place of business.

These elements in the definition of what constitutes PE are heavily reliant on the place of business, geographical presence, and the physical presence of the entity within the Republic. This requirement of a fixed place of doing business faces challenges when trade is conducted through e-commerce which has dismantled the feasibility, relevance, and legitimacy of laws based on fixed places or geographical boundaries. This is because e-commerce may make it difficult to identify a taxable presence in South Africa thereby rendering the requirement of a fixed place of business insignificant when trade is conducted over the internet.[111] For example, both individuals and companies can accomplish much of their sales and related business activities via a website that transfers transaction costs to customers thereby eliminating the necessity of having intermediaries or subsidiaries that can attract tax liability in a given jurisdiction.[112] In practice, multinationals can centralise and minimise their tax liability by creating internet platforms that can allow their customers to select products for purchase from an online catalogue and buy them

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[110] Oguttu (2009) 4(3) *Journal of International Commercial Law and Technology* 213-223.
[111] Johnson and Post (1996) 48 *Stanford Law Review* 1367, 1370-1371.
[112] Shapiro 1998 *Ohio North University Law Review* 795.

by completing a form and charging the purchase on their credit cards. These internet platforms do not require fixed places of business within the source countries. They, therefore, allow multinational firms with existing PEs in other countries an opportunity to limit their tax exposure within the intermediary countries.[113]

From the foregoing it is apparent that the traditional elements that are centred on a fixed place of business which is part of the current definition of a PE are wholly inadequate to deal with the phenomena of e-commerce which creates difficulties in the identification and location of taxpayers, taxable transactions, and the ability to establish a connection between taxpayers and their taxable transactions.[114] If not addressed, the current tax regime which relies heavily on physical and geographical boundaries through the concept of PE, could lead to serious base erosion and profit shifting of the country's rightful tax to other jurisdictions.[115]

This thesis examines whether the current South African income tax regime can deal with these problems and other emerging issues surrounding the taxation of e-commerce business profits. Some of the emerging challenges posed by the PE concept in the current e-commerce environment include but are not limited to, the following:

a) whether a website can constitute a PE;
b) whether an Internet Service Provider (ISP) can constitute a dependent agent PE;
c) whether a server can constitute a PE;
d) whether the physical location of an enterprise that is engaged in electronic commerce is the place of jurisdiction or is this rather the location of the server or the location of the purchaser of services or goods;
e) whether income generated by electronic commerce transactions is categorised as sales income, royalties, rental income, or income from services. The response to this question is central in determining how the revenue realised is to be taxed; and

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113 Oguttu and Tladi (2009) 4(3) *Journal of International Commercial Law and Technology* 216.
114 Buys and Cronjé *Cyberlaw* 307.
115 Oguttu and Tladi (2009) 4(3) *Journal of International Commercial Law and Technology* 216.

f) how income and deductions should be allocated among various parts of a multi-jurisdictional enterprise engaged in electronic commerce.

1.3.4.2 The Principle of the Place of Effective Management

Residency is vital in determining a person's tax obligation in South Africa. The Act provides that a resident is liable to pay tax on income derived from South Africa, while non-residents are only liable for income tax on revenue earned from a source within South Africa.[116] A non-natural person is deemed a resident of South Africa if it is either incorporated in South Africa or has its PEM in South Africa.

The term PEM has not been defined in the Act even though it is very crucial in helping SARS to determine the residency of non-natural persons. SARS IN 6 (Issue 2) dated 3 November 2015 provides that the PEM of a company is the place where the key management and commercial decisions necessary for the conduct of the business as a whole are in substance actually made.

This thesis examines the application, relevance, and efficiency of the PEM principle in the taxation e-commerce transactions in South Africa's digital environment where multinational companies no longer have a fixed or identifiable location where their key management and commercial decisions are made.

1.3.4.3 Taxation of Controlled Foreign Companies

To control tax avoidance by South African residents who have an interest in a foreign company, South Africa enacted specific anti-tax-avoidance laws known as the Controlled Foreign Companies (CFC) Rules.[117] CFC rules are legal provisions which a country can use to prevent its corporate taxpayers from moving capital into mobile assets in offshore subsidiaries so that the income from those assets accrue outside the local jurisdiction of the country.[118] Legally, a CFC is defined as a foreign company in which one or more South African residents, directly or indirectly, hold

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[116] Definition of gross income in s 1 of the Act.
[117] Controlled Foreign Companies (CFCs) provisions are contained in s 9D(*e*) of the Act.
[118] Mcgowan and Thomson (2012) 14(1) *Practical European Tax Strategies* <www.sullcrom.com/files> accessed 25 August 2016.

more than 50% of the total participation rights of the company, or more than 50% of the voting rights in that foreign company which are held (or exercisable) directly or indirectly by one or more residents.[119] The CFC rules have long controlled or prevented unscrupulous taxpayers from shielding their offshore income from taxation in South Africa.[120]

The CFC provisions in the Act are primarily intended to ensure that income earned by a South African resident from a foreign company is taxed in the hands of the resident/shareholder on a current basis as if that income had been earned from a source within the country's borders.[121] The philosophy behind the CFC provisions is that they allow SARS to tax the residents who control the CFC on the assumption that the income from the CFC has been distributed to the shareholders from a source within the country. Such a taxation system which allows for taxation of income from a foreign source against the revenue of local shareholders or equity holders, would not have been possible in the absence of the CFC provisions.

The OECD supports the CFC legal regime as a workable method by which to control the transfer of passive income to low-tax jurisdictions rather than the profit of the CFC itself.[122] The CFC rules also proceeded on the premise that the directorship of a corporate entity can be easily established by consulting the incorporation documents of any company. This assists in the determination of whether a South African resident holds more than 50% of the total participation or voting rights in a foreign company. Some directors have, however, taken advantage of the internet age by assigning their voting or shareholder rights to offshore companies whose owners and directors are concealed in secret offshore financial systems to facilitate tax avoidance practices.[123]

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[119] Section 9D(1)(*e*) of the Act.

[120] OECD 'Controlled Foreign Companies Legislation' (1996) <www.oecd.org> 10 accessed 13 March 2016.

[121] Olivier and Honiball *International Tax* 429.

[122] OECD 'Studies in Taxation of Foreign Source Income: Controlled Foreign Company Legislation' (2000) <www.oecd.org> accessed 7 September 2016.

[123] Olivier and Honiball *International Tax* 435.

Moreover, the architecture of the CFC regime was grounded in the idea of physical presence. The existence of a physical location was vital in determining which companies could qualify as CFCs. The physical presence of a company with a controlling interest in a foreign company qualified the foreign company as a CFC. This definition did not foresee the emergence of a digital world in which companies would not require physical presence in order to buy or sell products in South Africa.[124] Today's networked world has diminished the importance and relevance of physical presence as a pre-requisite for doing business as shown by companies that use servers with a '.za' domain name while they are actually located outside South Africa.[125]

Despite its novelty, the reality is that most CFC anti-avoidance provisions were developed and designed to work before the advent of e-commerce when the jurisdictional right of taxation was based on the physical location of taxpayers or the geographical boundaries of a country. It is, therefore, possible that these CFC rules may not have been tailored to aptly deal with the virtual and anonymous nature of today's digital trade.[126] The outcome of this could be that the digital multi-national corporations may use internet technology to manipulate their business operations to move their income beyond the jurisdictional definition of a CFC. This thesis delves deeper into the application of these CFC rules in the taxation of digital trade in South Africa. It, thereafter, offers proposals on how the CFC rules could be amended or aligned to deal with the challenges of today's digital economy.

1.4 Statement of The Problem

Most individuals and multinational corporations today undertake their transactions over the internet. The revenue earned from South Africa's internet economy stood at 2.6 billion Rand in 2011.[127] This was predicted to grow to some 52 billion Rand

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[124] Cox (2002) 11 *Information & Communications Technology Law Journal* 244-245.
[125] Schulze (2006) 18 *SA Merc LJ* 33.
[126] Kau *South African Controlled Foreign Company Rules* <https://repository.nwu.ac.za/bitstream/handle/10394/37432/Molefi-Kau_N.pdf?sequence=1> accessed 23 November 2021.
[127] Deubert *E-commerce in South Africa* <https://www.grin.com/document/284115> accessed 23 December 2021.

by 2019 with a subsequent annual growth rate of 10% per annum.[128] The transaction value of the global digital commerce was valued at 26.7 trillion dollars in 2019.[129] This is a clear indicator that the internet economy has now reached a point at which it can be said to be competing robustly with the mainstream brick and mortar economy for trade and revenue sales.[130]

The critical problem I seek to answer is whether South Africa's income tax legal regime, which is based largely on a nexus system that requires the physical presence of a taxpayer in the country, can effectively tax these digital transactions. The other consideration is whether the country's reliance on the geographical location of a taxpayer can lead to tax avoidance and/or evasion by taxpayers who use and rely on the internet for their trade? The OECD has also hypothesised that South Africa's failure to tax all digital transactions continues to result in a substantial loss of tax revenue.[131]

It is against this background that the study ventures into determining the challenges posed by the internet economy under the South African income tax regime. The study also makes recommendations that can be adopted by South Africa to improve its tax laws and policies thereby making them effective in the taxation of digital transactions.

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[128] The World Bank Group 'South Africa Digital Economy Assessment' (2018) <https://openknowledge.worldbank.org/bitstream/handle/10986/33632/South-Africa-Digital-Economy-Assessment-Digital-Entrepreneurship-Pillar.pdf?sequence=1&isAllowed=y> accessed 23 December 2021.
[129] UNCTAD 'Global E-commerce jumps to $26.7 Trillion, Covi-19 Boosts Online Retail Sales' (Press Release 3 May 2021) <https://unctad.org/press-material/global-e-commerce-jumps-267-trillion-covid-19-boosts-online-retail-sales#:~:text=Meanwhile%2C%20global%20e%2Dcommerce%20sales,product%20(GDP)%20that%20year> accessed 6 February 2022.
[130] The mainstream brick and mortar economy is the traditional economy or trade that is largely conducted physically on a face-to-face basis and without the aid of the internet. An office, a shop, or a store where goods are physically sold to customers face-to-face is a good example of a brick and mortar business. See Smeets M "Adapting the Digital Trade Era: Challenges and opportunities" (2021) WTO Chairs Programme <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.wto.org/english/res_e/booksp_e/adtera_e.pdf> 259 accessed 10 September 2022.
[131] OECD 'Addressing the Tax Challenges of the Digital Economy' (2015) Final Report <www.oecd.org> 78 accessed 15 August 2016.

1.5 Research Question

This thesis reflects on whether and how the revenue derived from internet-based transactions can be effectively taxed under South Africa's current income tax legal framework.

1.6 Research Objectives

The thesis is guided by the following objectives:

a) to give an overview of the growth and development of the global and South Africa's internet economy;

b) to discuss the country's income tax framework and its ability to tax internet-based transactions;

c) to identify the gaps and areas of ambiguity in South Africa's income tax framework;

d) to discuss the extent and nature of the challenges posed to the country's tax base by the gaps and ambiguities identified in the research;

e) to analyse the latest developments and best practice adopted by the OECD and identified countries in dealing with similar challenges of taxing internet-based transactions;

f) to determine whether in comparison to other countries, the South African system needs reform; and

g) to formulate solutions to the challenges surrounding the taxation of the internet economy.

1.7 Aim of the Research

This thesis aims at:

a) investigating and determining the effectiveness and efficiency of South Africa's income tax legal framework for the taxation of internet-based transactions;

b) investigating and determining the main challenges posed by the taxation of the internet economy;

c) investigating and determining whether selected countries, the OECD, and the EU have managed to promulgate laws that can effectively tax the internet economy; and

d) proposing practical recommendations that the government of South Africa could consider to assist it to tax income arising from its internet economy more effectively and efficiently.

1.8 Hypothesis

This thesis advances the argument that the current South African income tax laws are not effective and efficient enough in taxing digital transactions that have become commonplace in today's digital economy. The identified weaknesses within the Act and the enumerated tax challenges that will be identified in the course of the thesis need to be addressed so as to curb the ensuing tax avoidance.

The internet has opened up e-commerce as a new route for the exchange of goods and services. However, e-commerce and its taxation are areas that have not been fully regulated.[132] This thesis has hypothesised that South Africa's physical jurisdictional tax model may not be the most appropriate model for taxing borderless internet-based transactions. The government, therefore, ought to consider amendments to its income tax laws to make them more efficient and effective in the taxation of the internet economy so as to protect its tax base from possible erosion.

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[132] Oguttu *Curbing Offshore Tax Avoidance* 15 <thesis Oguttu.pdf> accessed 23 November 2017.

The thesis does not undertake a detailed study of e-commerce or any form of internet trade, it does, however, identify and propose solutions to the tax challenges that internet-based transactions have posed for South Africa's income tax system.

1.9 Scope and Limitations of the Thesis

The thesis focuses on the Income Tax 58 of 1962and its ability to tax digital transactions. The related concepts and principles such as PEM and PE that SARS can rely on in taxing such transactions are also discussed. It focuses primarily on the taxation of persons who are operating in an e-commerce environment. Examination of available information is carried out to offer a clearer understanding of the research topic. This thesis also makes a conscious effort to identify some of the main challenges that make it difficult for the South African income tax legal regime to tax digital transactions. This clarity in turn allows for appropriate recommendations and conclusions that can be extended to other types of e-commerce transaction that may emerge.

Digital transactions may result in different tax consequences under different regimes including excise duty, income tax, value-added tax, and sales tax. The thesis is limited to the challenges posed by digital transactions pose for the taxation of revenue under the Act.

The thesis does not discuss the concept or application of the law regarding transfer pricing and CFCs in detail. Instead, section 9D of the Act is discussed only to the limited extent to which it has aided SARS in the taxation of digital transactions. The operation of certain tax avoidance strategies and the effectiveness of the anti-avoidance provisions in the Act which are designed to curb tax avoidance.

The thesis was conducted within the constraints of the following limitations:

a) Inadequacy of literature relevant to the thesis.
b) Many countries, particularly in Africa, have not developed legislation and policies to offer guidance to countries like South Africa on how to deal with this 21st-century phenomenon.

c) The taxation of the internet economy is an emerging issue and several countries, including leading tax institutions like the OECD, are still grappling with how to deal effectively with this aspect of taxation. Therefore, most of the available literature emphasises the commercial aspect of e-commerce rather than the taxability of e-commerce transactions.

d) The IoT gives rise to new types of model on an almost daily basis. It was therefore not possible for this study to cover all types of internet-based transactions.

Finally, this thesis has cited the law as of 30 May 2022.

1.10 Purpose and Justification for the Thesis

The emergence of the digital economy has brought a considerable amount of uncertainty when it comes to taxing trade that is supported by or carried out over the internet. The OECD has since 2013 striven to come up with ways of reaching consensus and providing solutions on how to tax the digital economy.[133]

The main purpose of this thesis is to evaluate South Africa's income tax legal framework and its ability to tax today's internet economy. It also evaluates whether the South African government's explanation for not introducing a unilateral tax on digital transactions holds water. It also endeavours to determine whether there is anything that South Africa could borrow from the international community as it awaits global consensus on the taxation of the digital economy.

South Africa lives under the reality of an interconnected global economy. It must therefore, be alive to the models used by its trading partners to tax the internet economy. This thesis undertakes a comparative study of how certain selected countries have modelled their income tax laws to deal with this 21st century phenomenon with a view of coming up with proposals and recommendations that are realistic, practical, and suitable for South Africa.

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133 OECD 'Action Plan on Base Erosion and Profit Shifting' (2013) <https://www.oecd.org/ctp/BEPSActionPlan.pdf> accessed 23 November 2021.

Fundamentally, this research will also assist SARS in identifying loopholes and gaps in the country's digital taxation framework which has not been aligned with the reality of today's digital world.[134] It also addresses the Davis Committee's concerns which regarding gaps in the country's tax laws that have allowed taxpayers to shift their profits to offshore jurisdictions.[135] The concerns of the government which has admitted that the country's laws are not capable of dealing with all the challenges brought about by the internet economy are also addressed.[136]

A further justification for this thesis is that it identifies, collates, summarises, categorises, interprets, and makes information available that will be useful in improving the understanding of the specific issues that need to be addressed to ensure effective and efficient taxation of the digital economy in South Africa and beyond.

1.11 Methodology

This thesis is primarily based on a desktop literature study. As such it reviews information sourced from textbooks, journals, case law, theses, reports, government publications, the Act as amended, SARS' Interpretation Notes, OECD Model Tax Conventions and their commentaries, electronic resources, and other materials on the topics studied and related issues.

1.12 Chapter Outline

The thesis is presented in seven chapters which are divided as follows:

Chapter 1 introduces the research issues discussed in the thesis. The history of South Africa's tax system from the 1951 Steyn Commission to the 2018 Davis Tax Committee is also discussed to provide a perspective of the strides that South Africa

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134 Jinyan Li 'Protecting the Tax Base in the Digital Economy' (2014) Paper 9 United Nations <www.un.int/un-official-documents and publications> accessed 25 September 2016.
135 Davis Tax Committee 'Interim Report Addressing Base Erosion and Profit Shifting in South Africa' (2014) <www.taxcom.org.za/> accessed 29 July 2016.
136 Department of Finance 'The 2015 Budget Speech' (25 February 2015) <www.treasury.gov.za> accessed 15 May 2016.

has made in improving its income tax system. It also outlines the research problem; purpose, aims, and justification for the thesis. The thesis concludes by discussing its hypothesis, scope, and an outline of its chapters.

Chapter 2 defines and explains the common terms and concepts used in the taxation of digital transactions. The general nature, development, and economic impact of the internet on South Africa’s ability to protect its tax base is also considered. It concludes by indicating whether or to what extent digital transactions are taxable in South Africa.

Chapter 3 provides an overview of South Africa’s income tax framework, the function of these laws in taxing digital transactions and the international tax principles that can be used to augment the Act in the taxation of digital transactions. It also undertakes an in-depth discussion of the specific challenges posed by the internet economy for the South African income tax legal regime.

Chapter 4 explores how the global digital landscape has evolved over the years. It analyses whether South Africa's income tax law has been updated to respond to today’s digital economy. The thesis discusses some of the evolving digital strategies adopted by taxpayers to limit their tax liability using internet-based services. The G-24 and OECD's proposals on how to deal with identified tax challenges are also considered. This provides insights as to whether the country's tax system is aligned with the best international practice and is consequently suited to the taxation of digital transactions.

Chapter 5 outlines the measures that the EU and certain selected countries have adopted to address the taxation of a digital economy as they await a global consensus on the matter. It also considers the proposals under discussion at the OECD-led global digital taxation forum and evaluates whether South Africa can adopt some of these best global practices and the impact this will have on the country's economy and stability.

The OECD was chosen for this thesis because it is the leading international organisation that currently work towards the realisation of a global all-inclusive digital tax policy. It is also known for developing BEPS reports that have been used and adopted by most world economies that are grappling with the challenges brought about by the growing digital economy to improve their tax system.[137] Policymakers and governments all over the world have also relied on it to negotiate and propose all-inclusive tax solutions that cater for the interests of both the developed and developing economies.[138]

The EU was selected because its members pledged under the Rome Declaration of 27[h] March 2017 to embrace the digital technology transformation and to use it to their benefit.[139] It is on this premise that the EU commenced the process of developing appropriate policies and regulations to ensure an effective and fair taxation of the digital economy.[140] The thesis analyses the digital taxation concepts and policies that have been proposed by the EU.[141] The influence of the EU in shaping global economic, trade, and tax policies makes it appropriate for consideration in this comparative study.

As South Africa is an African country, it is appropriate to identify and compare its digital tax regime with another African country which has attempted to tax the digital economy. It is on this premise that Kenya was chosen for this thesis. Kenya's fairly advanced digitised infrastructure, with market value estimated at some 5.48 billion

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137 The latest report is the OECD/G-20 Inclusive Framework on BEPS: Progress Report July 2018-May 2019 <https://www.oecd.org/tax/beps/inclusive-framework-on-beps-progress-report-july-2018-may-2019.pdf> accessed 28 December 2020.

138 OECD 'Country Reviews and Advice' <https://www.oecd.org/tax/tax-policy/country-reviews-advice/> accessed 28 December 2020.

139 EU Council 'The Rome Declaration – Declaration of the Leaders of 27 Member States and the European Council' Press Release the European Parliament and the European Commission (25 March 2017 <https://www.consilium.europa.eu/en/press/press-releases/2017/03/25/rome-declaration/pdf> accessed 2 January 2021.

140 EU Commission 'Communication from the Commission to the European Parliament and the Council. A Fair and Efficient Tax System in the European Union for the Digital Single Market' (2017) <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52017DC0547> accessed 7 April 2022.

141 Kofler G and Sinnig J 'Equalization Taxes and the EUs Digital Services Tax' <https://www.researchgate.net/publication/332540731_Equalization_taxes_and_the_EU's_digital_services_tax> accessed 28 December 2020.

US dollars in 2017. The fact that it has recently introduced a digital service tax (DST) system[142] and its reputation as one of the leading digital economies in Africa also make it relevant to this comparative study.[143]

Like South Africa, a number of countries have not introduced a DST system.[144] Although certain countries have considered introducing DST, they have thereafter postponed or abandoned the idea altogether.[145] New Zealand is an example of such a country. New Zealand consumers are avid users of digital technology, and this is perhaps why the government issued proposals on the need to tax transactions aided or supported by digital technology. Its position is, therefore, similar to that of South Africa in that neither country has amended its income tax legal regime to provide for specific and direct taxation of digital transactions. Unlike South Africa, New Zealand proposed the way in which its digital economy could be taxed. This thesis examines this proposal to establish why the country has elected to postpone the implementation of this tax system indefinitely and whether South Africa could face the same challenges were it to opt to implement a DST system. It also examines New Zealand's proposed digital tax system with a view to borrowing the positive provisions that could help the South African government to protect and possibly expand its tax base.

India was chosen for this thesis because it has implemented a DST system. It had some 560 million internet users in 2018, second only to China,[146] which makes it a significant user of digital trade in the world. It is projected that the core digital sector will contribute at least 435 billion US dollars to India's economy by 2025 thereby

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[142] Section 3 of the Finance Act 23 of 2019 <https://www.kra.go.ke/images/publications/Revised-Draft-Digital-Service-Tax-Regulations-2020---07-08-2020.pdf> accessed 5 November 2020.
[143] World Bank Group 'Kenya's Digital Economy Assessment: Summary Report' (2019) at 10, 12 <http://pubdocs.worldbank.org/en/345341601590631958/DE4A-Kenya-summary-paper-final.pdf> accessed 29December 2020.
[144] DST is the name given to the tax imposed on income earned from the sale of goods and services in the digital space. It is implemented as a turnover tax, meaning that it is imposed on the total revenue earned rather than on the profit made by the affected taxpayer.
[145] McKinsey Global Institute 'Digital India: Technology to Transform a Connected Nation' (2019) <https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/McKinsey%20Digital/Our%20Insights/Digital%20India%20Technology%20to%20transform%20a%20connected%20nation/MGI-Digital-India-Report-April-2019.pdf> accessed 25 March 2021.
[146] ibid

accounting for 10% of its GDP.[147] India transacted some 83 billion US dollars' worth of service exports in the 2016-2017 financial year.[148] Information and technology business process outsourcing alone earned India 154 billion dollars in 2017.[149] It was also projected that the Indian digital economy had the potential to grow to a 4 trillion US dollar economy by the year 2022.[150] This data illustrates the significance of India's digital economy and its relevance to this thesis.

It is also significant that India was among the first countries in the world to introduce a DST – the Equalisation Fund – in 2016.[151] The vast size of its digital economy, its pioneering experience with the taxation of digital transactions, and the rapid development of its digital infrastructure makes it ideal for this thesis. South Africa's growing digital economy could, therefore, benefit immensely from the lessons learned by India in taxing its highly digitalised economy.

Among the comparator countries, New Zealand is a member of the OECD but Kenya and India are not. This makes the comparison appropriate because the latter two countries are in a similar position to South Africa which is also not a member of the OECD. The Kenyan and Indian experiences in taxation of the digital economy could therefore offer useful insight to South Africa as a fellow non-member of the OECD. On the other hand, New Zealand enriches the study by illustrating the benefits its tax system has enjoyed in the taxation of its digital economy as a member state of the OECD.

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[147] ibid.
[148] The information is available at <https://unctad.org/system/files/official-document/ier2017_en.pdf> accessed 30 December 2020.
[149] Chaudhary D 'Digital Taxation in India' <https://taxguru.in/income-tax/digital-taxation-india.html > accessed 30 December 2020.
[150] Insights Mind Maps 'India's Digital Economy' <https://www.insightsonindia.com/wp-content/uploads/2017/12/Indias-Digital-Economy.pdf> accessed 29 December 2020.
[151] *Financial Express* 'Taxing Foreign Digital Companies: India Must take Cue from Europe; Consider Narrowing Scope of Digital Tax' (12 August 2020) <https://www.financialexpress.com/industry/taxing-foreign-digital-companies-india-must-take-cue-from-Europe-consider-narrowing-scope-of-digital-tax/2051418/> accessed 30 December 2020.

The United Nations (UN) is a global international organisation to which almost all countries in the world belong. This thesis briefly considers how the UN has responded to the issues around the taxation of the digital economy.

Chapter 6 makes recommendations that South Africa could consider adopting in order to protect its tax base as it awaits an international consensus on how to tax the digital economy.

Chapter 7 concludes the study by reconciling the key points from the thesis with its research aims, objectives, and questions. It concludes with a discussion of the contribution of the thesis to the development of the law and identifies areas that may require further research to assist the government of South Africa in achieving an efficient and effective income tax law regime.

1.13 Conclusion

Addressing tax evasion schemes that arise from digital transactions has become a key priority of governments around the world including South Africa.[152] It is anticipated that this thesis may help the South African government in identifying some of the legal loopholes in the current Act, and recommend measures that could be considered to protect the country's tax base. These recommendations are exhaustive and are likely to require constant updates in light of the continuing changes within any digitised environment. They do, however, offer appropriate solutions on how to solve the tax challenges raised by today's digital environment. They also act as an appropriate platform from which future income tax laws could be improved to deal with the anticipated changes and advances in the evolving digital economy.

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[152] OECD 'Addressing the Tax Challenges of the Digital Economy' (2015) Final Report <http://dx.doi.org/10.1787/9789264241046-en> accessed 9 June 2016.

CHAPTER 2

THE GROWTH OF THE INTERNET ECONOMY AND ITS IMPLICATION ON SOUTH AFRICA'S INCOME TAX SYSTEM

2.1 Introduction

Unlike the third industrial revolution, which used electronics and information technology to spur industrial growth,[153] the world is today standing on the brink of a technological revolution that is fast changing the way we live, relate, work, and interact with each other. The internet of things (IoT)[154] has revolutionised the way we relate to each other by making it possible for any object to be connected to the internet to receive or send data.[155] This transition of the world from an industry-based economy to an internet-based digital economy presents several opportunities and far-reaching challenges to South Africa and its income tax regime.[156]

The growth and prevalence of the internet in South Africa is exemplified by the fact that at least 21 million people in the country currently have access to the internet.[157] This means that at least 40% of South Africans can access the internet and other trade opportunities on the e-commerce platform. This, in turn, means that SARS has a huge opportunity to raise income tax from people who use the internet to communicate and make sales. These opportunities created by the IoT also come with some challenges. For example, an individual or an enterprise can use the

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153 Klaus S 'The Fourth Industrial Revolution: What It Means, How to Respond' (2015) Council of Foreign Affairs <https://www.weforum.org/agenda/2016/01/the-fourth-industrial-revolution-what-it-means-and-how-to-respond/> accessed 23 November 2017.

154 Internet of things (IoT) is defined as the proliferation of all sorts of devices, equipment, buildings and other related devices that can be connected to the internet which enable these objects to collect, send, and exchange data. The definition of IoT is available at <www.internetofthingsagenda.techtarget.com.> accessed 2 June 2018.

155 Feinschreiber and Kent (2001) 3 *Corporate Business Taxation Monthly* 3-13.

156 Department of Communication 'Green Paper or Electronic Commerce for South Africa (2000) <https://www.gov.za/sites/default/files/gcis_document/201409/electroniccommerce1.pdf> accessed 8 June 2018.

157 Information available at <www.forbes.com> *Forbes Magazine* 19 July 2017.

internet to create an artificial low-tax location as their place of residence[158] using an internet storefront application like Shopify[159] to sell their products digitally. Taxpayers may find it easy to limit their tax liability because of the provisions in the Act which provide that tax is be levied on the income of non-residents[160] in exceptional circumstances where their income is connected to a permanent establishment located in South Africa.[161] This open and liberal model adopted by the Act in creating a tax *nexus* has made it possible for taxpayers to limit their tax exposure if they acquire virtual residency in low-tax jurisdictions which have no connection to a permanent establishment located in South Africa.

Secondly, the anonymous nature of the internet can provide taxpayers with a platform to carry on business and earn income without revealing their identity. In any event, even if the identity of the taxpayer were to be established, the process of identifying, verifying, and establishing a link between that taxpayer and a taxable transaction in the country, could be expensive[162] and difficult to achieve.[163] A detailed analysis of these challenges is undertaken in chapter 4 of this thesis.

The next frontier of tax controversy could be the IoT because internet trade has made the traditional tax concepts of permanent establishment, origin of goods or services, and point of sale or location of the vendor difficult to apply in a world where a taxpayer can manipulate the internet to erase his or her tax footprint. It is estimated that half of the world's population currently uses the internet and that the value of the world's digital economy is some 17 trillion dollars.[164] This is almost

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158 Virtual presence, residency, or fixed place of business is defined as the place where an enterprise creates a presence through a website, a server, or by the adoption and application of internet technology in its transactions. See Tipmar *International Taxation of Electronic Commerce* 74.

159 Shopify is an e-commerce software that allows an entrepreneur to set up an online store to sell almost anything. See definition at <www.cyberwalker.com> accessed 2 June 2018.

160 Section 5(1) of Act 58 of 1962 (as amended).

161 Article 7(1) of the OECD Model Tax Convention on Income and on Capital (2005 Condensed Version) (Model Tax Convention).

162 Subajit (2008) 1 *Journal of Information, Law, and Technology* 8 and 13.

163 SARS ‘Discussion Document on Electronic Commerce and South African Taxation’ (March 2000) <file:///C:/Users/user/Downloads/electroniccommerce1.pdf.> accessed on the 23 of November 2017.

164 Boston Consulting Group ‘Report, the Internet Economy in the G-20’ (2012) <https://eizba.pl/wp-content/uploads/2018/07/BCG_3._Internet_Economy_G20.pdf> accessed 23 November 2017.

equal to the United States of America's (USA) GDP which was valued at some 18.6 trillion dollars in 2016 and 19.39 trillion dollars in 2017.[165]

The potential revenue that can be realised from this economy has attracted the attention of SARS who are keen on ensuring that digital transactions in South Africa are taxed. The urgent need for SARS to tax the internet has been strengthened by the fact that the digital economy today far exceeds the individual economies of leading and developed countries such as the USA,[166] China,[167] Japan,[168] India,[169] Germany,[170] and the United Kingdom.[171]

This chapter gives a brief history of how the IoT has evolved over time to become an integral part of today's daily commercial transactions. The question as to whether it is necessary or right to tax the internet, the definition of what constitutes a digital economy, and the position of the OECD on whether the internet should be taxed is discussed in this chapter. The chapter concludes by determining whether digital transactions are taxable in South Africa.

2.2 Nature, Development, and Economic Impact of the Internet

2.2.1 Nature of the Internet

The internet can be defined as a massive network of networks that connects millions of computers globally forming a network in which the computers can communicate

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[165] Byun K.J. and Bradley N. "The US Economy to 2024" (2015) December *Monthly Labour Review* https://doi.org/10.21916/mlr.2015.51 accessed 15 May 2022.

[166] Boston Consulting Group 'Report of the Internet Economy in the G-20' (2012) <https://eizba.pl/wp-content/uploads/2018/07/BCG_3._Internet_Economy_G20.pdf> accessed 23 November 2017.

[167] China had a GDP of 11.2 trillion dollars in 2016. See <www.worldbank.org> accessed 2 June 2018.

[168] Japan had a GDP of 4.9 trillion dollars in 2016. See <www.worldbank.org> accessed 2 June 2018.

[169] India had a GDP of 2.2 trillion dollars in 2016, see <www.tradingeonomics.com> and <www.worldbank.org> accessed 2 June 2018.

[170] Germany had a GDP of 3.4 trillion dollars in 2016. See <www.worldbank.org> and <www.tradingeconomics.com> accessed 2 June 2018.

[171] United Kingdom had a GDP of 2.6 trillion dollars in the year 2016. Information obtained from <www.worldbank.org> accessed 2 June 2018.

with each other.[172] It can also be defined as a means of connecting a computer to any other computer anywhere in the world by using dedicated routers and servers.[173] The difficulty in defining the internet is illustrated in these two general definitions, which fail to recognise that today the internet can be connected to non-conventional objects like cars, electronic gadgets, buildings, and other devices using internet protocol suites to connect devices worldwide.[174] The president of the Chicago Internet Society defines it as a network of networks joining many governments, universities, and private computers together and providing an infrastructure for use of e-mail, bulletin boards, file archives, hypertext documents, databases, and other computational resources.[175]

In this thesis, the term internet refers to network connectivity which provides a connection between computers and other objects, devices, sensors, or equipment other than computers using standardised communication protocols.[176] By its nature, the internet is made up of networks which connect different people and protocols, and allow the participants to read the information sent to them as well as the internet address which identifies the host and ensures that the message sent within the network reaches the correct participant.[177] Every participant or host on the internet network is allocated a unique address when they are connected to the internet. These networks can create a global interconnection that is able to reach all others.[178]

The foregoing is the basic process through which the internet is connected between all endpoints. In its finer detail, it can allow a purchaser on one endpoint to purchase an e-book or download music in the form of bytes downloaded over the internet.

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172 Definition available at <www.dictionary.com> accessed 15 March 2017.
173 Definition available at <www.businessdictionary.com> accessed 15 March 2017.
174 Definition available at <www.wikipedia.org> accessed 15 March 2017.
175 William FS 'Internet History and Growth' (2002) Chicago Chapter of the Internet Society <file:///C:/Users/Admin/Desktop/Internet_History.pdf> accessed 20 March 2022.
176 Definition available at <www.gogle.com> accessed 15 March 2017.
177 Leslie D 'The Nature of the Internet and Global Commission on Internet Governance' (2015) Paper Series 7 <www.ourinetrnet.org> accessed 4 April 2017.
178 Rekhter Y, Li T and Hares S (eds) 'A Border Gateway Protocol 4(BGP-4)' (2006) <http://www.ietf.org/rfc/rfc4271.txt.> accessed 4 April 2017.

These downloaded bytes are paid for with bytes in the form of electronic or digital cash. The receiving computer will permit the downloading of the bytes without having to know the identity or location of the sender. Using the same system, any person can purchase any goods or services irrespective of the geographical location of the buyer or the seller in the transaction.[179]

2.2.2 What is the Internet of Things?

The IoT allows objects to be controlled and detected using the existing internet network to create a cyber-physical system which creates a smart and intelligent system which can receive and send data within the existing internet infrastructure.[180] This interconnectivity creates opportunities for direct integration of the physical world and computer-based systems. This has made it possible for people to operate smart systems that allow the sale and purchase of goods and services online or the connection of the IoT to physical assets. In fact, experts estimate that by the year 2025 the IoT will be able to connect to almost 75 billion objects.[181] It is further estimated that the IoT has the capacity to generate up to 11. 5 trillion dollars in global economic value by 2025.[182] This could result in the automation of virtually all areas of our daily lives.

The IoT is what has enabled some taxpayers to create a new tax jurisdiction known as the virtual world from where a person can work or earn an income by offering services or selling goods to South African residents without creating a permanent establishment in South Africa. This and similar challenges resulting from this new technology will require tax authorities to devise creative ways of bridging the gap

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179 Hoke W 'Tax Complexity Expands as Internet of Things Explodes' (2016) April *News and Analysis* 316 <file:///C:/Users/user/Downloads/us-tax-tax-analysts-complexity-expands-internet-of-things%20(1).pdf> accessed 2 September 2022.

180 Igor and Sergey B *Harvard Business Review* 'Internet of Things: Science Fiction or Business Fact?' <http://blog.dataart.com> accessed 15 February 2017.

181 Alam (2018) 53(3) *International Journal of Scientific Research in Computer Science, Engineering and Information Technology* 450.

182 McKinsey and Company 'The Internet of Things: Catching Up to an Accelerated Opportunity' (2021) <file:///C:/Users/Admin/Desktop/the-internet-of-things-catching-up-to-an-accelerating-opportunity-final.pdf> accessed 31 March 2022.

between the traditional principles of taxation and the IoT, which is slowly taking over worldwide commercial transactions and eroding the tax bases of most countries.[183]

2.2.3 Potential Economic Impact of the Internet

Business enterprises and individuals can today use the IoT to manage and run almost every business transaction in the world.[184] The popularity of the internet as a tool of trade is clear from the fact that the 2015 United Nations Conference on Trade and Development (UNCTAD) estimates that the value of e-commerce trade stood at some 26 trillion dollars and had approximately 3 billion internet users globally – almost half the global population.[185] In addition, the internet economy accounted for 5.3% of the GDP of the G-20 countries[186] and is valued at about 4.2 trillion within the G-20 economies. This means that if it was a national economy, the internet economy would be ranked among the five top world economies, behind the USA, China, Japan, and India in that order.[187] Furthermore, it would be way ahead of leading economies like Germany, the United Kingdom, and Italy.

The vast economic potential of the IoT can be illustrated using 'Black Friday' sales in South Africa as an example. The tradition of annual Black Friday sales originated in the USA where retailers took advantage of the day (Friday) following the traditional Thanksgiving Day on the fourth Thursday of November, to make early Christmas sales available to shoppers who were in a holiday mood. Globalisation and digitisation of retail online sales spread the practice and shopping tradition of Black Friday sales to South Africa. On this day, both the USA and South African retailers offer huge discounts or irresistible price deals on online goods. The huge price discounts on almost all goods and services on offer have moved perceptive

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183 Davis Tax Committee 'Interim Report Addressing Base Erosion and Profit Shifting in South Africa' (2014) <http://www.taxcom.org.za/docs/New_Folder/2> accessed 18 April 2017.
184 Internet Society 'The Internet of Things: An Overview' <https://www.internetsociety.org/> accessed 4 May 2017.
185 UNCTAD 'E-commerce: Global Trends and Developments' <https://www.unescap.org/sites/default/files/Ecommerce%20Global%20Trend%20and%20Development.pdf> accessed 30 May 2018.
186 ibid.
187 Boston Consulting Group 'The Connected World: The 4.2 Trillion Opportunity' <https://eizba.pl/wp-content/uploads/2018/07/BCG_3._Internet_Economy_G20.pdf> accessed 30 May 2018.

South African consumers to shift their Christmas shopping a month earlier to November.[188] Covid -19 had initially supressed its growth but recent data shows that it has surpassed this pitfall and become resurgent across all sale metrics.[189] Black Friday has evolved over time with big retailers opening their shops for 24 hours commencing at 00.00 hours on Friday until 00.00 hours on Saturday. Facebook data shows that Black Friday is South Africa's busiest online shopping day of the year.[190] Spending on ABSA cards increased by 81% on Black Friday in 2015 as compared to average monthly online sales throughout that year.[191] The number of ABSA cards used on Black Friday reached an all-time high of some 2.5 million in 2019.[192] This fell to 2 million in 2020 and rose slightly to 2.1 million in 2021.[193] About a fifth of ABSA cardholders used their cards to purchase something on Black Friday in 2021 translating to sales worth 3.6 billion Rand made using ABSA cards.[194]

Although the country has not kept absolute figures of the total Black Friday sales across all sectors, available data shows that Takealot was among the leading online stores for 2017 and 2021 sales. It began by making sales worth 1 million Rand in 2011. This figure rose phenomenally to 17 million Rand in 2015 and then more than triple the following year when online sales worth 56 million Rand were made in 2016.[195] The 2017 Black Friday was on 24 November 2017. Takealot commenced its sales at 00.00 hours of that day and realised sales worth 4 million Rand within

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[188] Information available at <www.broadband.co.za> accessed 2 June 2018.
[189] Absa 'Card Data Analysis Black Friday 2021' (2021) 3 < file:///C:/Users/user/Downloads/black-friday-2021-report.pdf> accessed on 6th June 2022.
[190] Qwerty Digital 'Black Friday and Cyber Monday in South Africa 2017' <https://qwertydigital.co.za/wp-content/uploads/2017/10/Black-Friday-and-Cyber-Monday-in-South-Africa-2017-1.pdf> accessed 2 June 2018. See also Business Tech 'Like it or Not, Black Friday is officially a Thing in South Africa - Here is Why (24 November 2016) <https://businesstech.co.za/news/finance/144397/like-it-or-not-black-friday-is-officially-a-thing-in-south-africa-heres-why/> accessed 2 June 2018.
[191] ABSA 'Card Data Analysis Black Friday 2021' <https://cib.absa.africa/wp-content/uploads/2021/12/black-friday-2021-report.pdf> accessed 31 March 2022.
[192] ABSA 'Card Data Analysis Black Friday 2021' <https://cib.absa.africa/wp-content/uploads/2021/12/black-friday-2021-report.pdf> accessed 31 March 2022.
[193] ibid.
[194] ibid.
[195] Fin24 'Takealot Cashes in Big Time Despite Black Friday Downtime' (24 November 2017). <https://www.fin24.com/Tech/News/takealot-cashes-in-big-time-despite-blackfriday-downtime-20171124> accessed 2 June 2018.

the first hour of business and 10 million Rand by the end of the second hour, despite a massive crush on its websites occasioned by the huge influx of online visitors.[196] A total of 87 million Rand was realised by the end of the day with a footprint of about 2.2 million users.[197] Although Takealot was inaccessible for many shoppers, it still managed to record impressive sales on that day with its revenue stream from Black Friday sales growing to 6.78 billion Rands in 2021 constituting 60% of the day's sales.[198] Other e-commerce companies like Loot.co.za also recorded a 149% increase in sales on the 2017 Black Friday.[199] Data on these sales made by other retail companies on this day is not readily available. If this is considered alongside the fact that some 314 online stores participated in the 2017 Black Friday sales,[200] it is clear that the actual value of online sales on Black Friday 2017 could have been much higher. South Africa had its most successful Black Friday in 2019 when retail spending reached 15.4 billion Rand before it fell to 10.2 billion Rand in 2020 before rising slightly to 11.3 billion Rands in 2021.[201]

The gross merchandise value for sales on future Black Fridays is likely to boost the country's e-commerce revenue which stood at 14.1 billion Rand in 2018 and rose phenomenally to 30.242 billion Rand in 2020 before hitting a high of 42 billion Rand in 2021.[202] This means that South Africa's e-commerce value has tripled since 2018 outpacing the predictions that had indicated that its value would be 20 billion Rand

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196 Fin24 'Takealot Cashes in Big Time Despite # black Friday Downtime' (24 November 2017) <https://www.fin24.com/Tech/News/takealot-cashes-in-big-time-despite-blackfriday-downtime-20171124> accessed 10 June 2018.

197 Fin24 "Takealot Cashes in Big Time Despite # black Friday Downtime" (24 November 2017 Edition). Available at https://www.fin24.com/Tech/News/takealot-cashes-in-big-time-despite-blackfriday-downtime-20171124 [accessed on the 10 June 2018].

198 ABSA 'Card Data Analysis Black Friday 2021' <https://cib.absa.africa/wp-content/uploads/2021/12/black-friday-2021-report.pdf> accessed 31 March 2022.

199 Business Report 'Black Friday Boost for Loots Revenue' (6 December 2017) <https://www.iol.co.za/business-report/companies/black-friday-boost-for-loots-revenue-12287641> accessed 2 June 2018.

200 Information available at <www.nichemarket.co.za> accessed 2 June 2018.

201 Bureau of Market Research 'The Next Normal for SA Retail Sales' (November 2021) <https://bmr.co.za/2021/11/25/south-african-retail-to-get-r11-3-billion-boost-from-black-friday-over-november-2021/> accessed 1 April 2022. See also Soweto Live 'Black Friday Spending to increase to 11.3 Billion Rands This Year' (17 November 2021) <https://www.sowetanlive.co.za/ news/south-africa/2021-11-17-black-friday-spending-to-increase-to-r113bn-this-year-study/> accessed 1 April 2022.

202 Worldwide Worx 'SA Online Retail Leaps to R 30 Billion' (12 May 2021) <http://www.worldwideworx.com/online-retail-in-sa-2021/> accessed 1 April 2022.

by 2021.[203] This growth in e-commerce trade is significant because South Africa's economy recorded a low GDP growth rate of 1.49% in 2018 before slumping to an all-time low (-6.43%) in 2020 and recovering to about 5% in 2021.[204] This data shows that e-commerce trade has bucked the trend and recorded phenomenal growth at a time when other sectors of the economy were shrinking. Its contribution in sustaining the country's economy and GDP since 2015 to date cannot be gainsaid. The time is therefore ripe for SARS to start viewing internet trade as a prime tax avenue that could help protect the country's tax base which has been affected by shrinking income from traditional revenue earners such as agriculture, mining, manufacturing, electricity, and construction.[205]

At the continental level, Nigeria has the biggest e-commerce market in Africa with sales worth 550 million dollars in 2015.[206] This escalated to 7 billion dollars in 2021 placing it ahead of even developed countries like Denmark.[207] On the other hand, South Africa's e-commerce market value stood at 10.5 billion dollars which was about 3% of GDP in 2017.[208] The Mckinsey Institute predicts that the value of online sales in Nigeria will hit the 10-billion-dollar mark by 2025. The leading e-commerce platforms in Nigeria are Jumia[209] and Konga.[210] As in South Africa, Black Friday attracts huge one-day sales in Nigeria. In 2015 Konga registered sales worth 5 million dollars on Black Friday. This figure grew phenomenally to 17.5 million dollars

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[203] ibid.
[204] Statista 'South Africa: Real Gross Domestic Product (GDP) Growth Rate From 2016 to 2026' <https://www.statista.com/statistics/370514/gross-domestic-product-gdp-growth-rate-in-south-africa/> and Statistics South Africa 'The South African Economy Records a Positive Fourth Quarte'"(8 March 2022) <http://www.statssa.gov.za/?p=15214> accessed 30 March 2022.
[205] Information available at <http://www.statssa.gov.za/?cat=30> accessed 7 June 2018.
[206] Information available at <https://www.mckinsey.com> accessed 3 June 2018.
[207] ecommerce DB 'The eCommerce Market in Nigeria' <https://ecommercedb.com/en/markets/ng/all#:~:text=The%20eCommerce%20market%20in%20Nigeria,rate%20of%2029%25%20in%202021> accessed 1 April 2022.
[208] ecommerce DB 'The eCommerce Market in South Africa' <https://ecommercedb.com/en/markets/za/all> accessed 1 April 2022. See also Herbert G and Loudon L 'The Size and Growth Potential of the Digital Economy in ODA-eligible Countries' (2020) <file:///C:/Users/user/Downloads/915_size_and_growth_potential_of_the_digital_economy_in_ODA-eligible_countries.pdf> 16 accessed 12 September 2022.
[209] Jumia is a leading internet platform in Africa which offers easy online and mobile shopping, travel, classifieds, and other smart one-stop-shop e-commerce solutions across the African continent. It currently operates in over 30 African countries.
[210] Konga is the leading Nigerian internet platform and offers online trade services for various products.

the following year. Sales figures made by Jumia on Black Friday are not available, but the giant online company has confirmed that over 2.3 million Nigerians visited its site on the Black Friday of 27 November 2015.[211] This number was equivalent to the total population of Jamaica and it was nine times higher than the total number of people who visited the site on Black Friday 2014. It also virtually equals the entire population of the African countries of Botswana, Lesotho, Gambia, and Gabon whose population then stood at 2 374 636, 2 292 682, 2 228 075, and 2 109 099 respectively.[212] The largest ever Black Friday sales for Jumia Nigeria were recorded in 2021 when 4.3 million orders were received and sales totalling 150 million dollars achieved.[213] These figures give the impression that the growth of the e-commerce sector is on the rise on both the local and continental levels. The e-commerce market thus portends huge revenue potential for SARS, but only if it is able to devise an effective and efficient model for taxing these internet-based transactions.

At the global level, China is the most successful story of the enormous revenue potential that can be realised on only one day's trade on a digital platform. This country celebrates 'Singles Day' on 11 November annually. The day is celebrated by the youth who are proud to be single. Over the years this day has evolved into one of the most celebrated days in China outstripping the more traditional holidays like Valentine's Day or Christmas which do not evoke an equivalent shopping frenzy among the Chinese. In 2013 and 2014, Alibaba[214] registered online sales valued at 5.8 and 9.3 billion dollars respectively on Singles Day.[215] This rose from 14.3 billion dollars in 2015 to 17.8 billion dollars in 2016 and an overwhelming 151 billion dollars in 2021 when 828 million mobile shoppers participated in this mega shopping

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211 Information available at <https://www.africa-newsroom.com/files/large/ec017fc4cc6ba26> accessed 10 June 2018.
212 Data and information obtained from <https://www.worldometers.info/world-population/population-by-country/> accessed 10 June 2018.
213 Yahoo Finance 'Jumia 2021 Black Friday Highlights' (7 December 2021) <https://finance.yahoo.com/news/jumia-2021-black-friday-highlights-110000493.html> accessed 1 April 2022.
214 Alibaba is the largest online portal company in China.
215 Information available at <www.alibaba.com> accessed 12 June 2018.

spree.[216] The 2021 Singles Day mega sale even exceeded eBay's annual gross merchandise value which stood at 609 billion dollars in 2021.[217]

All these sales took place within a window period of 24 hours. In addition, Alibaba was valued at about 200 billion dollars in 2014 when it listed on the New York Stock Exchange.[218] It also has about 231 million users who place some 11 billion orders annually.

The day of internet sales in China in 2016 was higher than the entire tax of 15 billion dollars raised by the Kenya Revenue Authority that year and only 67 billion shy of the revenue collected by SARS in the whole of 2016.[219] It was also only about 10 billion dollars less than the revenue realised by Facebook in the entire 2016 financial year.[220] These statistics confirm that the economic value and impact of the digital economy has become so huge that the tax authorities can no longer ignore it.[221]

In the USA, Amazon also holds an annual summer online shopping day known as the 'prime day sales' which is premised on the same philosophy as the Chinese Singles Day. Its 2016 annual sales generated some 1.5 billion dollars,[222] while its 2017 annual sales day grew by 50% to some 2.41 billion dollars and covered thirteen countries. Unlike the previous sales which were held within a period of 24 hours, the 2017 prime day was held for 30 hours from 10 to 11 of July 2017.[223]

Finally, the Alibaba and Amazon success stories are prime examples of how the internet has opened up trade in the new world order by gradually eliminating

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216 Data obtained from Statista <https://www.statista.com/topics/7112/singles-day-in-china/#dossierKeyfigures> accessed on 21 February 2022.

217 Data obtained from Statista <https://www.statista.com/statistics/885354/top-global-online-marketplaces-by-gmv/> accessed 21 February 2022.

218 *The Wall Street Journal* (19 September 2014) 'Alibaba Debut Makes a Splash' <http://on-line.wsj.com/articles/alibaba-shares-trade-higher> accessed 21 May 2017.

219 Data obtained at <www.sars.gov.za> accessed 21 May 2017.

220 Data obtained at <www.statista.com> accessed 21 May 2017.

221 *The New York Times* (6 May 2014) 'Alibaba, by the Numbers' <http://bits.blogs.nytimes.com/2014/05/06/alibaba-by-the-numbers> accessed 21 May 2017.

222 Information available at <www.statista.com> accessed 21 May 2017.

223 *Fortune* (12 July 2017) 'Prime Day Shattered Records, but it's Not All Good News' <www.Fortune.com> accessed 18 August 2017.

commercial intermediaries like wholesalers, retailers, and supermarkets who have over the years played a crucial role in identifying taxpayers and collecting tax on behalf of tax authorities. In fact, the five most valuable brands in the world – Google, Apple, Microsoft, Amazon, and Facebook in that order – are all internet-based companies.[224] The internet is, therefore, here to stay and any government wishing to protect its tax base must find a way of identifying and taxing transactions within the digital economy effectively and efficiently.[225] What then is a digital economy?

2.3 OECD and Taxation of Digital Transactions

After the First World War, the United States funded a plan to reconstruct war-torn Europe by forming the Organisation for European Economic Co-operation (OEEC).[226] The organisation focused on encouraging European countries to foster cooperation and interconnectivity to boost their economies. The dramatic growth of international trade later compelled the OEEC to come up with a continental body that could develop persuasive rules and regulations to govern international trade and tax disputes among themselves. The OEEC was transformed into the OECD on 14 December 1960 with a membership of 36 countries.[227] South Africa is, however, not a member of the OECD but has instead opted to strengthen its cooperation with the OECD through a programme of enhanced engagement and active participation in various publications and flagship projects initiated by the OECD. Among these are Economic Outlook and OECD Strategy and Development.[228] South Africa has also been invited to participate in several workshops and forums including the fourth international workshop on the practical application of tax treaties, the OECD Paris Forum on Electronic Commerce: Towards Convergence of Stakeholder Interests, and the Workshop on Barriers to Trade in Goods and Services in the Post-Uruguay Round Context. In addition,

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224 Information available at <www.forbes.com> accessed 18 April 2017.
225 SARS 'Annual Report and Financial Statement 2000/2001'. <http://www.gov.za/sites/www.gov.za/files/AnnualReports_2000-2001.pdf> accessed 18 April 2017.
226 The OECD "Organisation for Economic Co-operation and Development" 9 (2008) <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.oecd.org/newsroom/34011915.pdf> accessed 15 June 2022.
227 OECD 'Convention on the OECD' <www.oecd.org> accessed 5 June 2017.
228 Information available <http://www.oecd.org/about/membersandpartners/> accessed 3 September 2018.

South Africa is an observer to the OECD Committee of Fiscal Affairs which deals with key structural reforms in tax policy and administration.[229]

OECD members are benchmark countries that set the pace and standards in different areas of trade, investment, and taxation. These states benefit greatly from macro-economic reviews and studies carried out within their economies by OECD experts to determine whether they are compliant with current economic trends. Becoming an OECD member is also prestigious and enables such a country to obtain a wide array of data that can help it make prudent decisions in areas of the economy not covered under the Model Tax Convention. Moreover, any decision taken by the OECD on how to improve the OECD Model Tax Convention and other related policies, are made after consideration of the interests of the country. These benefits are not available to member countries that may eventually end up adopting OECD policies and guidelines which were not made to meet their needs. Even more significant is the fact that OECD countries are likely to have similar policy guidelines on taxation of digital transactions thereby facilitating member countries to carry out seamless investments and trade amongst themselves. This has the potential to attract foreign direct investments to the member countries. South Africa, therefore, stands to miss these benefits while it remains a non-member state of the OECD. In any event, the pre-admission requirements set out by the OECD – e.g., willingness to combat bribery of public officials in international business transactions, openness of its banking systems, and respect for human rights and democracy – are likely to help South Africa in its effort to be a better and more respected country amongst other nations.

The main objective of the OECD is to promote sustainable economic growth by facilitating world trade and ensuring financial stability.[230] It has achieved its objectives by issuing major publications including the OECD Economic Outlook, OECD Factbook, OECD Economic surveys, and the OECD Addressing the Tax

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[229] OECD ‘China, South Africa to Participate in Work of OECD Committee on Fiscal Affairs’ <http://www.oecd.org/general/chinasouthafricatoparticipateinworkofoecdscommitteeonfiscalaffairs.htm> accessed 3 September 2018.
[230] Article 1 of the OECD Model Tax Convention.

Challenges of the Digital Economy. It has also acted as a global thinktank to help the world maximise the benefits of free trade. This can be seen, for example, from the proposals contained in its publication OECD Tax Challenges Arising from Digitisation – Economic Impact Assessment Income.[231] This report, which gives practical measures on how to help countries control base erosion and profit shifting tendencies by taxpayers, has received the support of at least 110 countries.[232]

In addition, and in an effort to realise its main objective, the OECD has developed guidelines, Model Tax Conventions, and policy papers to position it as the world's leading forum for discussing and coordinating international tax policies. To this end, the OECD held a ministerial meeting in Ottawa, Canada on 7 October 1998 where it was agreed that the OECD should develop regulations and guidelines to guide the member and partner states to tax Internet-based transactions.[233] This led to the adoption of the Ottawa Taxation Framework which proposed that all transactions carried over the internet ought to be taxed.[234] This framework persuaded the OECD committee on fiscal affairs[235] to expand the definition of what constitutes 'a permanent establishment' in the OECD Model Tax Convention to include online transactions.[236] A 'permanent establishment' is defined in Article 5 of the Model Tax Convention as "a fixed place of business through which the business of an enterprise is wholly or partly carried on". From this definition, it became possible for member states to bring Internet-based transactions within the realm of their jurisdiction.

Many countries, including South Africa which is not a member of the OECD, have adopted the Model Tax Convention's definition of a permanent establishment in their

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231 OECD 'Tax Challenges Arising from Digitalisation-Economic Impact Assessment' (2020) <https://www.oecd-ilibrary.org/docserver/0e3cc2d4-en.pdf?expires=1648928610&id=id&accname=guest&checksum=A9BE879982B86C50E66799B538A991FE> accessed 2 April 2022.
232 OECD "Tax Challenges Arising from the Digitalization-Interim Report 2018' <https://www.g20.org/sites/default/files/documentos_producidos> accessed 5 June 2018.
233 OECD Committee on Fiscal Affairs 'Electronic Commerce: Taxation Framework Conditions' (1998) <www.oecd.org> accessed 5 June 2017.
234 ibid.
235 ibid.
236 Article 5 of the OECD Model Tax Convention.

local tax statutes to assist them in taxing cross-border and digital transactions.[237] The OECD Model Tax Convention does not bind non-member states like South Africa. These states are, however, at liberty to re-enact part or all the provisions in the Model Tax Convention or any of the OECD's policy guidelines in their local legislation if they so choose. This is provided in section 231(4) of the Constitution of the Republic of South Africa (1996), which provides that a treaty or any international agreement can become law in South Africa when it has been enacted into law through national legislation, and brought to the attention of the public by publication in the *Gazette*.[238] As the OECD is the leading body in developing tax policies in the world, South Africa has adopted several OECD tax proposals. Moreover, the OECD has also broadened its activities beyond its member countries by organising joint meetings to agree on a joint work programme or signing memoranda of understanding with such countries on identified thematic areas. In this regard, South Africa participates in twenty OECD bodies and projects where it has adhered to 21 legal instruments covering areas such as trade, tax, education, investment, and technology.[239] This has made it possible for South Africa to be integrated as part of the statistical database used by the OECD when formulating policy decisions.

2.4 History of South Africa's Tax Model

South Africa has applied the source basis of taxation ever since 1951 when the Steyn Commission recommended that its source basis tax system ought to be retained because of the perceived complexity and negative effects that any change in the tax system could have on the country's tax base.[240] Under this tax system, income is taxed where it is earned, regardless of the physical or legal residence of the recipient of the income.

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[237] Section 1 of the Act mirrors the definition of 'permanent establishment' in Article 5(1) of the OECD Model Tax Convention which defines it to mean a permanent establishment as defined from time to time in Article 5 of the OECD Model Tax Convention on Income and on Capital.
[238] Section 108(2) read with s 231(4) of the Constitution of the Republic of South Africa, 1996.
[239] OECD 'OECD Strengthens Engagement with Partner Countries During Annual Ministerial Meeting' <https://www.oecd.org/newsroom/oecd-strengthens-engagement-with-partner-countries-during-annual-ministerial-meeting.htm> accessed 3 September 2018.
[240] Steyn Commission 'Report of the Commission of Inquiry into the Income Tax Act' (1951 Government Printer, Pretoria). See <www.sars.gov.za> accessed 27 April 2017.

In 1969 the government of South Africa established the Franszen Commission to inquire into the suitability of the country's tax system and whether it has contributed to the economic growth and financial stability in the country.[241] In its final report, the Franszen Commission recommended that South Africa should abandon the source basis system of taxation and adopt the residence basis of taxation where residents are subject to tax on their worldwide income and non-residents are taxed only on income they have sourced from South Africa.[242] The Commission based this recommendation on the fact that more income was flowing into the country without being taxed and that a majority of the country's trading partners followed a residence basis system of taxation which had helped them widen their tax base.[243] The government accepted this report but the recommendation to change to a worldwide tax system was not further pursued.[244]

The 1987 Commission of Inquiry into the Tax Structure of the Republic of South Africa (Margo Commission) made recommendations that were largely similar to those of the Steyn Commission. It recommended the retention of the source-based system of taxation because a worldwide tax system would require a complex form of administration which would not result in increased revenue collection.[245] Despite the fact that it proposed the retention of the source-based system, the Margo Commission observed that the worldwide tax system would help curb tax avoidance schemes.[246]

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241 Franzen Commission 'The Second Report into Commission of Inquiry into the Fiscal and Monetary Policy in South Africa' (1970 Government Printer, Pretoria). See <www.sars.gov.za> accessed 27 April 2017.
242 ibid.
243 ibid.
244 Katz Commission 'Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1997 Government Printer Pretoria) para 2.1.2. See <www.sars.org> accessed 27 April 2017.
245 Margo Commission 'Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa' (1987 Government Printer Pretoria) para 26.3 <www.sars.gov.za> accessed 27 April 2017.
246 Katz Commission 'Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1997 Government Printer Pretoria) para 1.2.3 <www.sars.org> accessed 27 April 2017.

Recommendations of the Margo Commission were supported by some scholars like Meyerowitz, [247] who argued that source basis of taxation was suitable for the country as a test for tax liability because a country that produces any wealth is entitled to tax a share of that wealth irrespective of the country where the recipient of a portion of that wealth lives. On the other hand, some jurists like chief Justice Stratford, held the opposite view in *Kergeulen Sealing and Whaling Company Limited v Commissioner for Inland Revenue,*[248] where he stated that:

> .. for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him.

These jurists argued further that most developed, developing, and import-oriented countries have adopted the residence basis tax system.[249] As such it would be prudent for South Africa to consider adopting a tax system that is aligned with or similar to its trading partners and other developing countries.[250]

After the collapse of the apartheid regime, South Africa gained re-entry into the global economy where it began to participate in international and e-commerce transactions with other countries. The country, however, found itself in real difficulties in raising sufficient income to support its economy.[251] This compelled it to appoint the Katz Commission with a broad mandate to investigate every aspect of the South African tax system inherited from the previous pre-apartheid government covering but not limited to the political, social, economic, legal, structural, and administrative system and thereafter make recommendations for reform. It was expected that the recommendations from this Committee would align the South African tax system with best international tax practice.

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[247] Meyerowitz *Meyerowitz on Income Tax 7:2*.
[248] 1939 AD 487, 507.
[249] Albert *Source and Residence Principles of Taxation* 3.
[250] Olivier and Honniball *International Tax* 26.
[251] Aaron HJ and Slemrod J 'The South African Tax System: A Nation in Microcosm' (1999 Brookings Institute) <https://www.brookings.edu/articles/the-south-african-tax-system-a-nation-in-microcosm/> accessed 18 June 2019.

The Commission proposed wide-ranging institutional and policy reforms in the nine interim reports it produced between 1994 and 1999.The recommendations in those reports provided a solid foundation on which the government commenced the reform of the country's tax law practice to promote the fiscal stabilisation of the country. One of the recommendations was that the source basis of taxation ought to be retained in taxation of active income[252] to improve the competitive tax neutrality for South Africa in attracting direct foreign investments.[253] On the other hand, the Commission proposed that the law be amended to allow for taxation of passive income[254] on a residence basis.[255] It argued that this proposal would merely extend the current deeming provisions in section 9A of the Act to include passive income.[256] It would, therefore, not add any complexity or inefficiency to the general tax administration in the country.

In the totality of its report, the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, chaired by Michael Katz,[257] discussed the issue of source versus residence very comprehensively. The Commission was of the view that today's digital world has made it possible for people to move capital or any income earning enterprise very easily from South Africa to lower tax jurisdictions.[258] There was therefore an urgent need for the country to amend or modify its residence-based tax system to allow for the taxation of passive income. The Commission

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[252] Active income refers to revenue realised directly from a business or trade. It typically comes in the form of profits.
[253] Katz Commission 'Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1999 Government Printer Pretoria) para 3.1.2.7 <www.sars.org> accessed 27 April 2017.
[254] Passive income generally refers to investment income from portfolio investments, as opposed to income generated from a business or trade and includes annuities, rentals, interest, royalties, foreign dividends and related income.
[255] Katz Commission 'Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1997 Government Printer Pretoria) para 3.1.1.1 <www.sars.org> accessed 27 April 2017.
[256] Before it was repealed in 2000, s 9A of the Act deemed certain investment income of foreign investment companies based in neighbouring countries to be from a source within South Africa and therefore taxable in the hands of controlling shareholders who were ordinarily resident in South Africa or were domestic companies.
[257] The commission came to be known as the Katz Commission.
[258] Katz Commission 'Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1997 Government Printer Pretoria) para 3.1.3.1 <www.sars.org> accessed 27 April 2017.

argued that implementing the proposed changes would be easy because the current deeming provisions in the Act had already deemed any investment income of foreign investment companies located in the neighbouring countries to be from a source within the South Africa, and hence taxable in the hands of the shareholders ordinarily resident in South Africa.[259] The Commission recommended that these deeming provisions be expanded to ensure that all residents who may take advantage of technological developments like the internet to limit their tax exposure are brought within the tax net. In addition, to the foregoing, the Commission also justified its decision by asserting that the revenue gains likely to be realised from taxation of passive income would, in the long run, justify the proposal to adopt this new tax system.[260]

Unlike the recommendations of the previous commissions which had no impact on South African tax practice, the Katz Commission's recommendations were implemented progressively. The country moved to a residence-based tax system of taxing residents as from 1 January 2001.[261] Foreign source dividends accruing to South African residents also became taxable as ordinary income as from 23 February 2000.[262] This measure was intended to broaden South Africa's tax base and limit opportunities for tax arbitrage by residents. In the year 2002, the Finance Minister proposed the introduction of the deeming provisions to enforce the taxation of foreign income.[263] This culminated in the promulgation of both section 9C and 9D of the Act.

The broad aim of section 9C was, with certain exceptions, "to categorise investment income from sources outside South Africa which accrued to South African residents

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[259] Section 9A in its original format was repealed by s 8 of Act 59 of 2000.
[260] Katz Commission 'Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1997 Government Printer Pretoria) paras 6 and 3.1.1.1. <www.sars.org> accessed 27 April 2017.
[261] SARS 'Budget Speech of 23 February 2000' <www.treasury.gov.za http://www.treasury.gov.za/comm_media/speeches/2000/speech.pdf> accessed 7 May 2018.
[262] ibid.
[263] SARS 'Budget Speech of 20 February 2002' <http://www.treasury.gov.za/comm_media/speeches/2000/speech.pdf> accessed 7 May 2018.

as being from a source within South Africa and therefore taxable in South Africa".[264] This made it possible for SARS to tax foreign passive income in the hands of South African residents. On the other hand, the broad aim of section 9D of the Act was to ensure that any investment income which accrued to a foreign entity or any accrual in the hands of a South African resident who had participation rights in the income of the foreign entity, would be taxed by SARS.[265]

This default hybrid tax system adopted by south Africa, where residents are taxed on their worldwide income while non-residents are taxed on their passive income, made it possible for SARS to tax internet-based transactions and other cross-border transactions performed by non-residents who fell within the deeming provision in the Act.[266] The structural change to the Act was also intended to ensure that the South African tax system keeps pace with globalisation and the integration of the country with the world economy.[267] In fact, the application of section 9D of the Act as read with the transfer-pricing rules under section 31, has made it difficult for taxpayers to shift their profits to an offshore company. This happens because the transfer-pricing rules have made it possible for SARS to tax a significant portion of the income that could be transferred by an enterprise to an offshore company under its control.

The CFC rules were effective in the pre-Facebook and TikTok eras. The policy makers did not foresee that internet could change the business environment where virtual offices are the norm and trade can be carried out without the need for a physical meeting or physical office established in South Africa. South Africa's CFC rules which exempt amounts attributable to a foreign business establishment from taxation, are the weakest link in the Act for ensuring the taxation of digital transactions.[268] This exemption is not ideal in today's digital environment where an

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[264] Meyerowitz 1998 *Taxpayer* 81.
[265] ibid.
[266] Section 9D and 9(1) of the Act.
[267] SARS 'Budget Speech of 21 February 2001' <http://www.treasury.gov.za/documents/national%20budget/2001/speech/speech.pdf> accessed 7 May 2018.
[268] Section 9D(9)(*b*) of the Act.

enterprise could easily use the internet to ensure that its entire income is attributed to a foreign entity with no significant presence in South Arica.

It is perhaps for this reason that the government of South Africa has appointed various Commissions to help it reform its income tax law regime to comprehensively address all issues that expose its tax base to possible erosion.[269] This tax review which commenced in 2009 culminated in the formation of the Davis Tax Committee on 17 July 2013. The Committee's mandate was to inquire into the role of the tax system in the promotion of inclusive growth, employment creation, development, and fiscal sustainability.[270] The Committee was required to take into consideration global developments like the impact of e-commerce on the integrity of the tax base, and the long-term objectives of the National Development Plan, in the course of its work.

The Committee delivered 25 reports to the Minister of Finance. In its final report, the Davis Committee was of the opinion that while the current transfer pricing,[271] controlled foreign companies,[272] and the general anti-avoidance rules[273] as contained in the Act are capable of taxing most e-commerce transactions in the country, these laws nevertheless have their limitations in a digital environment. For example, the Committee concluded that the country's laws did not provide for the taxation of non-residents who supply goods and services through e-commerce.[274] This was mainly because section 231 of the Constitution of the Republic of South Africa,1996 read with sections 108 (2) and 9 of the Act, do not sufficiently provide

[269] SARS 'Budget Speech of 11 February 2009' <http://www.treasury.gov.za/documents/national%20budget/2009/speech/speech.pdf> accessed 7 August 2018.
[270] Davis Tax Committee 'Interim Report on Base Erosion and Profit Shifting' (2014) <www.sars.org> accessed 27 April 2017.
[271] Section 31 of the Act.
[272] Section 9D of the Act.
[273] Sections 80A to 80L of the Act. The previous general anti-avoidance rules were provided for under the repealed s 103(1) and (2) of the Act.
[274] Davis Tax Committee 'Second Interim Report on Base Erosion and Profit Shifting' <https://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20-%20Introductory%20Report.pdf> accessed 27 April 2017.

for the taxation of income on intangibles such as royalties or other related income that are obtained outside the country.[275]

The Committee was also of the view that taxation of a CFC which owned or operated offshore trusts was not sufficiently provided for under the Act.[276] Therefore, this could allow CFCs to avoid tax in South Africa if they used the available internet platforms and applications for the bulk of their trade from the off-shore trusts to help them ensure that the originating cause of their income was not in South Africa. The situation was exacerbated by section 1 of the Act which aligned the meaning of 'a permanent establishment' (PE) under the Act with the definition contained in Article 5 of the OECD Model Tax Convention.[277] This narrow definition of PE under the Act was not sufficiently detailed to allow for the taxation of a non-resident with regard to income derived by him or her from e-commerce transactions with South African residents. Companies could therefore easily avoid tax in South Africa because the originating cause of their income was not within the country.

The Davis Tax Committee found that as this challenge to the taxation of the digital economy was of an international nature, South Africa could change the definition of a PE in its double-tax treaties. In addition, the current source rules in section 9 of the Act ought to be expanded to cover proceeds obtained from the supply of digital goods and services derived from a source in South Africa, or where payments are made electronically for goods or services supplied to a non-resident. Enactment of such rules could form the basis on which South Africa could apply the OECD recommendations on the taxation of the digital economy.[278] From a policy perspective, the Committee stressed that it was important for the country to create a level playing field to allow South African digital companies that trade in digital goods and services to compete with the likes of Google.

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[275] ibid.
[276] ibid.
[277] Article 5 of the OECD Model Tax Convention on Income and on Capital defines a permanent establishment as a fixed place of business through which the business of an enterprise is wholly or partly conducted.
[278] Davis Tax Committee 'Second Interim Report on Base Erosion and Profit Shifting' <https://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20-%20Introductory%20Report.pdf> accessed 27 April 2017.

With regard to the tax administration challenges within the digital economy, the Committee observed that identification of businesses, their customers, and business transactions posed the greatest challenge to SARS.[279] It therefore, recommended that the Act should be amended to provide that the Electronic Communications and Transactions Act could be used to guide SARS in detecting and identifying taxable transactions so as to ensure tax compliance by taxpayers involved in e-commerce. The committee also proposed that South Africa could consider adopting the procedures established under the OECD Mutual Administrative Assistance in Tax Matters Convention, which encourages information sharing among signatories in matters of tax. This would in turn help SARS to access frequent, efficient, and up to date information which would help it collect tax effectively.

The Davis Tax Committee completed and submitted its final report to the Minister of Finance in March 2018. It is anticipated that, as stated in its terms of reference, the Minister of Finance will consider the recommendations of the Committee and make appropriate announcements as part of the country's normal budget and legislative process in the coming years. As at 20 December 2017, at least 72 countries, including South Africa, had signed the OECD Mutual Administrative Assistance in Tax Matters Convention. This was clearly consistent with the recommendations of the Davis Tax Committee.

In the 2018 budget, the Minister of Finance also decried the increase in the use of off-shore trusts by certain taxpayers to limit their tax.[280] The government subsequently adopted some of the recommendations of the Davis Tax Committee Report by creating a unit to investigate syndicated tax evasion schemes including

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[279] OECD 'BEPS Action: Address the tax Challenges of a Digital Economy' 61-62 (March 2014) <https://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf> accessed 7 May 2018.
[280] SARS 'Budget Speech of 21 February 2018' <http://www.treasury.gov.za/documents/national%20budget/2018/speech/speech.pdf> accessed 7 May 2018.

the use of off-trusts to evade or avoid taxation.[281] The government also affirmed that it had aligned its domestic legislation with the OECD/G-20 Inclusive Framework proposals on taxation of the digital economy to combat base erosion and profit shifting.[282] This was aimed at ensuring that beneficiaries and those with vested rights in off-shore trusts are prevented from using the IoT to limit their tax liability. SARS recruited 490 additional staff members and invested 430 million Rand in modernising its infrastructure in 2021 to facilitate the taxation of the digital economy and high-wealth individuals.[283]

As it is, residents have limited opportunities to evade tax due to the modernisation of the tax laws and application of the residence basis of taxation in terms of which residents are taxed on their worldwide income.[284] On the other hand, non-residents operating e-commerce-based enterprises have taken advantage of the law to establish their physical locations in low-tax jurisdictions. This has shielded them from tax liability in South Africa. These profit shifting activities have resulted in revenue authorities losing huge tax revenues.[285] Is it therefore now time for the government of South Africa to consider direct taxation of all the revenue realised by non-residents on their e-commerce enterprises so as to protect its tax base?

2.5 Should we Tax the Internet?

The rapid growth of the digital economy has made it difficult for anyone to ring-fence it as most companies in the world have adopted and embraced the IoT in transacting their daily business. This phenomenon has resulted in the internet becoming part of the country's economy and failure to tax or regulate it could result in unintended tax exemption for a sizeable portion of the population who rely on and use the internet

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[281] SARS 'Budget Speech of 24 February 2021 National Treasury' <https://www.gov.za/speeches/minister-tito-mboweni-2021-budget-speech-24-feb-2021-0000> accessed 2 April 2022.

[282] National Treasury "Budget Review 20 February 2019' <http://www.treasury.gov.za/documents/national%20budget/2019/review/FullBR.pdf> accessed 2 April 2022.

[283] National Treasury 'Budget Review 23 February 2022' <http://www.treasury.gov.za/documents/national%20budget/2022/review/FullBR.pdf> accessed 2 April 2022.

[284] Davis Tax Committee 'Addressing Base Erosion and Profit Shifting in South Africa' (2014) <http://www.taxcom.org.za/docs/New_Folder/1%20DTC%20BEPS%20Interim%20Report%20-%20The%20Introductory%20Report.pdf> accessed 27 April 2017.

[285] OECD 'OECD/G20 Base Erosion and Profit Shifting Project: 2015 Final Reports' (2015a). <http://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf> accessed 8 May 2019.

in the course of their daily trade transactions.[286] Some also argue that the internet is the future and we should not stifle innovation and upcoming digital enterprises with taxes before establishing clarity of concept of what constitutes a sharing economy.[287]

On the other hand, those who favour taxation of online trade argue that the failure of most governments to realise their tax targets can be attributed to the fact that most trade transactions take place over the internet which is safe from the clutches of many tax authorities like SARS.[288] Those who oppose taxation of internet-based transactions argue that there is nothing new under the sun because most governments continue to struggle with the same old challenges of determining tax *nexus* and residency in cross-border transactions.[289] It also emerges that taxing or not taxing internet-based transactions is not likely to address these fundamental tax challenges that are inherent in the tax system of most countries including South Africa. In the course of this discourse, those who support taxation have come to be known as the 'pragmatists' while those who oppose it are known as the 'purists'.[290]

2.5.1 A Case for Not Taxing the Internet

The following are the common arguments presented by the purists for not taxing the internet.[291]

2.5.1.1 Stifling Growth

Opponents of internet taxation have argued that taxing the internet will hinder its growth because taxation would stop people who are developing digital hubs from continuing with their enterprise.[292] Recent studies show that many people who shop online would refuse to purchase such goods if tax is levied on the goods purchased

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286 Information available at< http://www.htxt.co.za/2016/04/29/the-stuff-south-africa-26-8-mil-internet-users-spend-most-their-time-doing-on-line/> accessed 18 May 2017.
287 Bozdoganogly (2017) 8(8) *International Journal of Business and Social Science* 135.
288 Basu (2008) 1 *Journal of International Law and Technology* 72.
289 Li *International Taxation in the Age of Electronic Commerce: A Comparative Study* 494.
290 Cockfield (2004) 52 *Canadian Tax Journal* 606.
291 ibid 606-607.
292 Subhajit *E-commerce Taxation Law* 203.

or services offered over the internet.[293] They would instead move to other sites and purchase similar goods from vendors who do not levy tax on their products. The same studies indicate that whenever the law changes to provide for the taxation of the internet, purchases made from the internet predictably fell and, in some cases, consumers opted to purchase only the untaxed items.[294]

This implies that online tax can indeed stifle internet growth. This may perhaps explain why an online giant like Amazon has managed to avoid establishing a tax *nexus* in big states like California in the USA. Amazon established its first store in California in 2014 after striking a deal with the state government on how it will collect sales tax on its behalf. Failure to reach this deal would have meant that California would not have benefited from the investment and economic growth benefits that come with the establishment of an Amazon store in any state or country.

2.5.1.2 Huge Capital Investment Requirement

Taxing internet trade requires a huge investment in information technology infrastructure and continuous employment and training technically qualified personnel. This could mean that the investment outlay for a taxpayer in developing the necessary infrastructure to facilitate internet tax could easily exceed the value of the tax collected from internet sales.[295] Available studies by Ernst and Young indicate that the administrative costs for enforcing internet tax are likely to consume most of the anticipated revenue.[296] More specifically, the thesis confirmed that the cost of tax collection as a percentage of tax collected was 87% for small firms and about 50% for medium firms. On this basis, it appears unreasonable for the legislature to come up with tax legislation that would take back almost half of the revenue collected in the process of enforcement and administration. This cost-

[293] Leinav L Knoepfle D. *et al?* (2014) 1 *American Economic Review Journal 5-7*.
[294] ibid 5-7.
[295] Lee C.A (1999) 187(6) *Journal of Accountancy* 33-36.
[296] Simkin M.G, Graham W. B. and Shim J. P (2011) 1(2) *International Business and Economics Research Journal* 69.

benefit analysis of taxing digital transactions has moved some countries not to tax the internet.[297]

2.5.1.3 Difficulty in Managing Multiple Tax Laws

The tax purists opine that in practice digital transactions are similar to other transactions in the marketplace.[298] Therefore, this stream of business model should not be treated specially or be given too high a premium to a point where it specific legislation is required to govern it.[299] They further suggest that taxation of the internet is also not a new issue in tax administration.[300] As such, imposing another form of tax in the name of taxing Internet-based sales over and above the existing tax laws, would be unfair as many internet shoppers already pay tax on their daily purchases.

Moreover, introducing new legislation to tax the same income that can be taxed under the current Act is not only unnecessary but could also result in complexity in the management of income tax if it were to introduces taxation ideals that differ from those in the Act. In essence, these purists aver that income or profits are the same irrespective of how they are earned.[301] In addition, introducing new tax legislation to levy a 'special' category of income earned from the internet is a duplication and unnecessary exercise that is only likely to result in confusion and difficulties for the efficient management of tax income in the country.

A substantive Act aimed at taxing the internet would also require additional regulations or rules to operationalise it. It is for this reason that the scholars who fall in this school of thought are opposed to the introduction of a tax system which would add further regulations or statutes to those already existing. They argue that such additional statutes would only serve to make the tax system more complex and difficult for an ordinary taxpayer to navigate. This is important given that the issues

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[297] Krever 'Capital Gains Tax for South Africa' (on-line edn 2001) <http://www.omasek.com/RickKreverDraft> accessed 23 May 2017.
[298] Cockfield (2004) 52 *Canadian Tax Journal* 114-123.
[299] Li *International Taxation in the Age of Electronic Commerce: A Comparative Study* 494.
[300] Subhajit *E-commerce Taxation Law* 1.
[301] Cockfield (2004) 52 *Canadian Tax Journal* 114.

that are supposed to be addressed by any amendments to the Act are already captured in existing tax laws. Those ascribing to this school of thought believe that the easier it is for taxpayers to understand a tax system, the higher the voluntary compliance and lower the enforcement costs.[302] Adding more laws to regulate the tax environment would require taxpayers to go through a laborious process of familiarising themselves with many laws which they may not have the time to read and understand and could reduce the tax compliance rate.

This argument, however, loses sight of the fact that today most local and international transactions occur over the internet.[303] Very few companies encourage cash payments for their products or services. In addition, digital platforms like Facebook and Google today control some two thirds of global advertising revenue.[304] Given their tax avoidance strategies, their takeover of advertising revenue from the print media, and their economic importance, SARS and the global community ought to come up with effective strategies on how to tax internet-based transactions so as to save South Africa's tax base from erosion.[305]

Furthermore, the internet has dematerialised money, diminished national boundaries, and delegitimised the concept of permanent establishment as a basis of taxing cross-border transactions.[306] In essence, this means that the existing rules cannot be applied to e-commerce-based transactions unless they are re-modelled to fit internet conditions. The issues emerging from internet trade such as the use of electronic money, digitised products, the borderless nature of its transactions, and difficulties in identifying parties to a transaction are new issues in tax administration.[307] These may indeed require the legislature to develop regulations or laws which are adapted to these new challenges posed by the internet. The need

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302 Calvin A Kent 'Principles of a Good Tax System' <http://www.wvlegislature.gov/legisdocs/2015/committee/interim/TAX/TAX_20150504121250.pdf> accessed 4 October 2018.
303 Hoke W Tax Complexity Expands as Internet of Things Explodes' (2016) April *News and Analysis* 314-315 <file:///C:/Users/user/Downloads/us-tax-tax-analysts-complexity-expands-internet-of-things%20(1).pdf> accessed 2 September 2022.
304 Fuchs C 'The Online Advertising Tax: A Digital Policy Innovation' (2018) A Camri Policy Brief <file:///C:/Users/user/Downloads/UWP-024-fuchs.pdf> 6-7 accessed 3 September 2022.
305 ibid.
306 Oguttu and Tladi (2009) 4(3) *Journal of International Commercial Law and Technology* 213.
307 Fuchs C 'The Online Advertising Tax: A Digital Policy Innovation (2018) A Camri Policy Brief <file:///C:/Users/user/Downloads/UWP-024-fuchs.pdf>13-14 accessed 3 September 2022.

to ensure tax compliance and widen the tax base is more important than the proposal that this revenue stream should not be taxed simply because it may be difficult to manage.

2.5.1.4 Limiting Risk of Revenue Loss

Taxing the internet could easily drive away users of this service to jurisdictions where they are not taxed. The exit of such companies could negatively affect the revenue base of the country because migrating companies would not only cease to pay the minimum tax they are already paying, but could also migrate with the internet-based jobs that they have created for resident taxpayers.

This thesis also posits that most industries or enterprises in South Africa currently use some form of internet-based service to improve their efficiency and revenue bases. Taxing such internet-based activities could discourage these enterprises from engaging in internet-based transactions and result in job losses and a decrease in taxable revenue growth for SARS.[308]

2.5.1.5 Need for a Tax Break

The International Monetary Fund (IMF) has conducted a study and found that most governments across the world have increased their tax rates and introduced new tax laws to cater for their huge government expenditures.[309] This is also reflected in South Africa when in 2017 it introduced a top income tax bracket of 45% for individuals earning more than 1.5 million Rand per annum.[310] This followed a below-inflation tax adjustment to all tax brackets, and a 1% increase in personal income tax rates. This affected everyone except those who fell in the lowest income tax bracket in the year 2016.[311] The tax burden on individuals in South Africa has increased steadily from 8.3% of GDP in 2010/2011 to 9.8% in 2017/2018 to enable

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[308] Simkin M. G. Bartlet G.W. and Shim J.P. (2011) 1(2) *International Business and Economics Research Journal* 61.
[309] Ibid.
[310] The National Treasury 'Revenue Trends Tax Policy' <http://www.treasury.gov.za/documents/national%20budget/2018/review/Chapter%204.pdf> accessed 7 May 2019.
[311] The National Treasury 'Revenue Trends and Tax Policy' <http://www.treasury.gov.za/documents/national%20budget/2018/review/Chapter%204.pdf> accessed 7 May 2019.

the government to raise additional income to cover its expenses.[312] Similarly, in 2018 the government announced that Value Added Tax (VAT) was to be increased by 1% from 14% to 15%.[313] It was anticipated that this increase would help the government raise an additional 22 billion Rand to help government realise its overall tax revenue target of 1.422 trillion Rand for the 2019/2020 financial year.[314]

These tax increases have left the citizens reeling. The government must, therefore, develop new and less punitive methods of reducing the revenue shortfall which has grown from 30.7 billion Rand in 2017 to 48.2 billion Rand in 2018.[315] The government projected a budget deficit of 242.8 billion Rand for 2019/2020[316] and 370.5 billion Rand for the 2020/2021 financial years.[317] However, the actual reported shortfall was 551 billion Rand translating to 11.2% of the country's GDP.[318] This increase in the budget deficit was attributed to the negative effects of Covid-19 on South Africa's economy.[319] One of the available options is to consider the taxation of internet-based transactions. This would provide tax relief to the citizens burdened by heavy taxes and could even nurture the growth of internet-based enterprises in the country while ensuring that everyone who earns any form of income is taxed on any profit earned from their enterprise. Moreover, the fact that the value of the digital economy in the USA was placed at some 8.3% of the GDP in an economy whose size was estimated to be in the region of 18.12 trillion dollars in 2015, is a clear indicator that taxation of e-commerce trade could be a potential

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312 SouthAfrica.info 'Budget 2015: South Africa Raises Income Tax' <http://www.treasury.gov.za/documents/national%20budget/2015/review/FullReview.pdf> accessed 28 February 2018.

313 The National Treasury 'Revenue Trends and Tax Policy' http://www.treasury.gov.za/documents/national%20budget/2018/review/Chapter%204.pdf> accessed 7 May 2019.

314 The National Treasury 'Budget Review 2019' (20 February 2019) <http://www.treasury.gov.za/documents/national%20budget/2019/review/FullBR.pdf accessed 2 April 2022.

315 SARS 'Budget Speech of 21 February 2018' <http://www.treasury.gov.za/documents/national%20budget/2018/speech/speech.pdf> accessed 7 August 2018.

316 National Treasury 'Budget Review 2019' (20 February 2019) <http://www.treasury.gov.za/documents/national%20budget/2019/review/FullBR.pdf> accessed 2 April 2022.

317 National Treasury 'Budget Review 2020' (26 February 2019) <http://www.treasury.gov.za/documents/national%20budget/2020/review/fullbr.pdf> accessed 2 April 2022].

318 Business Tech 'South Africa' s Main Budget Gap at 11.2% of the GDP' (5 May 2021) <https://businesstech.co.za/news/business/487975/south-africas-main-budget-gap-at-11-2-of-gdp/> accessed 2 April 2022.

319 SARS 'SARS Announces Preliminary Revenue Outcome for 2020/21' Press Release (1 April 2021) <https://www.sars.gov.za/media-release/sars-announces-the-preliminary-revenue-outcome-for-2020-21/> accessed 2 April 2022.

revenue earner.[320] Countries like South Africa could, therefore, consider the taxation of this income stream which is slowly becoming a significant part of the main economy.[321]

2.5.1.6 Difficulty in Enforcement of a Pro-Internet Tax Regime

Tax purists have argued that collection and enforcement of tax on the internet is complex,[322] expensive, and can create inefficiencies in the entire tax system.[323] The enforcement costs, which entail what is taxable, exemptions applicable, protection of individual constitutional rights, assessment of tax, and prosecution of violators, can be expensive and unwieldy. A study conducted by Ernst and Young has shown that in general terms the administrative costs of enforcing internet tax, as a percentage of the total was 87% for small firms and 14% for big companies.[324] In addition, multiple discriminatory taxes, which are likely to derail and harm internet commerce, are likely to occur if tax is levied on digital transactions.[325] This could slow down job creation and other innovative opportunities associated with the internet contrary to economically settled principles that for a good tax system to be considered, it should be efficient and simple in its implementation.[326]

The anonymous nature of e-commerce transactions has made it difficult for tax authorities to identify the buyers or sellers of goods or services in the e-commerce trade. This means that to tax such transactions, SARS would be required to carry out an in-depth audit or investigation to identify the buyers or sellers party to such a transaction. Although such an exercise is not impossible it could be cumbersome

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320 International Monetary Fund 'Measuring the digital economy' (2018) <file:///C:/Users/Admin/Downloads/022818MeasuringDigitalEconomy.pdf> accessed 8 May 2019.
321 Manyika R and Roxburgh R 'The Great Transformer: The impact of the Internet on Economic Growth and Prosperity' (2011) <https://www.mckinsey.com/~/media/mckinsey/industries/technology%20media%20and%20telecommunications/high%20tech/our%20insights/the%20great%20transformer/mgi_impact_of_internet_on_economic_growth.pdf> accessed 18 October 2019.
322 Cockfield (2004) 52 *Canadian Tax Journal* 114.
323 Simkin M. G. Bartlet G.W. and Shim J.P. (2011) 1 *International Business and Economics Research Journal* 64.
324 Ibid
325 Ibid.
326 Maguire S 'State Taxation of Internet Transactions' (2012) Congressional Research Service Report for Congress <https://www.everycrsreport.com/files/20120806_R41853_0ea475326fe9fc0aa9f59b9f6f984a3a9db00bf7.pdf> accessed 13 May 2019.

and difficult for SARS to carry out a continuous audit on the 38.1 million internet users in South Africa.[327] The tax purists have consequently affirmed that the costs and difficulties associated with this compliance exercise should act as a sufficient indicator for government to abandon the idea of taxing internet-based transactions.[328]

2.5.2 A Case for Taxing the Internet

The proponents of internet taxation have argued that Armey's assertion has been overtaken by events because the internet economy, which was valued at some 1.2 trillion dollars in 2014,[329] has become part of the economy which is growing fast and steadily replacing the traditional modes of doing business.[330] Any government, which ignores the need to tax this new economy may, therefore, suffer severe erosion of its tax base.[331]

The following are some of the reasons advanced by tax pragmatists in support of the taxation of internet-based transactions:

2.5.2.1 Promotion of Fairness and Equity in Taxation

Fairness is a cardinal canon in any good tax system,[332] which demands that any fair and equitable tax system must treat all taxpayers equally and in a neutral manner irrespective of the platform which they have opted to use in conducting their business.[333] A tax system that levies tax on all other businesses but exempts income earned from internet-based trade promotes unfairness in the society.[334] This could easily lead to social disorder and disunity if the heavily taxed citizens' revolt

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[327] Statista 'Digital Population in South Africa as of January 2021' <https://www.statista.com/statistics/685134/south-africa-digital-population/> accessed 2 April 2022.
[328] Rasmussen BS 'On the Possibility and Desirability of Taxing E-Commerce' (Working Paper 2004-08) <https://repec.econ.au.dk/repec/afn/wp/04/wp04_08.pdf> accessed 2 April 2022.
[329] Information available at <https://internetassociation.org/121015econreport> accessed 3 June 2017.
[330] Ernst & Young (1999) 69(8) *CPA Journal* 10.
[331] Cobb P, Kobrin S.J, and Wagner *E* (2000) 21 University of Pennsylvania *Journal of International Economic Law* 663.
[332] Smith *Wealth of Nations* 676.
[333] Cigler J.D and Stinnett S. (1997) 8 *Journal of International Tax Law* Issue 247.
[334] GSR discussion paper 'Impact of Taxation on the Digital Economy' (2015) <www.itu.int> 5 June 2017.

against perceived excessive and unfair taxation which favours those who conduct their business over the internet.[335] The only way in which any government can prevent such societal disorder and possible anarchy is to promulgate laws that ensure that all taxpayers pay their fair share of tax irrespective of whether such income was realised from the trade conducted over the internet or using other traditional methods like sales from supermarkets, hardware centres, shops, or markets.[336] At the end of the day, taxing the internet will not only help South Africa realise a fair and equitable tax system but will also help to bolster its tax revenue base.[337]

2.5.2.2 Creation of a Neutral Tax System

Neutrality in a tax system means that tax rules should not negatively affect the economic choices of citizens.[338] A tax system which exempts a group of people who use the internet platform from taxation while levying tax on all transactions undertaken by another group of people who rely on the traditional physical counters to sell their products, is not neutral. In fact, such a tax system could encourage diligent taxpayers to adopt internet technology in their trade so that they too can benefit from the possibility of limiting the tax due on some aspects of their trade.[339]

2.5.2.3 Protection of the Tax Base

The financial expenditure of the government of South Africa has increased phenomenally in recent years. This has forced it to consider possible avenues through which it can raise extra revenue even as it protects its current base. The fact that the potential e-commerce revenue in South Africa was valued at some 3.1 billion Rand in 2018 – and projected to grow to 5.3 billion by 2022 – confirms that online trade is a very attractive income stream that could be exploited by SARS to

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[335] Smith *Wealth of Nations* 667.
[336] OECD 'Addressing the Tax Challenges of the Digital Economy, Action 1-2015 Final Report' <www.oecd.org> accessed 18 May 2017.
[337] Mphidi 'Digital Divide and E-Governance in South Africa' (Paper presented at the Research Innovation and Partnerships Conference at Tshwane University of Technology) <http://www.ais.up.ac.za/digi/docs/mphidi_paper.pdf> accessed 18 November 2017.
[338] Basu (2008) *Journal of Information Law and Technology* 19.
[339] Jones and Basu (2002) 6(1) *International Review of Law Computers* 35-51.

protect or expand the country's revenue base.[340] There were approximately 17.1 million users of e-commerce platform in 2016. This figure grew to 38.1 million as of January 2021[341] which translates to some 63% of the country's population.[342] It is also projected that internet-usage penetration is likely to grow to 80.8% by 2023. It is thus advisable for the country to consider taxing this growing revenue stream that is increasingly embraced by most traders and industries. Indeed, failure to tax the internet could result in erosion of the country's tax base as more and more taxpayers' resort to available e-commerce platforms not only to catch up with the changing trends of the new century, but also to improve the efficiency of their businesses.

2.5.2.4 Promotion of Internet Growth

The pro-taxation group believes that internet trade is similar to any other form of trade. Taxing it will not create a new tax as the law in South Africa already requires that tax be levied on any income received by or accruing in favour of any person in any year of assessment.[343] Moreover, taxation of the internet involves taxation of income and not taxation of internet use or internet services – SARS merely collects the revenue due to it from such transactions. Any claim that taxation of the internet could stifle internet growth is misplaced because internet tax is focused only on the income earned from a business transaction and not the taxation of internet use, its infrastructure, or any other aspect that could stifle internet growth. The requirement of taxing any income earned from whatever source and not the infrastructure which produces such income is defined in the Act which identifies income to include all income earned from trade.[344] This makes it clear that the Act provides only for the taxation of the income that is earned from an internet transaction and not for the taxation of the infrastructure. The assertion that internet tax would stifle growth is, therefore, misplaced in that such a tax would concentrate exclusively on income earned from internet-based transactions as is provided for under the Act.

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340 Data available at <www.statista.com> accessed 18 May 2017.
341 Statista 'Digital Population in South Africa as of January 2021' <https://www.statista.com/statistics/685134/south-africa-digital-population/> accessed 2 April 2022.
342 Querty digital 'The digital landscape in South Africa 2017' <https://qwertydigital.co.za/wp-content/uploads/2017/08/Digital-Statistics-in-South-Africa-2017-Report.pdf> accessed 7 May 2019.
343 Section 5(1) of the Act.
344 Definition of an income as is stated in s 1 of the Act.

Today, the internet is used for convenience in shopping. This trend does not, however, mean that every person who uses the internet does so with the intention of avoiding tax. Taxation of the internet would, therefore, not necessarily make these shoppers avoid or abandon the convenience of shopping online. In South Africa, it was estimated that the annual transactional value of e-commerce stood at approximately 50 billion Rand by the end of June 2018[345] and was anticipated to rise to some 83 billion Rand by 2022.

Outside South Africa the internet has continued to grow sporadically even in countries like the USA whose value of internet trade had reached 644 billion dollars by 2016[346]– despite digital transactions in the USA being taxable.[347] This phenomenal growth in online trade confirms that taxation of internet-based trade need not necessarily inhibit the growth of e-commerce trade.

At the global level, the value of global e-commerce has risen from 1.5 trillion dollars in 2015 to 2.9 trillion dollars in 2018 and 4.9 trillion dollars in 2021. It is projected that the value of the global e-commerce market will total some 7.3 trillion dollars by 2025.[348] This actual and projected phenomenal growth in internet trade shows that e-commerce has matured and ought to be taxed like any other trade and that this form of taxation is unlikely to affect the growth of the internet or internet trade. This is why several countries have come together under the umbrella of the OECD to devise an action plan on how to protect the revenue bases of member states by taxing digital transactions.[349] This concerted global effort in taxing the internet further confirms that the taxation of the digital economy will not stifle either the development or the growth of the internet.

345 Information available at <https://www.statista.com/outlook/243/112/ecommerce/south-africa>.
346 E-commerce Foundation 'Global B2C E-commerce Report 2016' <https://www.ecommercewiki.org/wikis/> accessed 5 June 2017.
347 UNCTAD 'World Investment Report 2017: Investment and the Digital Economy' <http://unctad.org/en/PublicationsLibrary/wir2017_en.pdf> accessed 5 June 2017.
348 Statista 'Retail E-commerce sales Worldwide from 2014 to 2025' <https://www.statista.com/statistics/379046/worldwide-retail-e-commerce-sales/> accessed 2 April 2022.
349 OECD 'About Base Erosion and Profit Shifting (BEPS)' <http://www.oecd.org/ctp/bepsabout.htm> accessed 3 July 2018.

2.5.3 Summary

The issue that scholars from these two opposing schools of thought should address is whether the countries that do not tax the internet can remain relevant and survive the vagaries of the digital economy. This should be viewed alongside the question of whether failure to tax the internet will still ensure that the country's general tax system remains fair, equitable, neutral, simple, and certain. The government of South Africa has recognised that the digital economy has become part of the economy itself[350] – a case for not taxing the internet would therefore be difficult to sustain.

2.6 Challenges Posed by the Internet for Taxation

It is evident that the IoT can pose serious challenges for the administration of any country's tax system. It can also help a country to model its tax system to be fair, effective, and equitable. This thesis proposes a path that the government could adopt while considering whether or not it should tax the internet. The proposal takes into consideration the best practice adopted by the OECD and other developed countries in dealing with this challenge.

While e-commerce has brought several benefits to businesses and consumers, governments around the world have lost revenue because some businesses have used the platform to limit their tax liability.[351] The fact that non-resident businesses engaging in e-commerce can avoid taxation in the countries in which they operate because of the difficulty of applying the domestic tax laws to e-commerce transactions, has posed challenges to the taxation of such non-residents. The following are some of the challenges posed by e-commerce trade in South Africa.

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[350] Davis Tax Committee Interim Report 'Addressing Base Erosion and Profit shifting in South Africa' <www.traesury.gov.za> accessed 1 September 2018.
[351] OECD 'OECD/G20 Base Erosion and Profit Shifting Project 2015' (2016) <http://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf> accessed 9 November 2019.

2.6.1 Identification of Taxpayers

One of the challenges that e-commerce poses to the country's tax regime is that it leads to the elimination of intermediaries or go-betweens who have been critical in helping SARS identify taxpayers in business transactions.[352] The trading enterprises prefer to deal directly with customers located in South Africa. In the process the taxing rights to these transactions are lost because digital trade does not require location (residency, or PE) in any jurisdiction as it takes place in cyberspace.[353] Moreover, the process of identifying taxpayers and the digital goods and services they deal in such as music, software, videos, or electronic books are in the main unknown to tax authorities.[354]

2.6.2 Records

Considering that payment of taxes is based on self-assessment, records of income and expenditure kept by the taxpayer often play a vital role in determining the tax owing to the tax authority, particularly when there is a dispute between the taxpayer and SARS on what is due and payable to the government. Creation of appropriate records during e-commerce transactions may be difficult to achieve because of its digital nature which is difficult to trace.[355] Furthermore, the digital form of the transactions may make it difficult for SARS to verify the parties or undertake an audit of the transaction to assist it in making a conclusive determination on whether it has jurisdiction to tax and how much tax should be payable on a specific transaction.[356] Even if SARS were to invest in digital forensic experts to attempt to establish the audit trail of each e-commerce transaction, it is submitted that the human resource, continuing training, and capital outlay required to achieve this goal may well far

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[352] Jones and Basu (2002) 16(1) *International Review of Law Computers & Technology* 35-52.

[353] Cyberspace is a virtual environment where communication occurs over and between computer networks through a network that is supported by the Internet. It is a conventional term used to describe to describe any transaction that is supported by the Internet such as social networking, e-commerce, e-mail, e-commerce trade, teleconferencing, social media, and other forms of e-based transaction. See Sai Y 'E-commerce Issues in Cyberspace' (2016) in Peter *Taxation of Electronic Commerce – A Commentary* <file:///C:/Users/Use1/Downloads/254-Article%20Text-995-2-10-20190820.pdf> accessed on the 29th of December 2019.

[354] Buys and Cronje (eds) *Cyber Law* 314.

[355] Basu (2001) 2 *Journal of Information Law and Technology* 20 <http://elj.warwick.ac.uk/jilt/01-2/basu1.html> accessed 28 December 2019.

[356] Peter M Taxation of Electronic Commerce – A Commentary' <file:///C:/Users/Use1/Downloads/254-Article%20Text-995-2-10-20190820.pdf> accessed 29 December 2019.

exceed the tax that could be collected from e-commerce trade. This is more so as it would require SARS to collaborate with other state agencies, financial institutions, and partner states to ensure efficient tax collection. These collaborating states and agencies would also have to keep up-to-date databases and technological solutions to ensure efficient tax collection.[357]

2.6.3 Trending Internet-Based Marketing Techniques

The IoT has made it possible for vendors to offer their products to worldwide customers through e-commerce platforms like Shopify, or auction sites such as E-Bay.[358] The internet is also generally used to link buyers and sellers through web sites where sellers can post what they are selling, and the buyers can view the site to identify and purchase what they want, or vice versa. The internet has also facilitated the use of web banners[359] by various companies and individual taxpayers which serve as advertising platforms. It is often difficult to determine the location of the people who post the advertisements on the platform or the location of the people who own, operate, and earn income from the web banners. An ISP[360] often hosts the websites on their servers. The question that many countries have grappled with is whether an ISP would constitute a dependent agent PE of the entity that conducts its business through websites hosted on the servers owned operated by an ISP.[361]

These new internet-based marketing techniques raise various tax issues, including whether an intermediary, a broker, or a hosting website should be considered a dependent agent PE for the person or entity whose content it hosts. It also poses a challenge as to how tax authorities can value the content of what is contained on

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[357] ibid.
[358] eBay is an American multinational e-commerce corporation that facilitates consumer-to-consumer and business-to-consumer sales through its website.
[359] A web banner is a form of advertising on the World Wide Web that is delivered by an advertising server. See definition and explanation of a web banner in Hofacker and Murphy 'World Wide Web Banner Advertisement Copy Testing' <file:///C:/Users/user/Downloads/World_Wide_Web_Banner_Advertisement_Copy_Testing.pdf> 704-705 accessed 10 September 2022.
[360] An ISP is a company that supplies connections to the Internet, usually for a monthly fee. Definition available at <https://www.whatismyisp.com/articles/what-is-an-isp> accessed 5 September 2022.
[361] Oguttu and Tladi (2009) 4(3) *Journal of International Commercial Law and Technology* 218.

these internet platforms or such e-commerce transactions for tax purposes. The source of the income for these transactions may also be difficult to establish.

2.6.4 Base Erosion

The need to raise income that can sustain the expenses of a government is a challenge facing most countries.[362] Protection of a country's tax base is thus one of the most important roles of any government. On the other hand, many taxpayers have adopted various strategies to limit their tax liability in any country which usually result in reduced income to the state. This reduction in tax income accruing to a state is referred to as base erosion.[363] On the other hand, profit shifting is a tax avoidance process which involves moving the profits earned from high-tax to low-tax jurisdictions. A combination of these two practices is generally referred to as BEPS-practice.

Today's digital economy has exacerbated the issue of BEPS because, in South Africa, non-residents are only subject to tax on income derived from a source in South Africa. However, if SARS is not able to attribute a PE to a transaction, then non-residents involved in the international transaction would not be taxed on their e-commerce profits as the source of their income would be deemed to be outside South Africa. This, in itself, is one of the main challenges the South African government has had to deal with.[364] It is perhaps this challenge which persuaded the former South African Finance Minister, Nhlanhla Nene, to announce that the government would propose changes to digital economy taxation rules in line with the guidance issued by the OECD.[365] It is vital to note that the proposed changes

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[362] Ault H and Arnold BJ 'Protecting the Tax Base of Developing Countries: An Overview' (2015) United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries <https://www.un.org/esa/ffd/wp-content/uploads/2014/10/20140604_Paper1_Ault.pdf> 1-45 19 October 2019.

[363] OECD 'Base Erosion and Profit Shifting- Final Report: Addressing the Tax Challenges of the Digital Economy, Action 1' (2015) <http://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en> accessed 29 December 2019.

[364] Camay A 'New Tax Rules Proposed for E-commerce Transactions' (2015) ENS Africa <https://www.ensafrica.com/news/new-tax-rules-proposed-for-e-commercetransactions?Id=1773&STitle=tax%20ENSight#> accessed 3 January 2020.

[365] SARS 'Budget Speech of 25 February 2015' <www.treasury.gov.za> accessed 7 January 2020.

to e-commerce and the taxation of the digital economy relate only to VAT.[366] The efforts that South Africa has made to deal with the tax challenges raised by the OECD are to be discussed in chapter 4 of this thesis.

2.6.5 The Decentralised Nature of Virtual Currencies

The structure of the block-chain technology that underlies all virtual currency (VC) transactions can present many challenges to its taxation. A block-chain is a stable, distributed, anonymous, and validated database which has several nodes. The genuineness of a VC is guaranteed only if it is approved by 51% of the nodes.[367] The block-chain technology can only allow access to one miner every ten minutes to append his or her set of records to the system. Once a miner has added the next 'block' to the 'chain' of mathematical equations that will result in the mining or transfer of a VC, the entire network of users has access to evaluate this addition every ten minutes for as long as the miner is online. It is then approved within the block-chain if it is not a double spend or if there are no objections.

An objectionable transaction is remedied using the consensus rules developed within the block-chain system. For example, a double spend will be picked out sooner because the block-chain system publicly shares the transactions amongst all users of the system through a global peer-to-peer network.[368] Block-chain technology is at the centre of all transactions involving VCs and has contributed to the following challenges that tax authorities face in the taxation of VCs.

To begin with, the trade in VC is anonymous. This means that whereas the block-chain technology records and verifies transactions, these records do not control any identifying information. The public address of the owner and other relevant identifying information visible in the block-chain are often pseudo addresses. In other words, the transactions that take place between buyers and sellers within the

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[366] On 21 February 2018 an amended draft regulation on electronic services for VAT was published in South Africa.
[367] Bambara and Allen *Blockchain*online. 580.
[368] Brito J and Castillo *Bitcoin* 4 <https://www.mercatus.org/system/files/Brito_BitcoinPrimer.pdf> accessed 21 November 2020.

block-chain can be anonymous at the option of the users.[369] This is because the block-chain technology allows users to adopt any convenient name and address to mine or transact in VCs. The end result is that the users of this technology can remain anonymous when settling their obligations using VCs.[370] Although the information of the user may not be visible on the block-chain platform, the details of his or her transaction is there for all users to see. This is why certain people refer to VC transactions as 'pseudonymous'.[371]

In simpler terms, a VC is like cash because the transactions are concluded without knowing the location of either party or the amount that paid in the transaction. Any person who receives benefits from a VC transaction and fails to declare these in his or her tax return will escape tax liability. The anonymous nature of the VC has today attracted people who are seeking to use it as a super tax haven[372] This is brought into perspective by the fact that a person can use the available online vendors to carry out his or her VC-based transactions without setting up his or her own website address or personal trading wallet. With no money trail or a website that is connected to the taxpayer, it would be difficult for any tax authority to link the taxpayer to such transactions unless he or she discloses his or her identity voluntarily.

Whereas the Taxation Amendment Act of 2018 introduced cryptocurrencies in the Act as part of the definition of financial instruments to facilitate the taxation of digital transactions, the rest of the Act was not amended to provide for the taxation of digital transactions. In essence, the recognition of cryptocurrencies as part of defined financial instruments implies that they were intended to be taxed under the extant provisions of the Act. The ideal situation would perhaps have been further to amend the Taxation Amendment Act of 2018, and subsequent amendments to the Act, to provide for appropriate taxation of cryptocurrencies. This explains why SARS has continued to face challenges in levying tax on digital transactions.

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[369] Molloy (2019) 20 *Oregon Review of International Law* 631-632.
[370] Ober, Katzenbeisser and Hamacher (2013) 5(2) *Future Internet* 237-250.
[371] Reddy and Lawack (2019) 31(1) *SA Merc LJ* 14.
[372] Molloy (2019) 20 *Oregon Review of International Law* 633.

Secondly, block-chain technology operates on an international computer network. This has made it possible for its users to move or hide some of their assets or income on the network to limit their tax liability in South Africa.[373] The complex algorithm on the block-chain makes the VCs a safe haven for hiding income or assets without fear of SARS unearthing and taxing tax such income.

The decentralised nature of block-chain technology can also prevent a tax authority from determining where the cryptocurrency coin is located or where it was mined. Moreover, unlike the Rand, cryptocurrency users exchange the coin on a network that traverses the national border of states. This makes it easy for such users to shield their wealth or income from tax authorities by moving their coins or assets within the block-chain network and for so long as they do not exchange their coins for Rand or any other traditional currency.[374]

2.6.6 Fluctuating Value of Crypto Currencies

Cryptocurrency is one of the VCs that received recognition and an identity in the Act. This perhaps points to its popularity and notoriety as a value of exchange in several transactions in South Africa and the need to include it within the definition of financial instruments listed in the Act. [375] It can also be classified as intangible property since, although it lacks a tangible physical property, it has value in the rights that are transferred to other parties.[376]

In theory, therefore, the taxable value of crypto currencies is determined based on the transaction value at the time when the coins were acquired. However, unlike other intangible assets, the value of crypto currencies raises a myriad of challenges. The price and value of cryptocurrencies fluctuate frequently.[377] In fact, a trader can

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[373] Marian (2013) 112 (38) *Michigan Law Review* 17.
[374] David Floyd 'How the New Tax Law Impacts Cryptocurrencies' Investopedia (2019) <https://www.investopedia.com/news/how-new-tax-law-impacts-cryptocurrencies-trump/> accessed 21 November 2020.
[375] Section 1 of the Act.
[376] Molloy (2019) 20 *Oregon Review of International Law* 635.
[377] Igwebuike and Nwadialor (2020) 2(6) *Economy Economics and Social Sciences Academic Journal* 87. See also Reddy and Lawack (2019) 31(1) *SA Merc LJ* 26.

acquire it at a low point in the morning, and its value could rise significantly by the end of the day. This unstable nature of the cryptocurrency affords any trader the option of limiting his or her tax liability by using the lower value of the coin during the course of the day as its 'fair market value'. The document submitted to SARS to support this transaction would also be the one that shows the lowest value of the VC as traded in the course of the day. The taxpayer would also not be penalised or prevented from adopting this tax avoidance tactic as there is no regulation or legislation directing taxpayers to use the higher value, or an average of the lowest and highest traded daily value of a VC.

The absence of an agreed valuation method in cases such as the one discussed above, could thus allow for tax arbitrage.[378] This contrasts with transactions that involve fiat currencies whose value and the attendant tax consequences cannot be similarly manipulated. Secondly, the fluctuation on the value of VCs has also made it possible for taxpayers to limit their tax liability by disputing the cost basis or the coin value adopted by the tax authority on the day on which the property was disposed of.[379] This is often intended to help the taxpayer minimise any gain that he or she realised when he or she sold off the property.

The volatility of cryptocurrencies can have significant tax benefits for traders engaged in long-term trade using this currency. They could over or under report the cost basis or fair market value of their cryptocurrency holding to maximise the amount of loss realised, or to minimise the value of gains realised. This would in turn help taxpayers shield their tax gains from any tax authority.

These developments and their taxation challenges in South Africa and the rest of the world, led SARS to amend the Act and issue a statement confirming that the normal income tax rules will apply to cryptocurrencies.[380] The affected taxpayers are required to declare their VC gains or losses as part of their taxable income.

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[378] ibid.

[379] Molloy (2019) 20 *Oregon Review of International Law* 633.

[380] SARS 'SARS's stance on the tax treatment of cryptocurrencies' Press Release (6 April 2018) <https://www.africataxjournal.com/wp-content/uploads/2018/04/22-23-2018-SARSs-stance-on-the-tax-treatment-of-cryptocurrencies.pdf> accessed 18 June 2019.

These improvements in the income tax regime have improved SARS ability to tax VCs. However, the movement of VCs from the virtual world to the real economy would require SARS to find ways of dealing with the tax challenges identified in paragraph 4.7.6.1 and 4.7.6.2 of this thesis. This continued acceptance and assimilation of VCs into the real economy means that their definite and infinite growth has the potential to erode the country's tax base.[381] There is therefore, an urgency to create a legal environment that would prevent the misuse of cryptocurrencies as a safe tax haven. This thesis offers some proposals in the subsequent chapters on what policy makers could do to tax this emerging problem effectively.

2.6.7 Applying the Withholding Tax System

Section 47D of the Act, provides that the taxation of digital transactions would require the resident to withhold tax. This resident must therefore be identified beforehand. Some residents may, however, transfer their residency to cyberspace or other jurisdictions to avoid the responsibility of collecting the withholding tax on behalf of SARS. This could, for example, occur where an enterprise trades from or through a website located in the cloud or in a location outside the territorial borders of South Africa. Such an action has the potential of blurring and or transferring the residency of such a taxpayer to the cloud which is beyond the jurisdictional reach of SARS.

Section 35A of the Act outlines how withholding tax can be applied on immovable property from persons who are not ordinarily resident in South Africa. Immovable property[382] is defined as an asset. This means that section 35A of the Act cannot be applied to tax most forms of digital trade which often involve sale or lease of movable properties such as servers and internet websites.

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[381] Ahmed S 'Cryptocurrency & Robots: How to Tax and Pay Tax on Them' (2017) *Yale Law School* 3 <https://www.kellogghansen.com/assets/htmldocuments/CryptocurrencydRobots-HowToTaxAndPayTaxOnThem69S.C.L.Rev.6972018.pdf> 20 September 2020.
[382] Hornby *Oxford Advanced Learner's Dictionary* (6th ed).

Income earned by foreign entertainers and sports persons is also subject to withholding tax at the rate of 15% of the amount received by or accrued to a non-resident.[383] The person making the interest payment to the foreigner is required to withhold the tax even though the foreigner is responsible for the tax. Interest,[384] dividends,[385] service fees,[386] royalties,[387] and compensation for service payments are also subject to withholding tax.

Whereas the withholding tax system has provided SARS with an appropriate method of collecting tax without going to the trouble of chasing foreigners, the reality is that this tax system has not specifically provided for the taxation of digital trade in South Africa.

It would thus be safe to state that South Africa has not expressly adopted the application of withholding tax as a model for taxing digital transactions. Chapter 5 of this thesis entails a comparative analysis and thereafter decides whether South Africa should adopt the proposals by Yonah and Oguttu that the introduction of a withholding tax could resolve the tax challenges surrounding the taxation of digital transactions.[388]

2.7 Should South Africa Tax Internet-Based Transactions?

The IoT has grown from a tool used by researchers to share information internally into an international platform for trade, business, research, commerce, banking, and advertising.[389] It was predicted that South Africa's e-commerce trade would grow to

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383 Section 47B read with s 47D provides for the imposition of withholding tax by residents in respect of any amount received by or accrued to foreign entertainers and sportspersons.
384 Section 50B of the Act.
385 Section 64E of the Act.
386 Section 51B of the Act.
387 Section 49B of the Act.
388 Avi-Yonah (1997) 52 *Tax Law Review* 507. See also Oguttu (2009) 4(3) *Journal of International Commercial Law and Technology* 222.
389 Gauteng Province Provincial Treasury Quarterly Bulletin 'The Retail Industry on the Rise in South Africa' < file:///C:/Users/user/Desktop/The%20Retail%20Industry%20on%20the%20Rise%20in%20South%20Africa%20-%20Gauteng%20Provincial%20....pdf accessed 23 July 2017.

about 4.7 billion dollars by 2021.[390] There has also been an entry of Several e-commerce giants such as Amazon-South Africa, E-bay, Bidorbuy, and Napster have entered the South African market. Price Waterhouse Coopers have predicted that the contribution of ICT to South Africa's GDP will be worth some 178 billion Rand by 2020.[391] There is, therefore, no doubt that the local and worldwide value of internet sales, which stood at 1.5 trillion dollars in 2014, is growing by the day.[392] This presents a huge tax base for any tax authority.[393] Retail figures confirm that the digital economy has indeed become part of the South African mainstream economy and that the government ought to give deeper consideration to how to tax the internet-based transactions.

Despite the phenomenal growth of internet trade and the fact that the Davis Tax Committee, the Katz Commission, and the country's Green Paper on E-commerce have all affirmed that the Act was inadequate to deal with the tax challenges posed by the internet, the government has been slow to react and regulate the digital economy.[394] It has, nevertheless, made efforts to establish a framework for taxation of e-commerce transactions through section 9 of the Act which provides that an income shall be deemed to have accrued within the country if it has been received or the rights to have accrued to a person within the Republic, irrespective of the source of the income.[395] Income from the sale of goods electronically can be taxed under this provision of the law if that income is received by or accrues to a person who is or can be deemed a South African resident. In addition, sections 9D and 31 of the Act, which deal with taxation of CFC's and transfer pricing respectively, has

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390 Adheesh B 'E-commerce Country Case Study: South Africa' (2017) Discussion Paper <file:///C:/Users/Admin/Downloads/GA_Th3_DP_Budhree_20170901.pdf> accessed 30 March 2022.

391 Telecommunication and Postal Services Department, South Africa 'National Integrated Information and Communication Policy White Paper' (2016) <https://www.dtps.gov.za/images/phocagallery/Popular_Topic_Pictures/National_Integrated_ICT_Policy_White.pdf> accessed 11 September 2017.

392 Nielsen NV 'E-Commerce: Evolution or Revolution in the Fast-Moving Consumer Goods World' www.q4cdn.com accessed 11 September 2017.

393 Bird RM 'Tax Challenges Facing Developing Countries' 2008 International Studies Program Working Paper 08-02 <https://icepp.gsu.edu/files/ 2015/03/ispwp0802.pdf> accessed 20 August 2017.

394 Department of Communications 'Green Paper of E-Commerce: Making it your Business' (2000) <www.gov.za/sites/> accessed 1 November 2017.

395 Section 9(1)(*b*) of the Act.

helped to limit South African residents transferring their profits to off-shore entities through digital transactions.

However, when it comes to non-residents who supply goods or services electronically to South African residents, the non-residents are only taxed on profits that are deemed to be from income-earning activities from sources within South Africa.[396] Companies or businesses operating in an e-commerce environment will only be taxed by SARS on their income if the business activity generating income is connected to a physical place in South Africa. This taxation model can expose South Africa to possible erosion of its tax because most e-commerce companies do not have physical companies or offices from which they operate within the country.[397] This avoidance is further enabled by the intrinsic characteristics of e-commerce businesses such as anonymity, mobility and provision of digital goods and services. Income tax is therefore easily evaded by non-residents because e-commerce operations can be conducted in the absence of physical presence in South Africa. This means that the current tax laws, which rely on connection to a physical presence in South Africa, are ineffective and incapable of taxing e-commerce transactions performed by non-residents.[398] The Davis Tax Committee agreed with this assertion when it remarked that there were gaps in the Act which needed to be filled to bring more non-resident digital traders within the taxation ambit of the Act.[399]

From the foregoing discussion, it is clear the digital economy has become part of the mainstream economy and tax authorities like SARS can no longer ignore it. Therefore, South Africa's interest would best be served and its tax base protected

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[396] Haupt *Notes on South African Income Tax* 37.

[397] Taxation of non-residents in South Africa incorporates the deemed source rules in ss 9 and 9D of the Act.

[398] Olivier and Honiball *International Tax* 54-58.

[399] Davis Tax Committee 'Second Interim Report on Base Erosion and Profit Shifting' <https://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20-%20Introductory%20Report.pdf> accessed 27 April 2017.

if were to consider amending its income tax laws and joins the rest of the world in seeking an urgent solution to this digital taxation challenge.[400]

2.8 Conclusion

SARS has asserted that relying on the traditional concept of geographical boundaries to levy tax would be difficult to implement in the world of the cyberspace.[401] The Davis Committee[402] and Katz Commission[403] both emphasised the need for the country to consider an amendment to its tax laws to deal with the tax challenges of the digital economy. In 2004, du Plessis noted that the:

> ...[t]ax authorities will have to adapt their application of existing tax principles, practices, and procedures for an e-commerce environment. Alternatively, new methods of levying and collecting taxes will have to be devised. Taxpayers, on the other hand, will have to adapt their tax planning strategies and consider the impact of a changing business environment on their global tax charge.[404]

Borkowski was even bolder when he asserted that both the Act and international conventions have failed to deal effectively with the challenge of taxing digital transactions.[405] Other jurists who have subsequently supported the position held by Borkowski and du Plessis have stressed that the threshold and international principles that SARS relies on to tax digital transactions ought to be amended or adjusted in line with the changes in today's business environment.[406]

It is, however, crucial that the provisions and operation of South Africa's tax system and other principles applicable in the taxation of e-commerce transactions are

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[400] Li J 'Protecting the Tax Base in the Digital Economy' (2015) in United Nations *Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* 430-449 <https://www.un.org/esa/ffd/wp-content/uploads/2017/08/handbook-tax-base-second-edition.pdf> accessed 23 June 2017.

[401] Davis Tax Committee 'Second Interim Report on Base Erosion and Profit Shifting' <https://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20-%20Introductory%20Report.pdf accessed 27 April 2017.

[402] ibid.

[403] Katz Commission 'The Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1997) <www.sars.org> accessed 27 April 2017.

[404] Du Plessis 'Taxation of E-commerce'.

[405] Borkowski (2000) 26(1) *International Tax Journal* 20.

[406] Doernberg *et al Multijurisdictional Taxation* 33.

discussed in detail before concluding that the country's income tax laws are either incapable or ineffective in the taxation of e-commerce transactions.

CHAPTER 3

LEGAL FRAMEWORK, PRINCIPLES, AND CHALLENGES GOVERNING THE INTERNET IN SOUTH AFRICA

3.1 Introduction

The internet can blur the location, value, and character of an economic or income-generating activity that is subject to taxation. This often makes the application of source-based taxing rights difficult, the permanent establishment concept complicated, and the implementation of double taxation agreements strenuous. Consequently, many countries that still rely on traditional tax principles may find it difficult to enforce their rights to tax internet-based transactions without introducing progressive and effective tax laws to tax all internet-based transactions. The disruption in the exercise of taxation rights arising from the internet use was succinctly explained by the Pennsylvanian Federal Court in *Zippo Manufacturing Co v Zippo Dot Com Inc,* where the court concluded:[407]

> With this global revolution looming on the horizon, the development of the law concerning the permissible scope of personal jurisdiction based on internet use is in its infant stages. The cases are scant. Nevertheless, our review of the available cases and materials reveals that the likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the internet. This sliding scale is consistent with well-developed personal jurisdiction principles. At one end of the spectrum are situations where a defendant does business over the internet. If the defendant enters into contracts with residents of a foreign jurisdiction that involve the knowing and repeated transmission of computer files over the internet, personal jurisdiction is proper. At the opposite end are situations where a defendant has simply posted information on an internet website, which is accessible to users in foreign jurisdictions. A passive website that does little more than make information available to those who are interested in it is not a ground for the exercise of personal jurisdiction. The middle ground is occupied by interactive websites where a user can exchange information with the host computer. In these cases, the exercise of

[407] 952 F Supp 1119 (WD Pa 1997) is a decision by the United States District Court for the Western District of Pennsylvania.

> jurisdiction is determined by examining the level of interactivity and commercial nature of the exchange of information that occurs on the website.

Considering that the internet is here to stay and has indeed become part of the mainstream economy, the government of South Africa is obliged to re-evaluate its tax legislation to determine whether it can tax profits earned from transactions conducted in today's digital environment.[408] The challenges posed by e-commerce are answered and put in perspective in this chapter of the thesis. This is, however, preceded by examining the steps that the government has taken through its policies and legislative frameworks to govern and tax the growing digital environment in South Africa.

3.2 Green Paper on Electronic Commerce in South Africa

The government of South Africa developed a Green Paper on E-commerce[409] (the Green Paper) in November 2000 to help it deal with the challenges posed by e-commerce transactions. The Green Paper was a consultative document intended as an initial step in developing a regulatory policy framework to govern the pervasive nature of e-commerce trade. It defined e-commerce for the first time as:[410]

> The use of electronic networks to exchange information, products, services, and payments for commercial and communication purposes between individuals (consumers) and businesses, between businesses themselves, between individuals themselves, within government or between the public and government and, last, between business and government.

This comprehensive definition, which covers most of the businesses that were conducted electronically, was taken, in the main, from the OECD, which had defined e-commerce as:

> [T]he sale or purchase of goods or services, whether between businesses, households, individuals, governments, and other public or private organisations, conducted over the internet. The goods and services are

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408 Du Plesis and Viljoen *Taxation of E-commerce: Income Tax* 231.
409 Department of Communications 'Green Paper on Electronic Commerce for South Africa' (2000) <https://www.westerncape.gov.za/Text/2004/6/green_paper_on_electronic_commerce.pdf> accessed 7 May 2018.
410 ibid.

ordered over those networks, but the payment and the ultimate delivery of the good or service may be conducted on or off-line.[411]

One of the primary objectives of the Green Paper was to help South Africa to begin the transition process from an industrial-focused economy to one based on the use of electronic networks to conduct trade. The Green Paper identified the following as some of the issues that the country needed to consider when developing its e-commerce policy:[412]

a) the application of electronic communication on paper or paper-based concepts such as original writing and signature;
b) electronic formation of contracts;
c) taxation in the e-commerce environment;
d) e-commerce and multilateral trading system;
e) authenticity and integrity of electronic communications;
f) information of material significance to confirm or enforce certain obligations to both dispatcher and recipient of goods or services, such as the time and place of dispatch and receipt of electronic information;
g) verification of dispatch;
h) new laws applicable in the taxation of e-commerce and the relevance of the older ones; and
i) legal implications of e-commerce

The government expected that the resulting policy would help the country come up with an e-commerce legal framework that could optimise and exploit the benefits of internet trade. In its final input and recommendations, the Green Paper adopted best practices from international bodies like the OECD, the UN Conference of Trade and Development (UNCTAD), and the World Trade Organisation (WTO) to obtain a global perspective on digital taxation. The paper cautioned that any amendments

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[411] OECD 'OECD Science, Technology and Industry Scoreboard 2011: Innovation and Growth in KnowledgeEconomies'<https://www.oecd-ilibrary.org/docserver/sti_scoreboard-2011-en.pdf?expires=1644695335&id=id&accname=guest&checksum=7DE751F9C73C617CBA5E023158DF7155> accessed 7 May 2018.

[412] Department of Communications 'A Green Paper on Electronic Commerce for South Africa' (2000) 24 <https://www.gov.za/sites/default/files/gcis_document/201409/electroniccommerce_1.pdf> accessed 7 May 2018.

made on the basis of its recommendations should be implemented with caution to protect the country's tax base from erosion that could arise from the adoption of international laws, practices, and principles that are not applicable in or compatible with the South African legal system.[413]

The Green Paper proposed the following as the areas that required the immediate attention of SARS:[414]

a) The need to tax residents on a worldwide income, irrespective of where the income was earned.[415] The Minister of Finance implemented this proposal, and it became effective from 1 January 2001.
b) The principles governing the identification of commercial websites owned by a South African resident, company, close corporation, or trust were out of touch with the digital world. There was need to update the Act to bring these website-based entities within the ambit of the country's tax system.

The issues raised in the Green Paper eventually led to the formulation of the National Integrity ICT Policy in 2016. The policy replaced the previous White Paper on Telecommunications.[416] Legislation that governed certain aspects of e-commerce trade, such as the Electronic Communications Act[417] and the Electronic Communications Transactions Act,[418] were to be amended in consonance with the National Integrity ICT Policy. A National Policy on Data and Cloud was to be developed and the Act to be reviewed to help the government of South Africa to protect and widen its tax base by effectively taxing e-commerce transactions.

3.3 Electronic Communications and Transactions Act 25 of 2002 and the Protection of Personal Information Act 4 of 2013

After much procrastination, South Africa opted to join the ranks of countries legislating on e-commerce by enacting the Electronic Communications and

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413 ibid.
414 ibid 46.
415 SARS 'Budget Speech of 23 February 2000' <www.treasury.gov.za> accessed 7 May 2018.
416 The Ministry for Post Telecommunication and Broadcasting 'White Paper on Telecommunication Policy' (1996) Government Printers Pretoria.
417 Act 36 of 2005.
418 Act 25 of 2002.

Transactions Act 25 of 2002 (ECTA). As much as it is not a taxation statute, the ECTA has facilitated the taxation of e-commerce trade in the country in various ways. It proposed to deal with issues such as writing and signature requirements, authentication, accreditation, safety and security, national strategy, e-government, access to electronic services, consumer protection, domain name administration, and cybercrime.

3.3.1 Electronic Signatures

Section 13 deals with electronic transactions that involve the use of electronic signatures (e-signatures). It recognises e-signatures as lawful and valid in all transactions where the type of signature to be used is not specified by law or by the parties to the contract.[419] The aim of the ECTA was to create certainty and validate the use of electronic signatures.

This means that the use of e-signatures has been raised to a legal issue in South Africa. And further, SARS could easily use the location of the holder of an e-signature to help it determine the location or residency of such a taxpayer, in particular if the taxpayer has used the virtual nature of the internet to hide or disguise its residency. In such a case the location from where a contract was signed or from where an e-signature was affixed on a document, or from where an e-mail issuing instruction on the daily operations or management of the company was issued could be deemed to be the location of residency of the signatory to that document.

The ECTA, therefore, clarified the uncertainty that had previously existed in South African law by placing digital transactions that are conducted using e-signatures on the same footing as traditional paper-based transactions.[420]

The place of e-signatures in the South African tax law landscape has been further confirmed in section 255(1)(*b*) of the Tax Administration Act [421] which provides that

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[419] Section 13(1) and (4) of the ECTA.
[420] Coetzee (2004) 3 *Stell LR* 520.
[421] 28 of 2011.

SARS may accept an e-signature or a digital signature as a valid signature for purposes of a tax which requires a signature.[422] This confirms that e-signatures are recognised in South Africa as a valid variable that can be used to determine the tax residency of a taxpayer or any other issues that relate to a tax Act. The model of how the e-signatures should be applied to specific transactions is contained in the rules for electronic communication promulgated by the Commissioner for SARS and gazetted on 25 August 2014.[423]

The ECTA defines a ‘‘consumer’’ as ‘‘any natural person who enters or intends entering into an electronic transaction with a supplier as the end user of the goods or services offered by the supplier”.[424] The implication is that the ECTA would not be invoked to fill the gaps in the Act which would make it possible for it to use a director’s e-signature to create a deemed residency for a close corporation or company.

The ECTA has eliminated stumbling blocks in the development and taxation of e-commerce transactions by according legal recognition to e-signatures so ensuring that electronic contracts on which digital signatures are affixed are enforceable in the same way as physical signatures to contracts.

3.3.2 Data Messages

Reduction of a document to writing has been one of the main obstacles in legalising electronic contracts. However, the ECTA has provided a solution to this dilemma by stating that this requirement will have been met if the information is in the form of a data message that can be displayed and reproduced.[425] The idea here was to find a replacement for the requirement of a written contract. This requirement would be met if one deals with a document which originated from a computer and which is capable of being produced either in electronic or paper format. In essence,

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[422] Section 255(2) of the Tax Administration Act 28 of 2011.
[423] Rule 7 of the rules for electronic communication prescribed under s 255(1) of the Tax Administration Act 28 of 2011 *Government Gazette* 37940 of 25 August 2014.
[424] Section 1 of the ECTA
[425] Section 14 of the ECTA.

therefore, any party in possession of an electronic document can use it as a binding document. SARS would therefore also be entitled to trace the origin of such electronic documents to help it determine the residency of its authors. This possibility is buttressed by the fact that the ECTA has expressly provided that data messages such as emails are admissible in court. [426]

Consequently, the ECTA has placed electronic transactions on the same footing as traditional paper-based transactions to the extent that it gives legal recognition to data messages in all electronic formats they may take. The fact that many South Africans have become comfortable with online shopping means that the ECTA is a useful piece of legislation that will influence how the government and its agencies such as SARS handle e-commerce transactions.

3.4 Draft National Policy on Data and Cloud

The government of South Africa recognised the challenges and opportunities that lie in its digital economy. It also recognised that various policies, legislation, and regulations that it had initiated did not deal with the issue of taxing the digital economy efficiently because the ECTA and Electronic Communication Act 35 of 2005 (ECA) were enacted at a time when the internet uptake and use in trade was low in South Africa.[427] Today, internet technology is applied widely and extensively to facilitate trade.

It has also recognised that the growth of the digital economy has resulted in the demand for storage and processing capacity in the cloud. The policy asserts that there is need to recognise that data is the infrastructure for the digital economy and so the enabler of macro-economic development. The policy elucidates that data is a primary driver for the digital economy. A country that controls data would therefore, have an advantage and a prime seat in the control of revenue benefits that flow from a digital economy.[428]

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[426] Section 16 of the ECTA.

[427] Department of Communications and Digital Technologies 'Draft National Policy on Data and Cloud' *Government Gazette* 44389 of 1 April 2021 at 8.

[428] ibid 8-9.

The draft policy appreciates that data is a tradable commodity. This means that the development of a data and cloud computing storage in South Africa would put the country in a position where it can sell the data it holds for advertising or related purposes.[429]

MNEs have also found innovative ways of conducting data-driven transactions in countries where they have no physical presence. Hosting a cloud storage capacity would attract such businesses to South Africa. The revenue that the country has been deprived of by its taxpayers who moved to operate their businesses from or by using cloud computing services based in other countries, would also be protected once this policy is enacted.[430]

Data analytics can create new knowledge and technology that can be used to generate data. This would in turn make it possible for the country to be a leading developer and manufacturer of cutting-edge technology which is in high demand globally. [431]The income earned from such innovations which is obtained through appropriate use of data by its local industries, would help the government in job creation, protection, and in broadening its tax base.

The growth of a digital economy is driven by cloud computing technologies that enable the collection, analysis, and synthesising of massive amounts of digital data. A country that does not have a plan or model on how to expand its data storage capacity would not be able to grow its digital economy and reap from the benefits which accrue from it.[432] In fact, the emerging trend in the developed countries is to priorities development of data as a strategic national asset which it would use as leverage to protect and realise the socio-economic value of data.

[429] ibid 26.
[430] ibid.
[431] ibid 35.
[432] ibid 35.

This draft policy aims at transforming the South African economy into a data-driven digital economy. This would help to protect the country's tax base by the creation of new employment opportunities, enhancing investment opportunities, improving access to internet connectivity, and increasing the volume of online trade, align the country to global trends, promotion of innovation and protect the loss of investment opportunities to other countries. The enactment of this draft policy would thus play a big role in complementing the Act as regards the taxation of revenue earned within the country's digital economy.

3.5 South African Income Tax Legal System

The Act defines gross income in relation to any year or period of assessment as follows:

> (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 or deemed to be within the Republic.

This definition clarifies that residents and non-residents are treated differently for tax purposes based on their residence and/or the source of their income. The classification of taxpayers as either residents or non-residents in South Africa often determines the tax treatment that such taxpayers receive under the Act. These two principles are discussed below.:

3.5.1 Residence Basis Taxation of Residents

South Africa adopted this tax system from the 1 January 2001 to protect its tax base, increase its trade with other countries, and provide for the taxation of e-commerce transactions.[433] Under this system residents are taxed on their worldwide income, irrespective of its source. All that SARS must establish is a connection between the income earned and South Africa's territorial jurisdiction.[434] Once this has been

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433 South African Revenue Service 'Briefing Note Residence Basis of Taxation' (2000) <https://www.sars.gov.za/> accessed 14 June 2019.

434 Olivier and Honiball *International Tax* 4 ed 297.

established income tax is levied on the worldwide income of the resident. The Act classifies residents as both natural persons and persons other than natural persons. A natural person is defined as a person who is:

(*i*) Ordinarily resident in the Republic; or

(*ii*) Not at any time during the relevant year of assessment ordinarily resident in the Republic if that person was physically present in the Republic –

(*aa*) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each year of the five years of assessment preceding such year of assessment; and

(*bb*) for a period or periods exceeding 915 days in aggregate during those five years of assessment, in which case that person will be a resident with effect from the first day of that relevant year of assessment.

From this definition, a person is considered a resident of South Africa using the test of ordinarily resident in the country,[435] or the test of being physically present in the country for a prescribed period.[436]

3.5.1.1 Ordinarily Resident

The Act does not define the phrase 'ordinarily resident in the Republic'. SARS has thus been compelled to rely on the definition ascribed to the phrase in case law and Interpretation Notes.[437] It is, however, vital to note that SARS' Interpretation Notes (SARS-IN) do not have the force of law and are therefore not legally binding on the taxpayers, the courts, or even SARS itself.[438]

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[435] Para (*a*)(*i*) of the definition of 'resident' in s 1(1) of the Act.
[436] Para (*a*) (*ii*) of the definition of 'resident' in s 1(1).
[437] In the case of *Commissioner for SARS v Marshall* 2017 (1) SA 114 (SCA), the Supreme Court of Appeal held that although Interpretation Notes are not binding on the courts or a taxpayer, they nevertheless constitute persuasive explanations in relation to the interpretation and application of statutory provisions in question.
[438] ITC1675 (2000), 62 SATC 219.

The courts have interpreted 'ordinarily resident in the Republic' as the country to which a person would naturally and as a matter of course return from his or her wanderings.[439] In *H v COT*, the court held that the term ordinarily resident refers to the place where a person's permanent abode is, where his or her permanent belongings are stored, and to which he or she would return after any temporary absence.[440] It could, therefore, be termed a person's real home or his or her usual or principal residence. This view was affirmed in *Cohen v Commissioner for Inland Revenue*,[441] where it was held that a person is 'ordinarily resident' where he or she has his or her usual or principal residence or what may be described as his or her real home. It is submitted that several factors could help SARS determine the real home of a taxpayer. For example, the country where the family of the taxpayer stays, or where his or her children go to school would be considered.

There are, to date, no hard and fast rules for establishing what constitutes ordinarily resident. Instead, each case is decided on its merits provided that the determined jurisdiction of the taxpayer must be the place he or she calls home and not necessarily the place where he or she spends the most time. This general guideline in determining the concept was laid down in *ITC 1170* where it was clarified that determination of residency is one of degree requiring SARS to look at the taxpayer's lifestyle beyond the period under consideration.[442] This view was re-affirmed in the case of *Commissioner for Inland Revenue v Kuttel*,[443] where the courts asserted that a person might have more than one residence at any one time in different countries. However, the term 'ordinarily resident' differ from the term 'ordinary residence'. Besides, residency may not necessarily impute tax liability on a taxpayer unless it is determined that he or she is ordinarily resident in the country of jurisdiction.

What emerges from the case law above is that courts will look at the totality of the facts before it when deciding this concept. However, the overriding strand is that the

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[439] *Cohen v CIR* 1946 AD 174, 13 SATC 362 and confirmed in *CIR v Kuttel* 54 SATC 298.
[440] 24 SATC 738. See also Coetzee *et al Students' Approach* 35.
[441]1946 AD 174, 13 SATC 362, 373.
[442] 34 SATC 76.
[443] 1992 (3) SA 242 (A), 54 SATC 298.

place chosen as the ordinary residence of a taxpayer is his or her real home or the principal place where he or she resides.

Turning to foreign jurisdictions across the borders, the Canadian courts defined ‘ordinarily resident’ in the case of *Thompson v Minister of National Revenue*[444] as:

> Where in the settled routine of his life he regularly, normally or customarily lives, or, at which he in mind and fact settles into or maintains or centralises his ordinary mode of living with its accessories in social relations, interests, and conveniences.

In *Shah v Barnet London Borough Council and Others Appeals*[445] the English courts described it as:

> Where a person must be habitually and normally resident, apart from the temporary or occasional absence of long or short duration.

From this there appears to be consensus that whether a taxpayer may be regarded as being 'ordinarily resident' at a particular place is measured in degree by looking at the taxpayer's lifestyle and not necessarily by the number of days in which he or she was physically present in South Africa. Each case is decided on its facts having regard to the principles already established by case law or SARS-IN 3[446] as it is not possible to lay down any clearly defined rules or period by which to determine the concept of ordinarily resident.

The SARS-IN 3 was enacted to fill a gap in the Act. It defined the term ‘ordinarily resident’ by adopting the definition ascribed to it by the courts.[447] In this regard it is proposed that the following factors be taken into consideration when assessing whether a person is ordinarily resident in South Africa: [448]

a) an intention to be ordinarily resident in the Republic;
b) the natural person’s most fixed and settled place of residence;

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444 2 DTC 812 (SCC).
445 [1983] 1 ALL ER 226 (HL) 234b-c.
446 SARS-IN 3 <file:///C:/Users/Admin/Desktop/NOW/achoki/LAPD-IntR-IN-2012-03-Resident-definition-natural-person-ordinarily-resident.pdf> accessed 9 November 2019.
447 ibid para 4.
448 ibid para 4.1.

c) the natural person's habitual abode, that is, the place where that person stays most often, and his or her present habits and mode of life;
d) the place of business and personal interests of the natural person and his or her family;
e) employment and economic factors;
f) the status of the individual in the Republic and other countries, for example, whether he or she is an immigrant and what the work permit periods and conditions are;
g) the location of the natural person's personal belongings;
h) the natural person's nationality;
i) family and social relations (e.g., schools, places of worship and sports or social clubs);
j) political, cultural, or other activities;
k) that natural person's application for permanent residence or citizenship;
l) periods abroad, the purpose and nature of the visits; and
m) the frequency of and reasons for visits;

The Katz Commission described these guidelines as subjective in that they place a significant premium on the intention of a taxpayer, unlike the physical presence test which is based on a more objective approach to determining residency.[449] The subjective nature of the ordinarily resident test under SARS-IN 3 is clear from the fact that a natural person may be resident and his or her income taxable in South Africa even if that person was not physically present in South Africa during the relevant year of assessment. Secondly, the purpose, nature, and intention of a natural person's absence from the country may be factored in by SARS as part of the facts used to determine whether he or she is ordinarily resident in the country.

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[449] Katz Commission '5th Report - Basing the South African Income Tax System on the Source or Residence Principle - Options and Recommendations' (7 March 1997) <http://www.treasury.gov.za/publications/other/katz/5.pdf> accessed 9 November 2019.

This subjective approach to the law applied by SARS in determining residency in South Africa for purposes of taxation has made it possible for SARS to levy a tax on natural persons involved in e-commerce. This is principally because the application of the ordinarily resident test allows for taxation of all persons who fall within the definition of the term 'ordinarily resident'. In addition, this tax system would be applied irrespective of the current physical location of the enterprise which was used to generate the income. What matters, under this test, is that there must have been a connection between South Africa and the income earned and/or an intention evident from the taxpayer's actions, to become ordinarily resident in South Africa.[450]

Proving that any person has become ordinarily resident in South Africa requires SARS to consider the facts of each case individually. This is mainly because some taxpayers can alter or change their mode of life to ensure that they do not have a real home anywhere.[451] It is, however difficult for a taxpayer to do this successfully as SARS is at liberty to consider the circumstances of each case before or after the specific year of assessment in arriving at a determination as to whether the taxpayer is ordinarily resident in South Africa. Therefore, a person who has never been a resident of South Africa but is engaged in e-commerce trade within the country could be considered as ordinarily resident in the country and thus liable to pay tax on his or her worldwide income.

3.5.1.2 Physical Presence

The physical-presence test requires that for one to be deemed a resident of South Africa for income tax purposes, he or she must have been physically present and spent a specified number of days in South Africa. The physical-presence test for natural persons requires that such a person must have been physically present in South Africa for at least the following periods before he or she can be deemed a resident for tax purposes:[452]

(i) 91 days in aggregate during the year of assessment under consideration;

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[450] Olivier and Honiball *International Tax* 4 ed 297.
[451] Meyerowitz *Meyerowitz on Income Tax 2003-2004* para 5.17
[452] Section 1(1) Items (*aa*) and (*bb*) of para (*a*)(*ii*) of the definition of a 'resident.'

(ii) 91 days in aggregate during each of the five years of assessment preceding the year of assessment under consideration; and

(iii) 915 days in aggregate during the five preceding years of assessment.

A natural person who meets these requirements set by the physical-presence test is deemed a resident from the first day of the year of assessment when the requirements in the test are met.[453] A natural person who is a resident under the physical-presence test, is deemed a non-resident if that person is physically outside South Africa for a continuous period of at least 330 full days.[454]

On the other hand, the physical presence test for juristic persons is determined using a combination of statutory tests based on its place of formation or establishment, place of incorporation, or PEM.

The Act defines a resident to include a person (other than a natural person) which is incorporated, established, or formed in the Republic, or which has its PEM in the Republic.[455] Whereas the term ordinarily resident has been used to determine the residency of a natural person for tax purposes, the determination of residency of persons other than natural persons – e.g., companies or close corporations – is established using the physical-presence test.

This definition has two limbs that are used in the determination of the residency of a juristic person. First, it can be done either through the place of the incorporation, establishment, or formation of the entity. And second, it can be done by determining the entity's PEM.

The Act does not define the terms formation, establishment, or incorporation. It is, therefore, presumed that any entity that is formed, incorporated, or established in

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453 SARS-IN 4 para 4.1 <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-04-Resident-definition-natural-person-physical-presence.pdf> accessed 9 November 2019.
454 ibid.
455 Section 1 of Act 58 of 1962.

South Africa and issued with an incorporation certificate under sections 13 and 14 of the Companies Act[456] read together with sections 2 and 12 of the Close Corporation Act[457] is considered as residing in South Africa.

The determination of the residency of a person other than a natural person using the test of formation, establishment, or incorporation is thus uncomplicated, predictable, and certain. SARS need simply request the Companies and Intellectual Property Commission to confirm from available records, whether the legal entity in question was formed, established, or incorporated in South Africa.

Technology has today made it possible for juristic persons to trade and operate in South Africa without setting foot in the country or performing any physical activities or setting up any physical premises in the country.[458] Such businesses that operate within a digital environment have posed severe challenges to the South African tax system, which relies on the physical presence test and the PE, to establish the formation or incorporation of an entity. This simple and straightforward model of determining residency has made it possible for any taxpayer freely to choose or manipulate its place of incorporation, formation, or establishment to limit its tax liability.[459] For this reason, SARS has opted to rely on the concept of 'PEM' to help it establish or determine the residence of persons other than natural persons who operate in an e-commerce environment for tax purposes.[460]

3.5.1.3 Place of Effective Management

Many countries around the world no longer rely on the concept of incorporation to determine tax liability for any transaction conducted over the internet. In its place most, tax authorities have opted to determine tax liability in such transactions using the concept 'PEM'. This is, in the main, because it applies the principle of substance over form in the determination of residence and it has been used in several

[456] Companies Act 71 of 2008.
[457] Close Corporation Act 69 of 1984.
[458] Oguttu and van der Merwe (2005) 17(3) *SA Merc LJ* 308.
[459] ibid 311.
[460] SARS-IN 6 at 14 <file:///C:/Users/Admin/Desktop/NOW/achoki/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf> accessed 9 November 2019.

jurisdictions to resolve disputes involving double-tax agreements and dual residency.[461] Considering that the term does not have a single, universally accepted meaning, different countries have adopted different meanings. The absence of a clear definition of PEM in the Act means that one must consider the approach and meaning which SARS and the courts have adopted in determining the PEM of any juristic persons.

3.5.1.3.1 SARS Interpretation of the Term 'Place of Effective Management'

The term PEM does not have a universal meaning and different countries, including organisations like the OECD, have accorded it different meaning. Its application and use in any jurisdiction could have substantial tax consequences for any taxpayer who falls within the meaning ascribed to the term. In South Africa, the term PEM is not defined in the Act; its meaning, interpretation, and application are however provided in SARS-IN 6 where it is defined as:[462]

> [T]he place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made.[463]

SARs-IN 6 listed the following factors as crucial in determining where decisions are substantively made: [464]

a) The location of a company's head office is the place where a company's senior management and its support staff are predominantly located.[465]
b) The location where the highest level of management and their direct support staff are located.[466]
c) The location where a company's board regularly meets and makes decisions.

In terms of practical application, SARS-IN 6 adopted a three-stage inquiry which was implemented in the following three sequential steps:[467]

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[461] Van Der Merwe (2006) 18(2) *SA Merc LJ* 127-129.
[462] SARS-IN 6 <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf> accessed 9 November 2019.
[463] ibid para 4.2.1
[464] ibid para 4.2.3.
[465] ibid.
[466] ibid.
[467] ibid.

a) The place where the relevant management functions are exercised by the highest level of management and their support staff would be the initial PEM.
b) If a taxpayer has employed the use of internet aids like webcam and video conferencing to spread such management functions in several locations, the PEM will be where the day-to-day operational management and commercial decisions taken by senior managers are implemented.
c) Finally, if the operations are conducted in various locations, the PEM shall be the place with the strongest *nexus*.

The OECD Model Tax Convention, defined PEM as:[468]

> The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made.

The approach taken by SARS in defining the term PEM is similar to the OECD's commentary and definition of the term. South Africa has, therefore, ascribed to international precedent and best practice from the OECD to fill the *lacuna* created by the Act when it failed to define this term.

Considering that the Supreme Court of Appeal stated in *SARS v Marshall*[469] that Interpretation Notes are merely persuasive and not binding on or conclusive for the taxpayer or the courts, it is important to consider how the courts have approached and interpreted the term PEM.

3.5.1.3.2 Courts' Interpretation of the Term 'Place of Effective Management'

The interpretation by SARS of what constitutes a PEM for a juristic person can be regarded as valid only if it is endorsed and accepted by the courts as judicial precedent is recognised under the Constitution of the Republic of South Africa, 1996 as a source of the country's common law.[470] On the other hand, the fact that Interpretation Notes are intended to provide guidelines to stakeholders on the

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[468] OECD 'Commentaries on the Articles of The Model Tax Convention' Commentary on Article 4 para 3 s 24 <https://www..org/berlin/publikationen/43324465.pdf> accessed 12 July 2020.
[469] 2017 (1) SA 114 (SCA).
[470] Section 173 of the of the Constitution of the Republic of South Africa, 1996.

application of tax statutes administered by the Commissioner was settled *Marshall and Others v Commissioner for SARS*[471] where the court held as follows:

> Why should a unilateral practice of one part of the executive arm of government play a role in the determination of the reasonable meaning to be given to a statutory provision? It might conceivably be justified where the practice is evidence of an impartial application of a custom recognised by all concerned, but not where the practice is unilaterally established by one of the litigating parties. In those circumstances, it is difficult to see what advantage evidence of the unilateral practice will have for the objective and independent interpretation by the courts of the meaning of legislation, in accordance with constitutionally compliant precepts. It is best avoided.

This decision has settled the issue that courts ought not to be guided by Interpretation Notes when interpreting legislation. The nett effect of this decision by the Constitutional Court is that it is only the interpretation applied by the court to give meaning to the term 'PEM' that will have a legal effect on a dispute between SARS and any taxpayer.

In the case of *Wensleydale's Settlement Trustees v Inland Revenue Commissioners,*[472] Special Commissioner Shirley dramatically defined it as:

> The place of effective management is where the shots are called to adopt a vivid transatlantic colloquialism.

In *Trevor Smallwood Trust v Revenue and Customs,*[473] the court held that determining the PEM required it to determine where, based on the facts presented, the real top level of management or realistic, positive management of the taxpayer, a trust, was exercised. This position was confirmed and reasserted by the Court of Appeal in the case of *Her Majesty's Revenue & Customs v Smallwood & Another.*[474] In the more recent case of *Oceanic Trust Co Ltd NO v The Commissioner for the South African Revenue Service*,[475] it was held that the PEM is the place where key

[471] (CCT208/17), [2018] ZACC 11 (25 April 2018) 6 para 10.
[472] [1996] STC (SCD) 241, 252.
[473] [2008] UUKSPC SPC00669.
[474] [2010] EWCA Civ 778 in 48.
[475] [2012] 74 SATC 127.

management and commercial decisions that are necessary for the conduct of its business are made.

These court decisions and SARS-IN 6 appear both to interpret the term PEM as the place where key management and commercial decisions necessary for the conduct of business are made. The only difference is that the Interpretation Note provides more details and some guidance on the facts and circumstances that could be considered to establish the residency of a taxpayer objectively on a case-by-case basis.

Having discussed the interpretation of the term by SARS and the courts, it is necessary also to consider other sources in order to find a conclusive meaning which SARS should ascribe to this term. Considering that the meaning of the term has not been discussed in other legislation, it is also helpful to consider the viewpoints of various jurists.

3.5.1.3.3 Scholars' Views of the Term 'Place of Effective Management'

Most scholars who have expressed an opinion on this subject did so before SARS-IN 6 was issued in 2015. It is, nevertheless, important to discuss their views on how SARS ought to define and apply the term 'PEM' in everyday transactions.

The Katz Commission recommended that the country should adopt the PEM definition in Article 4(3) of the OECD Model Convention.[476] In the view of the Commission, this would give the term an appropriate definition that would make it possible for the country to trade efficiently and competitively with other countries in the world market.[477]

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[476] Katz Commission 'Fifth Report "Basing the South African Income Tax System on the Source or Residence Principle - Options and Recommendations"' (7 March 1997) para 6.1.2 <http://www.treasury.gov.za/publications/other/katz/5.pdf> accessed 9 November 2019.
[477] Olivier and Honiball *International Tax* 27.

Meyerowitz argued that the PEM should be where the decisions are taken rather than where they are implemented.[478] His emphasis is, therefore, on the meeting place where the decision is made rather than where decisions are implemented. This view is supported by Olivier and Honiball who argue that it should be where the most important and pivotal management decisions of the company are taken.[479] This, in essence, would be where the highest level of day-to-day decisions on the running of the company take place.

For his part, Clegg is of the view that the term connotes the place where the operational level in the management of the company operates.[480] He, therefore, assigns the term to a place where lower-level management decisions are made. This view differs from that of Meyerowitz, Olivier and Honiball, who opine that it should be where the decisions are made and not where such decisions are implemented as proposed by Clegg.

Van der Merwe opined that the term economic *nexus,* which was proposed by SARS-IN 6 ought to have clarified that the content of an Interpretation Note is not legally binding on the parties.[481] He has, therefore, proposed that the use of the term 'economic *nexus*'[482] under SARS-IN 6 should be clarified before it can be adopted and applied as a formula for determining residency in South Africa.[483]

On what is deemed as an appropriate definition of this term, the authors of *Silke: South African Income Tax* expressed themselves as follows:[484]

> All relevant facts and circumstances must be examined to determine the place of effective management. A company may have more than one place of management, but it can only have one place of effective management at

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[478] Meyerowitz *Meyerowitz on Income Tax 2007-2008* para 5.19.
[479] Olivier, Honiball and Brincker *International Tax* 5 ed 29.
[480] Clegg (2011) 25 *Tax Planning* 60.
[481] Van Der Merwe (2006) 18(2) *SA Merc LJ* 121-137.
[482] The term 'economic nexus' is the location where a company is connected to another state through factors like land, labour, capital, and enterprise which it uses to derive profits. These factors which are used by the company to derive profits would act as the tie-breaker in helping a tax authority to determine the State that has the strongest tie to the company. The company shall subsequently be deemed to be a resident of the identified State to which it has the strongest tie. See Van Der Merwe ibid 121-125.
[483] Van Der Merwe ibid 121-137.
[484] Stiglingh *et al SILKE* 34 para 3.2.

> any one time. If a company's key management and commercial decisions affecting its business as a whole are made at a single location, that location will be its place of effective management. However, if those decisions are made at more than one location, the company's place of effective management will be the location where those decisions are primarily or predominantly made.

Their opinion that the PEM is the predominant or primary location where the company's key management and commercial decisions are made is, in the main, similar to that in SARS-IN 6.

Davis, Olivier and Urquhart were largely in agreement with authors of *Silke* when they stated:[485]

> Management requires the taking of decisions and the implementation of those decisions, and it is the place where the most vital of those actions take place that will determine the place of effective management. The place of effective management is not necessarily the same as the place where the assets of the enterprise are situated or the place where it is legally domiciled.

From the foregoing it is clear that even scholars have not been able to reach consensus on how residency should be determined. This situation has been complicated by the fact that the meaning assigned to the term PEM under SARS-IN 6, which was issued after the views of these scholars appeared, is not binding on SARS or taxpayers.

3.5.2 Taxation of Non-Residents

Non–residents in South Africa are taxed on their income using the source basis system of taxation.[486] This tax system requires that there must be a connection between the income accruing or received by a person and the country.[487] This means that the income accruing to or received by a non-resident from a source in or deemed to be in South Africa is taxed after taking any allowable deductions and exemptions provided for in the Act into account.[488]

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485 Davis, Olivier and Urquhart *Commentary on Income Tax* 1.
486 Haupt *Notes on South African Income Tax* 31.
487 Olivier and Honiball *International Tax* 4 ed 297.
488 Section 9 of the Act.

Anyone who does not fall within the test prescribed for residency under section 1 of the Act and who is deemed a non-resident is taxed on their income under the source rules. The term ‘source’ has not been defined under the Act and SARS relies on the meaning ascribed to it by case law.

In *Rhodesia Metals Ltd v COT*[489] the court stated that ‘source’ is not a legal term. Instead, it should be considered as a real source of income. The only problem with this definition was that there are transactions in which there could be multiple sources of income. This question was answered in *CIR v Black*[490] where it was held that the dominant activities associated with the generation of income shall be deemed to be the source of income earned in cases where there are multiple activities involved in its generation.

The meaning and understanding of the term ‘source’ are crucial in determining the tax liability of a non-resident taxpayer. The authoritative case in which the term source of income was decided in *CIR v Lever Bros (Lever Bros* case*),*[491] where the courts reflected on the issue of circumstances under which an interest income earned by a non-resident entity could be deemed to have been sourced from and therefore taxable in South Africa. The court held that two factors must be established in determining the source of an income, namely, the activities which gave rise to income, known as the 'originating cause'; and the location of the originating cause that has been identified.

The court noted that the originating cause of any income should be determined by looking at both the physical activities and intellectual abilities of the taxpayer which could have been responsible for the generation of the income under consideration. Once this originating cause has been established, the location of these activities

[489] (1938) AD 379.
[490] 1957 (3) SA 536 (A), 21 SATC 226, 393.
[491] 1946 AD 441, 14 SATC 1.

must be identified to enable SARS to determine whether to levy a tax on any transaction or not.[492]

This definition was effective in the pre-digital era when taxation by SARS relied heavily on the physical presence test and the tangible aspects of a location. However, in today's world many non-residents are involved in e-commerce which is virtual and lacks any physical or tangible attributes. The result is that non-residents can easily limit their tax liability in South Africa if SARS continues to rely on the source principle established in the *Lever Bros* case to tax non-residents who are operating from the virtual world. For example, a non-resident supplier of goods or services in South Africa may structure all its e-commerce sales through a website developed and hosted on a server. This would make it difficult for SARS to determine the originating source of such a transaction as the internet would blur the identification of the activities which generated the income. The use of a website and server could also confuse SARS as to whether they should rely on the website or the server that is serving an enterprise to determine the residency of such an enterprise. Moreover, by its very nature the multiple activities involved in the facilitation of any e-commerce could also make the identification of a dominant activity or the location of the originating cause of a transaction difficult.

The courts addressed the issue of multiple sources of income in a single transaction in the case of *CIR v Black*.[493] While agreeing with the dual-test source principle laid down in the *Lever Bros* case*,* the court held that the dominant activities associated with the generation of income in cases where there are multiple sources of income in a single transaction, should be deemed to be the source of income from that transaction. Provided the dominant activity as determined can be linked to South Africa, South Africa will be the source of that income. The reliance that the source principle places on the physical location in the country of business as a basis for taxation is not suitable for application in today's digital environment. This is because the jurisdiction to tax would only accrue to SARS if the source of income or activities

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[492] Haupt *Notes on South African Income Tax* 37.
[493] 1946 AD 174, 13 SATC 362.

responsible for the generation of income by a non-resident were to be deemed to arise from a source within the geographical territory of South Africa. [494]

The application of the source principle can, therefore, be manipulated by non-residents to limit their tax liability in the country because it relies heavily on physical presence and location. Nevertheless, both of these aspects can be easily manipulated by the IoT to transfer the location of a transaction to cyberspace. The multiple activities that accompany any e-commerce transaction have made identification of a dominant activity on internet-based transactions as guided by the *CIR v Black* case challenging. It is clear the source basis of taxation has not kept pace with the evolution of internet technology currently adopted and used by most entrepreneurs to conduct their business. This poses the risk that as non-residents transact with South African residents, such businesses take an international character thereby making it difficult for SARS to tax such global e-commerce transactions effectively.[495] This new paradigm shift in the business world where a taxpayer can manipulate and determine his or her own place of investment and residency has made the application of the principles of residency and PEM ineffective. Ways through which this challenge could be addressed are discussed in chapter 6 of this thesis.

It is appropriate to note that the court had an opportunity to examine the tax consequences of a trans-border transaction in the case of *M Ltd v COT*[496] The court stated that the location of the taxpayer's principal business was irrelevant and what ought to be considered in determining residency is where the business or trade that generated the profits was carried out or where these profits were realised. This decision does not, however, address the issue of how lack of physical presence of a business enterprise in South Africa and the ability of the internet to transfer the business location to a low-tax jurisdiction is to be addressed. SARS, however, have

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494 Du Plessis B and Viljoen M 'Taxation of E-commerce: Income Tax' <http://www.legalnet.co.za/cyberlaw/cybertext/chapter8.htm> accessed 5 August 2019.
495 Khurana A 'Advantages of E-commerce Over Traditional Retail' <https://www.thebalance.com/advantages-ofecommerce-1141610> accessed 5 August 2019.
496 (SR) 1958 (3) SA 18, 22 SATC 27.

the alternative of resorting to double-taxation treaties to levy tax on non-resident companies that have derived their income from a South African source.[497] This means that if the source of an income has been deemed to be from a source outside the country, SARS may still be at liberty to consider the concept of 'permanent establishment' under the double-taxation treaty to determine whether the income realised by a non-resident could be attributed to his or her permanent establishment in South Africa. This inquiry only becomes necessary after the question of "source" under the *Lever Bros* case test has been considered.

The inclusion of the ‘permanent establishment’ concept in the Act and the tax practice in South Africa have greatly improved the ability of SARS to levy tax on e-commerce transactions. It is thus necessary to explain how the concept of ‘permanent establishment’ is applied in South Africa.

3.6 Permanent Establishment

Generally, e-commerce or international trade raises the possibility of double taxation where a non-resident who does business within the South African market is taxed on its worldwide income in its country of residence. This also applies to the source basis of taxation in South Africa on the profits derived from the South African market.[498] The application of the combined principles of the residence and source basis of taxation systems can, therefore, result in double taxation of a taxpayer. The conventional way of avoiding such conflict and helping different countries determine their right to a taxable income in e-commerce or an international trade transaction, has been for the affected countries to enter into a double-tax treaty.

The concept of double-tax agreements has been incorporated into South African tax law in both the Act[499] and the Constitution.[500] All double-tax treaties signed by the country form part of the country’s tax laws upon publication in the *Government Gazette*.[501] However, incidences of double taxation can still arise in cases where

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[497] Section 9 of the Act.
[498] Haupt *Notes on South African Income Tax* 486.
[499] Section 108(1) of the Act.
[500] Section 231 of the Constitution of the Republic of South Africa, 1996.
[501] Oguttu and Tladi (2009) 4(3) *Journal of International Commercial Law and Technology* 213-223.

South Africa has not signed a double-tax treaty with a non-resident's country of residence. It is in a such situation where the concept of the permanent establishment comes into play to help SARS determine whether it has jurisdiction to attribute the profits made by a non-resident to a permanent establishment within South Africa for income tax purposes.[502]

Most countries, including South Africa, face challenges in taxing income earned by non-residents on their e-commerce trade because of the difficulty in connecting such sources of income to the country of tax jurisdiction. The tax authorities in such jurisdictions thus have resorted to the PE concept to assist in determining whether they have jurisdiction to tax non-resident businesses operating in their territory. The significance of the PE concept is that it can give any country the right to tax income attributed to a PE irrespective of the location of the non-resident entity.[503] It acts as a mechanism to help any tax authority determine the extent to which the income-earning activities of a non-resident in a source country can trigger tax liability. The PE is a concept that is based on the premise that there must be a physical presence of any business in the source country before that country can tax the profits of such an entity.[504]

3.6.1 Definition of the PE Concept and its Application in South Africa

Before any profit earned by a non-resident from a cross-border transaction is taxed, the tax authority must first establish that the activities of such a non-resident entity meets the requirements prescribed in the PE concept.

South Africa relies on section 1 of the Act for its application and implementation of the PE concept to non-residents. This provision is supplemented by section 31 of the Act which contains provisions for the application of the PE concept in transfer pricing transactions that can be attributed to a PE.[505] A transfer pricing transaction could typically occur where servers are regarded as constituting a PE and a

[502] Olivier and Honiball *International Tax* 322.
[503] ibid.
[504] Skaar *The History of the Concept of PE* 112.
[505] Olivier and Honiball *International Tax* 337.

multinational company takes advantage of this to transfer its profits from other related companies to the enterprise where the server located in a low tax jurisdiction is situated.[506] This tax avoidance practice enables any e-commerce company that does not have its servers located in South Africa to limit its tax liability because the originating source of the company's income could be deemed to be from a source outside South Africa. The most effective way of implementing this tax avoidance strategy has been for the affected company to ensure that its server, which is located in a low tax jurisdiction, performs all aspects of its business transactions. This way the server could be deemed to be a PE and the transactions on that server would be regarded as either the originating or the most dominant cause of the income related to that transaction.[507]

Most companies used the transfer pricing concept to limit their tax liability in South Africa for a very long time. However, the introduction of section 31 of the Act gave SARS the statutory power to unravel and levy a tax on transfer pricing transactions. This attribution of the PE concept to transfer pricing transactions has been useful in helping SARS to levy tax on such transactions that would otherwise have escaped tax liability.

Whereas the PE concept has been defined in the Act, how it is to be applied has not been provided in the Act. Considering that it is an international concept, it appears that the legislature left the model of its implementation to be determined by the courts and international best practice. The interaction between the Act and the OECD Model Tax Convention has clarified that this concept will be applied and interpreted in South Africa by considering the provisions of Article 5 of the Convention and its commentaries. Furthermore, in *CIR v Downing* it was held that South Africa is bound to recognise the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Tax

[506] OECD 'Commentaries on the Articles of The Model Tax Convention: Commentary on Article 5 para 7 s 42.10 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 3 February 2022.
[507] Cockfield (1999) 74 *Tulane Law Review* 33.

Convention.[508] On the constitutional front, it is clear that the courts, and indeed South Africans, are bound to apply international conventions like the OECD Model Tax Convention in filling gaps on issues or matters such as the application of the PE concept that is not expressly provided for by the country's Constitution or statutes.[509]

The term PE is defined in section 1 of the Act by referring to the meaning adopted by the OECD under Article 5 of the OECD Model Tax Convention. In terms of the OECD Model Tax Convention, the term PE is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on.[510] This definition has identified the following three elements that must be present in the application of the PE concept in South Africa.

3.6.1.1 Place of Business

This requirement is consistent with the basic PE concept which states that tax liability will only accrue if the enterprise has a presence in the host country. Examples of what could be considered the place of business are listed in the OECD Model Tax Convention to include a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.[511]

A business shall be deemed to be having fixed premises if it has fixed its machinery or equipment for conducting business at a specific place, even if it does not ordinarily use those premises. The fact that the space is at the disposal of an enterprise is sufficient for it to be deemed its PE.[512] Activities such as constructions, installations, renovations, and excavations constitute a place of business in the location where such activities take place. [513]

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[508] 1975 (4) SA 518 (A) 524.
[509] Section 233 of the Constitution of the Republic of South Africa, 1996.
[510] Article 5(1) of the OECD Model Tax Convention.
[511] Article 5(2) of the OECD Model Tax Convention.
[512] OECD 'Commentaries on the Articles of The Model Tax Convention: Commentary on Article 5 para 1 s 4' <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 12 July 2020.
[513] Article 5(3) of the OECD Model Tax Convention.

3.6.1.2 Fixed Place of Business

A PE shall only be found to exist if there is a physical presence of business which acts as a source state in a host country.[514] This means that any building or installations which is in use or under the control of a business enterprise will be considered to be its place of business irrespective of whether it owns those buildings or installations.[515] The fact that the OECD Model Tax Convention prescribes that the place must be fixed means that the place of business should have some degree of permanence or fixity in the location where it exists. This does not mean that intermittent interruption of business will result that the permanence of the business will cease to exist provided that the specified business was conducted regularly in the identified country. What is required is that the business must have operated at that fixed location for a period, even if it was interrupted from time to time by other factors. However, a place of business that is temporary does not qualify as a PE.[516]

Some businesses that are considered incidental or supplementary to the central business and, therefore, expressly excluded from the definition of a PE include the following:[517]

a) the use of facilities solely for storage, display, or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for processing by another enterprise;
d) the maintenance of a fixed place of business solely to purchase goods or merchandise or for collecting information for the enterprise;
e) the maintenance of a fixed place of business solely to carry out other activities of a preparatory or auxiliary character; and

[514] Olivier and Honiball *International Tax* 336.
[515] OECD "Commentaries on the Articles of the Model Tax Convention' (2010) <http://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 9 November 2019.
[516] Olivier and Honiball *International Tax* 339.
[517] Article 5(4) of the OECD Model Tax Convention.

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e) above.

3.6.1.3 Fixed Place of Business Through which Business is Conducted

The business of an enterprise should be carried out at or through its identified fixed place of business.[518] The nature of the business could be full-time or partial. It is, however, not compulsory that the employees of the enterprise or any specific individual must be present for the business in that enterprise to be deemed to have been carried out.[519] The purpose of the place of business is intended to serve and support the business activities of the enterprise. It could, therefore, include where both the main and the insignificant activities of the business are carried out depending on each circumstance.[520] This means that a PE could also be considered to exist at the location where the enterprise's employees or agents set up, installed, or operated its equipment or machines. The only exception to the latter would occur if the enterprise installs or sets up the equipment and it leases it to a third party.

In summary, the concept of PE has created a model for taxation of international trade. The application of the concept is guided by Article 5 of the OECD Model Tax Convention. The interpretation adopted by each jurisdiction will however differ from country to country depending on the individual facts that the respective tax authority has adopted in its interpretation of this Convention. How then does this concept apply in South Africa?

3.7 The Concept of Permanent Establishment in South Africa

Having a PE in a country gives that country the jurisdiction to tax the entity which is deemed to operate within its borders. It, therefore, makes it possible for countries like South Africa to tax a 'cross-border' transaction of non-residents if SARS can attribute such transactions to a PE within South Africa.

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[518] Olivier and Honiball *International T*ax 340.
[519] ibid 341.
[520] Skaar *The History of the Concept of PE* 112.

The definition of a PE in the Act makes it clear that Article 5 of the OECD Model Tax Convention does not allocate or create tax rights.[521] Instead, the tax laws applicable to any transaction attributed to a PE are the domestic tax laws of South Africa. The primary purpose of this concept is to help a country like South Africa establish the source of business profits or whether an entity has a taxable presence in the country.[522] South Africa would then be at liberty to tax such an enterprise under its domestic laws once a taxable presence has been established in the country using this concept. It is, therefore, this concept that could help SARS to create a tax *nexus* to the business profits of a non-resident.

Article 5 of the OECD Model Tax Convention anticipates two notions of a permanent establishment: physical PE and Agency PE.[523].

3.7.1 Physical Permanent Establishment

The permanent physical establishment contains the following four requirements.

(a) There must be a place of business, normally premises, although it can, in certain circumstances, be machinery or equipment; (*situs test).*

(b) The place of business must be fixed, that is, have a certain degree of permanence. It must be located in a certain territorial area (*locus test).*

(c)The taxpayer must have a certain right of use over the fixed place of business (*right-of-use test*).

(d) The activities performed through the fixed place of business must be of a business character as defined in the treaty law and the domestic tax laws (*business activity test*).

An enterprise can be regarded as a PE in South Africa once the elements above have been satisfied. It does not matter whether that business is making a profit, that it does not have a productive character, or that some of its subsidiaries are

[521] Olivier and Honiball *International Tax* 2011.
[522] Groenewald *Principle of Permanent Establishment para* 3.4.3.1.
[523] Schwarz *Schwarz on Tax Treaties* 189-190*.*

unproductive.[524] Temporary interruptions in operation do also not amount to a closure of the PE. A business will only cease to exist and have a PE if or when its operations stop or it is sold.[525] Places including offices, factories, workshops, and places of management are included as PEs.[526] Places or activities that are considered incidental to and supplementary in nature – e.g., the use of a facility for storage, a garage, or display area are not considered sufficient to create a PE for a non-resident.[527]

Application of the physical PE test is the most common and most natural in tax law practice.

3.7.2 Deemed Permanent Establishment

If an enterprise does not meet the physical PE requirements, a PE may still be established if an agent of that enterprise regularly conducts business in the source state on behalf of the enterprise.[528] Deemed PE, which is also referred to as agency PE, occurs when an enterprise not located in South Africa has persons acting on its behalf in South Africa.[529] It is not a requirement that the persons acting on its behalf must be agents; what matters is that they exercising authority regularly and also have the power to conclude contracts on behalf of the enterprise.[530] An independent contractor acting in the ordinary course of his or her business for an enterprise cannot, however, create a PE for the enterprise on whose behalf he or she acts.[531] This was confirmed in the case of *SIR v Downing*[532] where it was held that an independent broker does not create a PE in South Africa.

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524 OECD 'Commentaries on the Articles of The Model Tax Convention Commentary on Article 5 para 1 s 3' <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 3 February 2022.
525 OECD 'Commentaries on the Articles of The Model Tax Convention Commentary on Article 5 para 1 s 11 <https://www.oecd.org/berlin/publikationen/43324465.pdf> 1 accessed 3 February 2022.
526 OECD Model Tax Convention Article 5(2).
527 ibid.
528 Skaar *Permanent Establishment* 113.
529 Riberio (2009) 1(15) *Jurisprudence* 295-312.
530 Olivier and Honiball *International Tax* 420.
531 OECD 'Commentaries on the Articles of The Model Tax Convention: Commentary on Article 5 para 6 ss 36 and 37' <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 9 November 2019.
532 37 SATC 249.

Only dependant agents of a business can create a PE.[533] A dependant agent is a person who:[534]

a) has the authority to deal with the core business of the enterprise;
b) can negotiate contracts that bind the enterprise;
c) has the power to exercise a consistent and habitual authority on the enterprise – isolated authority does not count;
d) is allowed to take risks on behalf of the enterprise; and
e) exercises authority in the host country. The authority exercised in the country of residence does not create a deemed-PE relationship.

The interpretation and application of the PE concept in South Africa, therefore, relies on the meaning attached to it by the OECD, the Constitution of the Republic of South Africa,1996, and any other applicable statute or principle under the South African law.

To summarise, from what we have seen above South Africa triggers the right to invoke the PE concept if the business of an enterprise is wholly or partly conducted through a fixed place of business within the Republic. This means that the element of physical presence remains a crucial pillar in determining a given jurisdiction that could be used to establish a PE. This definition, however, does not take cognisance of the fact that physical location or presence is no longer required to conduct most forms of trade in today's digital world.[535] We now examine how the PE concept is applied in today's digital world.

3.8 Applying the Permanent Establishment Concept in a Digital South African Marketplace

The taxation of the digitalised economy has been an area of focus for international tax policymakers and jurisdictions since the emergence of e-commerce in the early 1990s. This online environment has presented complex taxation challenges for

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533 OECD Model Tax Convention Article 5.
534 Olivier and Honiball *International Tax* 346-347.
535 Oguttu (2009) 4(3) *Journal of International Commercial Law and Technology* 213 and 217.

many tax authorities, including SARS. This is more so because the existing tax concepts like PE was not designed to deal with the challenges of the 21st century.

The OECD has, however, attempted to extend the application and definition of the PE concept over the years using the OECD commentaries and the Base Erosion and Profit Shifting (BEPS) initiatives[536] to make this concept applicable and relevant to the taxation of transactions within the digital realm. To protect the tax bases of source countries, the OECD has provided the following guidelines on how to deal with the challenges posed by e-commerce transactions and how the PE concept can be applied to some of these transactions:

3.8.1 Use of a Server to Carry out E-commerce Transactions

A server is a computer that is connected to the internet to allow a business to perform activities such as sale of goods or services over the Internet.[537] Servers are typically stored in a computer which can be found in a fixed location within the country. The OECD has recommended that computer equipment can meet the requirements for a fixed place of business in the jurisdiction where it has been located for a reasonable period.[538]

Any e-commerce transaction carried out using computer equipment may be regarded as having trader's PE in the jurisdiction where the computer that hosts the server is located. However, the right to tax only arises if the activities performed using the server constitute the core or essential functions of the enterprise which is situated within the identified jurisdiction.[539] Consequently, if an enterprise operates computer equipment at a particular location, a PE may exist even though no personnel of that enterprise are required at that location to operate the

[536] Cockfield (2000) 21 *Tax Notes International* 2407.
[537] ibid.
[538] OECD 'Commentaries on the Articles of The Model Tax Convention: Commentary on Article 5 para 7 s 42.4 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 3 February 2022.
[539] OECD 'Commentaries on the Articles of The Model Tax Convention: Commentary on Article 5 para 7 s 42.5 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 3 February 2022.

equipment.[540] The OECD has, however, cautioned that a server owned by an internet service provider which hosts a website of an enterprise, cannot create a PE for the enterprise when it stated in the following terms:[541]

> [T]he question of whether computer equipment can create a fixed place of business to be considered a PE shall vary and be determined objectively from case to case.

In summary, a server would constitute a PE if it is:

a) at a fixed place;
b) at the disposal of the enterprise; and
c) not being used by the enterprise to conduct a business that is of a preliminary, preparatory, or auxiliary nature.

3.8.2 Use of a Website to Perform E-commerce Transactions

A website is made up of software and electronic data that is not tangible. Its revolutionary nature has made it possible for trading parties to have limited contact with each other because all trade interactions for exchange of goods and services take place through the website with no physical contact between the trading partners.[542]

A typical website of an e-commerce enterprise comprises a combination of hardware and software which facilitate the storage and processing of electronic data through servers located in multiple jurisdictions. The fact that a website is typically stored in a server as electronic bits of data that cannot be perceived by human senses has made it impossible for it to have any physical or tangible content. The intangible nature of any website has led the OECD to recommend that a website cannot constitute a PE because it cannot meet the 'physical place' requirement

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[540] OECD 'Commentaries on the Articles of The Model Tax Convention" Commentary on Article 5 para 7 ss 42.1 to 42.2 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 3 February 2022.
[541] OECD 'Commentaries on the Articles of The Model Tax Convention: Commentary on Article 5 para 7 ss 42.3 and 42.90 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 3 February 2022.
[542] Pumla Z *Taxation in South Africa of Non–residents* 7.

necessary to establish a PE in any jurisdiction.[543] Some scholars have described it as a virtual office that lacks a specific geographical point of location, and so cannot constitute a PE.[544] SARS can, therefore, only tax an enterprise that sells its products through a website if the enterprise was incorporated in South Africa. The result is that conducting business through a server is the ideal way for any non-resident taxpayer to minimise its tax liability.

3.8.3 Use of an Internet Service Provider (ISP) as a Dependant Agent in e-commerce Transaction

An ISP is a company that supplies internet connections and provides web-hosting services on its servers to its customers for consideration.[545] The question for consideration is whether hosting web services on the servers of various enterprises is sufficient to constitute a dependant PE of the enterprises that carry out their e-commerce business through these websites hosted on the servers of an ISP. The reality is that ISPs are independent agents and, therefore, transactions involving their use would not create a PE because they do not act, negotiate, or conclude contracts on behalf of and in the name of the enterprises they host. All the transactions carried out on an ISP in the ordinary course of business would therefore not create, make up, or be deemed to have created a PE on an ISP.[546]

3.9 The Future of the Permanent Establishment Concept in Taxing E-commerce Trade in South Africa

It is clear from what we have discussed so far that the current definition of PE under the OECD Model Tax Convention applies only where international trade is carried out or from a determinable fixed place of business. The application of this concept in the current digital world where most business is conducted out over websites and other related digital sites may pose a considerable challenge to the traditional rules under the OECD Model Convention.

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[543] OECD 'Commentaries on the Articles of The Model Tax Convention: Commentary on Article 5 para 7 ss 42.1 to 42.2 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 3 February 2022.
[544] Buys and Cronje *Cyberlaw* 153-154.
[545] ibid 303.
[546] Oguttu (2009) 4(3) *Journal of International Commercial Law and Technology* 218.

The biggest challenge to the OECD Model Tax Convention is that whereas the location of servers can be used to create a PE, the reality is that the servers and the functions performed by the software codes in the server are highly mobile.[547] Relying on physical location when servers can be moved from one jurisdiction to another without interfering with any of their underlying transactions would not be capable of protecting the country's tax base in most transactions.[548]

Servers can also easily transfer their programmes to a server in a different jurisdiction or to different concurrent jurisdictions to distort the possibility of such a transaction thereby creating a tax *nexus* in any country, or to blur the line between the core and auxiliary functions of an enterprise.[549] Moreover, the physical location of a server can be manipulated by ensuring that the employees who programme and maintain the servers do so remotely outside the source country. The obsession with the location of a server could also be misplaced because minimal profits could be attributed to servers which the taxpayers can place at convenient low-tax jurisdictions to limit their tax exposure.

Therefore, the OECD Model Tax Convention is not sufficiently stringent to prevent taxpayers from manipulating their server locations to limit their tax liability in South Africa. There is therefore a need for the OECD to determine whether the PE concept when applied to servers, is an effective way of taxing profits earned in a digital economy.

The flexible, intangible, and mobile nature of today's business environment has made it possible for enterprises to reduce their source-country business activities while still participating in the source country's commercial activity using internet-based model enterprises. These developments have led the OECD to recognise

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[547] Cockfield (2001) 85 *Minnesota Law Review* 1193.
[548] Oguttu and Tladi (2009) 20(1) *Stell LR* 87.
[549] Cockfield (2001) 85 *Minnesota Law Review* 1193.

and agree that the current PE concept is probably not capable of dealing with the challenges posed by e-commerce. It stated:[550]

> [T]he digital economy also raises broader tax challenges for policy makers. these challenges relate in particular to nexus, data, and characterisation for direct tax purposes. these challenges trigger more systemic questions about the ability of the current international tax framework (read the pe concept) to deal with the changes brought about by the digital economy and the business models that it makes possible and hence to ensure that profits are taxed in the jurisdiction where economic activities occur and where value is generate.

A Commentary to Article 5 was, therefore, developed to widen the base and application of this Article in the taxation of digital transactions.

The extension of the PE concept to servers under the commentaries to Article 5 has not addressed this challenge. This is because this extension fails to address issue inherent in the PE concept of over-reliance on physical connections in the new and non-territorial world of cyberspace. The OECD has acknowledged the ineffectiveness of this approach and even conceded that the income that can be connected or attributed to functions performed through a server would be minimal.[551] This further led the OECD and G20 countries to create the BEPS project to help it devise strategies to assist member states to reduce tax arbitrage facilitated by the evolving digital economy. In early 2013, the OECD issued a report titled 'Base erosion and profit shifting' to address the tax challenges raised by the digital economy in relation to BEPS.[552] Accordingly, it is submitted that the OECD's current PE guidelines, as adopted by South Africa as part of its tax laws, are outdated and

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[550] Oguttu and Tladi (2009) 20(1) *Stell LR* 86. See also OECD 'Addressing the Tax challenges of the Digital Economy OECD/G20 Base Erosion and Profit Shifting Project – 2015 Final Reports' (2014)<https://www.oecd-ilibrary.org/docserver/9789264218789-en.pdf?expires=1596443002&id=id&accname=guest&checksum=DB84E03F0825614C9397A175205AB6EA> accessed 7 December 2019.

[551] Nortje *Existing Permanent Establishment Concept* 45. See also OECD 'Commentaries on the Articles of The Model Tax Convention: Commentary on Article 5 para 7 s 42.3 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 3 February 2022. See further OECD 'Addressing the Tax challenges of the Digital Economy, OECD/G20 Base Erosion and Profit Shifting Project – 2015 Final Reports' (2014) 17, 124, 128 and 129 <https://www.oecd-ilibrary.org/docserver/9789264218789-en.pdf?expires=1596443002&id=id&accname=guest&checksum=DB84E03F0825614C9397A175205AB6EA> accessed 28 November 2019.

[552] OECD 'Addressing Base Erosion and Profit Shifting' (2013) <http://dx.doi.org/10.1787/9789264192744-en> accessed 14 June 2019.

ineffective in today's digital economy that is progressively negating the physical presence requirements.

3.10 Conclusion

The legislature did not foresee the possibility of an entity conducting its business without a physical presence in South Africa. The emergence of the internet resulted in the growth of non-physical, digitally controlled transactions. These have rendered the traditional PE rules ineffective in protecting the tax base of the source countries. Whereas the concept of taxing profits has remained relevant and consistent over the years, the challenge for tax authorities is that the internet has made it difficult to trace the source of these taxable profits. Moreover, non-residents no longer require any form of physical local presence to engage in any business within in the territory of the source country.

The existence of other tax principles – such as transfer pricing[553] and arm's length[554] principles – have not helped SARS to deal with this challenge. This is because they can only be applied once the PE has been established.[555] In effect, therefore, once the PE concept no longer applies, the principle of transfer pricing or arm's length principle will not come to the aid of SARS in dealing with challenges that the PE concept could not solve. Moreover, the principle of transfer pricing does not create a taxing right on foreign profits.

The OECD Model Tax Convention and its guidelines on the interpretation and application of the PE concept are, therefore, unsuitable, out-dated, and incapable of creating a tax *nexus* in an e-commerce economy. This has been shown clearly

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553 Transfer pricing is the general term that is used for the pricing of cross-border, intra-firm transactions between related parties. It could also be defined as the setting of prices for transactions between associated enterprises involving the transfer of property or services. See definition and explanation in Melyncheko, Pugachevska and Kasianok (2017) 14(4) *Investment Management and Financial Innovations* 40 and 44.

554 The arm's length principle requires the prices and other conditions of transactions between associated enterprises (related parties) to be the same as the prices and other conditions that would be provided in comparable transactions between independent enterprises (unrelated parties). See Challoumis (2019) 115 *World Scientific News* 208.

555 Nkerebuka *Permanent Establishment Concept* 52-53.

by the examples that have challenged the existing PE tax principles which are based on the physical connection. The OECD has itself acknowledged the ineffectiveness of the PE concept in taxing transactions in a digitalised economy.[556] This, therefore, calls for urgent changes to Article 5 of the OECD Model Tax Convention to help preserve the tax base of source countries. This thesis makes proposals on how to deal with this challenge in the final chapter. First, however, it identifies and analyses the strategies used by the government to tax internet-based transactions to protect its tax base.

[556] Nortje' *Existing Permanent Establishment Concept* 48.

CHAPTER 4

THE CHANGING LANDSCAPE OF SOUTH AFRICA'S DIGITAL ECONOMY AND THE RESPONSE TO THE CHALLENGES OF ITS TAXATION

4.1 Introduction

The assimilation of state economies and markets into the digital world has increased in recent years. This has placed a real strain on the applicable national and international tax rules which traditionally rely on the physical-presence test to establish tax liability.[557] Today's virtual, anonymous, and borderless nature of the digital world has made it difficult for tax authorities to identify the residency or location of a buyer or a seller for tax purposes in a commercial transaction.[558] The result is that many governments, including the South African government, are exposed to the risk of BEPS arising from internet-based transactions.[559]

For this reason, there is an urgent need for South Africa to come up with workable policies and laws through which the country's tax base can be protected from the threats posed by digitalisation. To this end, the OECD has taken a leading role in helping the world community address the e-commerce tax challenges by:[560]

a) Developing the Ottawa Taxation Framework[561] which proposes that the taxation principles of neutrality, efficiency, certainty, simplicity, and

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[557] OECD 'Addressing the Tax Challenges of the Digital Economy' (2015) <http://dx.doi.org/10.1787/9789264241046-en> accessed 8 March 2020.

[558] Peter (2019) 1(1) *Journal for Financing for Development* 69-78.

[559] Basu (2008) 1 *Journal of Information Law and Technology* 1-16.

[560] Cockfield (2006) 8(1) *Yale Journal of Law and Technology* 139.

[561] The Ottawa OECD Ministerial Conference 1998 themed 'A Borderless World – Realising the Potential of Electronic Commerce' brought both the OECD and non-OECD governments and the business community together to come up with a framework on how to tax e-commerce transactions within the conventional taxation principles. This conference led the OECD to adopt the Ottawa Taxation Framework Conditions which provided broad taxation principles that could be applied in taxing e-commerce-based transactions. See Committee on Fiscal Affairs of the OECD '"A Borderless World: Realising the Potential of Electronic Commerce" A Report by the Committee on Fiscal Affairs' presented to Ministers at the OECD Ministerial Conference on 8 October 1998 <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.oecd.org/ctp/consumption/1923256.pdf> 3 accessed 12 September 2022.

flexibility should be applied in e-commerce transactions. The framework proposes that cross-border e-commerce ought to be taxed in the jurisdiction where the consumption takes place.

b) Forming a task force on the digital economy, which makes recommendations on how income arising from a digital trade could be taxed.[562]

c) Coming up with a policy note to offer guidance on how income obtained from cross-border digital trade could be allocated or shared with other countries who may have concurrent jurisdiction over that income.[563]

This chapter examines the changing faces of the digital economy, the challenges they pose to taxation, proposals on how to tax digital transactions, and a brief analysis of how the South African income tax regime has levied tax on some of these transactions.

4.2 The OECD's General Views and Proposals in Dealing with E-commerce Taxation Challenges

The OECD has led the world community in fighting tax evasion and tax avoidance. It has also played a pivotal role in advising its members and affiliated States on how to tax the digital economy through the BEPS project. Its reports and instruments have been used by tax policy makers in many countries to help them develop or improve their tax laws to combat tax avoidance, tax evasion, and other tax challenges in today's virtual world.

The OECD and the G-20 countries came together in 2013 and joined forces to develop an action plan to address BEPS and other tax challenges that may arise from the taxation of a digitised and globalised economy. This culminated in the development of the fifteen packages for BEP Action which were agreed on in 2015.

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[562] OECD 'Addressing the Tax Challenges of the Digital Economy' *(*2015) <http://dx.doi.org/10.1787/9789264241046-en> accessed 8 March 2020.

[563] OECD 'Addressing the Tax Challenges of the Digital Economy: Policy Note' <http://dx.doi.org/10.1787/9789264241046-en> accessed 8 March 2020.

This resulted in a proposal to tax the digital economy under the Nexus and Anti-Base Erosion proposals.[564] The implementation of these proposals was, however, resisted by certain member states. This compelled the G20 Finance Ministers to extend and expand the mandate of the Task Force on Digital Economy (TFDE) to come up with a consensus-based proposal that would be more effective and acceptable to the majority of members.[565] This process resulted in the development of a two-pillar solution intended to change the global model of taxing the digital economy by revising the Nexus and Profit Allocation rules as follows:

4.2.1. The Nexus Rule

A tax authority will only have taxing rights over a person if it has a sufficient *nexus* with the economic life in the affected person's country of jurisdiction. The term '*nexus*', therefore, generally describes the basic requirements that a country must meet before it can establish income tax jurisdiction over any person. This means that a *nexus* can result in the creation of residency for a person who is not ordinarily resident in South Arica. The *nexus* rule thus makes it possible for South Africa to exercise taxation rights over a person who is conducting his business in another sovereign state. Different countries apply different *nexus* rules to tax non-resident income. Many, including South Africa, have, however, adopted the use of the PE principle to create a *nexus* for the taxation of e-commerce transactions and cross-border trade.[566]

This proposal recognises the different market perspectives created by different users in different market jurisdictions that are not recognised under the current *nexus* rules. Its over-arching objective is to recognise the value created by a business's activity or participation in user or market jurisdictions. These user and

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[564] OECD 'Two Pillar Solution to Address the Tax Challenges Arising from Digitalisation of the Economy' (2021) <https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf> accessed 2 April 2022.

[565] OECD 'Addressing the Tax Challenges of the Digitalisation of the Economy' (13 February-6 March 2019) <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> accessed 7 April 2022.

[566] Gadzo (2018) 46 (3) *Intertax Law Journal* 208 <https://www.researchgate.net/publication/326235458_The_Principle_of_%27Nexus%27_or_%27Genuine_Link%27_as_a_keystone_of_international_income_tax_law_A_reappraisal> accessed 5 August 2020.

participation rights are not adequately recognised under the current PE and PEM rules. The TFDE, therefore, recommended that the following proposals be included under the *nexus* rule.

4.2.1.1 Significant Economic Presence Proposal

To deal with the challenge of physical presence, the OECD came up with the significant economic presence (SEP) test. Under this concept it is proposed that the taxing rights for market or user jurisdictions could be allocated to places where a business activity created or added value to its merchandise or services through participation in the user or market jurisdiction.[567] The proposal has the potential of expanding the taxing rights of a nation to include transactions not trailing place within the confines of its physical borders.[568]

This may be principally ascribed to the fact that the SEP proposal has expanded the application of the PE concept by creating a tax *nexus* in a country where a non-resident has significant economic presence. Such a presence is to be determined by considering how a country interacts with any internet-based technological equipment. The place where there is a sustained interaction with any form of internet technology will be the location of SEP.

The SEP proposal, therefore, has the potential to create a tax *nexus* in transactions where internet-based technology could have been used to limit or transfer the taxable presence of a South African taxpayer to a low-tax jurisdiction. For example, under SEP proposal revenue from the sale of digital goods or services sold in South Africa could create a taxable presence in South Africa. This is because the use of or reliance on South Africa's telecommunication network and data by a non-resident to sell its goods or services would result in crucial interaction of the non-resident with internet technology in South Africa.

[567] OECD 'Addressing the Tax Challenges of the Digitalisation of the Economy: Policy Note' (2019) <https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf> accessed 8 March 2020.

[568] ibid.

Under the PE concept, such a transaction may not be taxable in South Africa if a taxpayer uses the internet to limit its physical presence in South Africa or if it relies on the internet to transfer its taxable presence to a low-tax jurisdiction. The creation of a tax *nexus* in cases where there is a sustained involvement or use of a digitalised enterprise in the economic life of a country is therefore likely to control BEPS in most countries. The OECD expected this concept to bring multinational companies who have multiple cross-border business operations within the tax basket of member Countries who would have signed up to the convention.

The proposal emphasises that tax jurisdiction will be allocated to the country where value is added to the goods or services of an enterprise. It departs from the current OECD edict which emphasises the 'fixed place of business' as the PE of an enterprise. Digital trade can be taxed under this proposal because taxing rights could, for example, be deemed to be the jurisdiction or location where sustained interaction through digital technology or any other automated means took place.[569] The confusion on how to determine the place of SEP led the OECD to identify the activities that could create a SEP in any country. Therefore, a tax authority would be guided by the existence of the following activities if it were to grant the source country the tax jurisdiction rights under the SEP test:[570]

a) the existence of a user base and the associated data input;
b) the volume of digital content derived from the jurisdiction;
c) billing and collection in local currency or with a local form of payment;
d) the maintenance of a website in a local language;
e) responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; or

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[569] Monica V "Addressing Developing Countries Tax Challenges of the Digitalization of the Economy" (2019) 10 *South Centre Tax Cooperation Policy Brief* 4 <https://www.southcentre.int/tax-cooperation-policy-brief-10-november-2019/> accessed on 8 April 2022.

[570] OECD 'Addressing the Tax Challenges of the Digitalisation of the Economy' (2019) 9-11 <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> accessed 8 March 2020.

f) sustained marketing and sales promotion activities, either online or otherwise, to attract customers.

Although it is not exhaustive, this list has taken sufficient consideration of the reality of today's digital world. The activities that it proposes to rely on in determining the tax *nexus* in a digital environment cover more activities and are better placed to deal with the vagaries of today's economy as compared to the 'fixed place of business' test under the PE concept.[571] A detailed study of the SEP test shows that it has balanced the application of the physical-presence test with the use of e-commerce platforms, Virtual Private Networks, servers, websites, World Wide Webs, and other internet-based trade enablers to bring as many people as possible within the tax net[572]

4.2.1.2 The User Participation Proposal

This proposal focuses on the location at which there is an active and engaged user base or where the content contribution of a digitised business is located. The proposal is premised on the assumption that digitalised enterprises draw their ability to generate income from advertisers or users who visit and obtain content from the platform of a digital enterprise. Similarly, social media users and online purchasers would also be obliged to visit the digital platform of their choice to obtain the value, product, or item they require. This value that could be obtained by users and the digital platforms they visit or access to create a tax *nexus* has not been aptly captured under the current international taxation framework rules which are focused on physical activities.

4.2.1.3 The 'Marketing Intangibles' Proposal

This proposal responds to the broader impact of the digitalised economy. It proceeds on the assumption that the market jurisdiction[573] of the identified

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[571] ibid.

[572] Monica V. "Addressing Developing Countries Tax Challenges of the Digitalization of the Economy" (2019) 10 *South Centre Tax Cooperation Policy Brief* 4 <https://www.southcentre.int/tax-cooperation-policy-brief-10-november-2019/> accessed on 8 April 2022..

[573] Market jurisdiction is the location or a country where a company or any of its subsidiaries sells its products or engage in any other business. Monica V. "Addressing Developing Countries Tax

marketing intangible is the location of jurisdictional tax liability. It appreciates the fact that internet can be used to manipulate the location of intangibles like goodwill, patents, trademarks, and copyright to manipulate the jurisdictional location of such intangibles.[574]

Its application is similar to that of the 'user participation proposal' except that it targets 'intangibles' such as brand names or trade names whose jurisdictional location can be easily manipulated because they exist only in the minds of customers.[575] It also targets other intangibles such as customer data and customer lists that can be compiled from the activities of customers and users who are based in specific and identifiable market jurisdictions.

Overall, the marketing intangible proposal aims to give the market jurisdictional right to tax all digitalised businesses in the identified jurisdictional location irrespective of whether or not the affected transactions or taxpayers had no physical or taxable presence in the jurisdictional market concerned. This indiscriminate taxation formula of intangible assets in the market jurisdiction can help mitigate BEPS concerns.[576] The concept is intended to operate as a rule of last resort to be invoked only in cases where the conventional principles of PEM or PE are not applicable or are inappropriate.

Challenges of the Digitalization of the Economy" (2019) 10 *South Centre Tax Cooperation Policy Brief* 4< https://www.southcentre.int/tax-cooperation-policy-brief-10-november-2019/> accessed on 8 April 2022.

[574] Monica V. "Addressing Developing Countries Tax Challenges of the Digitalization of the Economy" (2019) 10 *South Centre Tax Cooperation Policy Brief* 4< https://www.southcentre.int/tax-cooperation-policy-brief-10-november-2019/> accessed on 8 April 2022.

[575] 'An intangible that relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned.' Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers. Information available at OECD 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (2017) 27 <https://www.africataxjournal.com/wp-content/uploads/2018/05/OECD-TPG-Transfer-Pricing-Guidelines-for-Multinational-Enterprises-and-Tax-Administration-July-2017.pdf> accessed 8 April 2022.

[576] OECD 'Addressing the Tax Challenges of the Digitalisation of the Economy' (2019). 13 <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> accessed 8 March 2020.

Its application would help to ensure that market jurisdictions can rightfully tax income associated with market intangibles even in the absence of a conventional and determinable taxable presence.[577] However, its application will be complex in that it requires each market jurisdiction to determine and allocate the profit due to each jurisdiction on the basis of an agreed formula and not on the basis of residency. The model that the formula will take and how income will be apportioned between competing jurisdictional states has not been agreed upon. Failure to agree on an effective apportionment formula could result in cases of double taxation. This is particularly true of instances where a country with physical jurisdiction and another country that is favoured by the marketing intangible proposal assert concurrent jurisdiction over the same income. Although its application may appear complex, the TFDE is persuaded that it would provide the best solution for taxing the digitalised economy – provided that it is supported by a strong and efficient dispute resolution mechanism.

4.2.2 Global Anti-Base-Erosion Proposal

This proposal recognises the right of sovereign states to levy tax on transactions carried out within their jurisdictions. It also encourages source states to recognise the rights of other countries to tax income that could have earned from the country of source. The proposal is intended to reduce BEPS and it applies under the following two rules.

4.2.2.1 The Inclusion Rule

Under this rule, it is proposed that tax will be levied on the income of a foreign branch or controlled entity if that income was subject to a low effective tax rate in the jurisdiction of a PE or residence. This means that the income of a foreign country will fall to be taxed in South Africa at a minimum rate. This minimum rate of taxation could be determined by either the OECD or South Africa. The mechanisms to guide the OECD or member states on how to determine the actual minimum rate to be

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[577] OECD 'Addressing the Tax Challenges of the Digitalisation of the Economy' (13 February-6 March 2019) <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> accessed 7 April 2022.

applied under this rule have not been developed.[578] It is, however, proposed that the following elements could be used by the OECD or any local jurisdiction to guide it in determining the minimum rate of taxation:[579]

a) Use of financial accounts of a legal entity to determine tax base.
b) A comparison of the international and municipal laws to avoid the risk of double taxation.
c) The effect of tax grouping and consolidation practices between subsidiaries and holding under the municipal tax law.
d) A determination of whether there is an agreed approach for the allocation of income between the head office and its branches.
e) The need to have a simple tax system which allows for minimised compliance and administrative costs.

The OECD Inclusive Framework on BEPS has already received feedback from stakeholders on the elements it should consider in determining the inclusion rate.[580] At the time of writing, a series of meetings has already been planned to discuss and settle the final minimum tax rate elements.[581] This thesis anticipates that the OECD will come up with the final inclusion rate as soon as possible so that the tax base of countries like South Africa can be protected.[582]

The implementation of such a rate would mean that SARS would still be entitled to levy tax at the prescribed minimum rate on transactions by a taxpayer who relocates

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578 OECD 'Global Anti-Base-Erosion Proposal ("GLOBE") – Pillar Two' (2019) 7 <https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf> accessed 15 August 2020.

579 OECD 'Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy" (January 2020) 28-29 OECD <https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf> accessed 15 August 2020.

580 OECD 'Global Anti-Base-Erosion Proposal ("GLOBE") – Pillar Two' (2019) <https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf> accessed 15 August 2020.

581 OECD 'Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy' (January 2020) 28 <https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf> accessed 15 August 2020.

582 OECD 'Global Anti- Base Erosion Proposal ("GLOBE") – Pillar Two' (2019) 7 <https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf> accessed 15 August 2020.

his or her residency from South Africa to a low-tax haven. The OECD has also clarified that although the inclusion rule resembles a double taxation, the proposal was actually intended to ensure that a taxpayer:[583]

a) Does not gain advantage over other taxpayers doing similar business in the source country by benefiting from a low tax rate in a tax haven.
b) Does not deny the source country its rightful share of tax, even if it is at a minimal rate.
c) Is discouraged from shopping for low-tax jurisdictions because the inclusion rule would wipe out almost all the tax benefits that he would have obtained in the tax haven.
d) Any State is allowed by a second corresponding state to collect its rightful share of tax from a taxpayer in its jurisdiction.

When implemented, taxpayers who have used the internet to transfer their residency to low-tax jurisdictions would still pay tax in the source country, albeit at a minimum prescribed rate. The incentive for taxpayers to use the internet to manipulate residency would be minimised or eliminated.

4.2.2.2 Tax on Base Eroding Payments

This proposal emphases the need for cross-border international cooperation among states to ensure that taxpayers do not move from one state to another to shop for a convenient tax jurisdiction. The cooperation should also be extended to allow other countries to levy the minimum effective tax rate on the identified forum shopping transactions. The second limb of the proposal is that deduction will be denied to any related enterprise if it has not been subjected to a minimum effective tax rate. The

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583 Osler, Hoskin and Harcourt (Taxation Group) 'Global Anti-Base-Erosion Proposal under Pillar Two' <https://www.osler.com/osler/media/Osler/Content/PDFs/Submission-to-the-OECD-on-the-November-8-2019-Public-Consultation-Document-GloBE-Proposal-under-Pillar-Two-Final.pdf> accessed15 August 2020._See also OECD 'Global Anti-Base-Erosion Proposal ("GLOBE") – Pillar Two" (2019) 7 <https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf> accessed 15 August 2020 and OECD 'Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the a Tax Challenges Arising from the Digitalisation of the Economy" (January 2020) 28 <https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf> accessed 15 August 2020.

philosophy behind the proposal is that failure to forge such cooperation would result in the erosion of the tax bases of non-cooperative countries. In addition, the taxation exercise could even result in double taxation or normal tax where there has been no income.[584]

This proposal is premised on the understanding that profit shifting and forum shopping are often prevalent in a digital economy among taxpayers who are dealing in intangible goods or services. Further, it could result in BEPS if it is not controlled. It also supports the inclusion rule by facilitating the efficient and smooth application of the minimum effective tax in other countries.

The essential thread which runs through this two-tier proposal is to propose and implement a tax model with efficient and effective anti-avoidance tax measures which provide for taxation of income in foreign or low-tax jurisdictions. The result would be that in a typical identified case, a company that has used the internet to transfer its residency from South Africa to Malta would pay normal tax in Malta and a prescribed minimum tax in South Africa.[585]

When it is implemented, the OECD will prescribe the recommended applicable minimum tax. Its implementation will, however, pose the following challenges to South Africa:

a) SARS would be required to raise a huge infrastructure capital of some 1.4 billion dollars to invest in the information technology system required to operationalise this project.[586] This is mainly because SARS' current digital infrastructure, which is fairly modern,[587] still requires further improvement to help it tax evolving internet-based transactions like digital enterprises, cloud computing services, block-

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584 OECD 'Addressing the Tax Challenges of the Digitalisation of the Economy' (2019) 27 <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> accessed 8 March 2020.
585 Article 12(3) OECD Model Tax Convention.
586 Adam Bergman 'How Block chain Technology Can Save the IRS' (Forbes ed 4 June 2018) <https://www.forbes.com/sites/greatspeculations/2018/06/04/ho> accessed 18 April 2020.
587 ibid.

chain technology, and other modern digital systems.[588] A large portion of this investment would be used to update and upgrade SARS' information technology system to help it improve its tax collection in the digital economy. This expensive hardware investment would also make it possible for SARS to collect tax from global transactions that have been made using modern internet analytics like cloud computing services.[589]

b) It will need to re-negotiate some tax treaties and publish new tax regulations to guide the implementation of this tax system. The resolution of tax disputes between states would be difficult if the tax treaties are not re-drafted to provide for this new tax system.
c) Some taxpayers may incur the inconvenience of double payment of tax in countries that refuse to sign tax treaties with South Africa, or those who refuse to be guided by the OECD guidelines on this matter.

4.2.3 Organisation for Economic Co-operation and Development's Next Steps

The foregoing taxation propels are not conclusive. The OECD Inclusive Framework on BEPS has continued to work on and improve these proposals to address the concerns raised by member states Chapter 5 of this thesis discusses the changes, improvements, or developments that could have been made on the two-pillar solution to improve its efficiency and acceptability among the member states and other stakeholders.

4.3 Group of -24's Submissions on the *Nexus* Rule

The Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24), of which South Africa is a member, was formed in 1971. Its aim is to coordinate the position of developing countries on monetary and development issues. Its mandate is to negotiate the position of developing countries

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[588] Korovkin VV 'National Digital Economy Strategies: A Survey of Africa'" (July 2019) ORF Issue Brief 303 https://www.orfonline.org/wp-content/uploads/2019/07/ORF_IssueBrief_303_DigitalEcon-Africa.pdf> 8 accessed 4 April 2022.
[589] ibid 9.

on monetary issues with other entities or organisations.[590] Tax issues are monetary in nature hence the reason for the G-24 involvement in negotiating a favourable *nexus* rule that will favour developing countries in this internet age.

In addition, like the OECD, this group believes that the current profit allocation and PE attribution rules are irrelevant and impracticable in today's digital age.[591] Its solution to this challenge is that a business should be taxed from the location where it has interacted with its customers.[592] This means that the location of digital interaction with customers would give rise to the existence of PE in the source country, even if there was no physical contact between the vendor and the purchaser at the location of digital interaction. This will require the OECD and other countries to change the meaning and application of the PE to facilitate the application of this ground-breaking proposal. The G-24's solution to the limitation in the current definition of the PE is that the concept of SEP should be brought into and included in Article 5 of the OECD Model Tax Convention.[593] It could be made applicable where the PE concept is not appropriate, particularly in the case of digital transactions.

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[590] Information obtained from the G-24 website <https://www.g24.org/mandate/> accessed 23 March 2020.

[591] Monica V. "Addressing Developing Countries Tax Challenges of the Digitalization of the Economy" (2019) 10 *South Centre Tax Cooperation Policy Brief*< https://www.southcentre.int/tax-cooperation-policy-brief-10-november-2019/> accessed on 8 April 2022.See also Uy M 'The G-24 Proposal and the Challenges of the Inclusive Framework' Paper delivered at the Tax Justice Network virtual conference 11 December 2019 <https://www.taxjustice.net/wp-content/uploads/2019/12/Marilou-Uy.pdf.> See also G-24 Working Group on Tax Policy and International Tax Cooperation 'Comments of the G-24 on the OECD Secretariat Proposal for a Unified Approach to the Nexus and Profit Allocation Challenges Arising from the Digitalisation (Pillar 1)' <https://www.g24.org/wp-content/uploads/2019/12/G-24_Comments-on-OECD-Secretariat-Proposal-for-a-Unified-Approach.pdf> accessed 16 August 2020.

[592] G-24 Working Group on Tax Policy and International Tax Cooperation 'Proposal for Addressing Tax Challenges Arising from Digitalisation' <https://www.g24.org/wp-content/uploads/2019/03/G24_proposal_for_Taxation_of_Digital_Economy_Jan17_Special_Session_2.pdf> accessed 18 August 2020.

[593] The G-24 Working Group on Tax Policy and International Tax Cooperation 'Proposal for Addressing Tax Challenges Arising from Digitalisation'(17 January 2019) <https://www.g24.org/wp-content/uploads/2019/03/G-24_proposal_for_Taxation_of_Digital_Economy_Jan17_Special_Session_2.pdf> 8 para 17 accessed 15 August 2020.

The G-24 countries proposed that the following factors should guide the source country in determining a tax *nexus* if the SEP concept were to be included in the OECD Model Tax Convention.[594]

4.3.3.1 The Place Where Revenue is Generated on a Sustained Basis

All businesses are formed to generate income. Therefore, the place where the income is generated, even by digital means, would be a clear indicator of the involvement of a non-resident in another country. Under this rule, a taxable presence in a country would be created in a country where revenue has been generated on a sustained basis. It does not matter whether that revenue was generated directly by a person or indirectly through digital equipment.

The G-24 also believed that this would be an ideal way of determining the residency of a taxpayer because the location where sales are made is often determined by the market factors of demand and supply.[595] It may thus not be possible to manipulate the locations of sales using the internet.[596]

As a result, any revenue earned from sale of goods and service conducted by digital means would create residency in the location where the digital asset which was used to earn revenue was located. The sustained activities carried out regarding the digital asset would be a clear indicator that the non-resident who used the digital asset intended to create a taxable presence in the country where the asset was used to earn revenue on a sustained basis. It is irrelevant that both or either of the parties in the transaction are not based or resident in the same location as the revenue-earning digital asset. SARS could therefore, rely on frequency of usage and the huge volume of trade conducted through a digital asset located in South Africa to justify its decision to impute that the digital asset has a taxable presence in South Africa.

[594] ibid.
[595] ibid.
[596] ibid.

An example of this is where an enterprise based in Kenya offers live streaming or advertising services using servers located in South Africa. As much as the enterprise is based in Kenya, the fact that it relies on a server based in South Africa to generate its revenue means that it will have a taxable presence in South Africa and not Kenya.

Similarly, a customer's computer or whatever digital technology he or she uses to purchase goods or services can create a tax *nexus*[597] provided the revenue in question was raised or obtained from the location where the computer or technological device is located. For example, a company located in Kenya but whose website is accessible in or from South Africa could be deemed to have a physical presence in South Africa through the customer's computer.[598] In the same way companies could also be deemed to have a physical and taxable presence in those countries in which their customers have downloaded the company's application[599] on their phones or any other device.[600] It could also be where a company has leased a warehouse or cloud for the storage of its data.[601] What tax authorities would consider in such transactions is the location where the income in question was raised on a sustained basis and not the location of the taxpayer. This proposal on tax *nexus* by the G-24 has already been adopted by the United States of America. This was evident in the majority decision of the Supreme Court of the United States in the case of *South Dakota v Wayfair Inc, Overstock.com Inc and Newegg Inc,*[602] where the court held that:

> States may charge tax on purchases made from out-of-state sellers, even if the seller does not have a physical presence in the taxing state.

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[597] ibid.
[598] The US Supreme Court adopted this evolving model of creating a tax *nexus* in the case of *South Dakota v Wayfair Inc, Overstock.com Inc and Newegg Inc* (South Dakota 17-494 June 21, 2018).
[599] An 'Application' is a software program that is typically downloaded on phones or computers to enable users to access desired services such as the fast and convenient purchase of goods or services from various vendors. See definition at <https://www.techtarget.com/searchsoftwarequality/definition/application> accessed 10 September 2022.
[600] *South Dakota v Wayfair Inc, Overstock.com Inc and Newegg Inc* (South Dakota 17-494, June 21, 2018).
[601] ibid.
[602] ibid.

As it is clear from the examples above, the adoption of this new tax nexus has the potential of helping most countries protect their tax bases from the tax challenges posed by the digital economy.

4.3.3.2 The User Base and Place of Data Input

This proposal borrows from the physical-presence test in terms of which the more users an enterprise has in a certain location, the more significant its presence in that economy. As regards digital transactions, a tax *nexus* shall be established based on the volume of data collected in that country. The data could be in the form of product reviews, search engines, billing points and collection in local currency, location of online sales deliveries, or other related online activities.

This proposal was intended to improve on the SEP proposal of devising a concrete model for taxing digital transactions. It, however, goes against long-established international tax principles which link taxing rights to the location of the economic activity.

The proposal also ignores the international sanctity of countries' sovereign right to determine issues of fiscal policy such as tax rate or tax base. Therein lies the challenge. How would the G-24 countries convince the rest of the world to abandon these long-standing traditions in the interest taxing the digital economy? This would also require clarification as to whether the income stream from the digital economy is more significant than that from traditional trade to justify these amendments. This thesis attempts to provide answers to these questions in chapter 5.

4.4 Taxing Cyberspace Under the Withholding-Tax Approach

The Act imposes a withholding tax on royalties[603] and capital gains[604] realised by non-residents from the sale of immovable property in South Africa. The rate of withholding tax payable is 7.5% if the seller is a natural person,[605] 10% if the seller

[603] Section 35A of the Act.
[604] Section 35A of the Act.
[605] Section 35A(1)(*a*) of the Act.

is a company,[606] and 15% if the seller is a trust.[607] The Act has also introduced a final tax at 15% in respect of any amount received by non-residents who are foreign entertainers or sports people.[608] It is, therefore, the responsibility of residents involved in a transaction with a non-resident to withhold the prescribed final tax payable by the foreign entertainer and sports person.[609] The OECD has also recommended the introduction of a withholding tax on digital transactions.[610] This tax would be levied on payments by residents and local PEs on goods or services purchased online from non-residents. It is anticipated that this tax system would support the *nexus* principle and widen the tax net of any country that adopts it.[611] In addition, it would not only widen South Africa's tax base but it could also bring South Africa's tax system in line with the OECD recommendation on how to tax the digital economy.[612]

4.4 Taxing the Cyberspace

The internet and computer technology have today combined to create the 'cyberspace'. A cyberspace is a virtual environment in which many internet users trade to limit their exposure to any tax jurisdiction. It is typically indifferent to location and does not recognise borders or physical locations.[613] The result is that it creates anonymous and virtual transactions that are difficult to identify and tax using the current *nexus* rules.[614]

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606 Section 35A(1)(*b*) of the Act.
607 Section 35A(1)(*c*) of the Act.
608 Section 47 B of the Act.
609 Section 47 D of the Act.
610 OECD 'Addressing the Tax Challenges of the Digital Economy' (2015) <http://dx.doi.org/10.1787/9789264241046-en> accessed 8 March 2020.
611 RKG Consulting 'A Withholding Tax on Digital Transactions" <https://www.rkgconsulting.com/vat-issues/beps-project-digital-economy/beps-issues-in-the-digital-economy/direct-tax-main-policy-challenges/options-to-address-the-broader-direct-tax-challenges/a-withholding-tax-on-digital-transactions/> accessed 1 November 2020.
612 The Davis Tax Committee 'Second Interim Report: Addressing Base Erosion and Profit Shifting in South Africa' 63 <https://www.taxcom.org.za/docs/New_Folder3/3%20BEPS%20Final%20Report%20-%20Action%201.pdf> accessed 23 May 2020.
613 Nellen A 'Overview of Internet Taxation Issues' Internet Law Resource Centre (2012) <https://www.sjsu.edu/people/annette.nellen/website/Taxation%20Overview%202012.pdf> accessed 25 May 2020.
614 Papadopolous and Snail S *Cyberlaw @ SA III* 103.

The use of cyberspace to perform trade transactions is known as the ‘cyberisation’ of the economy. Using artificial planning methods to shift income into cyberspace thereby eroding the tax base of many countries, is termed 'base cyberisation’. ‘Base cyberisation’ often occurs under the following circumstances:[615]

a) Where a business enterprise is conducted through a website in the market country without the use of any physical presence. This often occurs where an enterprise uses information technology to transfer the location of its website to a server located outside the source country thereby creating a residency for tax purposes outside the source country.
b) When an enterprise limits contact in the source country through various cyberisation methods like dematerialisation[616] to limit physical contact to a high-tax jurisdiction.
c) Where an enterprise replaces traditional physical sale outlets with online outlets.

These identified cyberisation activities can place trade transactions beyond the reach of local jurisdictional laws. An example of a typical cyberisation concept is Google’s business operation model. Google has its global headquarters in the USA but operates and earns income in over 180 countries around the world without having a physical offices or presence of any sort in those countries; all it has are computer servers that feed the domains that earn them income from the cyberspace within each of these countries.[617]

This cyberisation exercise has made it possible for Google to earn and retain some 60 billion dollars in overseas revenue which it is reluctant to repatriate to the USA

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615 Jinyan L ‘Protecting the Tax Base in the Digital Economy’ (2014) UN paper 9 on Selected Topics in Protecting the Tax Base of Developing Countries 31 <https://www.un.org/esa/ffd/wp-content/uploads/2014/10/20140604_Paper9_Li.pdf> accessed 16 August 2020.
616 Dematerialisation refers to transformation of a metal object into a virtual or digital nature. See Jinyan ibid 30.
617 Azam (2012) 31(4) *Virginia Tax Review* 639.

where it stands to lose a substantial portion of that revenue to the USA Tax Code.[618] An even better illustration of a cyberisation arrangement exists in Europe, where digital platforms[619] interact with users to transfer the revenue earned from all the European countries to Ireland which is a low-tax member state.[620] Google therefore ends up earning huge advertising and operation revenue from all over Europe without setting foot or creating any physical presence in any of those countries. All this income is instead taxed at a single location in Ireland where Google has established its European Union (EU) headquarters. Facebook also borrowed the Google script, and all its revenue from the EU is also transferred through digital platforms to its European headquarters in Ireland.

Other digital companies like Amazon, which has several national websites, have ensured that all their European income is earned and taxed in the Duchy of Luxembourg,[621] one of Europe's low-tax jurisdictions. The investigations launched into its tax practices by the EU Commission caused it to commence the payment of its rightful tax in the UK and Germany in 2015. However, despite this commendable progress, Amazon has continued to limit its tax liability by:[622]

a) not reporting any profits or reporting very low profit margins; and
b) classifying its profits as royalty income and thereafter paying it to a tax-exempt entity known as Amazon Europe Technology SCS.

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618 The Verge 'Google Still Exploiting Tax Loopholes to shelter Billion in Overseas Tax Revenue' (2 January 2018) <https://www.theverge.com/2018/1/2/16842876/google-double-irish-tax-loopholes-european-billions-ad-revenue> accessed 26 August 2020.

619 A digital platform is an internet-enabled technology model which facilitates commercial interaction between at least two different groups—with one typically being suppliers and the other consumers. It handles an end-to-end business process necessary to achieve the improved experience for suppliers, consumers, tax authorities, and other stakeholders within a trading or commercial cycle. See Spagnoletti, Resca, and Lee (2015) 30(4) *Journal of Information Technology* 364-365.

620 Tang P and Bussink H 'EU Tax Revenue Loss from Google and Facebook' <https://static.financieel-management.nl/documents/16690/EU-Tax-Revenue-Loss-from-Google-and-Facebook.pdf> accessed 26 August 2020.

621 Tang P and Bussink H 'EU Tax Revenue Loss from Google and Facebook' <https://static.financieel-management.nl/documents/16690/EU-Tax-Revenue-Loss-from-Google-and-Facebook.pdf> accessed 25 August 2020.

622 ibid.

In 2016, Apple was ordered by the EU to pay some 14 billion Euros to the Irish government in unpaid taxes for a period of about ten years.[623] These tax arrears emanated from its exploitation of legal loopholes which allowed it to transfer and store all its tax profits in Ireland without paying any tax in Ireland and the countries in which these profits were earned. Apple, however, successfully appealed this decision at the Court of Justice of the EU which reversed the decision of the EU Commission on the ground that Apple's anti-avoidance tax practices did not breach the EU's competition rules.[624]

In South Africa, Google has been accused of avoiding the payment of tax by carrying out all its local transactions through an off-shore entity based in Ireland.[625] This arrangement has made it possible for Google to avoid the payment of some 140 million Rand annually from the revenue generated by its online advertising in South Africa.[626] Failure to find ways of tightening or sealing these loopholes which allow internet companies like Google or Amazon to avoid paying their rightful share of tax, could expose the South African tax base to severe erosion.

The possibility of this happening is supported by conservative estimates which indicate that South Africa could realise annual tax revenue of about 4.4 billion Rand from the efficient taxation of digital companies like Google.[627] This is further reinforced by studies which indicate that the current revenue stream from South Africa's online transactions is some 77.4 billion Rand.[628] The possibility that the government of South Africa could be losing out on the taxation of this revenue stream has now caught the attention of the Parliamentary Budget Office which has recommended that the legislature propose reforms to the way the players in the

[623] ibid.
[624] *Ireland v Commission* (T-778/16) and *Apple Sales International and Apple Operations Europe v Commission* (T-892/16).
[625] Fin 24 'Google Avoids SA Taxes' (11 February 2014) <https://www.news24.com/Fin24/google-avoids-sa-taxes-20140211> accessed 16 August 2020.
[626] ibid.
[627] Tax Consulting South Africa 'Tech Giant's Tax Avoidance Hurts South Africa's Media' <https://www.taxconsulting.co.za/tech-giants-tax-avoidance-hurts-south-africas-media/> accessed 16 August 2020.
[628] ibid.

country's digital economy are paying their taxes.[629] For example, it mentioned Netflix's streaming service as an example of a digital giant that is not paying its rightful share of taxes. It is hoped that this legislative reform momentum to deal with the tax challenges of the digital economy will be maintained by the legislature.

Action Aid International revealed that some 20 developing countries could be losing 2.8 billion dollars in revenue from unfair trading practices by Facebook, Google, and Microsoft.[630] It also divulged that the world's largest economies (G-20 countries) lost 32 billion dollars in annual revenue in 2019 to Apple, Google, Amazon, Facebook, and Microsoft who made billions of untaxed dollars during the Covid-19 pandemic.[631] The severity of this loss is explained by the fact that fair payment of tax by these companies could have provided two full-dose vaccines for every living human being on earth. Fair taxation of the 2020 profits of digital Multinational Enterprises (MNEs) in selected countries could have generated a global tax revenue of some 89 billion dollars as is shown in table 4.1 below.[632]

Table 4.1 Global Tax Revenue Likely to Be Obtained from Fair taxation of Taxing Microsoft, Amazon, Alphabet, Apple, and Facebook on their 2020 Profits.

No	Union	Revenue in Dollars
1	G-20 countries	32 billion
2	OECD countries	28 billion
3	G-7 Countries	21 billion
4	European Union	8 billion
	TOTAL	**89 billion**

629 The South African 'A Tax on Netflix? Parliamentary Proposal Seek Digital Reform' (19 June 2020) <https://www.thesouthafrican.com/news/finance/netflix-tax-south-africa-proposals-parliament/> accessed16 August 2020.
630 Action Aid '$2.8 billion "Tax Gap" Exposed by Action Aid Research Reveals Tip of the Iceberg of Big Tech's Big Tax Bill in the Global South' <https://actionaid.org/news/2020/28bn-tax-gap-exposed-actionaid-research-reveals-tip-iceberg-big-techs-big-tax-bill-global> accessed 30 August 2020.
631 Tax Justice 'World's Largest Economies Losing Up to $32 billion in Annual Tax Revenue from Silicon Valley's Top Five Tech Companies' (20 May 2021) <https://actionaid.org/news/2021/worlds-largest-economies-losing-32-billion-annual-tax-revenue-silicon-valleys-top-five> accessed 30 August 2021.
632 ibid.

Source: Action Aid International Report[633]

On the other hand, the Tax Justice Network reported that the global loss that arose from corporate tax abuse stood at 427 billion dollars.[634]

The annual loss to MNEs rose phenomenally in 2020 to some 483 billion dollars.[635] The Cayman Islands alone is responsible for a tax loss of about 83 billion dollars. And 312 billion of the 483 billion dollars was reported to have been lost through cross-border MNE tax abuse while the balance of 171 billion dollars was lost to off-shore tax avoidance by rich individuals.[636] This huge revenue loss has been caused by the ability of these five digital MNEs to adopt technology to minimise their tax liability in any country from where they are located or could have residence. For example, Apple has applied complex digital manipulation in Ireland to make an income of 110 billion Euros from stateless or virtual nations.[637] This means that no country, including Ireland, can tax this income. The USA has also sued Facebook for 9 billion dollars in unpaid tax based on the way the company manipulated the internet to shift its profits in different jurisdictions around the world to limit its residency in the USA.[638]

South Africa has also not been exempted from this global tax pilferage. A report by Tax Justice Network shows that the country loses 3.5 billion dollars or 54 billion

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633 ibid.

634 Tax Justice Network 'The State of Tax Justice in 2021' (November 2020) <https://taxjustice.net/wp-content/uploads/2020/11/The_State_of_Tax_Justice_2020_ENGLISH.pdf> accessed 3 January 2022.

635 Tax Justice Network 'Tax Justice Network Research Again Draws Flak from Tax Havens and Critics' (17 December 2021) < https://taxjustice.net/2021/12/17/tax-justice-network-research-again-draws-flak-from-tax-havens-and-critics/> accessed 3 January 2022. See also Tax Justice Network 'The State of Tax Justice in 2021' (November 2021) <file:///C:/Users/Admin/Desktop/NOW/achoki/State_of_Tax_Justice_Report_2021_ENGLISH.pdf> accessed 3 January 2022.

636 Tax Justice Network 'The State of Tax Justice in 2021' ibid.

637 Regan A 'Until the Eu Tackles Tax Avoidance Big Companies Will Continue Getting Away with It' (16 July 2020) <https://www.theguardian.com/commentisfree/2020/jul/16/eu-tax-avoidance-big-companies-ireland-apple-state-aid> accessed 20 July 2020.

638 White J 'The IRS Take Facebook to Court Over its Irish Tax Structure' (19 February 2020) Irish Tax Dispute <https://www.internationaltaxreview.com/article/b1kdw0nx8h3jz1/the-irs-takes-facebook-to-court-over-its-irish-tax-structure> accessed 20 July 2020.

Rand to corporate tax abuses by MNEs.[639] This rose slightly from 3.3 billion dollars in 2019. Significantly, the revenue that was lost in 2020 was enough to provide three doses of Covid-19 vaccine to all South Africans. It was reported that the common method used by MNEs to limit their tax liabilities is the use of the internet and complex accounting methods to shift their profits to tax havens.

The EU has attempted to resolve certain disputes with these five MNEs by diplomatic means. The European Commission has pushed Google to pay taxes in some member states. For example, it settled a tax dispute with the UK Revenue Services in the UK when it paid 130 million Pounds as underpaid taxes between 2005 and 2015.[640] The UK government had accused Google of using artificial digital tax structures to avoid payment of tax in the UK where it had generated 18 billion dollars between 2006 and 2015.[641] However, it had only paid 16 million dollars incorporation tax during the same period.[642] Google also agreed to pay 306 million Euros to Italy as underpaid taxes between the years 2002 to 2015.[643] The agreement resolved a dispute in which the Italian government had accused Google of using artificial digital means to transfer about 1 billion Euros from Italy to Ireland.[644]

This model of negotiating tax that is due to a taxing authority after the transaction has been completed and income earned, is not the most appropriate way of protecting the tax base of any country. The fact that Italy only obtained 306 million Euros while it claimed 1 billion Euros from Google, confirms that negotiated tax

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639 Tax Justice Network 'The State of Tax Justice in 2021' (November 2021) <file:///C:/Users/Admin/Desktop/NOW/achoki/State_of_Tax_Justice_Report_2021_ENGLISH.pdf> accessed 3 January 2022.

640 Tang P and Bussink H 'EU Tax Revenue Loss from Google and Facebook' <https://static.financieel-management.nl/documents/16690/EU-Tax-Revenue-Loss-from-Google-and-Facebook.pdf> accessed 15 October 2020.

641 House of Commons Committee of Public Accounts 'Tax Avoidance - Google' Ninth Report of Session 2013–14 <https://publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf> accessed 16 October 2020.

642 House of Commons Committee of Public Accounts 'Tax Avoidance - Google' 9th Report of Session2013–14 https://publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf> 16 October 2020.

643 Tang P and Bussink H 'EU Tax Revenue Loss from Google and Facebook' <https://static.financieel-management.nl/documents/16690/EU-Tax-Revenue-Loss-from-Google-and-Facebook.pdf> accessed 16 October 2020.

644 ibid.

settlements cannot help a country realise optimum tax collection. The best way is to ensure that the tax due to any country is levied and collected in real time when the transaction occurs.

Furthermore, the data in Figure 4.1 above shows that, in addition to paying for a double full dose of Covid-19 vaccine for every human being on earth, the revenue lost from digital trade in 2020 could easily have paid for billions worth of new global public sector investments and infrastructure. This, therefore, points to an urgent need for the global community to come up with a compromise method or agreement to address the challenge of how to tax today's digital economy fairly. Failure to secure this consensus will result in continuous loss of hundreds of billions of dollars to these MNEs whose technological knowhow has continued to grow at a speed which outpaces that of tax authorities, income tax laws, and the applicable international tax principles.

4.4.1 Can Cyberspace Create a Taxable Presence in South Africa?

The Katz Commission commented as follows regarding e-commerce:[645]

> [It] 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 significantly impact on some basic tenets of international taxation as they exist today.

South Africa is a residence-based tax jurisdiction. This means that, subject to certain exclusions, South Africa taxes residents on their worldwide gains irrespective of where the income was earned. Non-residents are, however, taxed on their income from a South-African source.[646] For example, a South African resident who offers any service outside the country on behalf of a South African employer; or any South African resident who earns interest income from outside the country, could be required to pay tax in terms of the deeming provisions.

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645 Katz Committee 'Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1995 Government Printer Pretoria).

646 Section 5 read with s 9(1)(*a*) of the Act.

Most international transactions involving non-residents are taxed under the PE attribution and PEM concepts. Under these rules, a PE is deemed to exist where a dependant agent has authority to contract, or where a PE can be attributed to that non-resident within South Africa.[647] The deeming provision in section 9 of the Act also provides for circumstances in which an income can be deemed to have accrued from sources within the Republic. This applies even if income was earned from a source outside South Africa.

4.4.1.1 Applying the PE Concept

South Africa is guided by the OECD Model Tax Convention in its application of the PE concept.[648] Cyberspace can be taxed by attributing the income earned from cyberspace to a PE in South Africa. The PE concept is applied to levy tax on digital transaction by finding a component of the internet that meets the OECD's requirements for PE status.[649] Any business conducted through or with the aid of a server could thus be taxed from the location of the server. This is because the OECD considers the location of the server as the fixed place through which business can be conducted.[650] Moreover, a server that is at the disposal of an enterprise and is also used regularly to conduct the business of an enterprise can be deemed to constitute the PE of that enterprise.[651]

Article 5(4) of the OECD Model Tax Convention provides that a server will be considered a PE of an enterprise in cases where the exclusions itemised in Article 5(4) of the OECD Model Tax Convention do not apply.[652] This means that a PE *nexus* will not be created in cases where activities that have been carried out through the server are preparatory or auxiliary in nature. However, a PE *nexus* will

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[647] Article 5 of the OECD Model Tax Convention.
[648] *CIR v Downing* 1975 (4) SA 518 (A) 524 See also s 108(1) read with s 233 of the Constitution of the Republic of South Africa, 1996.
[649] The OECD requirements for taxation under the PE concept in Article 5(1) of the OECD Model Tax Convention are that there must be place of business; the place of business must be 'fixed'; and the business of the enterprise must be conducted through this fixed place of business.
[650] OECD 'Commentaries on the Articles of The Model Tax Convention: Commentary on Article 5 para 7 s 42.2 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 12 July 2020.
[651] ibid Article 5 para 7 s 42.3.
[652] ibid Article 5 para 7 s 42.7.

be created if the server is used to carry out the core or main functions of an enterprise.[653]

The examples above lead to the conclusion that the PE concept can be used to levy tax on cyberspace-based transactions carried out through a website that has a server at its disposal. In addition, the PE will be deemed to exist at the fixed location where the server is located. The users of cyberspace have, however, sidestepped tax liability in South Africa under the PE concept by doing the following:

a) Limiting their footprints or presence in the course of their trade in South Africa by using digital platforms like servers and websites which do not constitute tangible property under the OECD guidelines.[654] The ability of such digital platforms to create virtual offices without a link to a place of business or physical geographical location in South Africa means that their transactions do not qualify for attribution to a PE in South Africa.
b) Considering that the OECD has prescribed that a server can constitute a PE if it supports or facilitates the core functions of an enterprise's business activities.[655] A PE presence would, however, only be created if the server is located somewhere in South Africa. Most non-resident traders have bypassed this provision in the OECD Model Tax Convention by carrying out their businesses through non-resident servers of other enterprises that facilitate core functions of other enterprise and which have created no PE in South Africa. For example, companies like e-Bay, Samsung, Boeing, and Johannesburg stock exchange listed Altron have migrated their core functions to a cloud-based server known as Microsoft Azure.[656] Microsoft Azure is a cloud-based computing platform that could be used by any enterprise to offer various cloud services and products in South Africa without setting foot in South Africa or employing any person to run its operations in the country. Its servers are often located in tax

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653 ibid Article 5 para 7 s 42.8.
654 ibid Article 5 para 7 s 42.2.
655 ibid Article 5 para 7 ss 42.7 and 42.8.
656 Microsoft Azure has been described as a 'cloud layer' on top of a number of Windows Server systems which use Windows Server 2008 and a customised version of Hyper-V, known as the Microsoft Azure Hypervisor, to provide virtualisation of services.

havens like Ireland and Luxembourg thereby making it difficult for countries like South Africa to apply the PE concept to tax transactions that have been conducted using Azure servers. This is because the Azure servers have the potential of placing the fixed location through which the business of an enterprise is conducted in the tax haven where the servers are located.

c) They use internet service providers (ISPs) to host their websites on their servers. Considering that the OCED has advised that ISPs do not constitute a dependant agent of an enterprise to which a website belongs, all transactions carried out through these ISPs could escape tax liability in South Africa.[657]

From the above, it appears that PE may no longer be reliable in taxing cyberspace. There is an urgent need for the global community to come up with better and more efficient concepts or methods of taxing the digital economy.[658] This would be the only way of controlling or stopping MNEs from eroding South Africa's tax base which could be losing annual revenue of about 140 million Rand to digital MNEs like Google which has exploited the current gaps in the Act and international *nexus* principles to avoid paying its rightful share of tax.[659]

This then begs the question whether the deeming provisions in the Act are capable of taxing transactions that have taken place within South Africa's digital economy effectively.

4.4.1.2 Applying the Deeming Provisions

The absence of direct digital service tax provisions in the Act has compelled SARS to rely on the exiting deeming provisions in section 9 of the Act to tax digital transactions. The deeming provisions provide for circumstances under which income may be deemed to have accrued from a source within South Africa if that

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[657] OECD 'Commentaries on the Articles of The Model Tax Convention" Commentary on Article 5 para 7 s 42.10 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 12 July 2020.
[658]Skaar *Permanent Establishment* 559 and 573.
[659] Fin 24 'Google Avoids SA Tax' (11 February 2014) <https://www.news24.com/Fin24/google-avoids-sa-taxes-20140211> accessed 10 July 2020.

amount constitutes income from leases, services, royalties, or technological know-how as is explained hereunder.

4.4.1.2.1 Lease Income

A lease is an agreement where the lessor conveys an asset to the lessee for consideration for the right to use that asset for an agreed period. This definition of what makes up a lease and how it accrues is similar to the definition of royalty income which is defined in section 49A of the Act as:

> any amount that is received or accrues in respect of the use, right of use or permission to use any intellectual property as defined in section 23I.[660]

Lease income earned from the use of intellectual property can be taxed under section 9(1) of the Act. This implies that the income of a lessor who leased computer hardware or a server for a consideration to conduct digital trade may not be taxed on its income. Omitting lease from the list of deeming provisions in section 9 of the Act means that SARS would have to rely on the common law to determine whether any lease income from tangible or intangible assets is taxable in South Africa. The most relevant doctrine to rely on in making such a determination is the principle of originating cause.[661] This principle was established in *Commissioner of Inland Revenue v Lever Brothers and another*[662] where it was stated that the originating cause of income is determined by looking at the nature of the asset that generates the income. The interpretation was clarified in the latter case of *Commissioner of Taxes v British United Shoe Machinery (SA)(Pty)Ltd*[663] where it was held that the originating cause of a tangible asset is determined by looking at the purpose for which the lease was created. This object of the lease could be determined by looking at the duration of the lease or how the lessor uses the asset concerned.

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[660] Section 9(1) of the Act. See also SARS-IN 116 para 4.1.2 <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/IntR-IN-2021-03-IN-116-Withholding-tax-on-royalties.pdf> accessed 20 August 2021.
[661] Nel and Steenkamp 2016 9(2) *Journal of Economic and Financial Sciences* 531.
[662] 1946 AD 441.
[663] 26 SATC 163 (1964).

Longer leases would be an indication that the intention of setting up the lease agreement was for commercial purposes.[664] On the other hand, a shorter lease implies that commercial considerations may not have been the main intention in setting up the agreement. Every case would, however, be determined on its own unique circumstances. There would also be cases where income earned from short lease agreements could be deemed taxable. In all these cases, the location of the asset would be the originating source of the lease income. Therefore, e-commerce transactions that involve the signing of lease agreements would attract taxation at the location where the lease asset is situated. This taxation model is based on a physical test. It requires SARS to identify the location of the asset leased to determine whether it has taxation rights over the resulting income. Using this physical test to create a tax *nexus* in today's digital economy may pose the following implementation challenges for SARS[665]

First, cyber-based lessees rarely have physical access to or possession of the leased assets in a cyberspace environment. This would make the application of any income earned from the leased assets difficult.

Second, locations where the physical asset is situated and the place or location where it is used to generate an income are, in cyber-based transactions, often in different jurisdictions. This could make it difficult for SARS to establish where the tax *nexus* was created. The location of the market goods or the consumer of the goods could also be transferred to a huge network of remote servers linked to the internet and operating together as a single ecosystem. This virtual, interconnected, and invisible network is known as the cloud. The virtual and imperceptible nature of the cloud can make it possible for a taxpayer who is using it to place his or her transactions outside the tax jurisdiction of the source country. Moreover, the transactions performed on the cloud are based on global computing networks which defy borders. This makes it difficult to apply the current South African system which, as we have seen, is based on physical presence and the PE concept.

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[664] Meyerowitz *Meyerowitz on Normal Tax* (2005-2006 ed) 532.
[665] Oguttu and Tladi (2009) 4(3) *Journal of International Commercial Law and Technology* 217-218.

Third, cloud-based transactions[666] can create an arrangement where both the lessor and the lessee have no control over the income-generating asset. This is, in the main, because the use of cloud-based servers can result in a transaction where both the lessee and lessor do not have physical possession of, control over, or access to the leased assets. Instead, both have only auxiliary rights to use the income-generating asset remotely via the Internet. The tax consequence of such a transaction is that neither the lessee nor the lessor would create a physical presence or a PE *nexus* under the current OECD guidelines.[667] Chapter 6 of this thesis shall, therefore, makes proposals on how the OECD and South Africa could ascribe tax liability to similar lease transactions in today's digital environment.

Lastly, the interpretation of the term 'market' means different things to different people. Is it where the customer is located, is it where the goods are made available to the customer irrespective of his or her location, or where the enterprise promotes the sale of its goods, or perhaps where the right to use the cyber services or goods is accessed? In the traditional market the definition of market was generally known as the location where the physical asset was made available for use. The digital world has, however, made the application of the physical presence test difficult because cloud computing can be applied to place the physical location of an asset in a low-tax jurisdiction or any other location that is convenient for the consumer. This could result in BEPS in many countries. Chapter 6 of this thesis offers proposals on how to determine the location of a market in a digital transaction. The outcome of these challenges is that SARS is likely to suffer erosion of its tax base if these challenges are not addressed.

4.4.1.2.2 Royalty and Income from Knowhow Activities

Sections 9(2)(*c*) to 9(2)(*f*) of the Act provide that an amount shall be received by or accrue to a person from a source within South Africa if that amount constitutes a

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[666] Cloud transactions are transactions carried out through or with the aid virtual networks connected to the internet. They make it possible for the user to access the digital software as a service, a platform, or an infrastructure to aid the user in his or her transactions.

[667] OECD 'Commentaries on the Articles of The Model Tax Convention: Commentary on Article 5 para 7 s 42.7 <https://www.oecd.org/berlin/publikationen/43324465.pdf> accessed 12 July 2020.

royalty or it is received in respect of imparting or undertaking scientific, technical, industrial, commercial, or ancillary knowhow activity related to the use of such knowledge. The Act, however, provides that the income from these activities would be taxable only if it is earned by a person resident in South Africa, or who has a PE situated outside South Africa.[668] The law, therefore, appears to prescribe that the physical test would first be applied to this kind of transaction to determine tax liability. It would, thereafter, resort to applying the broad PE test where the physical test is inappropriate, and perhaps more so in taxing cyber based transactions. SARS prefer the use of the latter approach in the taxation of cyber-based activities to avoid the administrative difficulties associated with a physical-presence test.[669] This approach is, however, not without challenges.

The first challenge is that consumers of cyber-based activities could transfer their residency to cyberspace.[670] This occurs where an enterprise opts to use a website located in the clouds as its storefront. Its reliance on the websites as a storefront for its trade helps it to limit its physical presence and that of its employees in South Africa. The application of the traditional residency concepts, e.g. PE, in such a transaction would place the central place of management and control of such enterprises either in the clouds or in a low-tax jurisdiction where the servers are located.[671] This attribution of the taxpayer's PE to the cyberworld or a tax haven, and not South Africa, would result in loss of tax income for SARS.

Second, income listed in section 9(2)(*c*)-(*f*) of the Act would only exist as taxable source-income if the receipt is related to use, grant permission to use, or right of use within South Africa. Consequently, cyber-based transactions that have manipulated the source of royalty income or knowhow income to a source outside South Africa would not attract tax liability under section 9 of the Act.

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[668] Section 9(2)(*c*)-(*f*) of the Act.

[669] SARS 'Explanatory Memorandum of the Taxation Laws Amendment Bill 2013' <https://www.sars.gov.za/Legal/Preparation-of-Legislation/Pages/Explanatory-Memoranda.aspx> accessed 25 May 2020.

[670] Nel and Steenkamp (2016) 9(2) *Journal of Economic and Financial Sciences* 535.

[671] Bradshaw, Millard and Walden (2011) 19(3) *International Journal of Law and Information Technology* 187-223.

Finally, it is not clear whether cyber-based transactions are included in the knowhow rubric, which was described as including scientific, technical, industrial, or commercial information, and ancillary services in connection with such knowledge. It is posited that failure to include cyber-based transactions in the list of knowhow activities in section (2)(*e*)-(*f*) of the Act implies that the legislature intentionally omitted it from this group. Its inclusion cannot, therefore, be inferred or implied. This means that the cyberisation and related activities have been excluded from the group of knowhow activities which can give rise to taxable source income in the Republic.

It is clear that cyber-based transactions pose various challenges to determining the source of income for tax purposes. This thesis therefore proposes how to improve the country's legal tax regime to make it possible for the government to protect its tax base by collecting all the taxes due to it from cyber-based transactions.

4.4.1.2.3 Service Income

The model for determining the taxability and source of service income was discussed in *Commissioner of Taxes v Shein*[672] where it was stated that the source of income in a service transaction is the place where the service is performed. The fact that the virtual nature of cyberspace can allow a non-resident to render its services from different convenient locations could make the application of the principle in the *Shein* case problematic.

A typical example of this is subscription-based services like Netflix, Amazon Prime, instant Video and e-books where the content is produced at a location other than that at which the server and the consumer of the content are located.[673] Attempts to tax these digitalised commercial activities have been resisted by the digital companies on the basis that their services are performed or rendered either at the location where the content was produced or where their server is located.[674] They

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[672] 1958 (3) SA 14 (FC).
[673] Nel and Steenkamp (2016) 9(2) *Journal of Economic and Financial Sciences* 536.
[674] PricewaterouseCoopers 'Online Streaming Should be Taxed' <https://www.pwc.co.za/en/press-room/electronic-tax.html> accessed 13 October 2020.

posit that no service is rendered by the service provider when a consumer downloads its content from a location within South Africa where it has no physical presence.[675] It is contended that downloading content from a website is not a primary activity of a digital company. As such, it ought not to be used as a determinant of tax residency or liability. The primary activity of the service provider is the production of content, and this could easily be traced either to its physical location, or the location of its servers. Netflix has scattered its servers over 243 different locations which has made it possible for Netflix to avoid the use of the servers located in the country where it streams its content. The outcome is that it has aligned itself to the *Shein* case to limit its tax liability in South Africa by insisting that it does not undertake any service transaction in South Africa.

The position taken by Netflix and other digital companies means that non-resident taxpayers can easily minimise their tax liability in South Africa by using the internet to manipulate the location from where their services are rendered. SARS confirmed and emphasised this position when it raised a concern that unlike physical services, it may even be impossible to determine the place of performance of an electronic service.[676]

This concern by SARS is an indicator that there is an urgent need for it clarify where the location or source of a service income ought to be located. The following questions may be asked:

a) is it where the value was added to the service?
b) is it where the server or the website is located?
c) is it where the consumer is located? or
d) is it where the digital platform interacts with the consumer?

The courts have recently attempted to resolve this problematic issue of source determination in *Casino Enterprises (Pty) Ltd v The Gauteng Gambling Board*[677]

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675 ibid.
676 SARS Explanatory Memorandum of the Taxation Laws Amendment Bill 2013' <https://www.sars.gov.za/Legal/Preparation-of-Legislation/Pages/Explanatory-Memoranda.aspx> accessed 14 May 2020.
677 2011 (6) SA 614 (SCA) 653 para 10.

where it was held that the source location in internet (gambling) transactions is where the main online activity takes place. The court also clarified that other aspects which are irrelevant to the primary activity of an enterprise should be ignored when deciding on where the main activity took place. The source location or the originating cause of a digital transaction as applied in the *Casino Enterprise* case could be identified using either the literal or the broad approach.[678]

The literal approach is the traditional view that relies on the physical location of the consumer in terms of which the source of income is deemed to be where the consumer is located. Its application is easy as tax authorities assign tax liability to whomever is identified as the consumer of the services in any transaction. On the other hand, its application would also be problematic in cases where the user has used the internet to hide or blur his or her physical location. An example is where a vendor based in cyberspace sells an e-book to a consumer based in South Africa. SARS would find it difficult to tax that vendor under the literal approach.

The literal approach is, therefore, best applied in typical face-to-face transactions where the service provider has not used the internet to avoid or limit his or her physical presence in South Africa. SARS has asserted that it would use the broad approach concept in determining tax liability in cases where the taxpayers have transferred all or most of their transactions to cyberspace in order to limit their tax liability under the physical approach.[679]

Under this approach a consumer of electrical services, for example, will be deemed to be located in South Africa if the source of payment is from a source within South Africa, or if the consumer of the services is a South African resident. This approach is far easier to apply as it eliminates the possibility of both the taxpayer and SARS having divergent tax liability interpretations in transactions where the residency of the taxpayer or the source of its payment is clear. This approach appears to address

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[678] O'Sullivan, Edmond and Hofstede (2002) 12 *Distributed and Parallel Databases* 119.
[679] SARS 'Explanatory Memorandum of the Taxation Laws Amendment Bill 2013' <https://www.sars.gov.za/Legal/Preparation-of-Legislation/Pages/Explanatory-Memoranda.aspx> accessed 14 May 2020.

the problem that arises with the taxation of lease income by providing that it is the location of the consumer that creates the tax *nexus.*

This means that tax liability will be deemed to have arisen in South Africa if a person is physically present in South Africa at the point at which he or she is using the internet to access or use cloud activities to purchase services, or if he pays for services from his or her South African bank account. It is irrelevant here that the consumer's digital footprints may have been identified as being in cyberspace or that the service provider's server is located outside of South Africa's jurisdiction.

Despite the clarity and simplicity of this broad approach to the taxation of service income, it proceeds on the presumption that:

a) All trade transactions are paid through bank accounts and that SARS could easily recover the tax due to it by tracing the service payments that have been made by the consumers to these bank accounts. It was therefore, presumed that these bank accounts could help it determine the location of the consumers and the value of income earned from services offered by a service provider in South Africa. The reality, however, is that complex cyber-based transactions are today paid through bitcoins and other related virtual currencies. Such transactions could be difficult to trace and could also be manipulated to a location that suits the bitcoin miners. This will defeat the purpose of relying on bank accounts to determine source of income.
b) South African consumers of digital services could easily use the internet to relocate their residency to cyberspace or other low-tax jurisdictions to create the impression that the consumer of services is not a South African resident. This would bring administrative difficulties because SARS who would be expected to make every effort to track the locations of such consumers so as to apportion tax liability to their digital transactions.
c) All consumers would easily disclose their location, income, and bank details in order to comply with the regular South African tax liability.
d) All people who operate a bank account within South Africa are consumers of services who should be taxed on their service income. This proposal is likely to affect the country's investment in trade because international

traders may shy away from opening bank accounts in South Africa for fear of being taxed on non-residential transactions. Residents who want to limit their tax liability in South Africa would also be persuaded to open bank accounts in other countries so that they do not have to pay tax to SARS on all electronic services they may consume.

This thesis makes proposals on how to deal with the taxation uncertainties and challenges created by these presumptions and confirms that whereas some progress has been made in taxation of online service income, the process is still plagued by uncertainty.

4.5 The Advent of the Electronic Signature

An electronic signature (e-signature) is defined as data attached to, incorporated in, or associated with other data which is intended to serve as a signature[680] It may be used to identify the signatory with the data message or to show the signatory's approval of the information contained in the data message.[681] An e-signature is used in an e-commerce environment to facilitate the supply or exchange of goods and services, joint ventures, leasing, licensing, and other similar transactions performed over the internet. However, e-signatures are only used to identify the signatory and/or confirm the taxpayer's approval of the document in question.[682]

The question that tax authorities have grappled with is whether an e-signature could be used in a trade transaction to determine the residence of a taxpayer. The answer to this question was provided in the case of *Spring Forest Trading 599 CC v Wilberry (Pty) t/a Ecowashand Another*[683] where it was held that e-signatures could authenticate the identity of the signatory. It was further stated that the initials or names of the parties at the bottom of an email used to identify parties, qualify as an e-signature under section 13(3) of the Electronic Communications and Transactions

680 Section 1 of the Electronic Communications and Transactions Act 25 of 2002.
681 Article 2(b) of UNCITRAL Model Law on Electronic Signatures.
682 Section 33(3) of the Electronic Communications and Transactions Act 25 of 2002.
683 (725/13) [2014] ZASCA 178, 2015 (2) SA 118 (SCA) (21st November 2014).

Act (ECTA).[684] It is therefore possible under sections 13(3) and 33(3) of the ECTA for SARS to use a taxpayer's e-signature to establish his or her residency.

The aim of the ECTA is to create legal certainty regarding the use of e-signatures in commercial transactions. It clarified the uncertainty that previously existed in South African law by placing digital transactions performed using e-signatures on the same footing as traditional paper-based transactions.[685] This recognition afforded to e-signatures by the ECTA eliminated the e-signature as a stumbling block to the growth of e-commerce in South Africa.[686]

Using e-signatures to determine residency could, however, pose the following challenges for SARS.

a) The *Spring Forest* case interpreted the meaning and application of an e-signature in South Africa under the ECTA. It is posited that applying this decision to the Act could be problematic. This is exacerbated by the established principle in *CIR v Frankel*[687] where Centlivres CJ stated:

> In a taxing Act, one has to look at what is clearly said. There is no room for any intendment. There is no equity abut a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.

The ECTA cannot, therefore, be read into the Act. The fact that the Act has no equivalent of section 13(3) of the ECTA means that e-signatures may be used to determine residency for tax purposes in South Africa only in cases where the tax statute (the Act) is silent, or when it is used to clarify or effect a specific tax-administration goal.[688] Section 13(3) of the ECTA, which has provided guidance on how to identify the residency of a person using e-signatures, can therefore be imported into the Act. The importation

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[684] Act 25 of 2002.
[685] Coetzee (2004) 5 *Stell LR* 520 <https://core.ac.uk/download/pdf/227005178.pdf> accessed 2 November 2020.
[686] ibid 521.
[687] 1949 (3) SA 733 (A) 738.
[688] Gordon 'Law of Tax Administration and Procedure' in Thuronyi V (ed)*Tax Law Design and Drafting* 99-100.

of non-tax statutes, like the ECTA, into tax statutes must however be approached with caution and to improve tax-administration issues such as to control tax-avoidance practices;[689] it should never be used to introduce a new taxing regime into the Act.[690] The fact that the ECTA can only be applied to limited transactions and within a narrow scope means that SARS will not benefit from its far-reaching and beneficial provisions which have already been covered by the Act.

b) Even if section 13(3) of ECTA were to be imposed or read into the Act to help SARS establish tax residency of non-resident taxpayers, SARS would still have to deal with the issue of taxpayers who have created an artificial residency in low-tax jurisdictions using their pseudo signatures while their actual residency is in South Africa. Artificial residency generally arises where a taxpayer develops an electronic signature which is placed in the custody of a third party who resides in a low-tax jurisdiction which does not have a bilateral tax agreement with South Africa. Subsequently, all agreements and commercial documents that require the signature of the taxpayer would be executed by this third-party agent in the low-tax jurisdiction. This way, the residency of the taxpayer would be deemed to have been created where the commercial documents were signed – i.e., in the low-tax jurisdiction. The absence of a bilateral tax agreement between South Africa and this low-tax jurisdiction would mean that the country cannot tax the income realised by this taxpayer in any of his or her transactions. This includes transactions where the taxpayer may have been physically present in the country when the transaction was negotiated or concluded with a South African resident.

c) The recent decision by the Supreme Court of Appeal, in *Global and Local Investments Advisors (Pty) Ltd v Fouche (Fouche* case*)*[691] reversed the gains made in the *Spring Forests* case. It held that an e-mail signature does not constitute a signature. Although the court in the *Fouche* case was dealing with an issue of fraudulent e-mails, this inconsistency by the courts

[689] *CIR v Frankel* 1949 (3) SA 733 (A) 738.
[690] ibid.
[691] (2020) ZASCA 8 (18 March 2020).

on the validity of e-signatures in commercial transactions is likely to cause confusion and uncertainty for SARS in its efforts to widen its tax net to include the digital space.

d) It could be difficult to use e-signatures to establish residency in contracts that require more than one signature. This is more so in cases where the signatories are located in different jurisdictions. The issue would be why or how a tax authority would rely on the e-signature of one signatory to determine residency and not that of the other signatory. The current Rules for Electronic Communication, however, offer no clarification or guidelines of how to deal with this dilemma.

e) It remains unclear how SARS could use e-signatures to help it determine the residency of taxpayers in cases where both parties to a contract have used cryptographic signatures in their transaction. This is where both the sender and receiver use a similar key which could help them hide their identity or the location in which they have signed a document.[692] This type of transaction would inevitably make it virtually impossible for SARS to draw such taxpayers within its jurisdictional tax purview.

f) The definition of a consumer as a natural person has excluded SARS from applying ECTA to juristic persons who enter into or intend entering into an electronic transaction with a supplier as the end user of the goods or services offered by the supplier. This could afford juristic persons, such as a close corporation or a company, an unfair advantage by limiting their tax liability even in cases where SARS has decided that a substantive contract was signed by non-residential directors from a server based in South Africa.

Whereas the use of e-signatures to determine residency could be crucial in helping any country to broaden its tax base, it is also clear from the above examples that it can also be used by taxpayers to manipulate their residency.[693] The impact that this is likely to have on the economy can be discerned from the fact that in 2020 the

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[692] Pacini C, Andrews C and Hillison W 'To Agree or Not To agree: Legal Issues In Online Contracting'<file:///C:/Users/USER/Downloads/To_agree_or_not_to_agree_-_legal_issues_ in_cybercontracting.pdf> accessed 1 November 2020.

[693] Abdulkarimli (2015) 1 *Baku State University Law Review* 97-107.

value of e-commerce trade in South Africa was projected to be some 3.6 billion dollars.[694] The 2020 growth target was not realised as the actual value of South Africa's e-commerce market was estimated at 2.1 billion dollars in 2020 before hitting the 2.9 billion dollar mark in 2021.[695] It is expected that it will grow to approximately 5.4 billion dollars by 2024.[696] The South African government cannot, therefore, afford to ignore this huge revenue stream.

A solution to how e-signatures could broaden or protect the South African tax base must be explored. This is all the more pressing when one recongises that the trade volume from e-commerce is now competing with other huge traditional physical traders like oil companies or car manufacturers.[697] Perhaps it is time for the legislature to considered replicating the provisions of section 13(3) of the ECTA in the Act. Such action should be accompanied by regulations offering clarification to SARS, taxpayers, and tax consultants on how to deal with the other challenges identified in this thesis.

4.6 Taxing Digital Currencies

Digital currency is the term used to describe all forms of electronic money, including virtual currency and cryptocurrency. The common types of digital currency in the word today are virtual currencies, cryptocurrencies, bitcoin, and Central Bank digital currencies.[698]

4.6.1 Taxing Virtual Currencies

The South African Reserve Bank (SARB) defines a virtual currency as:[699]

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694 See <https://www.statista.com/outlook/243/112/ecommerce/south-africa> accessed 13 May 2020.

695 WorldWide Worx 'SA Online Retail Leaps to R 30 Billion' (12 May 2021) <http://www.worldwideworx.com/online-retail-in-sa-2021/> accessed 1 April 2022.

696 See <https://www.statista.com/outlook/243/112/ecommerce/south-africa> accessed 13 May 2020.

697 Abdukarimli (2015) 1 *Baku State University Law Review* 97-107.

698 OECD 'Taxing Virtual Currencies: An Overview Of Tax Treatments And Emerging Tax Policy Issues' (2020) <file:///C:/Users/user/Downloads/taxing-virtual-currencies-an-overview-of-tax-treatments-and-emerging-tax-policy-issues.pdf> 3, 47-48 accessed 5 September 2022.

699 South African Reserve Bank 'Position Paper on Virtual Currencies' (December 2014) <http://www.resbank.co.za> accessed 25 May 2020.

> [A] digital representation of value that can be traded and functions as a medium of exchange, a unit of account, or a store of value, but does not have the legal tender status.

Although a virtual currency (VC) may operate as a medium of exchange, a unit of account, and a store of value, it has no central monitoring or oversight system to help in the control of its issuance, distribution, or regulation.[700] The South African Reserve Bank (SARB) Act 90 of 1989 only recognises tangible units like Rands and cents as monetary units in South Africa.[701] As much as there are no specific rules or laws to address the regulation or issuing of VC in South Africa, the VCs have over time increased in value, spread, use, and acceptance as an alternative means of paying bills, or for goods and services in several jurisdictions around the world.[702] This is borne out by the fact that there are some 1 658 known virtual currencies in the world today – up from only one virtual currency (the bitcoin[703]) in 2009.[704] Other examples of popular VCs other than the bitcoin and cryptocurrencies, include Litecoins, Binance coins, Facebook points, Amazon coins, Microsoft coins, and Nintendo points.[705]

Because they are unregulated, VCs are deemed to be illegal in South Africa. Any merchant can decline to accept them in trade without being in breach of the law. In fact, the SARB has expressly stated that VCs are not legal tender in South Africa and cannot be used in the discharge of any obligations.[706] However, the penal system in the country has not expressly prohibited or criminalised the use of and

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700 Financial Action Task Force Report 'Virtual Currencies Key Definitions and Potential AML/CFT Risks' (2014) <https://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf> 4 accessed 25 May 2020.

701 Section 15 of the South African Reserve Bank (SARB) Act 9 of 1989.

702 Mathew (2014) 27(2) *Harvard J of Law & Technology* 587.

703 A bitcoin is 'a digital, decentralized, partially anonymous currency, not backed by any government or other legal entity, and not redeemable for gold or other commodity'. See OECD 'Taxing Virtual Currencies: An Overview Of Tax Treatments And Emerging Tax Policy Issues' (2020) <file:///C:/Users/user/Downloads/taxing-virtual-currencies-an-overview-of-tax-treatments-and-emerging-tax-policy-issues.pdf> 3 accessed 5 September 2022.

704 See <www.investing.com> accessed 28 October 2020.

705 Grinberg R 'Bitcoin: An innovative Alternative Digital Currency' <https://www.researchgate.net/publication/228199328_Bitcoin_An_Innovative_Alternative_Digital_Currency> accessed 23 May 2020.

706 SARB 'Position Paper on Virtual Currencies' (2014) 4-5 read with s 14 of the South African Reserve Bank Act 90 of 1989.

trade in VCs. According to SARS, VCs are not illegal and are subject to normal tax.[707] SARS' view appears to be that the absence of regulation does not mean that VCs are illegal in South Africa. In any event, there are already over 700 VCs operating globally without any regulation and which are taxed in various jurisdictions.[708] Moreover, the amendment of the definition of financial instruments to include cryptocurrencies means that any transaction settled using VCs is taxable in South Africa.[709] It would thus be difficult to assert with confidence that VCs are illegal in South Africa when they have not been expressly proscribed in the Penal Code and SARS taxes transactions settled using VCs. It is submitted that whereas a VC is not legal tender,[710] the fact that it has been recognised as a legal and taxable financial instrument under the Act means that it is also not illegal. Moreover, unlike Egypt[711] and Lesotho[712] who have expressly banned the use of VCs, the South African Penal Code or any other laws of the country have not expressly banned the use of VCs.

A typical VC is protected by a mathematical formula known as cryptography which requires the user to sign into it cryptographically using some keys to transfer the required value of the virtual currency from one person to another.[713] It operates within a block-chain technology, which is the primary innovation responsible for the mining of the currencies[714] and updating the record for individual cryptocurrency[715]

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[707] SARS 'SARS Stance on the Tax Treatment of Cryptocurrencies' Media Release (6 April 2018) <http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-taxtreatment-of-cryptocurrencies-.aspx> accessed 1 November 2020.
[708] Mothokoa *Regulating Crypto-Currencies* 2.
[709] Section 1 of Act 58 of 1962 read with cl 1 of the Taxation Laws Amendment Bill of 2018.
[710] Bitcoin Broker 'Bitcoin exchanges in South Africa' (2015) <http://bitcoinbroker.co.za/bitcoin-exchanges-south-africa/> accessed 23 May 2020.
[711] Maanda *Legal Implications of virtual currencies* <https://repository.up.ac.za/bitstream/handle/2263/72771/Maanda_Legal_2019.pdf?sequence=1&isAllowed=y> 32 accessed 23 May 2020.
[712] ibid 33.
[713] Financial Action Task Force Report 'Virtual Currencies Key Definitions and Potential AML/CFT Risks (2014) <https://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf> 5 accessed 2 April 2020.
[714] Mining of currencies is a process where the transactions for various forms of currency are verified, added to the blockchain digital ledger which facilitates the release of new currency into the market.
[715] Cryptocurrency is form of digital currency or virtual currency. See <https://blog.idex.io/all-posts/whats-the-difference-between-digital-currency-virtual-currency-and-cryptocurrency> accessed 2 April 2020.

transactions. It operates like a bank ledger but differs in that its transactions are not monitored or verified by a central regulatory authority.[716]

4.6.2 Virtual Currencies and their Use in South Africa

We live in a borderless world which has also encouraged the growth of virtual trade.[717]

Whereas virtual currencies are not recognised as legal tender in South Africa, the country has not been left behind in the world-wide craze for bitcoins.[718] The fact that trade and dealing in VCs has not been directly illegalised by any statute in South Africa resulted in the country registering its first VC – BitX – in 2013. Ironically, despite registering as a South African VC, the BitX established its headquarters in Singapore with a meagre operations team in Cape Town, South Africa.[719] This arrangement could theoretically make it possible for BitX to use the internet to limit its physical presence in South Africa by digitally transferring all its core functions, operations, and decision making its headquarters in Singapore. This would mean that all its customers, including those based in South Africa, could easily be compelled log onto BitX websites from where they could digitally transfer or trade with their VCs without interacting with the BitX branch in South Africa. All its operations, including sales, marketing, and customer service which would have required the employment of people at a fixed place within South Africa, would then take place online. Such a strategic decision by BitX would ultimately help it shift its PE from South Africa to the internet. The absence of a PE in South Africa implies that SARS would not be able to exercise its taxing rights over BitX with regard to a large portion of its profits arising from transactions carried out in cyberspace.

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[716] The Trust Machine 'The Economist Technology Behind Bitcoin Could Transform How Economy Works' (31 October 2015) <https://www.economist.com/leaders/2015/10/31/the-trust-machine -technology-behind-bitcoin-could-transform-how-economy-works-trust-machine> accessed 28 June 2020.

[717] Davis Tax Committee 'First Interim Report: Addressing Base Erosion and Profit Shifting in South Africa 1-2 <www.taxcom.org.za> accessed 23 May 2020.

[718] Section 15 of the South African Reserve Bank Act 90 of 1989 does not recognise VCs as a monetary unit or an item to which designation or money value can be attributed in South Africa.

[719] Bitcoin Broker 'Bitcoin exchanges in South Africa' (2015) <http://bitcoinbroker.co.za/bitcoin-exchanges-south-africa/> accessed 23 May 2020.

On the other hand, the fact that South Africa follows a residence-based tax system means that SARS could still tax BitX on the limited income that its branch office may earn from the direct services that it could have provided from its local location. The reality, however, is that the bulk of BitX income generated online would remain untaxed. This is a clear example of the challenges that VCs can pose to the country's tax system.

The number of VCs in operation in the country has increased from the single BitX in 2013 to over 200 merchants. This is despite the lack of a regulatory legal regime formally to legitimise and govern its operations and the failure by the South African Reserve Bank to recognise it formally as a legal currency or a monetary unit.[720] These setbacks have, however, not stopped people from transacting in VCs. Some of the common VCs popularly traded in South Africa include Luno, Iced cubed, DoshEx, Altcoin, and Ovex.[721] The promoters of VCs have recently created a platform known as BitHub to create awareness and encourage South Africans to take part and trade in digital currencies.[722] SARS' tax base is likely to be exposed to erosion if this campaign succeeds as the anonymity and virtual nature of VCs could make it difficult for SARS to trace and levy tax on digital transactions paid for using any form of VC.

This means that any tax authority that wishes to protect its tax base must find a way of developing tax laws that can ensure the efficient and effective taxation of both e-commerce transactions and any other transaction where the goods or services are paid for using a VC. The Davis Tax Committee recognised this challenge when it identified VCs as an actual threat to the country's tax base because of their ability to facilitate an anonymous, instant, and virtually untraceable electronic payment to

[720] Section 15 of the South African Reserve Bank Act 90 of 1989 does not recognise VCs as a monetary unit or an item to which designation or money value can be attributed in South Africa.
[721] Bitcoinzar 'Buy Bitcoin in South Africa from a Bitcoin Exchange' (2015-b) <http://www.bitcoinzar.co.za/buy-bitcoin-in-south-africa/> accessed 2 April 2020.
[722] Tiwari D 'BitHub Aims to Take South African Bitcoin Scene to A New Level' (2015) <http://bitcoinist.net/bithub-takes-south-african-bitcoin-scene-new-level/> accessed 23 May 2020.

any location in the world.[723] It, therefore, recommended how SARS should treat cryptocurrencies in the following terms.[724]

> SARS does not regard cryptocurrencies as a currency for income tax purposes or Capital Gains Tax (CGT). Instead, cryptocurrencies are treated as assets of an intangible nature by SARS. While not constituting cash, cryptocurrencies can be valued to determine an amount received or accrued as envisaged in the definition of 'gross income' in the [Income Tax] Act. Following normal income tax rules, income received or accrued from cryptocurrency transactions can be taxed on revenue account under 'gross income.

This recommendation by the Davis Committee proposed that SARS could tax transactions that involve the use of cryptocurrencies by valuing or monetising the value of the VC received from that transaction. Thereafter, it could subject the income from the monetised VC to normal tax under the Act. This led SARS to issue a media release in 2018 where it stated that SARS:

> will continue to apply normal income tax rules to cryptocurrencies and expect affected taxpayers to declare cryptocurrency gains and losses as part of their taxable income.[725]

This pronouncement, which means that all VC transactions are taxable was perhaps a recognition that the use of VCs was becoming popular and accepted as an e-payment instrument as was captured by Nieman when she stated that:[726]

> If cash is king, cryptocurrencies may be the next closest thing and we, South African lawyers, are largely clueless (as with too much of the Internet of Everything unfortunately).

The popularity of VCs and their existence as a medium of exchange in South Africa was affirmed by Goodspeed, the former Governor of South African Institute of Financial Markets, who stated that the value of bitcoins held in South Africa in

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723 Davis Tax Committee 'Second Interim Report on Base Erosion and Profit Shifting in South Africa' 103-105 <www.taxcom.org.za> accessed 23 May 2020.
724 ibid.
725 South African Revenue Services 'SARS Stance on the Tax Treatment of Cryptocurrency' <http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018> accessed 2 June 2020.
726 Nieman (2015) 18(5) *Potchefstroom Electronic Law Journal* 1979.

2014 was worth some 7 billion dollars.[727] She also affirmed that bitcoin is likely to grow into a generally accepted and trusted service and that it was perhaps time the South African government heeded the advice of Paul when he stated:[728]

> The world is in the midst of a crisis today, and many of us believe it is related to a deeply flawed monetary system, a deeply flawed understanding of what money should be, a rejection of the notion that money should have real value and that money originated in the marketplace rather than originating from a computer over at the Federal Reserve.

This confirms that this digital phenomenon which is less than ten years old in South Africa, has the potential to grow and is here to stay.[729] Moreover, perhaps it is time that those in authority move away from the notion that only transactions settled in currencies issued by the Central Bank should attract tax liability. Such a notion would result in loss of revenue base because several transactions worth billions of dollars are today settled using VCs such as bitcoin. I now turn to the question of whether the South African tax-law system is prepared and ready to tax transactions paid using VCs?[730]

4.6.2.1 South Africa's Developing Position on Recognition of Virtual Currencies

Through the 2014 SARB position paper on VC the government of South Africa came to the realisation that VCs have migrated to the mainstream of financial transactions.[731] This led the government to make the following observations or clarifications with regard to the place of VCs in the South African economy.

a) VCs are today interacting with the real economy in exchange for legal tender to purchase real-world goods and services.[732]

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727 Goodspeed I 'Bitcoin' <http://financialmarketsjournal.co.za/oldsite/19thedition/printedarticles/bitcoin.pdf> accessed 5 May 2020.

728 ibid.

729 Block chain Academy 'South Africans, Cryptocurrency and Taxation 2018' <http://blockchainacademy.co.za/wp-content/uploads/2018/09/SA-Cryptocurrencies-Research-Report.pdf> accessed 2 June 2020.

730 The thesis focuses on the taxability of bitcoin because it is the most popular VC in the market today.

731 SARB 'Position Paper on Virtual Currencies' (2014) <https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NPS)/Legal/Documents/Position%20Paper/Virtual%20Currencies%20Position%20Paper%20%20Final_02of2014.pdf> accessed 3 November 2020.

732 ibid.

b) VCs are exerting significant competitive pressure on existing payment systems, for low-value and long-distance cross-border transactions such as remittances, which are deemed to be rather costly. Moreover, these VCs could divert an increasing stream of payments away from established retail payment infrastructure if they are permitted to take hold. [733]

c) In line with its position that regulation should follow innovation, SARB should continue monitoring developments in this regard and reserve the right to change its position on the legality or otherwise of VCs should the landscape warrant regulatory intervention.[734]

d) After the publication of the 2014 position paper on VCs, SARBS joined hands with other stakeholders under the umbrella of the Intergovernmental FinTech Working Group (IFWG). The IFWG is made up of representatives from SARBS, the National Treasury, the Financial Sector Conduct Authority (FSCA), and the Financial Intelligence Centre (FIC). It published a position paper on VCs in 2019 in which it adopted the term 'crypto assets' instead of VC to refer to the same asset.[735] This was intended to differentiate it from gaming currencies such as Minecraft which do not interact with the real economy in the same way as bitcoins or Luno.[736] The IFWG recognised that there was growing interest, investment, and participation in crypto assets by financial institutions and individuals in South Africa. [737] This trend was likely to impact on the financial sector of the economy. It was also of the view that the crypto-assets arena is an area that requires further review to make it fit within the current regulatory framework.[738] A regulatory

[733] ibid.
[734] ibid.
[735] SARB 'Consultation Paper on Policy Proposals for Crypto Assets' (2019) <http://www.treasury.gov.za/comm_media/press/2019/CAR%20WG%20Consultation%20paper%20on%20crypto%20assets_final.pdf> accessed 3 November 2020.
[736] Reddy and Lawack (2019) 31 *SA Merc LJ* 20 <file:///C:/Users/USER/Downloads/Reddy_Lawack2019SAML.pdf> accessed 1 November 2020.
[737] SARB 'Consultation Paper on Policy Proposals for Crypto Assets' (2019) 5-6 <http://www.treasury.gov.za/comm_media/press/2019/CAR%20WG%20Consultation%20paper%20on%20crypto%20assets_final.pdf> accessed 5 June 2020.
[738] ibid 6.

framework would therefore, help minimise cases of market manipulation and tax evasion.[739]

e) The IFWG suggested the following three-phase approach in an effort to deal with these challenges and possibly ensure wider taxation of transactions settled using cryptocurrencies. [740]

   i. Stage one: Registration of all cryptocurrency providers as accountable institutions under FIC. The registered institution would thereafter be expected to assist SARS in the collection any tax due from its membership.

   ii. Stage two: Review existing regulatory frameworks with a view to amending them where appropriate. The most complex question would be to determine whether cryptocurrencies require an entirely new regulation.[741]

   iii. Stage three: Assessment of regulatory actions already implemented. Current regulatory laws and regulations touching on cryptocurrencies – in particular the recent amendments to the Income Tax Act – would be assessed for their efficiency. More emphasis would be placed on determining whether they have helped protect or widen the country's tax base.

The IFWG also recommended that cryptocurrencies should remain unrecognised and without legal-tender status.[742] It, however, encouraged the government to act and amend appropriate legislation and regulations as innovation evolves to come up with a regulatory framework for the future. [743]

The fact that VCs today operate at a global level could potentially complicate their regulation as they pass across different and national jurisdictions.[744] A coordinated

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[739] Ibid 6.
[740] ibid 25.
[741] ibid 19.
[742] ibid 25.
[743] ibid 29-30.
[744] Intergovernmental Fintech Working Group 'Position Paper on virtual Currencies' (25 April 2020) <http://www.treasury.gov.za/comm_media/press/2020/20200414%20IFWG%20Position%20Paper%20on%20Crypto%20Assets> 21 para 5.1.1 accessed 14 June 2020.

global approach to the taxation of VCs may be central to the protection of the effectiveness of any regulatory action.[745] However, the emerging consensus from the latest advisory from IFWG is that the current model of taxing VCs under the Act appears to be adequate. It is areas that require amendments, refinements, and additions to cater for the evolving nature of VCs that would in future be communicated to government for consideration through a final position paper.[746]

These clarifications and proposals are a good indicator that South Africa is slowly accepting the reality that VCs are here to stay and that any country wishing to protect its tax base should endeavour to collect the tax benefits that VCs can offer. Perhaps it is only a matter of time before the Legislature comes up with laws that govern this sector of South Africa's growing economy. In the interim, taxpayers are expected to continue declaring any income received or accrued from any trade conducted using VCs as part of their taxable income.

4.6.2.2 Inclusion of Virtual Currencies in the Income Tax Act

The previous proposal by the National Treasury, SARB, and SARS to the legislature to consider amending the law to include the regulation or taxation of VCs was finally acted on in 2018 when the Act was amended as follows:

a) Section 20A(2)(*b*)(*ix*) of the Act was amended to list both the acquisition and disposal of any VCs by a natural person as legitimate, just like gambling and farming.[747] It then proceeded to ring-fence cryptocurrency trade from any assessed losses. This ring fence would only fall away in the circumstances listed in section 20A(3) of the Act (referred to as the 'facts-and-circumstances' test).

   This amendment resulted in the recognition of any income realised from a legitimate transaction involving the disposal of VCs as a taxable income within section 5(1) of the Act.

[745] ibid 22 para 5.1.3.
[746] ibid 32 paras 10.6 and 10.7.
[747] Section 1(1) of the Act.

b) The Taxation Laws Amendment Act 23 of 2018 also expanded the definition of financial instrument by amending subsection (1) of section 1 of the Act to include VCs.[748] This implies that a VC is now recognised as a legitimate financial instrument similar to a debenture, a bond, or a promissory note. It follows that any profit earned from obligations that are settled using VCs will be subject to normal tax requirements and treated in the same way – for tax purposes – as obligations that are settled using a promissory note or any other financial instrument.

The inclusion of cryptocurrencies in the Act confirms that it is the intention of the legislature, as it is of SARS, that all transactions settled using VCs are taxable. These tax amendments have been implemented and are applied in South Africa in various ways as will be shown below.

4.6.2.2.1 Treatment of Virtual Currency Transactions as a Normal Taxable Transaction

The inclusion of VCs within the definition of financial instruments in the Act confirms that, for South Africa's normal tax purposes, VCs are assets and not currencies.[749] This means that all transactions involving VCs are taxable under the normal income tax rules within the Act. The expenses incurred by VCs in the course of such transactions are also deductible if they meet the conditions laid down in the Act.[750]

The exchange of VCs for goods or services would also constitute barter trade.[751] Goods or services can be exchanged for VCs through barter. In such a case, the normal barter transaction rules apply in terms of which the open market value of the goods exchanged for the VC would be the amount to be included in the taxpayer's gross income.[752] The income earned from this trade would be taxable as normal

[748] A cryptocurrency is a form of decentralised virtual currency.
[749] Section 1 of the Act.
[750] Section 1 of the Act added by s 1(1)(*c*) of the Taxation Laws Amendment Act 23 of 2018.
[751] *South Atlantic Jazz Festival (Pty) Ltd v CSARS* (2015) 77 SATC 254, 257.
[752] Wicht *Tax Implications of Bitcoin* 62.

taxable income within the parameters of the Act. This view was affirmed in *South Atlantic Jazz Festival (Pty) Ltd v CSARS*[753] where it was held that in an ordinary arm's length barter transaction, the value that the parties attributed to the goods or services exchanged would be a reliable indicator of their equivalent market value.

4.6.2.2.2 Treatment of Virtual Currencies as Trading Stock

Apart from outright purchase with a fiat currency or through barter trade, VCs could also be acquired though mining. This is the process by which new units of VCs are generated.[754] Any VC acquired through mining often results in receipt or accrual of the units of VCs mined. The units of VCs held are deemed to be trading stock until such time that they are disposed of.[755] Secondly, anything that is acquired by a taxpayer for purposes of a possible future exchange is considered a trading stock.[756] All VC units are often held in anticipation of future exchange with fiat currency or goods and services. These characteristics of VC units qualify them for classification as a trading stock. The proceeds from the disposal of these VC units as trading stock would thus be included in the gross income of the taxpayer in terms of the general definition of gross income.[757] The expenses and costs incurred in mining or acquiring the trading stock would be deductible for normal tax purposes.[758]

The Act provides that the value of a VC held but not disposed of at the end of a financial year can be included in the calculation of a taxpayer's taxable income as part of his or her trading stock.[759] This was intended to ensure that a taxpayer does not limit his or her tax liability by reducing the cost price of a VC in subsequent financial years. The fact that VCs are now classified as financial instruments means

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753 (2015) 77 SATC 254, 257.
754 Nakamoto, S. 'Bitcoin: A Peer-to-peer Electronic Cash System' 4 <https://bitcoin.org/bitcoin.pdf.> accessed15 June 2020.
755 SARS 'SARS's Stance on The Tax Treatment of Cryptocurrencies' (2018a) Media Release 06 April 2018 <https://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx> accessed 17 November 2020.
756 Definition of trading stock s 1(1) of the Act.
757 Section 1(1) of the Act. See also Berger *Bitcoin Exchange Transactions* 50.
758 Section 11(*a*) of the Act.
759 Section 22(1)(*a*) of the Act. See also Berger *Bitcoin Exchange Transactions* 73.

that the cost price to be adopted by the taxpayer for this purpose would be the actual price of the trading stock when it was acquired. All expenses incurred in putting the trading stock in its current condition, excluding any differences in the exchange rates, would be deducted from the actual cost of the trading stock.[760]

The people who trade in VCs have also been prevented from offsetting the losses incurred in VC trade against income earned from any other trade.[761] These losses are therefore, ring-fenced to be used only against future profits earned by VCs. This amendment has the effect of protecting the country's tax base by ensuring that losses incurred in VC-based transactions are not applied by a taxpayer to reduce his or her tax liability.

4.6.2.2.3 Treatment of Virtual-Currency-Based Income as Revenue

SARS has asserted that VCs often experience volatile prices which makes them attractive as speculative assets.[762] The volatility of VC prices and its general use as a speculative profit-oriented investment vehicle means that the proceeds of its sale are deemed to be revenue in nature.[763] This position was affirmed by Van der Merwe AJS when he stated in *CSARS v Capstone 556 (Pty) Ltd*[764] that:

> [V]irtually every capital asset is purchased in the hope and anticipation that it will increase in value and in contemplation of the possibility that it may in future be sold at a profit.

In essence, he asserted that most VC units are purchased in anticipation of their value increasing. They thus ought to be classified and taxed as revenue income.

However, the best test for determining whether the proceeds of sale of a VC transaction are capital or revenue in nature is to apply the 'intention of the taxpayer'

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[760] 22(3)(*a*)(*i*) of the Act.
[761] Section 20A(2)(*b*)(*ix*) read with s 20 A(3) of the Act.
[762] SARS 'Comprehensive guide to capital gains tax' (2018 issue 7) <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20-%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 50 accessed 15 November 2020.
[763] Baek and Elbeck (2015) 22(1) *Applied Economics Letters* 30-34 <https://www.tandfonline.com/doi/abs/10.1080/13504851.2014.916379> accessed 15 November 2020.
[764] (2016) 78 SATC 231, 238.

test.[765] The application of this test was clarified by the courts in *CSARS v Founder Hill (Pty) Ltd*[766] where it was held that an asset acquired with an intention of making a profit would result in the proceeds of the sale of the asset being deemed to be revenue and thus taxable. It indicated further that the vital thing to determine in such cases is whether the taxpayer purchased the asset as a capital or with intention of making profit. Consequently, an acquisition that is made as part of a profit-making scheme and the proceeds realised from it or its sale would be classified as revenue.[767]

In general terms, therefore, any VC acquired in the hope and anticipation that its value will increase whereupon it could be sold for a profit is as trading stock and not as capital assets. The income received from its disposal would thus be included in the taxpayer's gross income for the determination of his or her taxable income. This general rule does not, however, apply to all VC transactions. In fact, SARS has cautioned that each transaction should be considered on merit to determine whether a receipt relating to a VC transaction is in form of capital or revenue.[768] For example, a VC acquired as a means of payment with no speculative intention of disposing of it at a profit, would constitute a capital asset.

Its ambiguous nature as a revenue and a capital asset can cause confusion in cases where a taxpayer is adjudged to have had the twin intentions of profit-making and holding the VC as an asset. The solution to this confusion was clarified in *Overseas Trust Corporation Ltd v CIR*[769] where the court held that the amount received by a taxpayer would be revenue in nature in all cases in which he or she had alternative and conflicting intentions.

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[765] *CIR v Nel* (199) 59 SATC 349.
[766] (2011) ZASCA 66.
[767] *Commissioner for Inland Revenue v Pick 'n Pay Employees share Purchase Trust* 1992 (4) SA 39 (A) 57E-G.
[768] SARS 'SARS's Stance on The Tax Treatment of Cryptocurrencies' (2018a) Media Release 06 April 2018 <https://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx> accessed 17 November 2020.
[769] (1969) 31 SATC 163, 251.

Furthermore, unlike other typical financial instruments, VC holders do not earn dividends or interest. Sale of VCs is, therefore, similar to sale of Krugerrands which do not have income producing capacity. In *ITC 1525*[770] the courts held that sale of Krugerrands is revenue in nature. In the same way, it could be asserted that income arising from VC transactions are likewise revenue in nature.

4.6.3 Cryptocurrencies

Cryptocurrencies[771] are a common and popular type of VC. Their use and application in daily commercial transactions have become a common and regular occurrence. Legally, they are defined as a digital representation of value that can be digitally traded; functions as a medium of exchange; operates as a unit of account or a store of value; but does not qualify as legal tender.[772] Some countries, Singapore for example, have recognised the growing significance of cryptocurrencies by taxing companies on their virtual currency sales.[773] Nigeria has formulated and implemented regulations that govern the use and taxation of its official digital currency, the eNaira[774]

Cryptocurrencies are generally transferred directly from the buyer's computer to the sellers who then holds it in an anonymous online wallet. The privacy, anonymity, and complexity of such a transaction mean that the government will have very limited insight into transactions settled using bitcoins. This limited visibility in turn

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770 (1991) 54 SATC 209, 210.

771 Cryptocurrency is a digital and unregulated currency in which encryption techniques are used to regulate the generation of units of currency to secure transactions and control the creation of new and parallel currency units. It usually operates independently of the SARB and is accepted by members of the virtual community. Cryptocurrencies are also known as virtual or digital currencies. This thesis uses the terms digital currency and virtual currency interchangeably as they bear the same meaning. See definition and explanation in Narayanan (2020) 8(8) *International Journal of Research* 96.

772 South African Reserve Bank 'Position Paper2 on Virtual Currencies' (2014) <https://www.golegal.co.za/wp-content/uploads/2018/01/Virtual-Currencies-Position-Paper-Final_02of2014.pdf> accessed 29 June 2016.

773 Simbula M 'Virtual Currencies: Legal Framework Countrywide' (2014) <www.studiolegalesimbula.com> accessed 23 December 2016. See also Inland Revenue Authority of Singapore 'Income Tax Treatment of Digital Tokens' (17 April 2020) <https://www.iras.gov.sg/media/docs/default-source/e-tax/etaxguide_cit_income-tax-treatment-of-digital-tokens_091020.pdf?sfvrsn=91dbe1f7_0> accessed 23 December 2021.

774 Chukwuere (2021) 9(1) *Journal of Emerging Technologies* 72 also at <file:///C:/Users/Admin/Downloads/Chukwuere2021.pdf> accessed 2 January 2021.

makes it difficult for SARS to identify and levy tax on commercial transactions settled using a cryptocurrency. Despite this, professionals, designers, and software support service providers,[775] accessory shops,[776] bitcoin gift shops,[777] and owners of luxury items such as yachts, watches, antiques,[778] and related artefacts continue to choose bitcoins as their preferred mode of payment.

Despite available evidence that a growing number of businesses accept cryptocurrencies as a method of payment,[779] the South African government is yet to take a firm legislative position on the taxability of transactions performed using cryptocurrencies within the Republic.[780] In fact, the definition of 'legal tender' under the 1989 South African Reserve Bank (SARB) Act does not include virtual or cryptocurrencies as part of the country's legal tender[781] limiting this status to banknotes, gold, and coins.[782] This limited definition of what constitutes legal tender has over the years made it impossible for SARS to tax income earned from any transaction paid using any virtual currency in that the SARB would not clear that currency for payment.[783] The predictable outcome is that such transactions are likely to escape tax liability in countries such as South Africa which have no specific laws, regulations, Interpretation Notes, published rulings, or court decisions targeting the taxation of transactions paid using cryptocurrencies in South Africa.[784]

Indeed, the non-recognition of cryptocurrencies as legal tender in South Africa has also contributed to making it difficult for SARS to tax transactions settled using

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775 Bitcoinzar 'Business that Accept Bitcoin in South Africa' <www.bitcoinzar.co.za> accessed 23 August 2016.
776 ibid.
777 eGIFTER 'Bitcoin to Gift Cards' (2015) <www.wgifter.com> accessed 23 August 2016.
778 Bitpremier 'How it Works' <www.bitpremier.com> accessed 23 August 2016.
779 Seforo 2014 *TaxTalk* 42-45.
780 'What Is Bitcoin? The Potential Tax Consequences of Transacting in Virtual Currency in South Africa' <www.academia.edu/> accessed 27 September 2016.
781 Crawford K 'Is Bitcoin Money' (2015) <www.finanacialinstitutionslegalsnapshot.com> accessed 22 November 2016.
782 Section 17 of the South African Reserve Bank (SARB) Act 90 of 1989.
783 Blundell-Wignall A 'The Bitcoin Question-Currency Versus Trust-less Transfer Technology' 2014 OECD Working Papers on Finance, Insurance and Private Pensions 37 <www.oecd.org> accessed 7 September 2016.
784 Fin24 'Treasury Warns of Virtual Currency Risk' <www.fin24.com> accessed 23 August 2016.

cryptocurrencies effectively.[785]The fact that the SARB does not recognise crypto-currencies as legal tender means that any proceeds realised from dealing in cryptocurrencies would not be recognised by the SARB. It cannot therefore be taxed or used to discharge any obligation.[786] The application of this decision to the reality of today's world where the use of virtual currencies is in rapid development and acceptance in South Africa, is likely to result in base erosion of the country's tax base. It is for this reason that the Davis Tax Committee recommended that South Africa undertake further studies to determine the impact of cryptocurrencies on tax compliance.[787] It also opined that the country should monitor international trends with a view to establishing the most suitable approach on how to deal with the taxation of transactions settled using cryptocurrencies.[788]

The Davis Tax Committee was of the view that the invisible and untraceable nature of cryptocurrencies makes them a convenient vehicle by which taxpayers can avoid tax.[789] This is attributable to the fact that, although everyone can see the key public accounts and transactions involving bitcoins, it is not very easy to identify the persons who are conducting such transactions.[790] The outcome of this is that it could be very difficult to determine the source and existence of revenue that is earned from such transactions.[791] This position has been affirmed by the OECD which has asserted that the anonymity of cryptocurrencies[792] usually makes it easy for its users to evade taxes.[793]

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785 Moosa (2019) 44(1) *Journal for Juridical Science* 14-15.
786 Department of National Treasury 'User Alert: Monitoring of Virtual Currencies' (2014) <www.Treasury.gov.za> accessed 25 May 2016.
787 Davis Tax Committee 'Davis Tax Committee Interim Introductory Report: Addressing Base Erosion and Profit Shifting in South Africa' <www.oecd.org> accessed 7 September 2016.
788 ibid.
789 Marian O (2013) 112(38) *Michigan Law Review First Impressions* 38-48 <www.scholarship.law.ufl.edu/facultypub> accessed 10 June 2016.
790 ibid.
791 Blundell-Wignall A 'The Bitcoin Question: Currency versus Trust-less Transfer Technology (2014) OECD Working Papers on Finance, Insurance and Private Pensions 37 <www.oecd.org> accessed 7 September 2016.
792 Cryptocurrency is a convertible virtual currency that is protected by cryptography. See definition and explanation in Narayanan (2020) 8(8) *International Journal of Research* 96.
793 Blundell-Wignall A "The Bitcoin Question: Currency versus Trust-less Transfer Technology' (2014) OECD Working Papers on Finance, Insurance and Private Pensions <www.oecd.org> 37 accessed 7 September 2016.

Moreover, the cryptocurrency market has grown phenomenally over the last ten years. They continue to operate as unregulated digital money distributed from one network to another to settle claims. The secured block-chain technology through which cryptocurrency payments are made has enabled participants to interact and make payments without involving intermediaries like banks. This has, in turn, hidden these transactions from the reach of SARS. It is these challenges that have recently led the World Economic Forum to create a Global Future Council on Cryptocurrencies to evaluate the challenges and opportunities that lie in the introduction of global recognition of a central digital currency.[794]

4.6.3.1 Taxing Cryptocurrencies

While the South African Reserve Bank is yet to provide definitive guidance with relation to cryptocurrency, SARS published a media statement on 6 April 2018 providing guidance on the treatment of cryptocurrency and related assets.[795] The statement provides that SARS will, "continue to apply normal income tax rules to cryptocurrencies and will expect affected taxpayers to declare cryptocurrency gains or losses as part of their taxable income". The statement further provides that although the term 'currency' is not defined in the Act, SARS will treat cryptocurrencies as "assets of an intangible nature".[796]

The recognition of cryptocurrencies as financial instruments or intangible assets implies that they are subject to normal income tax in South Africa. Normal income tax rules will also be applied to crypto transactions.[797] Parties to a transaction will be subject to tax based on the value of the asset received. South African taxpayers are also entitled to claim expenses associated with cryptocurrency accruals or

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794 World Economic Forum 'Cryptocurrencies: A Guide to Getting Started' (2021) Community Paper <https://www3.weforum.org/docs/WEF_Getting_Started_Cryptocurrency_2021.pdf> accessed 2 January 2022.

795 Information obtained at <http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx> accessed 2 September 2022.

796 Beckbessinger S and Dingle S 'South Africans, Cryptocurrencies and Taxation' (2018) 35 <file:///C:/Users/user/Downloads/SA-Cryptocurrencies-Research-Report.pdf> accessed 2 September 2022.

797 Williams P and Hare R 'Cryptocurrency and Tax in South Africa' 8 <file:///C:/Users/user/Downloads/Session-3-Cryptocurrency-and-Tax.pdf> accessed 2 September 2022.

receipts. The value of the asset is determined on the basis of the purchase price on the date of receipt and accrual, unlike the calculations applied to traded shares which may be calculated using averages of the actual value.[798]

From the discussion above, it is clear that this new technology has benefits and drawbacks for countries like South Africa which do not recognise cryptocurrencies as legal tender.[799] It is also important to conduct a brief study on the taxation of bitcoin as it remains the most popular form of cryptocurrency.[800]

4.6.4 Taxing Bitcoins in South Africa

There are many types of VCs traded in South Africa including Libra, Litecoin, Ethereum, Ice-X, and EOS. However, the bitcoin has not only caught the public's imagination but it is also the most visible VC in South Africa.[801] A bitcoin is

> a digital, decentralised, partially anonymous currency, not backed by any government or other legal entity, and not redeemable for gold or other commodity".[802]

They can be obtained from various bitcoin exchange points situated at different locations in South Africa. In order to trade or transact in bitcoins, a user needs a bitcoin wallet that can be accessed online from where his or her accounts are kept. The user then mines bitcoins from his or her wallet to complete the trade or related transactions. When mining, the user's computer uses complex equations to validate the bitcoin transaction he or she requires. Once the equation has been successfully applied, the network releases the transaction value of the bitcoins to the vendor of the products or services the user wishes to purchase. The vendor performs a similar mining exercise on his or her online platform to validate the uniqueness and authenticity of the transferred bitcoins before they can be credited to his or her

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798 ibid 4.

799 Department of National Treasury 'User Alert Monitoring of Virtual Currencies' (2014) <treasury.gov.za> accessed 25 May 2016.

800 Thieman A 'Cryptocurrencies: An empirical view from a tax perspective' (2021) JRC Working Papers on Taxation and Structural Reforms 12/2021 <file:///C:/Users/user/Downloads/jrc126109.pdf> accessed 5 of September 2022.

801 Nieman (2015) 18(5) *Potchefstroom Electronic Law Journal* 1992.

802 Grinberg (2012) 4(1) *Hastings Science and Technology Law Journal* 160.

wallet. The point at which the vendor supplies the user with the goods or services required is uncertain.

Bitcoins may be exchanged between holders using their wallets. They could also be exchanged by e-mail or third-party exchange points like Mt Gox. In the latter case, the parties are required to rely on third parties who own a bitcoin mining computer to mine the bitcoins for use or exchange on their behalf.

South Africa has held five conferences since 2015 to train people on bitcoins and block-chain technology.[803] This has resulted in exponential growth in the use of bitcoins.[804] There are at least seven VC automated teller machines in South Africa which have provided a platform for buying and selling bitcoins.[805] This platform has facilitated trade worth hundreds of millions of Rand.[806] Studies have shown that some 86% of participating companies in South Africa have confirmed the use of bitcoins as their preferred mode of payment.[807] This growth is exemplified by the fact that in 2017 bitcoins worth some 108,113 Rand were traded weekly in South Africa.[808] Bitcoin use as an alternative currency could soon become part of South Africa's mainstream economy if its popularity continues and its use continues to grow.

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[803] Blockchain is essentially a distributed data base of records or public ledger of all transactions or digital events conducted and shared among participating parties. Each transaction in the public ledger is verified by consensus of a majority of the participants in the system. And, once entered, information can never be erased. The block chain contains a reliable and verifiable record of every single transaction ever made. Bitcoin, the decentralised peer-to-peer digital currency, is the most popular example which uses blockchain technology. See definitio' in Crosby M, Nachiappan G, Pattanayak YP *et al* 'Blockchain Technology Beyond Bitcoin" (2015) Sutardja Center for Entrepreneurship & Technology Technical Report <file:///C:/Users/user/Downloads/BlockchainPaper.pdf> 1 accessed 10 September 2022.

[804] Grinberg (2012) 4(1) *Hastings Science and Technology Law Journal* 165.

[805] BlockNewsAfrica 'Bitcoin ATMs in Africa-Where to Find Them and How They Work' (2020) <https://blocknewsafrica.com/bitcoin-atms-in-africa/> accessed 2 November 2020.

[806] Burbridge M 'New SA crypto exchange starts Rand-Bitcoin trading' <https://www.itweb.co.za/content/kYbe97XxaVX7AWpG> accessed 1 November 2020.

[807] Reddy and Lawack (2019) 31 *SA Merc LJ* 17. Also at <file:///C:/Users/USER/Downloads/Reddy_Lawack2019SAML.pdf> accessed 1 November 2020.

[808] Staff Writer 'Thousands of Bitcoin being traded in South Africa every week' Business Tech <https://businesstech.co.za/news/finance/210667/thousands-of-bitcoin-being-traded-in-south-africa-every-week/> accessed 3 November 2018.

Despite this growth, the country has not promulgated specific legislation to deal with the taxation of transactions settled using a VC. It has instead opted to continue applying normal income tax rules to VCs and expects affected taxpayers to declare VC gains and losses as part of their income.[809] This means that any income received from a bitcoin, or any other form of VC is taxable. This taxable income could be earned from mining of VCs, using VCs to purchase goods, or any trade in or with VCs. In the circumstances, it is submitted that the question whether the current law is adequate to tax general VC transactions can only be determined after an examination of all the alternative ways through which bitcoins and all other forms of VCs could be taxed under the Act. The following section considers some of these alternatives.

4.6.4.1 Taxation Under the Gross Income Bracket

Normal tax in South Africa is payable on the income received by or accrued to a person during a year of assessment.[810] Taxable income is the aggregate of the amount that remains after deducting all the amounts allowed under parts I and II of the Act to be deducted from or set off against the income of any person together with the amounts included or deemed to be included in the taxable income of such persons in terms of the Act.[811] Gross income, therefore, plays a pivotal role in helping SARS determine normal tax payable. Gross income is defined as:

> The total amount, in cash or otherwise, received by or accrued to or in favour of such resident in case of a resident. In case of non-residents, it means 'the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic'.[812]

This definition confirms that the amount taxable could be in the form of cash or otherwise. It can thus be posited that it is not compulsory that all taxable income must be in the form of cash under the South African income tax regime. Other taxable income could be in a different form described as 'otherwise' in the Act. This

[809] South African Revenue Services 'SARS Stance on the Tax Treatment of Cryptocurrency' <http://www.sars.gov.za/Media/MediaReleases/Pages/6> accessed 3 November 2018.
[810] Section 5(1) of the Act.
[811] Section 1 of the Act.
[812] Section 1 of the Act.

thesis is of the view that the term ‘otherwise’ could include income earned or accrued in the form of bitcoins as ‘otherwise’ in the definition of gross income has been assigned a very wide meaning by the courts.[813]

In the case of *WH Lategan v Commissioners for Inland Revenue*[814] where it was stated that the term ‘otherwise’ could constitute payment in any other form other than cash. This view has been approved and clarified further in the latter case of *Cactus Investment (Pty) Ltd v CIR*[815] in which the court widened the scope of application of the term ‘otherwise’ when it held it to include:

> [n]ot only income actually received but also rights of a non-capital nature which accrued during the relevant year and [rights that] are capable of being valued in money.

The judgment in *CIR v People’s Stores (Walvis Bay) (Pty) Ltd*[816] indicates that the only thing required for an accrual is that the person concerned has become entitled to the right in question.

This means that digital currencies like bitcoins that are capable of being valued have now been introduced into the mainstream of income taxation in South Africa. That bitcoin has a monetary value can be deduced from the fact that it may be converted into real currency, and vice versa. [817]All that SARS or the taxpayer who is completing his or her return will be required to do is to convert the bitcoin into money or monetary value as at the date of the taxable transaction. The value that will be assigned to a bitcoin for tax purposes is the fair market price it would have fetched in an arm’s length transaction in the open market.[818] This position was affirmed in *South Atlantic Jazz Festival (Pty) Ltd v CSARS*[819] where it was held that the value parties may attribute to the goods or supplies exchanged is a reliable indicator of their market value at the time when the goods were initially obtained.

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813 *CIR v People’s Stores (Walvis Bay) (Pty)* Ltd 1990 (2) SA 353 (A), 52 SATC 9, 21.
814 1926 (2) SATC 16, 19 (CP).
815 1999 (1) SA 315 (SCA).
816 1990 (2) SA 353 (A), 52 SATC 9, 21.
817 Moosa (2019) 44(1) *Journal for Juridical Science* 21.
818 Clegg and Stretch *Income Tax in South Africa Paragraph 2.13.*
819 77 SATC 254.

Further, the term ‘amount’ in the definition of gross income refers not only to money but to every form of corporeal and incorporeal property which has monetary value. This implies that payment made by a bitcoin for a service or goods purchased would qualify as taxable under the term ‘amount’ as envisaged in the definition of gross income.[820] All profits realised by a bitcoin trader are thus taxable under section 1 read with section 5(1) of the Act. The Davis Tax Committee supported this view when it stated that:[821]

> Cryptocurrencies can be valued to ascertain an amount received or accrued as envisaged in the definition of ‘gross income’ in the [Income Tax] Act. Following normal income tax rules, income received or accrued from cryptocurrency transactions can be taxed on revenue account under ‘gross income.

In fact, bitcoin is property in the form of a digital unit which is stored in a wallet.[822] Its rights have value for its users and traders who can own and transfer it. These rights and values can also be proved by entries or postings in a digital ledger that records its historical chain of ownership. Therefore, although its nature is incorporeal, it clearly operates as a medium of exchange like cash.[823]

To qualify for inclusion in the gross income, an income ought to be received or accrued in the form or cash or otherwise (like bitcoin) and it must have a monetary value which can be denominated into South African Rand.[824] On the face of it, and as much as it is not a fiat currency, a bitcoin meets all the requirement for possible inclusion in the gross income of a taxpayer.

From the above discussion it is safe to conclude that transactions paid using cryptocurrencies[825] such as the bitcoin could be taxable as a normal tax in South

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820 Pienaar and Steyn March/April (2010) 26(2) *Journal of Applied Business Research* 55-56.
821 The Davis Tax Committee ‘First interim report: Addressing Base Erosion and Profit Shifting in South Africa’ 1-2 <www.taxcom.org.za> accessed 3 April 2020.
822 Moosa (2019) 44(1) *Journal for Juridical Science* 20.
823 ibid.
824 *Mooi v SIR* 1972 (1) SA 675 (A) 683A-F.
825 Cryptocurrencies are classified as a form of decentralised VCs.

Africa. This thesis also explores other methods through which this digital phenomenon could be taxed.

4.6.4.2 Taxing Bitcoins as Currencies

The term currency is not defined in the Act. In the absence of an express definition of currency in the Act, it is best to resort to its dictionary meaning. The *Oxford Advanced Learners Dictionary* defines 'currency' as the system of money that a country uses.[826] This confirms that the money used in a specific country could be referred to as local currency and that which is used in another country as foreign currency.

Section 15(1) of the SARB Act provides that South Africa's monetary unit is the Rand and the cent. Bitcoins are not included in Schedule 2 to the SARB Act which lists coins which are recognised as legal tender under section 17(2).

On the face of it, this implies that a bitcoin is not recognised as a currency in South Africa. The regulatory standard applicable to legal tender does not, therefore, apply to bitcoins and other VCs. Therefore, anyone who transacts in VCs does so at their own risk and will not be protected by the SARB. This position has been strengthened further by the National Treasury which has stated that VCs are not defined as securities under the Financial Markets Act.[827] The regulatory standards that apply to securities are hence not applicable to VCs.[828] Legally, therefore, a bitcoin does not qualify as a fiat currency, legal tender, or security under the South African legal regime.

The word currency has synonyms which include money, legal tender, medium of exchange, and cash.[829] Based on these synonyms, some argue that bitcoins can be categorised as currency in that they act as a medium of exchange.[830] The fact

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[826] Hornby *Oxford Advanced Learner's Dictionary* P26.
[827] Act 19 of 2012.
[828] National Treasury 'User alert: Monitoring of virtual currencies' (2014) <www.treasury.gov.za and accessed on 1oth November 2020. See also sections 30 -55 of Financial Markets act No. 19 of 2012> accessed 5 June 2020.
[829] See <https://www.thesaurus.com/browse/currency> accessed 5 June 2020.
[830] Sami Ahmed (2017) *Yale Law School* 30.

that the bitcoin is not recognised in South Africa by the SARB as a local currency implies that it can only be treated as a foreign currency. Section 24 I of the Act which defines foreign currency as any currency that is not local currency appears to support this argument. Therefore, whereas bitcoins could be recognised as currency they cannot be recognised as a local currency in South Africa and can only, at best, qualify as a foreign currency.

The question whether foreign currency is taxable in South Africa was answered in section 25D(1) of the Act which states that:

> Any amount received by or accrued to, or expenditure or loss incurred by, a person during any year of assessment in any currency other than the currency of the Republic must be translated to the currency of the Republic by applying the spot rate on the date on which that amount was so received or accrued or expenditure or loss was so incurred.

From the foregoing, bitcoins could be considered foreign currency with regard to any trade conducted in South Africa. The value of the bitcoins used to settle that transaction must be translated or exchanged into Rand by applying the spot rate on the date on which it was received or accrued.[831] The converted Rand value of the bitcoin would then be subjected to the country's normal tax.

4.6.5 Taxation of Digital Currencies

The evolving e-commerce environment has brought with it Fintech companies[832] that constantly innovate new models for settling payments. One of these innovative models of payment is the Central Bank Digital Currency (CBDC) that is in the form of a virtual currency issued by the Central Banks of the world to serve as legal tender. Central Banks are exploring the idea of introducing CBDC to help deal with challenges of making payments in a digital economy where the use of cash and other traditional modes of payment have declined over the years[833].

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[831] Section 25 D(1) of the Act.

[832] Fintech refers to the integration of technology into offerings by financial services companies in order to improve their use and delivery to consumers.

[833] OECD 'Taxing Virtual Currencies: An Overview of Tax Treatments and Emerging Tax Policy Issue' (2020) <https://www.oecd.org/tax/tax-policy/taxing-virtual-currencies-an-overview-of-tax-treatments-and-emerging-tax-policy-issues.pdf> accessed 9 February 2022.

Unlike VCs which are not recognised as legal tender, CBDCs would be issued and backed by the SARB to provide a digital fiat supported by the South African government. This means that a CBDC works just like physical money but is managed, stored, and exchanged digitally over the internet. It is expected to co-exist alongside the local cash and bank balances. Central banks would be required to open a special wallet for CBDC transactions. The CBDC is a digital store of value that can be used a medium of exchange and its value will be pegged to the local currency.

A recent survey shows that at least 86% of Central Banks around the world are conducting further research geared towards recognising and introducing a regulated digital currency.[834] The Central Bank of Bahamas launched the pilot phase of the Sand Dollar Project in December 2019.[835] The project was intended to help it introduce its digital version of the Bahamian dollar to be regulated by the Central Bank and used as a recognised currency within the digital currency ecosystem.[836] Just like cash, the Sand Dollar was to be issued by the Central Bank of Bahamas through authorised financial institutions. It has the same value and protection as the Bahamian dollar. The government of Bahamas has gone further and collaborated with the Mastercard to introduce a Sand Dollar pre-paid card which can be used for commercial transactions in all places where Mastercard is accepted.

The Bank of England is also considering a CBDC currency because the use of banknotes is falling while the use of alternative settlement methods is on the rise.[837]

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[834] See <https://www.bis.org/about/bisih/topics/cbdc.htm> accessed 5 February 2022. See also Central Bank of Kenya 'Discussion Paper on Central Bank Digital Currency' (2022) <file:///C:/Users/Admin/Downloads/CentralBankDigitalCurrency%20(1)%20(3).pdf> accessed 4 February 2022.

[835] Central Bank of the Bahamas 'Project Sand Dollar: A Bahamas Payment System Modernisation Initiative' Press Release (December 2019) <https://www.centralbankbahamas.com/viewPDF/documents/2019-12-25-02-18-11-Project-Sanddollar.pdf> accessed 4 February.

[836] Central Bank of the Bahamas 'Project Sand Dollar: The Central Bank Identifies Preferred Technology Solutions Provider for Bahamas Digital Currency' <file:///C:/Users/Admin/Downloads/2019-06-17-10-01-30-Project-Sand-Dollar.pdf> accessed 4 February 2022.

[837] Bank of England 'Central Bank Digital Currency: Opportunities Challenges and Design' (2020) Discussion Paper <https://www.bankofengland.co.uk/-/media/boe/files/paper/2020/central-bank-

It is intended that the regulated digital currency [838]could be introduced into the country's financial system to facilitate international trade and to help the government to tax all virtual transactions effectively. The government has responded to this challenge by implementing a retail digital currency system regulated by Riksbank (Central Bank of Sweden) to avert the risk of losing the sovereignty of the country's Central Bank currency.

Sweden has one of the most advanced digital economies in the world with 90% of all payments in the country being settled by various digital means.[839] The government opted to consider the introduction of a CBDC system known as the e-Krona to protect the sovereignty of the Central Bank's currency from this pressure.[840] This proposal would require Riksbank to operate an infrastructure system able to accommodate millions of users.

Kenya, India, Singapore, Turkey, Canada, USA, Australia, and the Eastern Caribbean Islands have also issued discussion papers proposing the introduction of CBDC.[841] South Africa, too, has proposed the introduction of a CBDC to facilitate cross-border payments and accommodate alternative sources of payment in use in the South African economy.[842]

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digital-currency-opportunities-challenges-and-design.pdf?la=en&hash=DFAD18646A77C00772AF1C5B18E63E71F68E4593> accessed 4 February 2022.

838 Digital Currency is a form of currency available in digital or electronic form and not in physical form, examples include bitcoins and cryptocurrencies. Another term for digital currency is virtual currency. See definition and explanation in Narayanan (2020) 8(8) *International Journal of Research* 96.

839 FebSveriges Riksbank Economic Review 'Second Special Issue on the e-krona:2020-2022' <https://www.riksbank.se/globalassets/media/rapporter/pov/engelska/2020/economic-review-2-2020.pdf> accessed 4 February 2022.

840 ibid.

841 Central Bank of Kenya 'Discussion Paper on Central Bank Digital Currency' (February 2022) <file:///C:/Users/Admin/Downloads/CentralBankDigitalCurrency%20(1)%20(3).pdf> accessed 4 February 2022.

842 Bank for International Settlements 'BIS Innovation Hub and central banks of Australia, Malaysia, Singapore and South Africa will test CBDCs for international settlements' Press Release 2 September 2021 <https://www.bis.org/press/p210902.htm> accessed 6 February 2022.

4.6.5.1 Opportunities in the Taxation of Central Bank Digital Currency

The following opportunities would be available to South Africa were it to adopt the use of CDBC:

a) ease in the determination and levying of tax on international transactions that are increasingly settled using digital means;

b) SARS would easily tax international transactions and also protect its tax base against digital MNEs that often settle their transactions using innovative digital payment models;

c) the losses often suffered by SARS in converting currency when taxing cross-border transactions would also be reduced because no currency conversion would be required under the CBDC platform;[843]

d) data held by the SARB and other financial institutions may be shared with other tax authorities to improve transparency, openness, and the exchange of information for tax purposes in line with the OECD's Global Forum's efforts to strengthen cooperation and fight tax evasion and fraud among member countries;

e) unlike other VCs, CBDCs are not anonymous, their use is therefore likely to help SARS reduce cases of tax evasion that are common in payments settled using VCs;

f) its users are not required to have a bank account. Just like M-pesa,[844] it therefore has the potential to reach the majority of South Africa's unbanked population which has the potential of helping SARS expand its base beyond the banked population;

g) transactions and tax due to SARS are processed and received instantly, unlike fiat currency transactions which usually require hours or a few days to process; and

h) SARS could expand its revenue as, unlike debit or credit card transactions which attract a transaction charge of between 2 and 5% which qualifies as a

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[843] OECD 'Taxing Virtual Currencies: An Overview of Tax Treatments and Emerging Tax Policy Issue' (2020) <https://www.oecd.org/tax/tax-policy/taxing-virtual-currencies-an-overview-of-tax-treatments-and-emerging-tax-policy-issues.pdf> accessed 9 February 2022.

[844] M-Pesa (the 'M' stands for mobile and 'Pesa' is the Swahili word for money) is a financial services platform operated by Safaricom in Kenya and South Africa's Vodacom.

deductible expense,[845] CBDC-based transactions do not attract transaction fees.

4.6.5.2 Difficulties in the Taxation of Central Bank Digital Currency

South Africa is likely to face the following difficulties if opts to use the CDBC system:

a) SARS would require some time to adjust to the reality that tax paid through this cashless system is equivalent to the tax paid through a fiat currency.
b) SARS would need to make a considerable investment in setting up the appropriate infrastructural technology to implement and run a CBDC platform.
c) The taxpayer's data kept by the SARB or supporting financial institutions may be shared or accessed by third parties thereby resulting in breach of the taxpayer's privacy rights.
d) SARS and the SARB would have to shoulder additional responsibilities in terms of compliance, human resource requirements, and other costs which would expose the country's tax system to greater risk as there is no reliable data to confirm that this investment will be equal to or exceed the expected returns.
e) The OECD has provided no guidance on how CBDCs should be treated for tax purposes. There is also limited consensus or guidance on whether they would be treated differently from other VCs and whether their unique features, such as their stability and resemblance to a fiat currency, may require different tax treatment. This will require a specific direction from SARS on how CBDC will be treated for tax purposes.

4.7 Conclusion

The changing landscape of the digital economy has made it difficult for tax authorities to determine the residency or source of income from transactions conducted over the internet. The reality is that the current provisions of the Act, though useful, are of limited value in realising the huge potential of tax income that

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[845] Section 11(*a*) of the Act.

exists in digital transactions. There is, therefore, an urgent need for South Africa to consider a reform of its tax system in that the protection of its tax base could be tied to the growing digital economy.[846] This would guarantee fair competition with a neutral tax system which ensures equal, fair, and equitable taxation of both the traditional and digital businesses.

This thesis therefore recommends how countries such as South Africa could strike a balance on how to tax both the traditional and the digital economy which currently co-exist within the South African economy. It also offers proposals on strategies SARS could adopt to deal with these challenges.

Before offering these proposed recommendations and to ensure that this thesis comes up with practical, fair, and implementable recommendations, a comparative study is undertaken on how other countries, leading tax entities, and the EU have dealt with the challenges of taxing the digital economy.

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[846] Li J 'Protecting the Tax Base in a Digital Economy' (2018) 13(17) *Osgoode Legal Studies* 552 Research Paper 78 <https://digitalcommons.osgoode.yorku.ca/scholarly_works/2618/> accessed 10 July 2020.

CHAPTER 5

COMPARATIVE STUDY ON TAXATION OF THE DIGITAL ECONOMY

5.1 Introduction

Chapters 1 to 4 of this thesis have shown that South Africa has resisted the urge to amend its laws to provide for legislation that deals with the direct taxation of digital trade. This chapter covers a comparative study on taxation of the digital economy. South Africa currently taxes some aspects of its digital economy under its income tax legal regime. This chapter assesses how the EU and a few selected countries – Kenya, New Zealand, and India – have dealt with the issue of the taxation of transactions that take place within the digital space. Developments and models proposed by the OECD are also discussed in this chapter.

5.2 Income Taxation Regimes in Kenya, New Zealand, and India

Before examining the models that these three countries have adopted in their effort to tax the digital economy, it is necessary to understand how their current tax systems levy tax on normal income. This is important because the country's income tax regime is the default tax system applied by tax authorities in all cases where their Income Tax Act does not provide for the direct taxation of a digital transaction. The tax model of any of these countries which have adopted any form of a digital tax system are also examined.

5.2.1 Income Taxation Regime in Kenya

Under Kenyan law income tax is charged on all the income of a resident or non-resident that has accrued in and which is deemed to be or has been derived from Kenya.[847] Any entity will be regarded as a resident if it is incorporated in Kenya, or is effectively managed and controlled in the country, or has been declared to be a resident of Kenya by the Cabinet Secretary of Finance by notice in the *Gazette*. The

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[847] Section 3 of the Income Tax Act CAP 470 of the Laws of Kenya <http://kenyalaw.org/kl/fileadmin/pdfdownloads/Acts/IncomeTaxAct_Cap470.pdf> accessed 5 December 2020.

corporate tax rates for resident and non-resident companies is set at 30% and 37.5% respectively.[848]

Companies newly listed on the Nairobi Securities Exchange (NSE) pay a tax rate of 25% for the first five years of their listing after which they pay the normal tax rate indicated above.[849] The tax is levied on taxable income after deducting the allowable expenses incurred in the course of the production of the income.

Individuals are taxed on a graduated basis depending on a tax basis ranging from a minimum of 10% for those earning below 2 880 US dollars annually to a maximum of 30% for those earning over 3 880 US dollars annually.[850]

5.2.1.1 Income Taxation of Digital Trade in Kenya

Section 3 of the Kenyan Income Tax Act was amended in November 2019 to include the income accruing through a digital marketplace.[851] The law defines a digital marketplace as "a platform that enables the direct interaction between buyers and sellers of goods and services through electronic means".[852] This amendment broadened the tax base to include income earned from the digital marketplace. The DST came into effect on 1 January 2021 and is payable at 1.5% of the gross transaction value.[853]

The DST is payable by both residents and non-residents who derive income in Kenya through the provision of digital services in the digital marketplace.[854] These

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[848] BDO 'Corporate Tax' <https://www.bdo-ea.com/en-gb/microsites/doing-business-and-investing-in-kenya/tax/page-elements/taxation-in-kenya/corporate-tax> accessed 23 January 2021.
[849]See <https://taxsummaries.pwc.com/kenya> accessed 4 February 2021.
[850] Section 2 of the Tax Law Amendment (No 2) Act 2020.
[851] Section 3(2)(ca) of the Income Tax Act CAP 470 of the Laws of Kenya provides that:
'Subject to this Act, income upon which tax is chargeable under this Act is income in respect of income accruing from a business carried out over the internet or an electronic network including through a digital marketplace.'
[852] Section 3(3)(ba) of the (c) of the Income Tax Act CAP 470 of the Laws of Kenya defines a digital marketplace as 'an online or electronic platform which enables users to sell or provide services, goods or other property to other users.
[853] Section 12E read with s 34(1)(o) and rule 12 of Schedule 3 to the Income Tax Act CAP 470 of the Laws of Kenya.
[854] Regulation 4(1) of the Income Tax (Digital Service Tax) Regulations 2020.

services include any form of digital transaction which connects a buyer and a seller, streaming and downloading of digital content such as music or videos, television subscriptions, media subscription such as e-journals or e-books, online ticketing, online sale of goods or services through providers like Alibaba, Jumia, or Takealot.com.[855] The collection of this tax is on a self-assessment basis. The affected taxpayers are required to register their details with the Kenya Revenue Authority (KRA). On doing so they are issued with a Personal Identification Number for filing returns and paying tax.[856] For residents and companies with PE in Kenya, DST will be an advance tax, which they can offset against their final income tax due at the end of a financial year. The tax will be due at the time of transfer of payment for services or goods through a digital marketplace. All income that is already subject to withholding tax is thus exempt from DST.

For non-residents and companies without a PE in Kenya, the DST operates as a final tax which is administered by tax representatives appointed by the KRA.[857] Non-resident companies are required to appoint local representatives to account for and remit the tax on their behalf.[858] It is, however, treated as an advance tax that can be offset against taxes that are payable by the company in the course of the financial year for non-residents with a PE in Kenya.[859] It is the responsibility of the digital owner of the marketplace or the representative appointed for it by the KRA to ensure that the tax is paid.[860]

DST is intended to establish a level playing field for all income-generating enterprises, thus promoting equity. Its implementation is expected to compel the non-resident enterprises which dominate the Kenyan digital marketplace to contribute to the growth of the country from which they derive their income, thereby

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[855] Regulation 3(1) of the Income Tax (Digital Service Tax) Regulations 2020.
[856] Regulation 9(4) of the Income Tax (Digital Service Tax) Regulations 2020.
[857] Regulation 4(3) of the Income Tax (Digital Service Tax) Regulations, 2020.
[858] Regulation of the Income Tax (Digital Service Tax) Regulations 2020.
[859] Regulation 4(2) of the Income Tax (Digital Service Tax) Regulations 2020.
[860] Regulation 7(3) of the Income Tax (Digital Service Tax) Regulations 2020.

expanding Kenya's tax base.[861] This ensures that the country's tax is fairly and equitably shared between the conventional and the modern digital companies. The KRA further aims to collect at least 30 million dollars by the end of the 2021/2022 financial year and in the region of 50 million dollars in the 2023/2024 financial year.[862]

A user of digital services is deemed to be in Kenya and its income shall be taxable under the DST regime if it meets any of the following requirements.[863]

a) The user accesses the digital interface from a computer or other electronic devices in Kenya.
b) Payment for the digital services is made using a credit or debit facility provided by any financial institution or company in Kenya.
c) The digital services are acquired using an internet protocol address registered in Kenya or an international mobile phone country code assigned to Kenya, and/or
d) The user has a business, residential, or billing address in Kenya.

Digital services to which DST applies include:[864]

a) downloadable digital content including downloadable mobile applications, e-books, and films;
b) over-the-top services including streaming television shows, films, music, podcasts, and any form of digital content;
c) sale of, licensing of, or any other form of monetising data collected about Kenyan users which have been generated from the users' activities on a digital marketplace;
d) provision of a digital marketplace;
e) subscription-based media including news, magazines, and journals;

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861 Gakweli M 'KRA Invites Comments On 1.5% Digital Tax' (10 August 2020) Kenyan *Wall Street Edition* <https://kenyanwallstreet.com/kra-invites-public-commentary-on-digital-tax/> 28 November 2020.

862 Kenya Revenue Authority '8th Corporate Tax Plan 2021/2022-2023/2024' <file:///C:/Users/Admin/Desktop/KRA-8TH-CORPORATE-PLAN-.pdf> accessed 2 January 2022.

863 Regulation 5(2) of the Income Tax (Digital Service Tax) Regulations 2020.

864 Regulation 3 of the Income Tax (Digital Service Tax) Regulations 2020.

f) electronic data management including website hosting, online data warehousing, file-sharing, and cloud-storage services;
g) electronic booking or electronic ticketing services including the online sale of tickets;
h) provision of search engine and automated help desk services including supply of customised search engine services;
i) Online distance training through pre-recorded media or e-learning including online courses and training; and
j) any other service provided through a digital marketplace.

This list of taxable digital services under the DST covers almost all digital services. This means that income earned from trending and common digital trade platforms like crypto-currency exchanges, downloading of online content, sales from online market platforms like Amazon, E-bay, or Takealot.com, live-streaming, and other online services are taxable in Kenya. Social media platforms and those who sell their products through social outlets like YouTube, TikTok, and WhatsApp are also required to register for DST and declare their taxes by the 20th of every subsequent month.[865] Tele-medicine applications, subscription-based media, online education platforms, and anything else that is done online and can raise income for the user will not be spared this tax. DST is not a new idea. Countries such as India and France have already implemented this tax system. It is viewed in some quarters as setting retaliatory trade wars between trading partners. It remains to be seen whether Kenya will face similar challenges with its trading partners as it implements this DST system.

5.2.1.2 Challenges to implementing a Digital Service Tax System in Kenya

The KRA introduced the DST to achieve the twin aims of ensuring that all taxpayers are treated equitably, and that the country's tax base is protected from the challenges associated with the growing digital economy.[866] Whereas the jury is still

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[865] Section 12E of the Income Tax Act CAP 470 of the Laws of Kenya.
[866] Gakweli M 'KRA Invites Comments On 1.5% Digital Tax' (10 August 2020) Kenyan *Wall Street Edition* <https://kenyanwallstreet.com/kra-invites-public-commentary-on-digital-tax/> accessed 28 November 2020.

out on whether these objectives will be realised, it is clear that the costs of these taxes will be passed on to the consumers. This will result in an increase in the price of goods and services at a time when many people have lost their sources of livelihood and most businesses have been affected negatively by the Covid-19 crisis. The World Bank economic update on Kenya shows that almost one in three household-run businesses are not operating, with revenues decreasing in all sectors because of the Covid-19 pandemic.[867] It indicates further that about two million people have been forced into poverty by the pandemic. It is therefore ironic that this tax was introduced at a time when the economy was in the doldrums and required a stimulus package to kick-start it – not a new tax system that could stifle the revival of enterprises negatively affected by Covid-19 pandemic.

The fact that KRA intends to rely on the self-assessment system to pay DST could make it easy for such entities to avoid the payment of this tax. This is more so because the services they provide may not be connected to their bank or mobile money accounts so making it difficult for the KRA to carry out a successful audit to determine if they earned any income from online activity. In some cases, dishonest taxpayers could simply decline to declare such income for tax when it is due.

Some service providers like WhatsApp or TikTok could refuse to share their data on customers' activities with KRA. This would leave KRA with no choice but to accept the income declared by the taxpayer as the final tax due from its transactions. KRA would therefore not achieve its aim of tax equity among all taxpayers, if taxpayers who are protected by their service providers' privacy policies do not declare their actual income for tax purposes.

Some non-resident taxpayers may opt not to appoint a tax representative in Kenya. It remains unclear how such a taxpayer would be compelled to pay DST if he or she has not only refused to register for DST tax in Kenya, but has also failed to appoint

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[867] The World Bank 'Kenya's Economic Update: Covid-19 Erodes Progress on Poverty Reduction in Kenya, Increase Number of Poor Citizens' (25 November 2020) <https://www.worldbank.org/en/country/kenya/publication/kenya-economic-update-covid-19-erodes-progress-in-poverty-reduction-in-kenya-increases-number-of-poor-citizens> accessed 23 January 2021.

a tax representative. How will KRA recover the tax due from such an entity when it is not a resident or physically located in Kenya.

The design of the DST could also be its Achilles heel. In France, for example, the DST applies to the giant digital companies such as Apple, Google, or Amazon on income earned from advertising online engagements or transmission of data. This allows other online enterprises to thrive and support the other aspects of the economy while declaring their income annually. This means that the facilitative services like direct sale of goods or services online and online platforms that provide users with digital content, communication services, and payment services are exempt from DST. This reduces the tax burden on a vast population and allows these facilitative online platforms to help grow the French economy.

Like other countries of the world, Kenya also designed its income tax system around the OECD Model Tax Convention.[868] This model did not envisage the implementation of a digital tax system outside the established international taxation principles under the PE and PEM concepts. This means that implementing a DST system on the foundations of a tax system that is based on the PE and PEM concept may present KRA with administrative and implementation challenges. For example, the OECD Model Tax Convention defines a PE as a fixed place of business, and a tax *nexus* is created at the location where income is derived.[869]

On the other hand, the DST law intends to levy tax on digital transactions on the basis of other considerations such as the location of significant economic presence or where the digital activity has a sustained interaction with the country's economy. These challenges could require Kenya to plan whether to abandon these well-established OECD principles so exposing itself to the risk of isolation from the international community for abandoning established international taxation norms. The alternative challenge is to take the Herculean task of lobbying sufficient

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[868] Kenya Revenue Authority 'Taxing the Digital Economy in Kenya' (September 2020) Policy Brief <https://www.kra.go.ke/images/publications/Policy-Brief---Taxing-the-Digital-Economy-in-Kenya.pdf> accessed 21 June 2021.
[869] Article 5 of the OECD Model Tax Convention.

members of the OECD to amend the scope and jurisdictional application of the PE, PEM and other related principles that support the taxation of cross-border transactions.

The DST system in Kenya applies to all digital services.[870] This places the country at a competitive disadvantage in that it has the potential to frustrate technological innovation and hamper the growth of facilitating technological applications which are crucial in helping the economy grow, particularly in these times of Covid-19 when people are encouraged to limit their contact with one another and even with physical retailers or services providers like banks. The introduction of DST could, therefore, reduce the number of people currently using facilitative online platforms such as e-banking. This impacts on the profit margins of such entities before they are driven into bankruptcy which could eventually impact on the vibrant digital economy that Kenya has striven to build over the last ten years. The ability of the wider population to access services like shopping, banking, medical care, education, and entertainment from the comfort of their offices or homes could also become expensive and unsustainable.

It is unclear whether the KRA has invested sufficiently in information technology to enable it audit companies that have failed or have under-declared their DST. The absence of such technological investment means that KRA would be compelled to rely on the income that is self-declared by the taxpayer without an option of establishing the accuracy of such data. The anonymity and thus the difficulty of identifying some online transactions or the location of the service providers would also make it difficult for KRA to tax or determine the appropriate tax payable by such entities in the absence of appropriate technology software to assist it in tracing them. This could result in a failure to realise of the envisaged equitable tax system and the tax targets set by KRA.

[870] Regulation 3 of the Income Tax (Digital Service Tax) Regulations 2020.

The OECD has recommended that tax should not be designed on an industry-by-industry basis because that would compel each state to come up with individual and customised legislation to tax Internet trade.[871] This would result in a plethora of laws that may be difficult to implement or coordinate at the international level. This would, in turn, compel many countries to conclude bilateral treaties with all their trading partners. The management of such a large number of treaties would be difficult for any country or tax authority to manage.

DST is also largely seen as a regressive, discriminatory, and punitive tax system. This is because it is levied on a gross revenue taxation system. It does not consider the losses an enterprise might have incurred. Moreover, if one makes losses in one's business, one will still have to pay the tax which cannot be carried forward and offset against the profits of subsequent years. An entity could therefore easily pay tax in a year when it has earned no profit. The OECD explained the regressive and punitive nature of this tax system when it stated that a 6% tax on gross revenue is equal or similar to a 50% tax on profits.[872] Conversely, a 1.5% DST tax equates to a 12.5% profits tax. The DST could therefore easily be seen as an additional corporate tax introduced through the backdoor. This means that Kenyan residents pay over 42.5% in corporate tax and non -residents pay 50% in corporate tax. It is therefore clear that the DST model adopted by Kenya is regressive, discriminatory, and punitive.

5.2.1.3 Minimised Cost and Complexity

Lastly, the OECD discourages states from adopting a tax system the administrative costs of which are equal to or in excess of the tax collected. It is only fair that the costs of collecting any tax should be kept to a bare minimum. It is even better and more convenient if a taxing state can use its existing infrastructure to implement a new tax regime. The government of New Zealand's proposes that DST will be taxed using the existing income tax infrastructure and any additional cost incurred in tax

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[871] Tax Foundation 'Digital Tax Deadlock: Where Do we go From Here' <https://taxfoundation.org/oecd-digital-tax-project-developments/> accessed 25 January 2021.
[872] ibid.

collection will be passed to the multinational enterprises from whom the tax has been collected.[873] To do otherwise would mean that NZIR would have to stretch itself thin in an attempt to collect tax from various small entities scattered throughout the country and multinational enterprises that are located in multiple global locations.

5.2.2 Income Taxation Regime in New Zealand

Resident companies are taxed on their worldwide income in New Zealand and non-residents are taxed on a source basis.[874] A company is considered as a New Zealand resident if it is either incorporated in New Zealand or if it has a PE in New Zealand. Profits made by companies in New Zealand are taxed where they are derived at the rate of 28%.[875]

New Zealand has not promulgated a specific law to tax Internet-based transactions and so relies on its domestic Income Tax Code and OECD guidelines to tax such transactions. Any multinational company that has some form of physical presence in New Zealand directly or through an agent is liable to pay tax on the profits attributed to it under the OECD's PE guidelines.[876] Under these guidelines, income is attributed to a PE by referring to the value of the income generated by a non-resident at the PE. This means that a non-resident who does not have an asset or an agent in the country is not liable to tax on their New Zealand income. This despite the fact that such an entity could be earning income from services offered to New Zealand residents digitally from a remote low-tax jurisdiction. Non-resident social-media platforms also derive income from selling their users' attention and time to advertisers. The users are thus connected with users and advertisers at a fee. The income earned by such non-resident digital platforms would not be taxed in New Zealand.

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[873] Littlewood M 'Taxing Highly digitalised Firms: The OECD and the New Zealand's Proposed Digital Services Tax' University of Auckland, Faculty of Law 25-26 <file:///C:/Users/Admin/Downloads/SSRN-id3> accessed 25 January 2021.

[874] KPMG 'New Zealand Tax Profile' (January 2020) <https://assets.kpmg/content/dam/kpmg/nz/pdf/2020/01/new-zealand-tax-profile-january-2020.pdf> accessed 24 January 2021.

[875] ibid.

[876] New Zealand ratified its membership to the OECD on 29 May 1973. The information is available at <https://www.oecd.org/about/document/list-oecd-member-countries.htm> accessed 25 January 2021.

The foregoing is an indicator that New Zealand's taxation practice has not kept pace with the realities of today's digital world where multinational entities can generate income from their operations in the country without putting up any asset or employing any agent in the country. The effect of this inadequacy is that such multinational companies such as Google and Facebook could easily derive huge revenue from New Zealand while paying no or much lower tax than resident companies. This has exposed New Zealand's tax base to possible BEPS and led to the release of a discussion document in 2019 to consider the introduction of a DST.[877]

5.2.2.1 Prospects of Taxing the Digital Economy in New Zealand Under the Digital Service Tax System

The government of New Zealand proposed the introduction of a DST as an interim solution if the OECD did not get a multilateral consensus on how to tax the digital economy.[878] DST was to be charged at a flat rate of 3% on the gross revenue derived by firms that conduct highly digitalised businesses. The tax was to be limited to firms:[879]

a) carrying out intermediary services like Uber or eBay;
b) operating social media platforms like Facebook or WhatsApp;
c) operating content sharing sites like YouTube or Instagram; and/or
d) operating search engines like Google.

It would, however, not apply to companies that merely use the internet to facilitate the sale of their goods or services like Netflix or Amazon. It would also not be imposed on financial services, television broadcasting, or telecommunication providers. The argument in favour of these exemptions was that these companies

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[877] Government Discussion Document 'Options for Taxing the Digital Economy" (2019) <https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2019/2019-dd-digital-economy/2019-dd-digital-economy-pdf.pdf> accessed 25 January 2021.
[878] Nash S and Robertson G "Options for Taxing the Digital Economy' (June 2019) Government Discussion Document <https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2019/2019-dd-digital-economy/2019-dd-digital-economy-pdf.pdf> accessed 25 January 2021.
[879] ibid.

only use the internet to offer services and not to derive any value from active use. Moreover, the tax would only apply if the affected firms met the following minimum threshold requirements:

a) have an annual consolidated turnover of at least 750 million sterling pounds, about 1.3 billion New Zealand dollars; and [880]

b) their digital revenue attributable to a PE in New Zealand or New Zealand users exceeds 3.5 million New Zealand dollars.

These threshold sums can be deducted or credited against other income tax obligations of a taxpayer, for example, the withholding tax or income tax due for the year. The government justified its DST on the premise that multinational digital companies do not pay their fair share of tax. It argued that studies have shown that digital companies are on average taxed at the rate of 9.5% while resident companies offering similar services are taxed at the rate of 23.2%.[881] The DST was intended to cure this inequality.

The New Zealand government has estimated that the value of cross-border digital service in the country stands at about $ 2.7 billion New Zealand dollars. The implementation of a DST system would make it possible for the New Zealand Inland Revenue (NZIR) to raise between 30 to 80 million New Zealand dollars annually.[882] The final tax revenue would depend on the final tax design adopted by the government.

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880 Littlewood M 'Taxing Highly Digitalised Firms: The OECD and the New Zealand's Proposed Digital Services Tax' The University of Auckland, Faculty of Law 25 <file:///C:/Users/Admin/Downloads/SSRN-id3692899%20(1).pdf> accessed 25 January 2021.

881 EU Commission 'Proposal for a Council Directive on The Common System of a Digital Services Tax on Revenues Resulting from The Provision of Certain Digital Services' (21 March 2018). Article 5(3) COM (2018) 148 Final Brussels <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf> accessed 12 March 2021. See also Government Discussion Document 'Options for Taxing the Digital Economy' (2019) <https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2019/2019-dd-digital-economy/2019-dd-digital-economy-pdf.pdf> accessed 25 January 2021.

882 Deloitte 'New Zealand Outlines its Proposal for a Digital Services Tax' (2019) Tax Alert <https://www2.deloitte.com/nz/en/pages/tax-alerts/articles/nz-outlines-proposal-for-digital-services-tax.html> accessed 25 January 2021.

The New Zealand government, however, suspended the implementation of this tax to allow for a multilateral solution under the leadership of the OECD. But consensus on the matter has remained elusive. New Zealand is a strong supporter of the OECD, but the slow pace of the OECD in reaching a consensus on the issue of global digital taxation prompted it to come up with its own DST proposals to protect its tax base. The little support received for the proposed DST during the consultation and public participation process has also contributed in the government's decision to suspend the implementation of this tax system.[883] It is, however, hoped that the OECD will secure consensus on the issue in the shortest time possible to help the government ensure that multinational enterprises that conduct substantial business in New Zealand pay their fair share of tax in the country.

In February 2019 the government resolved to consult the public on areas of concern so that it could address these issues and pave way for the implementation of DST in the country.[884] The government is also persuaded that it is only the DST that can help it tax the revenue of foreign companies that have gained advantage over resident companies in areas such as e-commerce, advertising, social networking, and other internet supported services.[885] It is, therefore, prudent to consider whether the proposed DST system which the government of New Zealand is eager to implement complies with the OECD guidelines on how to tax the digital economy.

5.2.2.2. Compliance of the New Zealand Proposed Digital Service Tax with the Organisation for Economic Co-operation and Development Guidelines

The OECD has recognised that there is need to allow states to begin temporary taxation of the digital economy to protect their economies as they await long-term consensus on the issue.[886] It has, in this regard, issued guidelines that member

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[883] Sawyer AJ 'Taxing the Digital Economy: Will New Zealand Tread Where Most Will Not Go?' (2019) 95(7) *Tax Notes International* 621 <file:///C:/Users/Admin/Downloads/2019tni32-10-Sawyer.pdf> accessed 15 December 2021.

[884] ibid.

[885] Robertson G and Nash G 'Ensuring Multinationals Pay Their Fair Share of Tax' (4 June 2019) Press Release by New Zealand Government <https://www.beehive.govt.nz/release/ensuring-multinationals-pay-their-fair-share-tax> accessed 15 December 2021.

[886] OECD 'Tax Challenges Arising from Digitalisation' <http://www.oecd.org/tax/beps/beps-actions/action1/> accessed 25 January 2021. See also OECD 'Tax Challenges Arising from

states ought to comply with when designing their DST laws. The guidelines provide that such laws must: [887]

a) be compliant with a country's international obligations;
b) be temporary;
c) be targeted;
d) minimise over-taxation;
e) minimise the impact on start-ups, business creation, and small businesses more generally; and
f) minimise cost and complexity.

The government of New Zealand asserts that its proposed DST law complies with these guidelines. The guidelines state that any DST should comply as indicated in the following areas:[888]

5.2.2.2.1 Temporary Tax

New Zealand's DST was introduced as a temporary tax to help protect its tax base from being eroded by the digital trade while it waits for the OECD to secure consensus on a permanent tax model.[889] It is committed to repealing this tax system once the consensus has been reached.[890]

5.2.2.2.2 Targeted Tax

Its decision to target entities that use the internet for operating intermediation platforms, social media platforms, content-sharing sites, and search engines means that its DST tax targets identified business entities. This is in line with the OECD

Digitalisation – Interim Report 2018: Inclusive Framework on BEPS' (OECD/G20 Base Erosion and Profit Shifting Project 2018) <http://dx.doi.org/10.1787/9789264293083-en692899%20(1).pdf> accessed 25 January 2021.

887 Interim Report 2018 ibid.

888 Government Discussion Document 'Options for Taxing the Digital Economy' (2019) <https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2019/2019-dd-digital-economy/2019-dd-digital-economy-pdf.pdf> accessed 25 January 2021.

889 Littlewood M 'Taxing Highly digitalised Firms: The OECD and the New Zealand's Proposed Digital Services Tax' University of Auckland, Faculty of Law <file:///C:/Users/Admin/Downloads/SSRN-id3> accessed 25 January 2021.

890 OECD 'Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS' (2018) <http://dx.doi.org/10.1787/9789264293083-en.692899%20(1).pdf> accessed 25 January 2021.

guidelines which provide that digital tax should not be imposed on entities that merely use the internet to sell goods or services. This guideline is intended to prevent the introduction of a broad tax on all e-services. It also recognises that some e-services are merely facilitative and that taxing them would lead to their collapse.

5.2.2.2.3 Minimised Taxation

The OECD adopted the position that any country intending to introduce DST should set it as low as possible compared to other taxes. This is because DST is levied on a business's gross turnover and adopting a high tax rate would 'eat into' its profits. The result would be that small companies and start-ups would be taxed out of business. The proposal of a maximum DST rate of 3% was, therefore, fairly low compared to New Zealand's corporate tax rate of 28%.[891]

5.2.2.2.4 Least Impact on Small Businesses

New Zealand's decision to introduce a threshold of 3.5 billion New Zealand dollars on the gross revenues of an entity, and a sales threshold of 3.5 million New Zealand dollars on the group's annual turnover attributable to New Zealand users, was intended to minimise the impact of this tax on small businesses or start-ups. This proposal, therefore, aptly protects small businesses and start-ups from the regressive effects of a DST.

5.2.3 New Zealand's Compliance with the OECD Guidelines

The discussion above confirms that New Zealand has complied with OECD guidelines on DST. This is important because such compliance could lead the USA and other countries who are opposed to the introduction of a DST system not to subject it to retaliatory sanctions. This is more so because an OECD-compliant DST tax system would not target giant multinational enterprises to selective punitive and unfair taxation.[892] This perhaps explains why the government is determined to introduce this new tax system. It is convinced that it will not be exposed to potential

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[891] New Zealand Income Tax Act 2007 Schedule 1, Part A, cl 2.

[892] OECD 'Public Consultation Document: Secretariat Proposal for a "Unified Approach" Under Pillar One' (9 October 2019–12 November 2019) https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf accessed 25 January 2021.

retaliatory trade sanctions from the USA – as has happened to China, the EU, France, and India – in that its proposed DST system is consistent with the OECD guidelines. [893]

The prospects of introducing DST in 2020 and 2021 in New Zealand was disrupted by the emergence of the Covid-19 pandemic. The New Zealand government therefore shifted its focus to amending its tax laws to deal with the direct negative effects and strains that the pandemic had caused on the country's economy and revenue base. The government was also of the view that introducing a new tax system in the middle of a pandemic would result in a heavier tax burden on a population and business enterprises whose spending power had already been reduced by the pandemic. It was also not lost on the government that the pandemic had pushed its citizens to resort to online trade for the purchase of various products and services they needed to survive the pandemic. Taxing the digital entities and platforms that citizens relied on for their sustenance during a pandemic would have been insensitive and unfair. We shall have to wait to see how New Zealand handles this issue once it has overcome the Covid-19 challenges.

5.2.3.1 Potential Challenges in Implementing the Proposed Digital Service Tax in New Zealand

As discussed in this thesis New Zealand's current income tax regime and international tax framework are ineffective in taxing the digital space. Some scholars have argued that DST could be the solution to the taxation of today's internet economy thereby protecting the global economy from BEPS.[894] New Zealand may also be compelled to proceed with its plan to introduce DST even if global consensus on digital taxation is reached by the OECD. This is because it may still

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[893] Lee-Makiyama H 'The Cost of Fiscal Unilateralism: Potential Retaliation Against the EU Digital Tax System' ECIPE Occasional Paper 5/2018 <https://ecipe.org/wp-content/ uploads/2018/11/The-Cost-of-fiscal-unilateralism-Potential-retaliation-against-the-EU-Digital-Services-Tax-DST-1.pdf> accessed 15 December 2021. See also Wilmehale 'USTR Terminates Section 301 Actions on Digital Services Taxes in Austria, France, Italy, Spain and the United Kingdom; Treasury Announces DST Agreement with Turkey' (23 November 2021) <file:///C:/Users/Admin/Downloads/USTR-Terminates-Section-301-Actions-on-Digital-Services-Taxes-in-Austria-France-Italy-Spain-and-the-United-Kingdom-Treasury-Announces-DST-Agreement-with-Turkey--WilmerHale.pdf> accessed15 January 2022.

[894] Lucas-Mas, Óliver and Junquera-Varela (2020) *Tax Theory Applied to the Digital Economy* 1979-2010.

need to tax digital companies that operate from countries that may be reluctant or unwilling to implement the OECD-based global solution to digital taxation of multinational enterprise. It, however, needs to overcome the following potential challenges and drawbacks that could curtail effective implementation of this taxation proposal.

5.2.3.1.1 Exemption of Facilitative Platforms from Taxation

The model of the New Zealand DST focusses on highly digitalised business models that rely on intangible assets and active user participation to value creation. The essence of this is that the focus of the proposed tax system is on taxing limited types of digital companies rather than the entire digital economy. The exemption of giant facilitative digital platforms like Amazon and Netflix from the tax defeats the whole purpose of introducing a DST. Why would New Zealand levy tax on smaller companies while it exempts giant digital companies like Amazon from taxation? This raises doubt as to whether the proposed DST system would realise its original intention of ensuring that everyone pays their fair share of tax.

5.2.3.1.2 Taxation of Gross Turnover and Double Taxation

The application of the tax on the gross turnover of companies under the proposed DST system implies that entities that have made losses will still be taxed without the option of carrying forward their losses to the next financial year. The eventual result is that DST's regressive tax system could easily wipe out the capital base of smaller enterprises.[895]

DST's model of levying minimal tax on gross turnover of a company poses the risk of double taxation. This is explained by the reality that DST would be applied on income that has already been subjected to income tax.

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[895] Rivares B, Millot G and Sorbe S 'Like it or not? The Impact of on-line Platforms on the Productivity of Incumbent Service Providers' (2019) OECD Economics Department Working Paper 548 of 2019. <https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP(2019)17&docLanguage=En> accessed 15 August 2021. See also Information Technology and Innovation Foundation 'Digital services Tax: A bad Idea Whose Time Should Never Come' (13 May 2019) <https://itif.org/sites/default/files/2019-digital-service-taxes.pdf> accessed 15 August 2021.

5.2.3.1.3 Restriction on Set-offs

The DST proposal does not allow taxpayers to offset their income tax or withholding tax against ~~from~~ the DST. The danger posed by this oversight is that taxpayers would be taxed twice on the same income if they pay both the DST and corporate tax. This would discourage investors from investing in New Zealand as the costs of capital and business in the country would be too high.

5.2.3.1.4 Delay in the Conclusion of the OECD-led Global Consensus

Waiting to see whether the OECD is likely to achieve consensus on this issue is itself a risk because it continues to delay the likelihood of New Zealand adopting this tax system. Moreover, it is projected that the soonest an international solution achieved by the OECD could take effect is 2025. Even if consensus was realised in 2020, the fact that no consensus has been achieved by 2021 means that the possible implementation date is only likely to be pushed further towards the year 2030. In the meantime, digital multinational companies operating in New Zealand continue do so ‘tax free’.[896]

5.2.3.1.5 Tax Incidence on Consumers

Several multinational enterprises provide free services to end users. An example is a media platform that provides free-to-air digital content to New Zealand citizens and in turn raises money from online advertising. The proposed DST is not clear on how it would ensure that tax is not levied on the consumers of digital content rather than the persons who are buying advertising space from the multinational.[897] It would thus be unfair for the country’s DST to tax consumers for a service that has been offered to them free of charge.

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[896] Government Discussion Document ‘Options for Taxing the Digital Economy’ (2019) 23 <https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2019/2019-dd-digital-economy/2019-dd-digital-economy-pdf.pdf> accessed 25 January 2021.

[897] Delloitte 'New Zealand Outlines its Proposals for a Digital Services Tax’ July 2019-Tax Alert. <https://www2.deloitte.com/nz/en/pages/tax-alerts/articles/nz-outlines-proposal-for-digital-services-tax.html> accessed 10 September 2022.

5.2.3.1.6 Repealing the Digital Service Tax

New Zealand has committed to adopting the OECD-led global digital taxation proposal. It is therefore expected that the country would repeal its DST system once a multilateral solution to this matter has been achieved.[898] This would pose twin challenges because the country would apply DST only for a short period. Furthermore, it is unclear what alternative solution will be available to the government in the event that parliament declines to approve the repeal of this law. Would it apply the OECD led global digital tax law alongside the domestic DST law? If this were to arise how would conflict-of-laws and forum-shopping by taxpayers be addressed?

5.2.3.1.7 Neutrality of a Tax System

It has been argued that DST could distort the neutrality of New Zealand's tax system in that it allows for the treatment of digital and non-digital transactions differently which could result in digital traders using the internet to limit their tax liability. This could leave the traditional non-digital companies in New Zealand shouldering the tax burden for the entire nation. Simplicity is a cardinal hallmark of a good tax system. The recognition that DST is likely to distort the neutrality of the New Zealand tax system is one of the main reasons for the government postponing its introduction.

5.2.3.1.8 Retaliatory Trade Sanctions from the United States of America

The USA has been at the forefront in opposing the introduction of DST. For example, in December 2019 it concluded that France's DST law had breached extant international tax policies. The USA Trade Representative concluded in its investigation under section 301 of the Trade Act of 1974, that France's DST discriminated against USA companies such as Google, Apple, Amazon, and

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[898] Government Discussion Document 'Options for Taxing the Digital Economy' (2019) 23 <https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2019/2019-dd-digital-economy/2019-dd-digital-economy-pdf.pdf> accessed 25 January 2021.

Facebook.[899] Furthermore, it found France’s DST inconsistent with canons of good tax systems in that it was retroactive in nature and it was also designed to apply extraterritorially.[900]

Its proposal to impose trade sanctions on France prompted the French government to suspend its DST in January 2020 in anticipation of a global compromise on international digital taxation. The USA also reached a similar conclusion in January 2021 when it stated that the DSTs adopted by Austria, India, Italy, Spain, Turkey, and the UK also discriminated against US digital companies and international tax laws.[901] The fear of sanction or financial backlash from the USA could also explain why the New Zealand government has been hesitant to introduce DST. Such unnecessary trade wars are also likely to result in higher prices for consumers in both countries. The revenue earned could also be relatively small and thus not worth a trade war between two friendly states. [902]

This perhaps explains why New Zealand has not been in a hurry to promulgate the DST system. Its preference has been to retain its current tax system which is considered neutral as it awaits the OECD to resolve some of these challenges.[903]

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[899] USA Trade Representative ‘Section 301 investigation: Report on France’s Digital Service Tax’ (December 2019) <https://ustr.gov/sites/default/files/Report_On_France%27s_Digital_Services_Tax.pdf> accessed 20 August 2021.

[900] USA Trade Representative ‘Section 301 investigation: Report on France’s Digital Service Tax’ (December 2019) <https://ustr.gov/sites/default/files/Report_On_France%27s_Digital_Services_Tax.pdf> accessed 20 August 2021.

[901] Congressional Research Service ‘Section 301 Investigations: Foreign Digital Services Taxes (DSTs)’ (1 March 2021) <https://crsreports.congress.gov/product/pdf/IF/IF11564> accessed 15 August 2021.

[902] Sawyer AJ ‘Taxing the Digital Economy: Will New Zealand Tread Where Most Will Not Go?’ (2019) 95(7) *Tax Notes International* <file:///C:/Users/Admin/Downloads/2019tni32-10-Sawyer.pdf> accessed 15 December 2021.

[903] Frydenberg J ‘Government Response to Digital Economy Consultation’ (20 March 2019) Press Release <https://parlinfo.aph.gov.au/parlInfo/download/media/pressrel/6568787/upload_binary/6568787.pdf;fileType=application%2Fpdf#search=%22media/pressrel/6568787%22> accessed 4 January 2021.

5.2.3.2 Summary

Internet use increased in New Zealand from 74% of the population in 2006 to 84% in 2016. And 68% of these internet users purchase goods and services online.[904] This percentage of people who use internet-related services for the sale and purchase of goods exceeds the OECD average of approximately 62%.[905] New Zealand is also rated the country most open country to digital trade among the 64 OECD and emerging economies. [906]

The foregoing information confirms that New Zealand's economy is highly digitalised and there is therefore a potential revenue income stream from which the government could tap in taxing the digital aspects of this economy. The fact that the OECD-led global consensus on digital taxation is yet to be implemented means that New Zealand will continue to lose out on this revenue stream indefinitely and its tax base will continue to be exposed to BEPS. The question that the government of New Zealand ought to ponder is how much revenue must it lose before it reconsiders its position on the need to start taxing its digital economy?

5.2.4 Income Taxation Regime in India

India applies a worldwide system of taxation where residents are taxed on their global income while non-residents are taxed on Indian-sourced income.[907] A company is considered a resident if it is incorporated in India or if it has its PEM in the country. The basic corporate tax rate for resident companies is 30%. While non-resident companies with a PE in India are taxed at 40%. From 2018, domestic

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904 Australian Productivity Commission and New Zealand Productivity Commission 'Growing the Digital Economy in Australia and New Zealand. Maximizing Opportunities for SMEs' (2019) Available <https://www.productivity.govt.nz/assets/Research/b32acca009/Growing-the-digital-economy-in-Australia-and-New-Zealand_Final-Report.pdf> accessed 19 August 2019.

905 OECD 'OECD Science, Technology and Industry Scoreboard 2017: The Digital Transformation' (2017b)<https://www.oecd-ilibrary.org/docserver/9789264268821-en.pdf?expires=1642935611&id=id&accname=guest&checksum=33BABD21A834C9814D3FD544C2FD38BE> accessed 7 January 2019.

906 Ferracane MF, Lee-Makiyama H and van der Marel E 'Digital Trade Restrictiveness Index' (2018) European Centre for International Political Economy Brussels <http://globalgovernanceprogramme.eui.eu/wpcontent/uploads/2018/09/DTRI-final.pdf> accessed 1 March 2019.

907 Such companies had to be engaged in the business of manufacture or production of an article or a thing to qualify for this lower tax rate. See also KPMG 'India Tax Profile' (April 2018) <https://assets.kpmg/content/dam/kpmg/xx/pdf/2018/10/india-2018-v2.pdf> accessed 25 January 2021.

companies which agree to forego several listed deductions and expenses could pay tax at an effective rate of 25.17%.[908] Any entity is at liberty to opt out of this favourable tax regime at any point before the due date for filing its tax returns.

Foreign income by non-residents can be deemed to have arisen or accrued in India:[909]

a) through or from any business connection in India;
b) through or from any property in India;
c) through or from any asset or source of income in India;
d) through the transfer of a capital asset situated in India.

This deeming provision in the Indian Income Tax Act is worded in an open and liberal manner. The terms 'through', 'any business connection', any property' and 'any asset' can be defined or construed widely by the Department of Revenue to compel non-residents to pay tax on the revenue earned from their cross-border transactions which have any form of connection to India. This deeming provision has thus served a useful purpose in helping the Indian Department of Revenue to impose tax on revenue earned by multinational corporations that may have had some form of presence, connection, asset, or any property in India.

This taxation model has, however, faced challenges over the years as the digital economy continued to grow at a phenomenal rate to the extent that multinational digital companies no longer require a connection, asset, or property to offer their services and goods in India. The change in the Indian commercial environment from a purely brick and mortar physical model to an e-commerce model has compelled the Indian government to consider alternative ways through which it could protect the country's tax base by taxing the huge commercial transactions that take place

[908] Section 115BAA of the Indian Income Tax Act 1961.
[909] Section 9 of the Indian Income Tax Act 1961.

within the digital economy. The existing PE rules were also thought to have been inadequate to deal with this challenge.[910]

5.2.4.1 Taxing the Indian Digital Economy

India had around 481 million internet users in 2017.[911] This number increased to 560 million in 2018. India's internet economy was expected to grow from 125 billion dollars in 2017 to 250 billion dollars in 2020.[912] It is also ranked as the country with the second-highest number of internet users after China.[913] These technological developments and the country's continual move towards a digital economy could have far-reaching implications on the country's tax base. Furthermore, the government of India anticipates that the country's digital economy will grow to 1 trillion dollars by 2022.[914] The government could, therefore, not ignore an opportunity to introduce an equalisation levy to help it tap into this huge potential revenue base. It is for this reason that India introduced an equalisation levy of 6% on 1 June 2016 to tap into the revenue potential of the digital economy. This tax was charged on the consideration paid on specified service.

The term 'specified service' is defined as:

> …online advertisement, any provision for digital advertising space or any other facility or service for online advertisement and includes any other service as may be notified by the Central Government in this behalf…[915]

In effect this provision gave the government the leeway to expand and include online marketing and advertising, cloud computing, website design, hosting and

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910 Nishith Desai Associates 'Digital Economy in India' (2018) <http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/DIGITAL_ECONOMY_IN_INDIA-web.pdf> accessed 3 January 2022.

911 Singh PR and Agarwal V 'Taxation of the Digital Economy in India: Way Forward' (March 2019) Vidhi Centre for Legal Policy Report <https://vidhilegalpolicy.in/wp-content/uploads/2019/05/DesignedReport_TaxingDigitalEconomyinIndia-TheWayForward.pdf> accessed 26 January 2021.

912 ibid.

913 Top 20 Countries with the Highest Number of Internet Users (30 June 2019) <https://www.internetworldstats.com/top20.htm> accessed on 6 March 2021.

914 Nishith Desai Associates 'Digital Economy in India' (2018) <http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/DIGITAL_ECONOMY_IN_INDIA-web.pdf> accessed 3 January 2022.

915 Section 164(i) of the Finance Act 2016.

maintenance, digital platforms, and several other related services in its tax basket.[916] This tax system generated an income of 3.4 billion INR in its first year of operation in the 2016/2017 financial year.[917]

The conditions under which the government can apply the equalisation levy are:

a) against a resident taxpayer;[918]

b) in transactions whose consideration value is above INR100 000 in any financial year; and/or [919]

c) in a transaction between an Indian resident or an entity having a PE in India and a non-resident service provider who does not have a PE in India.[920]

The equalisation levy is designed to apply outside the income tax regime of India. This means that a taxpayer will not benefit from the relief and exemptions available within the Income Tax Act for transactions in which the equalisation levy applies. For example, the relief arising from double-taxation agreements which would have been available to a non-resident under the double tax treaties signed by India is not available in transactions where India charges an equalisation levy. Although India did not use the term DST, the equalisation levy closely resembles DST.

The applicable tax rate of the equalisation levy was, however, reduced in 2020 to 2% of the amount of consideration received or receivable by an e-commerce operator from e-commerce supply or services made or provided or facilitated by it to:[921]

(a) a person in India;

(b) a non-resident in the specified circumstances; or

[916] Section 162(I) of the Finance Act 2016.
[917] PricewaterhouseCoopers 'Economic and Policy Aspects of Digital Services Turnover Tax: A Literature Review' (2018) 5 <https://www.pwc.com/gx/en/tax/tax-policy-administration/assets/pwc-dtsg-literature-review-final.pdf> accessed 1 March 2021.
[918] Section 162(I) of the Finance Act 2016.
[919] Section 163(I) of the Finance Act 2016.
[920] Section 162(I) of the Finance Act 2016.
[921] Section 165A(1) of the Finance Act, 2016 (as amended by Finance Act 2020).

(c) a person who buys such goods or services or both using an internet protocol address located in India with effect from 1 April 2020.

The amendments further provided that equalisation levy would not be charged under the following circumstances:

a) where the e-commerce operator making or providing or facilitating e-commerce supply or services has a permanent establishment in India and such e-commerce supply or services is effectively connected with such permanent establishment;
b) where the equalisation levy is leviable under section 165; or
c) where the sales, turnover, or gross receipts, as the case may be, of the e-commerce operator from the e-commerce supply or services made or provided or facilitated is less than two crore[922] rupees during the previous year.[923]

The reduction in the equalisation levy to 2% also necessitated the legislature's redefining of the term 'specified circumstances' under which a non-resident would be subject to the payment of equalisation levy as:

(i) sale of advertisement which targets a customer who is resident in India or a customer who accesses the advertisement though internet protocol address located in India; and
(ii) sale of data collected from a person who is resident in India or from a person who uses internet protocol address located in India".[924]

The 2% levy applies to all revenue generated from digital services offered in India. Any payment made in a transaction between a non-resident and an Indian user now attracts a 2% levy. The USA Trade Representative estimates that India is likely to realise revenue income of at least US$ 30 million annually from USA companies that operate in India.[925] The government of India justified this tax system as a

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[922] 2 Crore rupees is the equivalent of 20 million rupees.
[923] Section 165A(2) Finance Act 2016 (as amended by Finance Act 2020).
[924] Section 165A(3) Finance Act 2016 (as amended by Finance Act 2020).
[925] See <https://timesofindia.indiatimes.com/topic/US-Trade-Representative> accessed 3 January 2021.

measure to level the playing field regarding revenue generated from the Indian market by non-residents or those who do not have a PE in India.

India became the first country to impose a DST system. However, while the OECD recommended that they could impose equalisation levy as an indirect tax similar to VAT, India instead imposed it as a direct tax.[926] As a result it attracted the attention of the world immediately after its enactment. This led the Internet and Mobile Association of India to describe the levy as an impractical and unreasonable venture that is likely to harm small businesses seriously.[927] It further affirmed that India will stand out like a sore thumb if the government fails to withdraw this tax proposal.

5.2.4.2 The Challenges Posed to the Indian Digital Service Tax System

Some of the challenges posed to the Indian digital tax system include the following;

5.2.4.2.1 Retaliatory Action by the United States of America

The main challenge posed to the Indian equalisation levy is the recent decision by the USA to start investigations into its equalisation levy tax system. It anchored the justification of its actions in section 301 of the Trade Act of 1974 which allows it to investigate and act to enforce USA trade rights under international agreements or conventions. The challenge emanating from this investigation is the fear of the negative retaliatory sanctions that could be imposed by the USA if it concludes that India's equalisation levy is in breach of its international obligations.

Investigations by the USA Trade Representative under section 301 of the Trade Act of 1974 concluded that India's equalisation levy was discriminatory of USA digital companies.[928] This was because the Indian equalisation levy levied a tax on the

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[926] Korea Institute for International Economic Policy 'Economic Effect Indian e-commerce Taxation will Have on Industry' <https://www.ncaer.org/image/userfiles/file/Economic%20Effect%20Indian%20e-commerce%20taxation%20will%20have%20on%20industry(1).pdf> accessed 23 December 2021.

[927] ibid.

[928] Office of the USA Trade Representative 'Report on India's Digital Services Tax Prepared in the Investigation Under Section 301 of the Trade Act of 1974' (January 2021) 3 <https://ustr.gov/sites/default/files/enforcement/301Investigations/Report%20on%20India%E2%80%99s%20Digital%20Services%20Tax.pdf> accessed 28 January 2021.

income of non-resident digital service providers while a similar tax was not levied on similar income of resident digital service providers.[929] Moreover, some 72% of the companies that were required to pay the equalisation levy were USA- based companies.[930] This open and clear discriminatory practice within the Indian equalisation levy was confirmed by a senior Indian government official who stated that:

> All parts of the digital taxation incident should be on the foreign player, because if the incidence is passed on to the Indian player, then it does not serve the purpose.[931]

Although, this assertion may not be the official position of the Indian government, it is an indicator that the very aim of this tax could have been to discriminate against foreign digital companies.

These contraventions led the USA Trade Representative to recommend that the USA take retaliatory action against India for enacting a law that is discriminatory, unreasonable, and burdensome. The USA thereafter announced the imposition of 25% duty on several Indian products with an estimated trade value of 119 million dollars.[932] It also reserved the right add further retaliatory measures if India failed to withdraw or suspend its equalisation levy system awaiting the OECD-led global digital taxation proposal. This and similar retaliatory actions are likely to negatively affect the economy of India and the livelihoods of its citizens whose products would be required to pay a duty of 25% of the *ad valorem* value of their products to access the USA market.

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[929] Sections 164(ca) and 165A(1) Finance Act 2016 (as amended by Finance Act 2020).

[930] Office of the USA Trade Representative ‘Report on India’s Digital Services Tax Prepared in the Investigation Under Section 301 of the Trade Act of 1974’ (January 2021). Available at <https://ustr.gov/sites/default/files/enforcement/301Investigations/Report%20on%20India%E2%80%99s%20Digital%20Services%20Tax.pdf> accessed 28 January 2021.

[931] International Tax Review ‘Discussion: Kamlesh Varshney Talks About India’s Tax Policy Agenda’ (30 March 2020) <https://www.internationaltaxreview.com/article/b1kxs1b3pvv2x1/discussion-kamlesh-varshney-talks-about-indias-tax-policy-agenda> accessed 28 January 2021.

[932] Office of the United States Trade Representative ‘Notice of Action in the section 301 Investigation of India’s Digital Service Tax’ <https://www.govinfo.gov/content/pkg/FR-2021-06-07/pdf/2021-11858.pdf> accessed 30 May 2021.

The proposed retaliatory action against India was, however, suspended to give the USA time to investigate similar discriminatory practices in other countries including Austria, Spain, Turkey, the UK, and Italy.[933] It would, however, have been useful to see how the Indian government reacted to this retaliatory action by the USA so as to help this thesis to decide whether this threat of retaliatory action by the USA will continue to pose a serious challenge to countries that may be eager to introduce it. It is nevertheless vital to note that the threat of retaliatory action by the USA pushed countries like Austria, Italy, France, and the UK to suspend their DST and related unilateral measures. In return, the USA agreed to suspend its retaliatory action until the end of the interim period.[934] This thesis concludes that the decision by leading world economies like the UK, France, and Italy to suspend their DST system in the face of an imminent retaliatory trade sanction from the USA confirms that this threat will continue to pose serious challenges to unilateral enactment of DST.

5.2.4.2.2 Uncertainty of the Tax System

The Indian equalisation levy was also found to have contravened the international tax principle of certainty.[935] This is because the term 'specified services', which determines what is taxable under the DST, is overly wide and ambiguous. This makes it difficult to know what is excluded from the list of taxable transactions. This ambiguity has made it possible for the government to include all digital transactions within the definition of this term. This means that taxpayers cannot be certain whether their transactions fall within or outside the definition of ‘specified services.’ This has left taxpayers to operate in an uncertain tax environment which, in turn, makes India less attractive to investors.

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933 Congressional Research Services ‘Section 301 of the Trade Act of 1974’ (1 January 2021) <https://crsreports.congress.gov/product/pdf/IF/IF11346> accessed 30 January 2021.

934 The interim period begins on 1 January 2022 and ends on 31 December 2023 or on the date when the OECD Pillar 1 proposal comes into effect, whichever is earlier. See also HM Treasury ‘Joint Statement from the United Kingdom, Austria, France, Italy, Spain and the United States Regarding a Compromise on Traditional Approach to Existing Unilateral Measures During the Interim Period Before Pillar 1 is in Effect’ (8 October 2021) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1027640/Joint_statement.pdf> accessed 16 November 2021.

935 Office of the USA Trade Representative ‘Report on India’s Digital Services Tax Prepared in the Investigation Under Section 301 of the Trade Act of 1974’ (January 2021) 4 <https://ustr.gov/sites/default/files/enforcement/301Investigations/Report%20on%20India%E2%80%99s%20Digital%20Services%20Tax.pdf> accessed 28 January 2021.

5.2.4.2.3 Taxation on the Basis of Gross Turnover or Income

There is international consensus that tax ought to be levied on revenue not on income. This view is supported by the OECD which favours the taxation of business profits and not gross revenue.[936] The levying of tax on the gross income or turnover of an entity is discouraged and has been abandoned by most developed countries.[937] The Indian equalisation levy system is therefore regressive and unfair to the extent that it levies a tax on a taxpayer's gross turnover.[938] This is more so because this type of taxation can result in the taxation of a taxpayer who has not realised any profit in a particular financial year.

5.2.4.2.4 Taxation Without *Nexus*

The fact that the equalisation levy also provides for the taxation of companies that do not have a PE in India also contravenes the international tax *nexus* rule.[939] This renders the tax system unpredictable and unfair as non-resident foreigners offering services in India are taxed on their transactions. This is contrary to the settled international principle which decrees that companies should not be subject to a country's taxation regime in the absence of a territorial connection between the trader and that country.

5.2.4.2.5 Complex Tax system

The Indian equalisation levy system was also found to be complex and burdensome. It requires companies to file several compliance reports and also undertake expensive hardware and software upgrades and investments to comply with the basic equalisation levy's statutory requirements. For example, companies must re-engineer their information technology systems to collect and file the new

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936 Article 7 of the OECD Model Tax Convention.

937 Roxx J 'Gross Receipts Taxes: Theory and Recent Evidence' (October 2016) Tax Foundation <https://files.taxfoundation.org/20170403095541/TaxFoundation-FF529.pdf> accessed 5 January 2021.

938 Section 164 (cb) Indian Finance Act 2016 (as amended by Finance Act 2020).

939 Office of the United States Trade Representative 'Section 301 Investigation: Report on India's Digital Service Tax' (2021) <https://ustr.gov/sites/default/files/enforcement/301Investigations/Report%20on%20India%E2%80%99s%20Digital%20Services%20Tax.pdf> accessed 23 December 2021.

and different reports required under the equalisation levy system. The USA trade representative estimated that each compliance cost for each company would run into millions of dollars.[940]

5.2.4.2.6 Double Taxation

The Indian equalisation levy is favours to the possibility of double taxation because a company that pays income tax in its home country is also likely to be required to pay the equalisation levy on the same transaction in India. The non-resident company that has paid the equalisation levy is, however, not allowed to claim credit or relief on the basis of the levy from its annual corporate tax it may be required to pay in India.[941] Such a company is also not permitted to claim the deductions of the equalisation levy as a deduction from its taxable income.[942] This means that a non-resident company that pays the equalisation levy is also required to pay income or corporate tax. The exposes the company to the risk of double taxation.

5.3 OECD-led Global Proposal on Taxation of the Digital Economy

The OECD has long expressed concern over the difficulties faced by many governments in collecting taxes from huge international companies that operate in a digital economy and apply ubiquitous digital services, tools, and 'smart' technology to limit their tax liability.[943] In 2013 it therefore embarked on a process of working towards a multilateral solution on how to tax the digital marketplace with fifteen action points of BEPS. This led to the BEPS Action 1 report which identified the difficulties that the digital economy poses for the existing internal tax laws and principles.[944] This was the start of an international concerted effort that was led by

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[940] ibid.
[941] Sing PR and Agarwal V 'Taxation of Digital Economy in India: The Way Forward' (March 2019) 31 <https://vidhilegalpolicy.in/wp-content/uploads/2020/06/DesignedReport_TaxingDigitalEconomyinIndia-TheWayForward.pdf> accessed 5 January 2021.
[942] ibid.
[943] OECD 'Addressing the Tax Challenges of the Digital Economy, Action 1- 2015 Final Report' <https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1612350514&id=id&accname=guest&checksum=C996A1A737F5EA453886F2258DB55ACD> accessed 5 January 2021.
[944] ibid.

the OECD to try to find a multilateral solution on how to protect the world economies from BEPS that arise from digital trade.

To achieve its objective of finding new solutions to this challenge, the OECD established an 'Inclusive Framework'.[945] As of March 2020, the framework had 137 members and 15 observers including the UN and the World Bank.[946] Any government or entity that wanted to join this framework and thus have a say in the development of the policy on digital taxation, had to agree to support the BEPS project.

The OECD's first policy framework proposal on BEPS was released in 2015.[947] However, negotiating final consensus on what would have been the final policy framework proposal in taxing the digital economy has remained difficult. This is, in the main, because the OECD proceeded to publish the 2015 BEPS report in the belief that it would attract consensus from the larger economies like the USA, Japan, larger EU countries like the UK, Italy, France, Sweden, Netherlands, and Spain, as well as known tax havens like the Isle of Man, the Cayman Islands, and the Bahamas. Securing this consensus has, however, remained elusive and the OECD has been placed in a difficult position in that it lacks a legal or political sanction which it could use to compel dissenting members to support its proposal. This challenge has, however, not dampened its efforts, together with those of consenting member states, to continue publishing policy proposals on how to tax the digital economy. In 2018 it published an interim report that outlined the tax challenges that arise from digitalisation and solutions to those challenges.[948] Its most recent work

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945 The OECD Inclusive Framework is a group made up of all OECD members, the G-20 countries, and other willing non-member states and dependencies. See OECD 'OECD/G20 Inclusive Framework on BEPS: Progress Report July 2018 - May 2019' (2019) 28-29 <http://www.oecd.org/tax/beps/inclusive-framework-on-beps-progress-report-july-2018-may-2019.htm> accessed 5 January 2021.

946 ibid.

947 OECD 'Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report' <https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1612350514&id=id&accname=guest&checksum=C996A1A737F5EA453886F2258DB55ACD> accessed 5 January 2021.

948 OECD 'Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS' (2018) <https://www.oecd-ilibrary.org/docserver/9789264293083-en.pdf?expires=

is the publication of a consultative document in February 2019 which proposes three solutions to the taxation of the digital marketplace, namely:[949]

a) the ‘user participation’ proposal;[950]

b) the ‘marketing intangibles’ proposal;[951] and

c) the ‘significant economic presence’ proposal.[952]

This three-tier structure was actively debated by the OECD membership and the G20 nations and resulted in a consensus-based solution known as the 'unified approach' (UA) in October 2019.[953] This proposal combined the best aspects of the February 2019 OECD proposals for three types of taxable profit that could be allocated to market jurisdictions for tax purposes as discussed in this chapter[954] The OECD hoped that the participatory manner under which the UA was realised would also result in its unanimous support from the membership of the framework.[955]

1612351107&id=id&accname=guest&checksum=DEC120EF6D8D3FE1F693A5E17038CCCD> accessed 5 January 2021.

[949] OECD ‘Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy’ (2019) <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax> accessed 5 January 2021.

[950] User participation focuses on the location where value is created by certain highly digitalised businesses. An example of this could be the location where critical development for the digitised business occurs, where users participate to contribute to the creation of brand or product, where valuable data is generated, or where the critical mass of users who can help an entity create market power are located. See explanation in OECD ‘Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy' ibid 9-10.

[951] Marketing intangible proposal addresses a situation where a multinational enterprise can create or ‘reach into’ a jurisdiction, either remotely or through a limited local presence. It makes it possible for marketing intangibles like brand and trade names to create a *nexus* or market jurisdiction in the country where they are used or applied. The proposal anticipates that the market jurisdiction would be entitled to tax the non-routine income associated with such intangibles. See explanation in OECD ‘Addressing the Tax Challenges of the Digitalisation of the Economy’ ibid 11-12.

[952] The significant economic presence proposal provides that a taxable presence would be created in a jurisdiction where a non-resident enterprise has a significant economic presence. This presence could be created on the basis of factors like a purposeful and sustained interaction with the jurisdiction through digital technology and other automated means, the volume of digital content obtained from the jurisdiction, maintenance of website in a local language, or payments made through local currencies. See explanation in OECD ‘Addressing the Tax Challenges of the Digitalisation of the Economy’ ibid 16-17.

[953] OECD ‘Secretariat Proposal for a “Unified Approach” under Pillar One’ (9 October 2019 – 12 November 2019) <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> accessed 5 January 2021.

[954] OECD ‘Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy’ (2019) <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax accessed 5 January 2021.

[955] ibid.

In an effort to deliver a solution that was acceptable and as simple as possible, in January 2020 the OECD published a statement clarifying how the UA would be applied.[956] It also clarified that the UA proposal would supersede the previous February 2019 three-tier proposal. The process of obtaining final consensus on the UA document by December 2020 was disrupted by the Covid-19 pandemic as most countries opted to concentrate on helping their economies recover.[957] It was, therefore, not possible to call meetings and lobby the framework members to reach final consensus on the proposal.[958] The deadline for reaching consensus on this matter was then postponed to mid-2021. It was hoped that this consensus would be obtained before the end of 2021.

This thesis shall now discuss and consider a summary of how the UA will apply once it is approved by all member countries.

5.3.1 The 'Unified Approach' (UA) Proposal

The UA proposal is an improvement on the earlier three-tier tax proposals of user participation, marketing intangibles, and significant economic presence. The latter three proposals envisaged a new tax *nexus* rule that would not depend on the physical presence of a taxpayer. The UA built on this commonality and also came up with three proposals on how to divide and allocate the profits of foreign multinational enterprises between states for tax purposes. The three-part market jurisdiction allocation formula was described as Amount A, Amount B, and Amount C.

5.3.1.1 Amount A

This is also known as the multi-national deemed residual or non-routine profit system. Under this system, profits will be allocated to a market jurisdiction using an agreed formula regardless of whether any physical presence exists between a

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[956] OECD 'Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy' (January 2020) <https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps.htm> accessed 25 May 2021.
[957] Hodge S and Bunn D 'Digital Tax Deadlock: Where Do we Go from Here?' (2020) Tax Foundation <https://taxfoundation.org/oecd-digital-tax-project developments/> accessed 25 May 2021.
[958] ibid.

taxpayer and the country that claims tax rights. It proposes to allocate the profit using a formulaic approach where the multi-national enterprise (MNE) is expected to carry out a personal- or self-assessment to determine the total profit that it earned from all its activities. The total profit earned by the MNE after the personal assessment will be divided among the countries in which the MNE operated in that financial year using a predetermined formula. Each country will thereafter tax the MNE based on the profit allocated to it.[959] The profit allocated to each market jurisdiction will largely comprise of profitable activities carried out in the market jurisdiction or with citizens who are either residents or have a PE in the market jurisdiction.[960]

The drawback with this proposal is that the total profit earned by the MNE is determined and reported by the MNE itself. It would be difficult and sometimes impossible for a country that has been allocated profit rights to verify the actual profit earned by this MNE because its headquarters from where the group profit would be declared is likely to be based in a low-tax haven. The profit that the market jurisdictions had hoped to tax could therefore be manipulated to very low profit values. This would defeat the intention of the tax system.

The OECD has also not clarified which country would be in charge of allocating profits to the market jurisdictions. Failure to provide this clarification would lead to incessant disputes between countries that are entitled to a portion of the MNE's profits. The exhaustive list of the specific market activities and intangibles capable of creating a tax *nexus* should be provided by the OECD to limit tax disputes.[961]

The current proposal has also not addressed the issue of double counting. This occurs where interaction between market jurisdiction result in the market jurisdiction taxing the MNE under its income tax legal regime and thereafter it also becomes

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959 Krever and Vaillancourt (eds) *Allocation of Multinational Business Income* 277-296.
960 OECD 'Public Consultation Document: Secretariat Proposal for a "Unified Approach" Under Pillar One' (2019) <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> accessed 5 January 2021.
961 OECD 'Public Consultation Document: Pillar One – Tax Certainty for Issues Related to Amount A' (27 May - 10 June 2022) 2-3 <file:///C:/Users/user/Downloads/public-consultation-document-pillar-one-amount-a-tax-certainty-issues.pdf> accessed 10 September 2022.

entitled to taxation under Amount A. The dilemma that arises here is whether the market jurisdiction should levy both taxes or should only be allowed to levy tax under its income tax legal regime. In case of the former, its action will amount to double taxation. Adopting the latter method would defeat the entire process and reason for the enactment of Amount A which is intended to ensure that countries such as South Africa should be able to tax a portion of the profits earned by MNEs within their jurisdictions. The OECD needs to come up with a formula for resolving this dilemma.

The profit declaration by a group MNE often includes the profits earned from its various business activities. Caution should thus be taken to ensure that market jurisdictions do not benefit from group MNE profits that did not originate from digital activities. It is only fair that a market jurisdiction should benefit only from revenue attributable to Amount A. A model which ensures that less profitable market jurisdictions do not profit or unfairly benefit from profits made in the more profitable markets. The OECD will have to find a middle ground and an acceptable formula which caters for and balances these crucial interests. One option would be to reconsider its current formulaic calculation of Amount A by introducing an additional step to provide clarifications as to whether its proposed formula has addressed these competing interests There are doubts as to whether the proposed simplifying convention formula[962] will resolve this challenge.

Despite these challenges, the OECD is hopeful that this proposal will make it possible for the market jurisdictions to tax the portion of the profits attributed to business carried out within their jurisdictions. That the foreign MNE does not have a physical location or presence in the market jurisdiction concerned is of no importance. The OECD was convinced that 'Amount A' in this proposal would solve the current jurisdictional issue of physical presence by creating a compromise and acceptable tax *nexus* unconstrained by the requirements of physical presence.[963]

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[962] The convention could amount to the residual profit multiplied by a fixed percentage.
[963] OECD 'Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy' (2019) <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-taxchallenges-of-the-digitalisation-of-the-economy.pdf> accessed 5 January 2021.

5.3.1.2. Amount B

The principle under Amount B is also known as the ‘distribution of functions’ in the market jurisdiction proposal.[964] It proposes that the country where an MNE has a PE should be the one to tax the profits attributable to that MNE as per the existing PE rules. In essence, it has been proposed that profit allocation to market jurisdictions should be made using the ‘arm's length’ principle and routine distribution and marketing functions as anticipated under the PE or PEM principles. This proposal will, thus, ensure the continued application of the current physical presence and PE or PEM *nexus* rules in cases where their application does not invoke any jurisdictional dispute or conflict. This means that countries that are not opposed to the current international taxation rules or principles will be at liberty to continue using and applying them. Amount B is, therefore, not intended to create new taxing rights but rather to improve the application of the current tax principles.

The OECD also anticipated that situations could arise where one country prefers to apply the conventional taxation principles while the other country is opposed to the taxation of a digital MNE that operates within its jurisdiction under the conventional rules. To overcome this challenge, the OECD proposed that tax due under Amount B could be determined based on a 'fixed returns' of an MNE that performs marketing and distribution activities in a market jurisdiction.[965] This means that the tax due to a specific market jurisdiction will be determined with reference to the arm’s length principle.[966] The feuding member states will thus be entitled to taxation rights over income (fixed returns) that are proportional to the marketing and distribution activities carried out by the MNE within the borders of their country.

The unified approach under ‘Amount B’ resembles the transfer pricing principle. The only difference is that it seeks to allocate a portion of the MNE’s income to market jurisdictions using the modified residual profit split method to help it determine the

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[964] Collier and Andrus *Transfer Pricing* 285.
[965] OECD ‘Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy’ (2019) <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-taxchallenges-of-the-digitalisation-of-the-economy.pdf> accessed 5 January 2021.
[966] ibid.

profit to be allocated to the market jurisdiction.[967] This shift from the current pricing rules to embrace a simpler alternative is intended to help the OECD to avoid complexity in the implementation of the 'Amount B' proposal.[968] It is thus difficult to establish how the OECD will continue to apply the arm's length principle when the 'Amount B' approach to allocating profits is at odds with the arm's length principle. This is because it mainly uses a formula instead of relying on what independent parties would normally agree to in the ordinary course of their business. The proposal to use some form of a harmonised mathematical formula to allocate non-routine profit to the relevant market jurisdiction for taxation, could be the beginning of the end of the use of the arm's length principle as a principle in international taxation. In other words, this method would over time replace the arm's length principle and effectively introduce the world to formulary apportionment[969] as a new principle in international taxation.

The definition and scope of application of what constitutes 'fixed returns' baseline marketing and distribution activities which are the key technical terms under Amount B proposals, have not been agreed upon. The only agreement that the OECD has secured thus far for this formula is that taxation rights under Amount B will be applied in consistency with the arm's length principle. The determination of the scope of these terms is important in determining the efficiency of this tax proposal in the taxation of the digital economy. For example, what does 'fixed returns' mean – is it the operating margin or the return on total costs? Does it vary from one industry to the next?

Amount B is regarded as a safe harbour because it retains the internationally accepted arm's length and PE principles. It would also not require changes to

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967 The modified residual profit split method involves four stages: 1 Determining the total profit to be split; 2 Removal of 'routine' profit, based on either current transfer pricing rules or using simpler approaches; 3 Determining the non-routine profit (derived from the group's intangible assets) that can be allocated to the market jurisdictions either by adapting current transfer pricing rules or simpler proxies; and 4 Allocating of the non-routine profit to the relevant market jurisdictions using apportionment criteria such as number of employees.
968 Grant Thornton 'Say Goodbye To the Arm's Length Principle' <http://www.grantthornton.ga/ddoc-287-say_goodbye_to_the_arms_length_principle.pdf> accessed 10 January 2022.
969 Also known as unitary taxation.

existing bilateral treaties. Methods of resolving disputes related to the arm’s length principle and the concept of PE have been concretised over the years and this could help in eliminating persistent source disputes. The result is that most countries will still be able to protect their economies from BEPS without effecting a drastic change in their tax laws.[970]

5.3.1.3 Amount C

The principle under Amount C is also known as the 'baseline distribution' principle. It is aimed at taxing any additional profit by an MNE which exceeded the baseline activities under Amount B. It is intended to be applied as a complementing tax tool to Amount B whereby all profits that were not taxed under Amount B will be taxed under the proposed Amount C. This is premised on the OECD’s assumption that some MNEs could structure their activities to fall outside the jurisdictional tax realm of Amounts A and B.[971] Amount C will therefore act as a stop-gap measure to limit or discourage tax avoidance tendencies among digital MNEs.

The scope and final outlook of Amount C proposal and how it will be applied are still under discussion. Moreover, the possibility of obtaining final consensus on the Amount C proposal depends on how rapidly the negotiations under Amounts A and B can be concluded. The OECD has also proposed that the final outlook of Amount C should place some emphasis on the tax dispute resolution process.[972] This way, member states will not be denied their fair share of revenue as the dispute resolution process persists in courts or tribunals that are entrusted with jurisdiction to hear such disputes.

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[970] OECD ‘Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report’ (2015) <http://dx.doi.org/10.1787/9789264241046-en> accessed 5 January 2021.
[971] OECD ‘Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy’ (January 2020) <www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf> accessed 20 February 2021.
[972] ibid.

5.3.2 Application of the Proposed 'Unified Approach' (UA)

The UA generally seeks to create a new tax *nexus* that would allow for taxable presence in the absence of a physical presence of an enterprise. Once the *nexus* has been established, the UA proposes to establish a global minimum tax payable by MNEs irrespective of their location. It is considered a dynamic approach in allocating taxation rights to various jurisdictions while taking new business models and improved dispute resolution procedures into account.[973] To achieve this, it is proposed that the application of UA will eventually be guided by the following three-tier profit-allocation steps.

5.3.2.1 Formula Apportionment Proposal

This first step begins with the determination of the MNE's group's total profit.[974] This departs from the conventional system where each branch or subsidiarity of a group company is treated as a separate entity and only taxed in the country of jurisdiction. This means that several MNEs are able to limit their tax liability by transferring their country of residence to low-tax jurisdictions.

The UA proposal, which is also known as the 'formula apportionment', treats an MNE as a unit. The combined income of the MNE is apportioned using a predetermined formula among the countries in which it operates. That it has no physical presence or a PE in any of the countries from which it operates is irrelevant. The result is that the MNE will be taxed in each country from which it operates; the only difference is that the tax entitlement of each country is determined by an agreed formula. [975]

The challenge that this proposal poses for MNEs like Google and Facebook, which are present in virtually every country in the world, is that they would be required to pay tax in 206 countries. It is submitted that this would pose serious compliance

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[973] Ikigai L 'BEPS: Analysing the OECDs Unified Approach on Digital Tax and India's Response' (May 2020) <https://www.ikigailaw.com/beps-analysing-the-oecds-unified-approach-on-digital-tax-and-indias-response/#accept License> accessed 4 May 2021.

[974] OECD 'Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy' (2019) <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-taxchallenges-of-the-digitalisation-of-the-economy.pdf> accessed 5 January 2021.

[975] Krever and Vaillancourt (eds) *Multinational Business Income* 277-296.

complexities for such MNEs which would be required to prepare specific books of account and employ more people or relevant software to ensure equitable and fair payment of tax in all global market jurisdictions.

Moreover, the MNEs could use formulary apportionment to direct the majority of their presence to low-tax jurisdictions. Companies such as Google or Facebook may implement this by moving their assets to countries that have adopted a low- tax margin for e-commerce trade. This could have worse effects than the previous paper or manipulated profit shifting practice because the affected countries could lose not only tax revenue but also the economic benefits that accrue to them from hosting MNEs.[976] The other option that MNEs could adopt to minimise their tax exposure to digital taxation would be to sell their products to a distributor based in a low-tax tax jurisdiction. This distributor would then sell this product to a higher-tax jurisdiction. In this event, the MNE would be deemed to have made its profits in the low-tax jurisdiction thereby minimising its tax exposure.

However, despite these challenges, the formulary apportionment system is likely to radically change the international theory on how the international tax system operates. This is principally because it will make the common practice by MNEs of relocating to low-tax jurisdictions to limit their tax liability attractive.[977] The question that remains is how the apportionment formula will be implemented and more particularly, ratio that will be used to share profits among all the countries with jurisdictions.

5.3.2.2 Determining Residual Profits

The second step involves the calculation of Amount A which is also known as the residual profit of an MNE. Residual profit of an MNE is arrived at by determining the total profit of the MNE and subtracting from it the portion that is attributable to routine

[976] Clausing KA ‘Taxing Multinational Companies in the 21st Century’ <https://www.brookings.edu/wp-content/uploads/2020/01/Clausing_Book_LO_FINAL.pdf> accessed 3 August 2021.
[977] Brown and Oats (2020) 1 *British Tax Review* 63.

business activities.[978] This residual profit is then allocated to all market jurisdictions in accordance with an agreed apportionment formula. This can be based on sales and advertising revenue, among others. The current proposal by the OECD is that the 'simplified conventions' formula could be used to calculate Amount A.[979] Each country would thus levy tax on what has been attributed to it using this formula. The content, basis, and principles on which this ‘simplifying convention’ would be determined, other than the fact that it would be crafted and agreed on by consensus, remains a mystery.

5.3.3 Challenges in Applying the Proposed 'Unified Approach’

The UA proposal of re-writing profit allocation rules and revising the arm's length principle by introducing a new *nexus* rule and a three-tier step/mechanism for determining profits attributable to a market jurisdiction raises with several challenges. The basic and current challenge it faces, even before its promulgation, is that its implementation requires the unanimous support of over 130 countries that are part of the Inclusive Framework. However, some member states, for example, the USA, China, and a few tax havens like the Cayman Islands are reluctant to support this new approach. They argue that the UA proposals would result in the multiple taxations of their global brands in multiple jurisdictions.[980] The USA is also of the view that it is inequitable for it to work hard to nurture its MNEs only for the rest of the world to reap the benefits by imposing disproportionate tax burdens on companies with their headquarters in the USA.[981]

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978 Government Discussion Document ‘Options for Taxing the Digital Economy’ (2019) <https://www.beehive.govt.nz/sites/default/files/2019-06/20190604-dd-digital-economy.pdf> accessed 9 February 2021.
979 ibid.
980 OECD ‘Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy’ (2019) <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-taxchallenges-of-the-digitalisation-of-the-economy.pdf> accessed 5 January 2021.
981 KPMG ‘Treasury Opposition to Digital Services Tax Initiatives, Support for Pillar One’ (4 December 2019) <https://home.kpmg/us/en/home/insights/2019/12/tnf-treasury-opposition-digital-services-tax-initiatives-support-pillar-1.html> accessed 3 May 2021.

These concerns led the USA to threaten to withdraw from the Inclusive Framework Pillar One talks in June 2020, citing a lack of progress in the negotiations.[982] France, the UK, Spain, and Italy responded to this threat by offering a compromise offer to entice the USA back to the negotiation table.[983] The offer was that these four countries would not levy digital tax on USA-based MNEs pending the conclusion of the Inclusive Framework negotiations. The European Commission (EU Commission) took a different approach and affirmed that it would proceed to implement an EU-wide digital tax levy if the USA abandoned the negotiations – no consensus had been achieved by the end of 2020.[984] The USA returned to the negotiating table but the significant divergent views and the outstanding technical issues surrounding the application of the UA have so far made it difficult for the Inclusive Framework to secure consensus.

These divergent positions between the USA, the EU Commission, and three EU members have posed a key challenge to the Inclusive Framework in developing a consensus report that satisfies and reconciles the differing positions of its members. The OECD had hoped that a consensus-based solution to the tax challenges under the UA proposal would have been reached by mid-2021.[985] At the time of writing this chapter this has not yet materialised. The Inclusive Framework continues to work and refine the proposals in the hope that consensus will be soon be achieved.

The introduction of 'simplified convention' as the formula to be used in determining profit allocation under Amount A is a step forward in resolving the outstanding technical issues under pillar one. It is proposed that the level of profitability under the simplified conventions will be determined using a fixed percentage with industry-to-industry variations. The expectation here is that the simplified conventions will

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982 Parliament of Australia ‘Multinational Tax: The OECD’s Pillar One Proposal’ (27 November 2020) Research Series Paper 2020-21 <https://parlinfo.aph.gov.au/parlInfo/download/library/prspub/7661351/upload_binary/7661351.pdf> accessed 3 May 2020.
983 ibid.
984 ibid.
985 OECD ‘OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors–April 2021’ <www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-april-2021.pdf.> accessed 1 June 2021.

make it possible to levy tax on the non-routine profits of MNEs which extend beyond the current PE and physical jurisdictional conventions.

The OECD, however, has not shared the details of how the non-routine profits will be determined and apportioned between the states that host MNEs. Moreover, it has failed to explain what will happen if consensus is not reached on how the proposed formula will be applied. In effect, failure to agree on the finer details of this formula has the potential of taking the OECD two steps backwards in its effort to achieve consensus on the implementation of the UA. The OECD has expressed its concern on the reluctance of member states to agree on the profit apportionment formula as proposed in the simplified convention formula.

To reach a consensus, the OECD has proposed to remodel this formula by the application of different percentages for different business lines or industries.[986] It is likely that the industries which will end up paying higher taxes under this proposal will claim that this taxation system is inequitable and lobby their governments not to agree to the adoption of the UA proposal. This would, in turn, result in continued stagnation of the negotiations on how to implement the UA proposal.

The application of a mandatory time-bound dispute resolution system is the fulcrum around which the UA approach operates. However, very little detail has been provided on how this elaborative dispute resolution system will be implemented. The finer details and procedure in this regard are likely to determine whether it will be accepted by all member states. For example, there is a real possibility that civil-law countries which favour a multi-layered appeal process may not be comfortable with a legal system which provides that the outcome of an arbitration process is final and binding on the parties. This could be why the Inclusive Framework members

[986] OECD 'Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy' (2019) <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-taxchallenges-of-the-digitalisation-of-the-economy.pdf> accessed 5 January 2021.

are still not in agreement on the extent to which this dispute resolution mechanism should be applied.[987]

The mechanisms to be used by market jurisdictions to enforce and collect tax from MNEs not located within their geographical jurisdiction, remain unresolved. The reality is that enforcement of tax liability against an MNE that is not physically located in the market jurisdiction poses tax-*nexus* challenges.[988] The country of jurisdiction receives no benefit from being assigned a tax jurisdictional right which does not result in tangible revenue benefit. Failure to propose and agree on a method through which market jurisdictions will collect their fair and tangible share of tax benefits from this new tax system makes the UA proposal less attractive.

Many countries, including France, the UK, and India, have recently acted unilaterally by adopting a DST system based largely based on user participation and significant economic presence.[989] This has left them with the illusion that DST is an adequate model for taxing the internet and that there is no need for them to align themselves with the Inclusive Framework's initiative in trying to reach a consensus on the application of the UA tax system. This explains the European Commission's decision to assert that it will continue to apply the DST system if the USA withdraws from negotiating a compromise on the UA.[990] The only risk in this approach is that the USA is likely to invoke section 301 to investigate the DST systems of all its trading partners.[991] True to its character, the USA has already commenced

[987] KPMG 'OECDs revised "Unified Approach" To Tax Challenges of Digitalisation' (13 February 2020) <https://home.kpmg/us/en/home/insights/2020/02/tnf-oecd-revised-unified-approach-to-tax-challenges-of-digitalisation.html> accessed 20 May 2021.
[988] Plekhanova V 'Digital Services Tax and the Unified Approach Under the Pillar One Proposal: Exploring the Nexus Frameworks Through the Example of Alibaba' (2020) <file:///C:/Users/user/Desktop/SSRN-id3856721.pdf> 312-313 accessed 12 September 2020.
[989] ibid 320.
[990] Parliament of Australia 'Multinational Tax: The OECDs Pillar One Proposal' (27 November 2020) Research Series Paper 2020-21 <https://parlinfo.aph.gov.au/parlInfo/download/library/prspub/7661351/upload_binary/7661351.pdf> accessed 3 May 2020.
[991] Section 301 of the Trade Act of 1974 allows the USA to initiate an investigation to determine whether an act, policy, or practice of a foreign country is actionable. An actionable act includes, *inter alia*, acts, policies, and practices of a foreign country that are unreasonable or discriminatory and burden or restrict US commerce. An act, policy, or practice is unreasonable if the act, policy, or practice, while not necessarily in violation of, or inconsistent with, the international legal rights of the United States, is otherwise unfair and inequitable.

investigations into the DST in France, the UK, the EU, India, Italy, and other states.[992]

The outcome of this investigation could be used by the USA to impose severe trade sanctions against countries whose DST systems are found to have discriminated against USA digital companies, or those whose principles are consistent with those of international taxation and burden USA companies.[993] It could easily be argued that the USA could be using section 301 investigations to intimidate the countries that have adopted the DST system to consider abandoning it in favour of the modified UA that would hopefully be agreed on under the umbrella of the Inclusive Framework negotiations. Overcoming this challenge and coming up with a model of the UA that is agreeable to the USA remains the biggest hurdle for the Inclusive Framework in obtaining a consensus on how to tax the internet globally.

The introduction of additional factors, for example the location of sustained business interaction with the market, will play an important role in improving the scope of the current *nexus* rules. The problem, however, is that some sales such as online advertising could still be undertaken through unrelated intermediaries without interacting with the market jurisdiction. The UA has proposed that further work be done to find a model for taxing this type of transaction. Failure to find a solution will leave the UA with a tax avoidance avenue that could be used by MNEs to limit their tax liability in most market jurisdictions.[994]

The rules that determine the level of business interaction in a market jurisdiction capable of constituting a *nexus* remain unclear. The likelihood that the adopted rule could leave out some low level of 'interactions' in the formula could create an

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[992] Federal Register Vol 85 No 109 "5th June 2020 Notices" <https://ustr.gov/sites/default/files/enforcement/301Investigations/DST_Initiation_Notice_June_2020.pdf> accessed 20 May 2021.

[993] Congressional Research Service 'Section 301 Investigations: Foreign Digital Services Taxes (DSTs)' (March 2021) <https://crsreports.congress.gov/product/pdf/IF/IF11564> accessed 15 May 2021.

994 KPMG 'OECD's revised "Unified Approach" To tax Challenges of Digitalisation' (13 February 2020) <https://home.kpmg/us/en/home/insights/2020/02/tnf-oecd-revised-unified-approach-to-tax-challenges-of-digitalisation.html> accessed 20 May 2021.

avenue for tax avoidance. Some MNEs could easily organise their transactions to fall within the low-level interactions window which does not attract tax.[995]

The successful application of the UA would require changes in the treaties and domestic laws of member countries. This means that there will be need for the OECD to lead a new multilateral convention to guide member states in consistent and uniform application of the UA. The outcome of this convention could include proposals to change some treaties, and also the conclusion of new treaties where none exist. The process of changing or developing new treaties is generally lengthy and complicated in that it demands the involvement and participation of all OECD member states.

The elaborate, procedural, and consultative processes involved in developing a new tax principle would also mean that the members of the Inclusive Framework may have to wait indefinitely to enjoy the full benefits promised by the UA. It is not inconceivable that by this time, the dynamics of how to tax the internet economy may have changed and need further amendments or changes. In some cases, the other countries may have become impatient due to the long wait and opted to implement unilateral tax measures as happened with the DST which France and Italy opted to implement unilaterally when faced with the inordinate delay in the OECD's ability to reach consensus.

All in all, the UA approach still faces challenges. The reality is that allocation of taxing rights can no longer be based on physical presence if it is to ensure a fair allocation of taxation rights in an increasingly digital and globalised world. It is on this premise that the OECD has made proposals to address these tax challenges. As indicated above, these proposals could result in an additional administrative burden for tax administrators and a huge compliance burden for most MNEs. It is, therefore, incumbent on the Inclusive Framework to ensure that the final consensus document allows for a phased implementation of the UA approach. In this way the

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995 Plekhanova V 'Digital Services Tax and the Unified Approach Under the Pillar One Proposal: Exploring the Nexus Frameworks Through the Example of Alibaba' 330 (2020) <file:///C:/Users/user/Desktop/SSRN-id3856721.pdf> accessed 12 September 2020.

non-contentious portions of the proposal could be implemented to control BEPS, even as we wait for the development of the relevant legal instruments which will facilitate the full implementation of the UA proposal.

In conclusion, the UA is a novel proposal that could help the OECD provide a solution to BEPS in today's digital economy. However, the success of this proposal depends on how the Inclusive Framework applies its negotiation skills to reach a final compromise document acceptable to all member states, and in particular to the USA.[996]

5.4 European Union Proposal on Taxation of the Digital Economy

5.4.1 The European Union

The EU was created by the Maastricht Treaty which came into force on 1 November 1993.[997] It is a political and economic union comprising 27 countries primarily based in Europe. It has a total combined population of some 447 million people[998] and has developed a single seamless market governed by standardised laws and protocols to ensure free movement of goods, services, and capital within the Union and to help it maintain common policies on trade. The EU also introduced a common currency known as the Euro. This has been adopted as the currency of choice and is used in 19 member states.[999] The Euro is now the second-largest reserve currency in the international monetary system, just behind the dollar.[1000] It, however, surpassed the dollar as the currency with the highest value of money in circulation when it recorded a total of 1 109 000 000 000 Euros in circulation as of January

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996 Faulhaber L.V (2019) 39 V*irginia Tax Review* 145.

997 Treaty of Maastricht on European Union <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=LEGISSUM:xy0026> accessed 25 June 2021.

998 Information and data obtained from <https://en.wikipedia.org/wiki/European_Union> accessed 25 June 2021.

999 Hlavac Marek 'Less than a State, More than an International Organization: The Sui Generis Nature of the European Union' (2010) Central European Labour Studies Institute <https://mpra.ub.uni-muenchen.de/27179/1/MPRA_paper_27179.pdf> accessed 3 March 2021.

1000 European Central Bank 'The International Role of the Euro' (June 2020) <https://www.ecb.europa.eu/pub/pdf/ire/ecb.ire202006~81495c263a.en.pdf> accessed 3 March 2021.

2017.[1001] The gross domestic product (GDP) of the EU stood at 15.6 trillion dollars in 2019, which was only 5.8 trillion lower than the USA's GDP which stood at $21.4 trillion in the same period.[1002] The significance of the EU in international trade makes it crucial for this thesis to evaluate how this economic bloc deals with the challenge of taxing the digital economy.

The current EU member states are Austria, Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden. The UK was among the founding nations of the EU but left the Union on 31 January 2020.

5.4.2 Digital Tax Proposals within the European Union

The EU has recognised the fact that the existing international tax rules have not been able to tax the digital economy appropriately. It is for this reason that it coalesced its members under the Rome Declaration of 27 March 2017 where they pledged to work together to deal with the challenges posed by this technological transformation.[1003] This declaration led to the development of two proposals on how the EU could tax the digital economy. These proposals, which were presented to the members for the first time in March 2018, provide that:

a) the significant digital presence could supplement the applicable PE rules to tax the digital economy. It thus, proposes that members should re-negotiate their tax treaties with their trading partners to facilitate the application of significant digital presence;[1004] and

b) the DST system be adopted and applied at the rate of 3% to address issues of value creation that are typical in most digital transactions.

[1001] Data obtained from Book My Forex.com <https://www.bookmyforex.com/blog/highest-currency-in-the-world/> accessed 3 March 2021.

[1002] ibid. <https://www.investopedia.com/terms/e/europeanunion.asp> accessed 3 March 2021.

[1003] EU Council Press Release 'The Rome Declaration – Declaration of the Leaders of 27 Member States and the European Council, the European Parliament and the European Commission' (25 March 2017) <http://www.consilium.europa.eu/en/press/press-releases/2017/03/25/rome-declaration/> accessed 9 March 2021.

[1004] EU Commission 'Proposal for a Council Directive Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence' COM(2018)147 Final, Brussels (21 March 2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf> accessed 9 March 2021.

These proposals are similar to the on-going digital tax negotiation proposals by the OECD. The implementation of these twin proposals has, however, remained in abeyance because the EU Council was unable to muster a unanimous vote to approve either of them. The opposition to this tax system from countries like Sweden has denied the Union the unanimous vote required to implement the DSP or the DST tax system uniformly across the EU. This stalemate led the EU Commission to give its member states tacit approval to proceed with the implementation of either of these tax proposals in order to protect the tax base of their economies from the burgeoning internet trade.

Consequently, some countries like Austria, France, Hungary, Italy, Poland, Spain, Czech Republic, and the UK proceeded to introduce DST to protect their tax bases. Countries like Latvia, Norway, and Slovenia have either introduced or given indications of their intention to introduce DST. The DST tax rate in these countries ranges from as low of 1.5% in Poland to a high of 7.5% in Hungary.[1005] The EU approved the application of these DSTs on the understanding that they are interim tax measures that apply only until such time that a unanimous approval or agreement would be reached at the EU or OECD levels. The understanding is that all these DSTs applied by the EU member states would be repealed if a consensus on the application of a uniform digital tax system is obtained by both the EU and OECD. The following are the highlights of the two proposals on how to tax the digital economy that are under review by the EU.

5.4.2.1 Proposal 1: The Significant Digital Presence Significant Digital Presence Rule

This rule is based on the current PE framework of allocating profits to the location or country with significant digital activity. This can be determined by examining certain significant economic activities performed through a digital interface that facilitates a digital transaction, or where significant functions are performed using

[1005] Asen E 'What European OECD Countries are Doing about Digital Services Taxes' (June 2020) Tax Foundation <https://taxfoundation.org/digital-tax-europe-2020/> accessed 8 March 2021.

significant digital operations.[1006] The activities undertaken by any entity through a digital interface, therefore, play a significant role in profit attribution of tax rights.

The functions performed by the asset and the risk that it has assumed concerning the subject transaction will also be considered as tiebreakers where there are conflicting jurisdictional tax rights.[1007] A digital platform under this proposal will be deemed to have a digital presence in a member state if it satisfies one of the following conditions:[1008]

a) it exceeded a 7 million Euros revenue threshold in a member state;
b) it had over 100 000 users in a member state in a taxable year; and
c) at least 3 000 digital service contracts are created between the entity and the business users in a member state in a financial year.

The SDP test, which is also known as Pillar One proposal, is intended to coexist with the current OECD principle, and even expand the scope of its application. The OECD hoped that the EU member states would embrace this proposal readily because its application was based on an established PE doctrine that has been applied in international trade and taxation for at least one century.[1009]

The general intention of Pillar One was to give countries a share of tax on profits earned within their jurisdictional tax borders, although the tax would still be collected where the digital company has its physical base. This would, in the long run, discourage companies from establishing their bases in low-tax jurisdictions to maximise the profits earned in other countries. The final decision on whether this proposal will be applied across Europe depends on whether the EU Council will be able to persuade all its members to approve it. It is however significant to note that

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1006 EU Commission 'Proposal for a Council Directive Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence' COM(2018)147 Final, Brussels (21 March 2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf> accessed 8 March 2021.
1007 ibid.
1008 EU Commission Communication 'Fair Taxation and Digital Economy' (2018) <https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en#heading_1> accessed 8 March 2021.
1009 Almudí, Gutiérrez and González-Barreda (eds) *Combating Tax Avoidance in the EU* 570.

the EU Commission has welcomed the proposed SDP directive as a good starting point for fair taxation of the EU's digital economy.[1010]

5.4.2.2 Proposal 2: The Digital Service Tax (DST) Rule

The Pillar One proposal was a long-term solution to rally the world's top global economies around a global plan on how to tax multinational digital companies in a fair, effective, and equitable manner. The EU, however, recognised that achieving consensus on Pillar One would require more time and consultations. It thus proposed a DST under the Pillar Two model as a stop-gap tax measure that could be applied by the member states to tax digital transactions as they await a global or EU wide consensus on the SDP proposal.[1011]

The DST, which is also known as the Pillar Two proposal is a minimum corporate tax on the gross revenue obtained from the provision or supply of digital services by any taxable entity within the EU.[1012] The implementation of this tax system has not taken off because low-tax EU countries such as Ireland, Luxembourg, and Estonia have declined to sign up to the OECD and EU proposal to levy DST on global companies' digital transactions. The EU Commission is, however, optimistic that a uniform DST will be agreed upon by all EU member states in the course of 2021.[1013] The EU Commission, under this proposal, intended to apply a DST within the EU as a temporary digital taxation measure until such time that consensus can be reached on the permanent solution proposed under the DST.

In the absence of a consensus at the EU or OECD levels, the EU Council has allowed its member states to continue with the unilateral implementation of the DST.

[1010] EU Legislation 'Corporate Taxation of Significant Digital Presence' (2018) <https://www.europarl.europa.eu/RegData/etudes/BRIE/2018/623571/EPRS_BRI(2018)623571_EN.pdf> accessed 10 March 2021.
[1011] Haslehner W. *et* al (eds) *Tax and the Digital Economy* 143-145.
[1012] EU Commission 'Proposal for a Council Directive on The Common System of a Digital Services Tax on Revenues Resulting from The Provision of Certain Digital Services' COM (2018)148 Final, Brussels (21 March 2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf> accessed 10 March 2021.
[1013] Haines A 'This Week in Tax: EU Plans to Announce its DST in 2021' (18 September 2020) <https://www.internationaltaxreview.com/article/b1nfjnlpv95dfq/this-week-in-tax-eu-plans-to-announce-its-dst-in-2021> accessed 10 March 2021.

For example, Poland levies the tax at 1.5%, Spain, Italy, Belgium, and France at 3%, Austria at 5% and Hungary at 7.5%.[1014] Their DST system has largely borrowed from and is inconsistent with the EU Commission's proposals on DST.[1015] For example, the OECD reform proposal is fundamentally about creating a new *nexus* rule to tax the digital economy. On the other hand, the EU is focused on controlling profit-shifting tendencies by MNEs.[1016] The EU Commission's proposal which allows member states to introduce DST at a rate of 3% on gross revenue of digital services is also inconsistent with the OECD's view that a fair tax system should be implemented on the basis of profit and not gross revenue.[1017]

The EU estimated that its member countries could collect tax revenue of at least 5 billion Euros annually if the DST were to be set at 3%.[1018] The tax was to apply to all enterprises with a digital interface and which provided any of the following services:[1019]

a) Provision of advertising space aimed at users of the interface (e.g., Google, Facebook, or YouTube);

b) intermediation services like Airbnb and Uber; and

c) the sale or act of transmitting data collected about users and generated from users' activities as done by Facebook and Google).

1014 Tax Foundation 'What European OECD Countries Are Doing About Digital Services Taxes' (2020) <https://taxfoundation.org/digital-tax-europe-2020/> accessed 10 March 2021.

1015 EU Commission 'Proposal for a Council Directive on The Common System of a Digital Services Tax on Revenues Resulting from The Provision of Certain Digital Services' COM(2018)148 Final, Brussels (21 March 2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf> accessed 10 March 2021.

1016 Treidler O 'Is the EU (Unintentionally) Undermining Ongoing OECD Work on Digital Taxation?' <https://mnetax.com/is-the-eu-unintentionally-undermining-ongoing-oecd-work-on-digital-taxation-42533> accessed 10 August 2021.

1017 OECD 'Fundamental Principles of Taxation' <file:///C:/Users/Admin/Desktop/9789264218789-5-en.pdf> accessed 10 August 2021.

1018 EU Commission 'Proposal for a Council Directive on The Common System of a Digital Services Tax on Revenues Resulting from The Provision of Certain Digital Services' COM (2018)148 Final, Brussels (21 March 2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf> accessed 10 March 2021.

1019 Becker J and Englisch J *EU Digital Service Tax: A Populist and Flawed Proposal* (Kluwer International Tax 2018).Blog <http://kluwertaxblog.com/2018/03/16/eu-digital-services-tax-populist-flawed-proposal/> accessed 10 March 2021.

These enterprises would be liable to taxation only if they meet the following minimum thresholds:[1020]

a) a total taxable revenue of at least 750 million Euros in a financial year; and

b) at least 50 million Euros earned within the EU market.

This means that the DST would apply only to the bigger digital companies whose revenue exceeds at least 750 million dollars in a financial year. Cases of double taxation were also limited by the proposal requiring member states to deduct DST paid in any jurisdiction from their corporate income tax.[1021] It would also apply to both domestic and non-resident enterprises, and also to local and cross-border transactions.[1022] Tax revenue emanating from these transactions was to be allocated to each member state in proportion to the number of users of the taxable service.[1023]

Pillar Two has proposed a simple and efficient solution to the under-taxation of the digital businesses among the member countries. Lack of consensus on this issue has, therefore, resulted in a varied, inconsistent, and uncoordinated implementation of the DST system across the EU. This thesis envisages that countries like Luxembourg, Sweden, and Ireland that have resisted the implementation of this tax system could be persuaded to consider adopting it, particularly now that they have witnessed the risks[1024] and benefits[1025] in countries such as the UK, Italy, and Spain who have implemented it.

[1020] Haslehner W *et al* (eds) *Tax and the Digital Economy* 143-145.

[1021] EU Commission 'Proposal for a Council Directive on The Common System of a Digital Services Tax on Revenues Resulting from The Provision of Certain Digital Services' COM (2018)148 Final, Brussels (21 March 2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf> accessed 10 March 2021.

[1022] European Parliament 'Digital Taxation: State of Play and Way Forward' (2020) <https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/649340/EPRS_BRI(2020)649340_EN.pdf> accessed 12 July 2021.

[1023] ibid.

[1024] Allocation of profits between countries contribute to wealth creation like investments and jobs. Aggressive implementation of DST could lead MNEs to relocate their tax jurisdiction and infrastructure to a lower-tax jurisdiction.

[1025] Taxation of the digital economy can expand and or protect a country's tax base from BEPS. It is, for example, estimated that Italy's DST will generate 708 million Euros annually. This is significant revenue that very few countries can afford to forego. See also Office of the USA Trade

5.4.3. Challenges and Criticism of the European Union's Proposal on Digital Taxation

A 'tax war' is emerging in the EU where some states have tried to get their fair share of tax from internet-based transactions while others prefer to hold out for a multilateral consensus on the issue of internet taxation. The lack of consensus and the open resistance to this tax system by countries such as Ireland and Sweden, indicate that the proposal could raise challenges which the EU must address. It is anticipated that the countries that have not signed up to support the proposal could sign up and give the EU the unanimous support requires to adopt its new rules for fair taxation of the digital economy. However, this objective can only be achieved if the challenges posed by the digital taxation systems are addressed. The following are some of the challenges faced by the EU's proposed two-tier system of taxing the digital economy:

5.4.3.1. Opposition from the United States of America

The USA views the DST as a discriminatory tax system targeted at its multinational companies. They support their argument on by claiming that it is only USA-based companies such as Google, Facebook, Uber, Amazon that are able to realise the proposed global tax revenue threshold of at least 750 million Euros in a financial year and at least 50 million Euros from within the EU market. Their argument is supported by the data shown in the table below as obtained from the Peterson Institute for International Economics.[1026]

Table 5.1: Revenue of Digital Companies in 2017 Financial Year in Millions

No.	Company	Total Revenue in 000,000	EU Revenue in 000,000	Headquarters
1	Amazon	$106,110	$21,710	USA
2.	Facebook	$40,653	$9,168	USA

Representative 'Report on Italy's Digital Services Tax Prepared in the Investigation Under Section 301 of the Trade Act of 1974' (January 2021) 5 <https://ustr.gov/sites/default/files/enforcement/301Investigations/Report%20on%20Italy%E2%80%99s%20Digital%20Services%20Tax.pdf> accessed 12 July 2021.

[1026] See <https://piie.com/system/files/documents/pb18-15.pdf> accessed 12 March 2021.

3.	Google	$110,855	$36,582	USA
4.	Microsoft	$89,950	$17,881	USA
5.	Netflix	$11,693	$1,284	USA
6.	Oracle	$37,728	$8,524	USA
7.	Expedia	$10,060	$1,810	USA
8.	Spotify	$4,090	$1,170	SWEDEN
9.	SAP	$23,461	$10,415	GERMANY

Source: The Peterson Institute for International Economics[1027]

Table 5.1 above confirms that a majority of USA-based companies trading within the EU are likely to be affected by the proposed tax directive. On the face of it, this directive – which resembles a 'tariff' targeted at USA-based firms – appears to have settled on a tax threshold that excludes most EU-based companies from the digital tax net.[1028]

The EU Commission defined taxable revenue under digital interface to include:[1029]

a) digital advertising that is the main domain of Google, Twitter, and Facebook;

b) digital platforms and marketplaces where Amazon, e-bay, and Airbnb ply their trade; and

c) transmission of users' data to other users which is the business that Facebook and Twitter are known for.

This definition of what constitutes the taxable digital interface of a business was structured in a manner that solely targeted USA-based firms for taxation. This is supported by the fact that activities carried out by giant EU companies like Spotify have been excluded from the list of taxable digital interface transactions.[1030]

1027 ibid.

1028 Lucy Z and Hufbauer GC 'The EU Proposed Digital Service Tax: A De facto Tariff' (June 2018) <https://piie.com/system/files/documents/pb18-15.pdf> accessed 12 March 2021.

1029 EU Commission Communication 'Fair Taxation and Digital Economy' (2018) <https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en#heading_1> accessed 8 March 2021.

1030 Lucy Z and Hufbauer GC 'The EU Proposed Digital Service Tax: A De facto Tariff' (June 2018) <https://piie.com/system/files/documents/pb18-15.pdf> accessed 12 March 2021.

5.4.3.2 Breach of International Commitments

The EU has made commitments under the principle of national treatment in the General Agreement on Trade in Services (GATS), which was the predecessor of the World Trade Organisation (WTO) that was created in 1995. Under this principle, it committed not to discriminate or treat any member less favourably by modifying the conditions of competition for services in favour of a member.[1031] Its current tax proposals which are aimed at discriminating against USA-based firms are a direct contravention of this commitment.

In its schedule of commitments to GATS, the EU also undertook to grant any member broad access to its market. Its current actions clearly limit market access for USA-based companies through a discriminatory tax system contravene this commitment.

The consequence of these breaches is that the USA could file a case against the EU at the WTO disputes settlement body on grounds of violation of the national treatment commitment. This could result in the imposition of trade sanctions against the EU.

The USA could also pursue the path of punitive retaliatory trade restrictions on the EU by invoking sections 301 or 891 of its Internal Revenue Code. The consequence of invoking section 301 is that the United States Trade Representative would investigate the EU to establish whether its acts, policies, and practices relating to taxation of the digital economy are unreasonable or discriminatory. Trade sanctions could be imposed on the EU if it is found guilty of discriminating against USA-based companies using its proposed digital tax system. Such sanctions will hurt the EU's economy because the USA remains its largest trade and investment partner.[1032] The EU would then have to strike a balance between taxing the giant USA-based companies and losing multi-billion-dollar trans-Atlantic trade and investment.

[1031] Article XVII of the General Agreement on Trade in Services.

[1032] European Commission 'Countries and Regions' <https://ec.europa.eu/trade/policy/countries-and-regions/countries/united-states/> accessed 12 July 2021.

5.4.3.3 Unfairness

The EU proposes that DST will be levied at the rate of 3% on the gross revenue of an enterprise that generates the taxable revenues. The EU Commission has described this as an indirect tax [1033] This means that it should be levied on the ultimate taxpayer, i.e., the consumer. However, the EU Commission has explained that this digital tax targets the profits of the enterprise and should not be passed on to consumers.[1034] It is intended to operate as a direct tax on a digital company to compel them to pay their fair share of tax. This creates the impression that the DST is a new tax system.

The upshot is that a tax on the gross revenue of an entity would be so huge that no entity would be able to bear it without sharing the heavy tax burden with the consumers. The rhetoric by the EU that this tax should not affect or be passed to the ultimate consumer is likely to be ignored by most entities. The inevitable result would be an increase in the cost of goods and services. The direct taxation of revenue could also affect business start-ups whose re-investment capital could be swept away by the punitive taxation system.

This tax system also raises the possibility of double taxation of the affected entities in that they would also have to pay corporate income tax in the countries where they are based. At present there is no provision for the affected companies to offset DST from their corporate income tax and vice versa. This fear has been confirmed by the EU which has conceded that DST may expose taxpayers to double taxation.[1035] It

[1033] See <https://ec.europa.eu/taxationcustoms/business/company-tax/fair-taxation-digital-economy en> accessed 12 July 2021.

[1034] Richter W 'Taxing Direct Sales of Digital Services: A Plea for Regulated and Internationally Coordinated Profit Splitting' (2018) CESifo Working Paper 7017 <https://www.econstor.eu/bitstream/10419/180279/1/cesifo1_wp7017.pdf> accessed 12 July 2021.

[1035] EU Commission 'Proposal for a Council Directive on The Common System of a Digital Services Tax on Revenues Resulting from The Provision of Certain Digital Services' Article 5(3) COM (2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf> accessed 12 March 2021.

has, however, also indicated that it is still negotiating with member states to find ways of correcting this anomaly. This makes the DST unfair.[1036]

5.4.3.4 Jurisdictional Rights

The definition of taxable revenue under the EU's proposed directives has introduced the concept of 'covered' and 'not-covered' services.[1037] The items that fall in the latter category are not taxable. The challenge arises as to what would happen to business models that cover or combine both the 'covered' and 'not- covered' services. For example, how would Netflix or Facebook whose products allow for targeting advertising by users and whose other purpose is to make a digital interface available which supplies or provides digital content to users, be treated? Would it be treated as a digital platform that merely provides digital content and therefore is not taxable, or would it be treated as an entity that is using a digital platform to conduct its trade and therefore is taxable on its profit? This *lacuna* is likely to confuse the exercise of jurisdictional rights between taxing authorities and taxpayers if the EU does not bring clarity in the wording and definition of its proposed

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[1036] EU Commission 'Proposal for a Council Directive on The Common System of a Digital Services Tax on Revenues Resulting From The Provision of Certain Digital Services' Article 5(3) COM (2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf> accessed 12 March 2021.

[1037] Article 3 of the Council Directive provides thus:

(1) The revenues resulting from the provision of each of the following services by an entity shall qualify as "taxable revenues" for the purposes of this Directive:
(a) the placing on a digital interface of advertising targeted at users of that interface;
(b) the making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users;
(c) the transmission of data collected about users and generated from user's activities on digital interfaces.

(4) Point (b) of paragraph 1 shall not include:
(a) the making available of a digital interface where the sole or main purpose of making the interface available is for the entity making it available to supply digital content to users or to supply communication services to users or to supply payment services to users;
(b) the supply by a trading venue or a systematic internaliser of any of the services referred to in points (1) to (9) of section A of Annex I to Directive 2014/65/EU;
(c) the supply by a regulated crowdfunding service provider of any of the services referred to in points (1) to (9) of section A of Annex I to Directive 2014/65/EU, or a service consisting in the facilitation of the granting of loans.

directives.[1038] The result is that it could be used by taxpayers to limit their tax liability thereby defeating the purpose for which the digital tax was introduced.

5.4.3.5 Administrative Burden

The proposed digital tax directives are premised on the EU member states sharing revenue in proportion to the number of times an entity has, for example, aired an advertisement within its jurisdiction.[1039] This assertion presupposes that all EU member states have sufficient technological infrastructure to assist them to calculate and determine the revenue due to each state. This may also require member states to employ additional staff members or to purchase appropriate technology to deal with this challenge. Both options are expensive.

Each country will also have to decide on the likely costs of investing in human resources or technological development required to monitor the online digital presence of various entities against the expected revenue from these digital activities. This will determine its decision on whether an investment in the taxation of digital trade is worth its while.

The other administrative burdens likely to pose a challenge regarding this tax system are:[1040]

a) How will each country collect or ensure that it receives its share of taxable revenue from an advertising entity located in another country, more particularly if that advertising entity does not have a physical office or an agent in the country?
b) What will happen if the collecting country declines to submit the tax it collects for advertising aired in the receiving country?
c) Will it be possible for the two countries to do a tax set off?

[1038] European Parliament 'Taxing the Digital Economy New Developments and the Way forward' 2021 European Parliamentary Research Service <file:///C:/Users/user/Downloads/EPRS_BRI(2021)698761_EN.pdf> 7 accessed 10 September 2022.
[1039] EU Commission 'Proposal For a Council Directive on The Common System of a Digital Services Tax On Revenues Resulting From The Provision of Certain Digital Services' Article 5(3) COM (2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf> accessed 12 March 2021.
[1040] ibid.

d) What will happen if the collecting country simply declines or fails to help collect the revenue due to the receiving country? Will the collecting country be sanctioned for its omission?
e) Will the collecting country be entitled to a fee for having employed its human and technical resources to help the receiving country collect its tax?
f) How will the collecting country enforce the collection of the self-assessed tax of non-residents who do not have local offices or agents?
g) How will tax authorities handle a situation where a company has multiple *nexuses*? Which rule will be applied in taxing such an entity; will it be taxed based on the users in one country, or consumers in another country, or will it be based on economic ties in a third country?

The model to be adopted by the EU in addressing these challenges could determine the success or failure of the proposal to tax the digital space across the EU.

5.4.3.6 Absence of a Sunset Clause

The EU intended to have the DST system as an interim tax measure**.** It did not, however, include a sunset clause for this interim solution both in its substantive proposal and in the tacit consent that it gave its members who wished to apply DST unilaterally. The countries that have introduced DST like France, Belgium, and Spain have also not stipulated a specific expiry date for this tax system.[1041]

This has led to the fear that DST may not be a temporary tax after all. The argument that the EU and its member states could repeal DST once a unanimous model for taxing the digital economy has been agreed on either at the EU or OECD levels, has been rebuffed as unrealistic. This is mainly because each country which has adopted DST unilaterally would require its legislature to repeal this law. What if

[1041] Kofler G and Sinnig J ‘Equalization Taxes and the EUs Digital Services Tax’ <https://www.researchgate.net/publication/332540731_Equalization_taxes_and_the_EU’s_digital_services_tax> 199 accessed 28 December 2020.

some of the legislatures in these countries decline to repeal this law? This apprehension is justified because countries that have realised that DST is an effective way of collecting revenue are unlikely to be in a hurry to repeal it,[1042] unless they are persuaded over time that the EU-wide DST will bring them equal or better tax returns.

This unintended omission by the EU in excluding a sunset clause to the DST could have been one of its biggest mistakes. It must now grapple with how it will persuade all its members to repeal their unilateral DST in favour of the EU-wide DST. It must also contemplate the possible options available to it if the countries that have introduced DST decline to repeal such laws. This issue that hitherto appeared simple and was taken for granted, could morph into a big challenge with unintended consequences if it is not well handled. It could end up in DST changing from an interim to a permanent digital tax measure.

5.4.3.7 Political Challenges

Getting all 27 EU member states to reach consensus on the final text and format of how to tax the digital space has been the biggest barrier for the EU Council. This is mainly attributed to the different competitive forces and interests among member states. Countries like Sweden and Luxembourg that benefit and have not suffered tax base erosion from the use of the current international tax system, support the *status quo.* Others like Ireland who are likely to lose a portion of their tax base to competing countries on the basis of this new tax system also support the *status quo.*[1043] This scenario has made it difficult for the EU to agree on the tax reforms proposed to help its members in deciding how to tax the digital economy.

The EU Council has since 2018 attempted to reconcile the partisan interests of members who have declined to sign up to and support the digital taxation proposal. It even tried to narrow the issues in March 2019 to accommodate members'

[1043] Faulhaber LV 'The Trouble with Tax Competition: From Practice to Theory' (2018) 71 *Tax Law Review* 311 <file:///C:/Users/Admin/Downloads/SSRN-id3460741.pdf> accessed 12 March 2021.

concerns.[1044] It proposed an interim DST to start the process of digital taxation within the EU as the negotiations on the SDP proposal as a long-term measure continued. It, however, received the votes of 16 members and missed out on the votes of three-member states.[1045] These three-member states argued that DST deviates from the fundamental principle of income taxation by levying a tax on gross income rather than of profits. These three-member states further argued that the implementation of the two-tier tax proposals breached the non-discrimination commitments of EU member states to the WTO.[1046] In their view, the implementation of this tax system would expose the EU and its member states to retaliatory action from the WTO.[1047]

It is worth noting that Sweden, which is one of the countries opposed to DST, is home to several digital companies, including Spotify. The introduction of DST is, therefore, likely to expose Spotify and several other digital companies based in Sweden to cross-border taxation. This could result in the erosion of its tax base if it is forced to share the profits of these multinational digital companies based in Sweden with other EU member states. This could be the reason behind its reluctance to sign up for the digital taxation reform proposals.

The only way for the EU to overcome this challenge is to find a political solution that will persuade these three countries to abandon their hard stand on the matter. The political solution could include a model through which they would still be able to protect their tax as the *de facto* hosts of USA's multinational companies.

5.5 Recent Developments in Digital Taxation

The OECD and EU proposals on global tax reforms have been under intense discussion at the OECD/G-20 Inclusive Framework on BEPS since 2019. The USA

1044 Kofler G and Sinnig J 'Equalization Taxes and the EUs Digital Services Tax' <https://www.researchgate.net/publication/332540731_Equalization_taxes_and_the_EU's_digital_services_tax> 180, 197 accessed 28 December 2020.

1045 Valero J 'The EU's Digital Tax Is Dead, Long Live the OECD's Plans' (8 March 2019) <https://www.euractiv.com/section/economy-jobs/news/the-eus-digital-tax-isdead-long-live-the-oecds-plans/> accessed 12 March 2021.

1046 Faulhaber LV 'The Trouble with Tax Competition: From Practice to Theory' (2018) 71 *Tax Law Review* 311 <file:///C:/Users/Admin/Downloads/SSRN-id3460741.pdf> accessed 12 March 2021.

1047 ibid.

has been at the forefront in opposing the implementation of these reforms because of its apprehension that the reforms are likely to result in the erosion of its tax base and unfair taxation of its giant companies like Google, Amazon, and Facebook. Other countries like Ireland, Switzerland, and Luxembourg also joined hands with the USA to oppose these reforms to protect the revenue that they earn from multinational USA companies resident in their countries.

These global discussions on how best to tax the digital economy recently bore fruit when the OECD/G-20 Inclusive Framework released a statement on 1 July 2021 confirming that they had agreed on a way forward on how to tax the digital economy.[1048] The compromise agreement was intended to update the key elements of the current international tax system which are becoming increasingly irrelevant by the globalised and digitalised 21st-Century economy.[1049]

The OECD has a membership of 139 countries. Of these, at least 131 countries – representing 90% of the global GDP – have confirmed their support for these global tax reforms. Major economies such as India, Brazil, and China are among the countries that have supported the USA-driven global minimum tax on multinational corporations initiative. Kenya and Nigeria are among the top African countries that have not supported the reforms as they are persuaded that their current DST system works well and there is no need to embrace a new tax system that is likely to result in lower tax returns.

The other reason for their withdrawal from the global tax reform plan is that the OECD's proposals were tilted to favour countries where MNEs have their headquarters. They disagreed with the formulary apportionment which would result in the countries where the MNEs have their headquarters netting the biggest share of the tax income. The fact that there are few MNEs with headquarters in Kenya and

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[1048] OECD '130 Countries and Jurisdictions Join Bold New Framework for International Tax Reform' <https://www.oecd.org/newsroom/130-countries-and-jurisdictions-join-bold-new-framework-for-international-tax-reform.htm> accessed 12 July 2021.

[1049] ibid

Nigeria means that both countries, and perhaps other African countries, would not benefit to any great extent in tax revenue from these global tax reforms.

Leading African economies like South Africa, Egypt, and Morocco have also backed the OECD-led global tax reform proposals. Well known tax havens like Bermuda, the Cayman Islands, Switzerland, and Singapore have also supported this global tax revision plan. A few countries in Europe, including Ireland, Hungary, and Estonia objected to the minimum tax rate as it would reduce their desirability as ideal foreign investment destinations. This fear emanates from their current low tax rates making it possible for them to attract several multinational companies like Apple and Google to their shores. Ireland and Hungary offer a low corporate tax rate of 12.5% and 9% respectively. The global tax rate is, therefore, likely to render them less attractive as an investment destination for global multinational companies.

These concerns were addressed when the OECD agreed to set the minimum global tax rate at 15% instead of 'at least 15%'. This addressed Ireland's concern whose corporate tax rate is 12.5%. Estonia and Hungary joined Ireland in signing up to the OECD tax reform proposal. The OECD is, however, optimistic that the remaining elements of the framework, including the need to persuade the remaining four countries[1050] to approve these global tax reforms, will be finalised before the tax proposal comes into effect.[1051] The OECD members who have signed up believe that continued negotiations, commitment to address their concerns in future, and continued pressure from the rest of the international community, and in particular from the G-7 nations, will persuade the four hold-out nations to sign up to the proposal.

The tax reform agreement and its approval by 136 OECD member countries is a significant step in a bold initiative to reform the global tax system. The main hurdle

[1050] Nigeria, Kenya, Sri Lanka, and Pakistan are still holding out on signing up to the proposed global tax reforms.
[1051] OECD '130 Countries and Jurisdictions Join Bold New Framework for International Tax Reform' <https://www.oecd.org/newsroom/130-countries-and-jurisdictions-join-bold-new-framework-for-international-tax-reform.htm> accessed 12 July 2021.

that remains in its implementation path is how the outstanding technical and political issues can be resolved and whether the G-20 countries and both the USA Senate and Congress will approve it.[1052]

The OECD resolved the first hurdle when the G-20 ministers approved the implementation of the proposed global tax reforms at their two-day meeting in Venice, Italy from 9 to 10 July 2021.[1053] But for Hungary and the Republic of Ireland which declined to sign the deal as they viewed the proposed global tax rate of 15% as too high, this endorsement would have made it possible for the EU to commence the application of this global tax deal. The other hurdle standing in the way of implementing these tax reforms is the USA Senate and Congress which are required to approve this multilateral agreement plus the necessary legislative amendments required to make this tax deal a reality.

The global tax reforms agreed on by the OECD/G-20 Inclusive Framework were premised on two pillars. The conceptual framework of these proposals, which were identified as Pillar One and Pillar Two are discussed below:

5.5.1 Pillar One

The Pillar One proposal is premised on the following principles:

5.5.1.1 Scope

Scope deals with issues of *nexus* and profit-allocation rules. Pillar One will permit the taxation of all MNEs that are deemed to be in-scope. The in-scope companies are expected to meet the following requirements:[1054]

1052 Holland and Knight 'Agreement on Global Tax Reforms: What Happened and What's Next?' <file:///C:/Users/Admin/Desktop/Agreement%20on%20Global%20Tax%20Reform%20What%20Happened%20and%20Whats%20Next.pdf> accessed 12 July 2021.

1053 Le Roux G and Hagemann B 'G-20 Endorses Global Tax Reforms' (10 July 2021) <file:///C:/Users/Admin/Downloads/2021-07-g20-ministers-green-global-tax.pdf> accessed 12 July 2021.

1054 OECD/G20 Base Erosion and Profit Shifting Project 'Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy' (July 2021) <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf> accessed 1 July 2021.

a) a global turnover above 20 billion Euros or approximately 23.5 billion US dollars and profitability comprising profit before taxation that is above 10%;

b) the turnover threshold of 10 billion Euros or approximately 11.8 billion US dollars, is dependent on the successful implementation of Amount A.[1055]

The proposal would hereafter be reviewed within a period of seven to eight years after the agreement has come into force. Extractive and regulated financial services are considered as on-scope entities and are thus excluded from this tax system.

5.5.1.2 *Nexus*

The proposal under *nexus* is to have a special *nexus* rule permitting allocation of amount A to a market jurisdiction where the in-scope MNE derived at least 1 million Euros in revenue from that specific jurisdiction.[1056] This could have the effect of bringing more companies, including middle-sized companies, within the scope of this tax system. Smaller countries with a GDP less than 40 billion Euros will have their nexus set at 250 000 Euros. This new *nexus* rule will compel MNEs to pay a share of their residual profit in the jurisdiction where they are located under a system known as Amount A. Market jurisdictions would be allocated 20%-30% of MNE profit using a revenue-based key allocation formula.[1057] The safe harbour principle would also be applied under to cap the residual profits that are allocated to the market jurisdiction under the new *nexus* rules. The formula to be used in determining the allocation will be ready by the end of 2022.

5.5.1.3 Arm's Length Principle

The application of the arm's length principle will continue to apply under a tax system that is referred to as Amount B. MNEs will be required to pay tax in jurisdictions where they have a physical presence. This tax amount is arrived at by

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[1055] Amount A is the proposed taxing right that allocates high-value residual profits. It is based on a formula that is not necessarily determined on the arm's length principle.

[1056] Marley *et al* 'OECD/G20 Inclusive Framework Reaches High-level Agreement on a Two-pillar Approach to International Tax Reform' (5 July 2021) <https://www.osler.com/PDFs/Resource/en-ca/OECD-G20-inclusive-framework-reaches-high-level-ag.pdf> accessed 1 July 2021.

[1057] OECD/G20 Base Erosion and Profit Shifting Project 'Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy' (July 2021) <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf> accessed 1 July 2021.

calculating the fixed returns on certain baseline and marketing distribution activities in that jurisdiction. The model of how Amount B will work seamlessly alongside Amount A will be clarified in a policy document by end of 2022.

5.5.1.4 Tax Certainty

The OECD has proposed robust dispute prevention and resolution mechanisms that it has referred to as tax certainty. Under this proposal members will participate in binding dispute resolution mechanisms for disputes related to Amount A.[1058] This is intended to limit cases of double taxation and ensure faster resolution of disputes. Consideration has also been proposed for an elective binding dispute resolution for Amount A disputes that involve developing countries. The latter mechanism is intended to support developing countries that may not have efficient and robust dispute settlement mechanisms. It will also make it possible for developed countries to avoid the possibility of being compelled to participate in a mandatory dispute resolution process with or against a country that does not have an efficient and robust dispute settlement mechanism.[1059] The proposal also recognises the fact that some developing countries may not have mutual agreement dispute procedures with their trading partners. Resolution of disputes between states that do not have mutual agreement dispute procedures can be difficult to commence and enforce.

Pillar One is generally intended to replace the unilateral DST that is currently being implemented by several OECD member states. It also allocates additional taxation rights to market jurisdictions. The final multilateral instrument to be used to implement pillar one proposals will be opened for signatures in 2022. Thereafter it will come into effect in 2023.

[1058] Granwell AW and Odintz DJ 'Agreement on Global Tax Reform: What Happened and What's Next' (7 July 2021) Holland and Knight Alert <https://www.hklaw.com/en/insights/publications/2021/07/agreement-on-global-tax-reform-what-happened-and-whats-next> accessed 2 July 2021.

[1059] Kofler G and Sinnig J 'Equalization Taxes and the EUs Digital Services Tax' <https://www.researchgate.net/publication/332540731_Equalization_taxes_and_the_EU's_digital_services_tax> 195 accessed 28 December 2020.

5.5.2 Pillar Two

Pillar Two is also known as the GloBE proposal.[1060] It is designed to make in-scope MNE pay minimum tax irrespective of where they are based or the jurisdiction from where they operate. The GloBE proposal operates based on:[1061]

a) Two interlocking domestic rules are intended to protect the global tax base from erosion. The first is an income inclusion rule which will impose a top-up tax on the parent company in instances where its subsidiaries have under-declared their profits to limit their tax liabilities. It is also applicable in cases where the effective tax rate applied to a foreign-controlled company is below a prescribed rate.

   The second is the under-taxed payment rule, which denies the subsidiary company the right to make a deduction equivalent to its under-declared income which was not subject to tax under the income inclusion rule. Alternatively, it can also adjust its statement to reflect the value of income which was not subject to tax under the income inclusion rule.

b) A treaty-based rule is known as the subject-to-tax rule. It ensures that treaty benefits related to party payments are granted in cases where an item of income has already been taxed at a minimum rate in the recipient jurisdiction.[1062]

The OECD has proposed a global minimum tax rate of 15% to protect the global tax base from erosion.[1063] This means that the minimum tax rate under the income

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[1060] GloBe Means Global Anti-Base Erosion.
[1061] OECD/G20 Base Erosion and Profit Shifting Project 'Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy' (July 2021) <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf> accessed 1 July 2021.
[1062] Marley *et al* 'OECD/G20 Inclusive Framework Reaches High-level Agreement on The Two-Pillar Approach to International Tax Reform' <https://www.osler.com/PDFs/Resource/en-ca/OECD-G20-inclusive-framework-reaches-high-level-ag.pdf> accessed 1 July 2021.
[1063] ibid.

inclusion and under-taxed payment rules will be 15%. The minimum rate for the subject-to-tax rule has been proposed to be between 7% and 9%.

The OECD/G20 Inclusive Framework proposes that Pillar Two be applied using the common approach. This means that another country will have the right to collect additional tax from the parent entity up to the minimum rate in cases where an MNE is not taxed at the agreed minimum rate.[1064] This, in effect, means that an MNE will still be subject to additional tax recoverable from its parent company if the corporate tax rate of the country where the MNE is located is lower than the prescribed minimum rate.

This proposal will create a level playing field for all states if a low-tax jurisdiction such as the Republic of Ireland opts to continue taxing all Irish based MNEs at its current rate of 12.5%. It is, however, not clear how or which country will have the jurisdictional right to collect the additional tax from the parent company to top up the tax revenue not paid by the MNE. Government entities, international organisations, non-profit organisations, pension funds, investment funds, or any holding vehicle used by these entities are excluded from the application of Pillar Two.

The outstanding challenge to the implementation of this proposal is how the GloBE rules will co-exist with the USA GILTI[1065] rules. A clarification on this matter will also resolve the dilemma that is likely to be faced by other countries with similar rules on the taxation of foreign companies.

5.6 Conclusion

Whereas the world economies recognise the need and the urgency to tax the digital space, it has been difficult to reach consensus on either the EU proposal or the OECD's two-pillar approach to global tax reforms. However, pressure from the EU

1064 OECD/G20 Base Erosion and Profit Shifting Project 'Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy' (July 2021) <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf> accessed 1 July 2021.

1065 GILTI meaning global intangible low-taxed income is the income earned by foreign affiliates of USA companies from intangible assets.

and developed countries such as the UK which apply the DST, has convinced the USA of the need to consider reaching a consensus-based multilateral agreement. This is an improvement on its previous stance of threatening countries with trade sanctions and the imposition of tariffs. Its role in joining the OECD/G20 Inclusive Framework and coming up with a consensus-based proposal on how to initiate and implement global tax reforms is laudable. The next step for OECD is to ensure that it develops a successful implementation framework that will facilitate a coordinated implementation of the Two Pillar solution that is intended to reform the international tax framework in response to the digitalised global economy. The OECD anticipates that it will have developed an implementation framework to facilitate a smooth, consistent, and co-ordinated implementation of the Two Pillar rules by the end of 2022. Some of the measures proposed to ensure a smooth transition into the new international tax law by the end of 2022 include:[1066]

a) commitment from all member states that they will remove all DSTs and similar laws;
b) commitment not to introduce DST laws in the future;
c) Commitment from all members states to amend their domestic law to implement the new taxation rights created under Amount A;
d) the Implementation Framework mandated the TFDE to develop model treaty rules for possible adoption by member countries to give effect to Amount A;
e) undertaking by the TFDE to develop commentaries explaining the purpose, intention, and operation of the rules to supplement the model rules; and
f) commitment from the Implementation Framework to secure consensus on how to define the in-country baseline marketing and distribution activities in Amount-B.

[1066] OECD 'Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy' (8 October 2021) <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf> accessed 8 April 2022. List of member states as at November 2021 is available at <https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-members-joining-statement-on-two-pillar-solution-to-address-tax-challenges-arising-from-digitalisation-october-2021.pdf> accessed 8 April 2022.

The agreement reached by 137 members of the OECD/G20 Inclusive Framework on BEPS in November 2021 regarding the Two Pillar solution resolved the political issues threatening to curtail the successful implementation of the two-tier digital tax proposal.[1067] The Implementation Framework is thus left with the work of coming up with the technical and administrative guidelines on how this law could be implemented. This work is ongoing. It is thus anticipated that the ECD/G20 Inclusive Framework timelines for having the Model Treaty, guidelines, regulations, and everything else that is required for the successful and seamless implementation of this two-tier tax proposal will be ready by 31 December 2022. This would in turn make it possible for the OECD/G20 Inclusive Framework to introduce the two-pillar taxation proposal seamlessly from 2023 onwards.[1068]

This chapter of the thesis has offered useful insights on how various countries tax their digital economies. It has also considered the proposals advanced by the OECD and the EU on how to tax the digital economy. It concluded by discussing the latest developments in the ongoing global efforts by the OECD/G20 Inclusive Framework at secure a consensus-based multilateral digital economy taxation agreement. The next chapter of the thesis borrows from these comparative experiences to recommend how South Africa could improve its income tax system to tax its digital economy effectively and efficiently. It also draws concluding remarks from the thesis.

[1067] OECD 'Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy' (9 October 2021) <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf> accessed 8 April 2022.

[1068] OECD 'Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy' (October 2021) <https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf> accessed 8 April 2022.

CHAPTER 6

CONCLUSION AND RECOMMENDATIONS

6.1 Introduction

This thesis has established that the global digital economy poses a major threat to South Africa's tax base. The OECD has estimated that the global economy suffers a revenue loss of between 100 and 240 billion dollars annually because world economies are unable to agree on a compromise on how to tax the digital economy.[1069] Available data shows that the global digital economy, which was valued at 11.5 trillion dollars or 15.5% of the global GDP in 2016, is currently growing 2.5 times faster than the global economy.[1070] This growth rate is likely to be exacerbated by the effects of Covid-19 which has forced the global community to resort to technological adaptations to overcome the challenges of lockdowns and social distancing. These technological adaptations have encouraged and normalised online trade, online banking, online teaching, and other online related services and are likely to accelerate the growth of the global digital economy.[1071] This apparent and predictable prospect of growth of the digital economy has led some news magazines such as *The Economist,* to claim that "the world's most valuable resource is no longer oil, but data".[1072]

Therefore, the global threat posed by the digital economy to the tax base of the world economy can no longer be ignored. The urgency of finding a compromise on how to tax this 21st-century phenomenon has never been greater. It follows that the

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[1069] OECD 'OECD/G20 Base Erosion and Profit Shifting Project: Addressing the Tax Challenges Arising from the Digitalisation of the Economy' (July 2021) <https://www.oecd.org/tax/beps/brochure-addressing-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf> accessed 10 September 2021.

[1070] Oxford Economic 'Digital Spill over: Measuring the True Impact of the Digital Economy' <file:///C:/Users/Admin/Downloads/open20170913102600.pdf> accessed 10 September 2021.

[1071] George Herbert and Lucas Loudon 'The Size and Growth Potential of the Digital Economy in ODA-eligible Countries' (December 2020) <https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/15963/915_size_and_growth_potential_of_the_digital_economy_in_ODA-eligible_countries.pdf?sequence=1&isAllowed=y> accessed 2 November 2021.

[1072] The Economist 'The World's Most Valuable Resource is No Longer Oil, But Data' (2017) *The Economist* 6 May <https://www.economist.com/leaders/2017/05/06/the-worldsmost-valuable-resource-is-no-longer-oil-but-data> accessed 10 September 2021.

recent compromise among OECD member states on how to tax the digital economy could not have come at a better time.[1073]

This global digital growth has also been replicated in South Africa where the internet economy was valued at 21.55 billion dollars or 6.5% of the GDP in 2020.[1074] This is forecast to grow to 31.45 billion dollars or 7.86% of the GDP by 2025 and 125.08 billion dollars or 12.92% of the GDP by 2050.[1075] This illustrates that the contribution of the internet economy to South Africa's GDP will double within the next 30 years, while the overall value of digital trade in the country will also grow by at least 500% or more than five times its current value within the next 30 years.[1076] This data is an indicator to SARS that it needs to find an effective way of taxing this 21st-century phenomenon if it is to protect its tax base from BEPS. Seeking ways of taxing the digital economy should therefore be a key priority for South Africa.

This chapter proposes recommendations on how South Africa can improve the effectiveness of its income tax regime to allow it to tax the transactions that arise from the digital economy more effectively.

6.3 Recommendations

These thirteen recommendations for the improvement of the South African income tax legal regime have borrowed heavily from the best practices in Kenya, India, New-Zealand, the EU and the OECD. They have also taken South Africa's unique diversity, history, heritage and economic circumstances into consideration.

6.3.1 Recommendation on the Adoption of the OECD's Two Pillar Solution

The current international tax convention rules based on the PE and PEM principles were enacted one hundred (100) years ago. This thesis has revealed that today's

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1073 It is only Kenya, Nigeria, Pakistan, and Sri Lanka who have not signed up to the global tax rules proposals that were led by the OECD and the G20 nations. Of 139 OECD members 135 nations have agreed to support this effort.

1074 George Herbert and Lucas Loudon 'The size and Growth Potential of the Digital Economy in ODA-eligible Countries' (December 2020) <https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/15963/915_size_and_growth_potential_of_the_digital_economy_in_ODA-eligible_countries.pdf?sequence=1&isAllowed=y> accessed 2 November 2021.

1075 ibid.

1076 ibid.

digital economy cannot be taxed effectively and efficiently under the existing tax system which was formulated without the foresight of what the world would look like today. The growth of the IoT and its general effect on trade and commerce has left the international community grappling with the pressing issue of how to tax the digital economy fairly.

For this reason, the international community, led by the EU, the G-20, and the OECD, has been at the forefront in in developing a consensual remedial action on how to deal with the two main questions raised by the current international tax rules. The first is that the profits of a foreign company are only taxable in a country where the foreign company has a physical presence.[1077] This requirement no longer reflects today's reality where foreign companies can conduct large-scale business in jurisdictions in which they have no physical presence. This was not possible one hundred (100) years ago as foreign companies generally opened branches, warehouses, or factories in every country from which they were operating.

Second, most countries including South Africa can only tax the domestic revenue of MNEs. Their foreign revenue is currently left to be taxed in the country where it is earned. The emergence of intangibles like patents, copyrights, and the general ability by MNEs to shift profits to low-tax jurisdictions means that the profits of such MNEs will often escape taxation. This is particularly true in that most MNEs have perfected the art of relying on the internet to shift their PE or PEM to a low-tax jurisdiction of their choice.

This thesis is of the view that the OECD-led two-tier digital taxation proposal has offered solutions that are likely to address the tax challenges faced by the current international taxation rules.[1078] It is also relevant that both ATAF and South Africa participated actively in the development of these two-tier proposals and their views

[1077] The exception only applies to a CFC to which CFC rules applies.

[1078] As discussed in Chapter 5 of this thesis, Pillar One aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest MNEs, which are the winners of globalisation. This will be done using an agreed allocation formula. Pillar Two puts a floor on tax competition on corporate income tax through the introduction of a global minimum corporate tax at a rate of 15% that countries can use to protect their tax bases.

were taken into consideration in developing the final taxation proposal that has been approved for implementation. South Africa has joined the rest of the international community by approving the introduction of this new framework for international tax reform aimed at ending tax avoidance practices by MNEs. Of the 141 members of the OECD/G20 Inclusive Framework on BEPS 137 have agreed to the introduction of this new tax system.[1079] Even low-tax-haven jurisdictions such as Ireland, Estonia, and Hungary have now abandoned their objections and joined the rest of the world in supporting this ground-breaking proposal.

It is therefore clear that refusal to join the OECD/G-20-led Inclusive Framework which is working on new global tax rules would have put South Africa at a competitive disadvantage with its main trading partners who have already joined. Moreover, sticking to international tax rules like PE and PEM that have been abandoned by the rest of the world would be difficult to enforce against an international community that has started with the implementation of new tax principles. South Africa’s trading partners would have found it difficult to cooperate with the country or implement the existing bilateral treaties with South Africa if it persisted in implementing a tax system that the rest of the world has abandoned. This would eventually have exposed South Africa's tax base to BEPS regarding most international digital transactions for which it would have needed the cooperation of its trading partners to enforce its tax rights under the PE and PEM principles.[1080]

This thesis agrees that South Africa’s decision to join the rest of the international community in adopting the two-tier global digital tax rules is a step in the right direction. The decision is also in tandem with the Davis Tax Committee recommendations which proposed that South Africa should adopt tax solutions

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1079 The information is available and accessed at <https://www.oecd.org/tax/beps/> accessed 10 December 2021.

1080 African Tax Administration Forum ‘The Inclusive Framework’s Two-Pillar Solution to Address the Tax Challenges Arising from The Digitalisation Of the Economy’ Technical Note 08 of 2021 <ATAF_Technical_Note_ENG_v3 (1).pdf> accessed 4 November 2021.

proposed by the international community and the OECD.[1081] It must, however, be pointed out that this two-tier global tax proposal faces the challenges.

The amount of residual profit of in scope multinationals[1082] to market jurisdictions has been set at 25%. It would have been fair to have at least 50% of the residual profits allocated to the market jurisdiction under Amount A. This would be fair on the market jurisdiction as it would ensure that at least half of the profits of large digital MNEs like Google and Facebook are taxed in a market jurisdiction like South Africa where the users of their services are located. The ripple effect is that South Africa would be able to collect more tax revenue lawfully to help it build its economy and provide better services to its citizens. The basis of the decision that a market jurisdiction where the products are sold is entitled to only 25% of the tax revenue of the MNE, comes close to frustrating why many countries pushed for a reform of the global tax system. One of the main reasons for the agitation over global digital tax rules was to assist middle-level economies like South Africa to collect additional revenue from trade activities carried out by MNEs within their jurisdiction.

The current proposal is an improvement on the previous position where the tax jurisdictional country was entitled to the entire revenue without any obligation to share it with the market jurisdiction country. But more needs to be done to allocate equal tax rights between the source and market jurisdictions.

The proposed global minimum tax rate of 15% under the Pillar Two proposals is too low. A minimum tax of between 25% and 30% – which is close to the statutory corporate tax rates charged by most countries including South Africa – would be fair. Setting the tax rate at a law 15% will not deter most MNEs from transfer pricing and shifting profits from South Africa to low-tax jurisdictions. As things currently

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[1081] Davis Tax Committee 'Second Interim Report on Base Erosion and Profit Shifting in South Africa' (2016) <https://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20-%20Introductory%20Report.pdf> accessed 23 December 2021.

[1082] In-scope companies are the MNEs with global turnover above 20 billion euros and profitability above 10%. See OECD 'The Impact of the Pillar One and Pillar Two Proposals on MNE's Investment Costs <file:///C:/Users/user/Downloads/b0876dcf-en%20(1).pdf> accessed 10 September 2022.

stand, the low value of the global minimum tax will continue to give tax havens like Ireland a competitive tax advantage over South Africa. This is due to the fact that MNEs would inevitably prefer to create their residency in Ireland where both the global minimum tax and corporate tax are charged at 15%. Setting up its residency in South Africa would therefore, require it to pay corporate tax at the rate of 25% while surrendering the global minimum tax rate to the jurisdictional market at the rate of 15% subject to any set-offs that may be allowed by the Act. This means that most MNEs would naturally prefer to set up residency in countries like Ireland where the low corporate tax liability would make it possible for them to maximise their profits.

It is submitted that one of the reasons for reforming the current international tax system was to come up with a tax system that would discourage MNEs from using the IoT to shop for convenient residencies and profit shifting. The current proposal has improved on the previous position by providing for a direct way of taxing digital transactions to replace the unilateral DST adopted individually by different countries to protect their tax bases. Future amendments to this proposal could consider raising the global minimum tax rate to at least 25% to forestall MNEs from profit shifting and transfer pricing tendencies which could expose South Africa's tax base to erosion.

The subject-to-tax rule is the primary means intended to assist the OECD in addressing the current imbalance in the allocation of taxation rights between market and source jurisdictions. This imbalance could be resolved were the subject-to-tax rule to be broadly defined to include royalties, interest, and service payments. The current proposal provides that service-to-tax rule will cover royalties, interest, and a defined set of payments. It does not, however, define what was meant by or included under the service payment bracket. This could be a potential source of conflict between SARS and taxpayers because each party would prefer to include what is convenient to it under the broad term of service payments. For example, SARS could interpret this to mean that items such as management fees and fees for technical services are taxable within the broad term known as service payments.

The taxpayer could hold the opposite view that these items have not been specifically provided for and as such are not taxable.

The use of an open and ambiguous term like ‘service payments’ which can attract various meanings leaves room for speculation and conflict on what it does or does not include. The end result is that SARS could find it difficult to tax all transactions based on service payments with the result that service payments which have often been classified as high BEPS risk, would go untaxed This would result in inequity whereby some taxpayers are taxed on service payments while others who have successfully challenged SARS’ interpretation of what constitutes service payments could be untaxed on similar transactions. Amending this provision in the Act to specifically enumerate or define what sort or type of payments ought to be included under service payments could, therefore, resolve this problem.

While this thesis has recommended the adoption and intended application of the two-tier global tax rules by South Africa by 2023 as a step in the right direction,[1083] it also hastens to add that South Africa should work with ATAF to engage the OECD and the international community in general to address these challenges that occur frequently in this new tax proposals. This would be the only way to improve this new global tax proposal to make it effective, efficient, and more beneficial for South Africa and other developing nations within the African continent and beyond. South Africa cannot, however, afford to opt out of this OECD/G-20-led global tax reform which has the potential of increasing its tax base.[1084]

6.3.2 Recommendation on the Place of OECD in Development and Promulgation of International Tax Conventions

The evolution of the digital environment has over time made it difficult for the PE and PEM principles to operate effectively in controlling profit shifting tendencies that

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[1083] OECD ‘Addressing the Tax challenges Arising from Digitalisation of the Economy’ (2021) <https://www.oecd.org/tax/beps/brochure-addressing-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf> accessed 7 October 2021.

[1084] Research ICT Africa ‘Multi-faceted Challenges of Digital Taxation in Africa’ (November 2020) Policy Brief 7 South Africa <https://media.africaportal.org/documents/Final-Tax-PB_30112020.pdf> accessed 28 January 2022.

are common among today's digital MNEs. This has resulted in an annual tax loss of some 378 billion dollars.[1085] This is an indicator that it is time for the international community to reconsider the relevance, efficiency, and effectiveness of the current international taxation principles of PE and PEM. The introduction of the two-tier digital taxation proposal led by the OECD and the USA is intended to provide a solution to protect the tax base of low- and middle-level income countries like South Africa from this challenge.

The first challenge inherent in this proposal is the dilemma as to whether the outcome of the two-tier digital tax proposal could be effective for and binding on that the OECD has only 38 members while there are 195 countries in the world. This means that 157 countries could be excluded from the tax negotiation process at any time unless such a proposal is brought under a wider framework arrangement where non-members could be part of the convention-making process. However, in the amendment approval process, a tax convention could also produce a rule approved by a minority if the OECD agrees to amendments to its existing internal rules without involving non-member states. The OECD Model Tax Convention provides that the decisions of the organisation, which include amendments to all its Conventions, are made by its members and approved by its Council.[1086]

In other words, whereas the OECD retains a monopoly in developing international tax conventions, the reality is that the collaborative work of the international community like the two-tier proposed digital taxation tax rules could be amended by member countries who could be in the minority.[1087] The irony is that, whereas a convention like the proposed two tier global digital tax proposal has been approved by at least 137 countries, it could be repealed by the 38 countries that make up the OECD membership. This could threaten the efforts and enthusiasm of the international community to continue abiding by such rules or conventions. It also

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1085 Tax Justice Network Report 'The State of Tax Justice 2021' (November 2021) <https://pop-umbrella.s3.amazonaws.com/uploads/cc309a62-1eb0-49ab-864e-fd53a21e47b5_State_of_Tax_Justice_Report_2021_ENGLISH_EMBARGOED.pdf> accessed 10 November 2021.
1086 Articles 5, 6 and 15 of the OECD Model Convention. See <https://www.oecd.org/> accessed 18 May 2022.
1087 The OECD membership totals 38 of the 195 countries in the world today.

has the distinct possibility of having other international tax conventions made for 195 countries by only 38 countries, most of which are in Europe and the Americas. This is hardly desirable for South Africa and most African states who are not OECD members.

Second, the OECD also lacks an enforcement and sanction mechanism to compel its member states to comply with international tax norms it promulgates.[1088] More specifically, the 157 non-member countries, including South Africa, cannot be compelled to comply with any tax convention that is promulgated by the OECD. The Convention governing the organisation for OECD is also silent on how the resolutions of the member states will be enforced.

The dilemma here is whether it is relevant and useful to have an international tax convention that lacks a binding and enforceable mechanism. It is proposed that the negotiation of international tax conventions should be undertaken under the auspices of the United Nations.[1089] These tax conventions could be negotiated and adopted in an open and transparent manner that follows the regular procedures used for negotiation other UN conventions. This proposal holds many advantages because more countries, including South Africa,[1090] who are UN members will be party to the convention-making process. The tax conventions would, therefore, reflect international sentiment, acceptability, and wider application in that the entire global community – a save for the Vatican City and Palestine – would have participated in their adoption.[1091]

Furthermore, the Security Council of the UN could help in the enforcement of appropriate sanctions against countries that contravene the tax convention. The UN

1088 The OECD can provide binding norms to its member states under Article 5(a) of the OECD Convention. However, in practice the OECD produces only soft law on tax matters and cannot impose sanctions on errant OECD members. See OECD 'Towards an OECD-Africa Partnership' (June 2022) <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.oecd.org/mcm/2022-OECD-Africa-Partnership-EN.pdf> accessed 10 September 2022.

1089 South Africa is a member of the United Nations and would thus be bound by any UN convention upon its ratification of the proposed tax convention.

1090 South Africa is not a member of the OECD, but it interacts and is an associate member in six OECD bodies and projects, and a participant in fifteen others. This does not give it membership rights such as the right to participate and vote in the repeal or amendment OECD Conventions.

1091 These two countries are the only nations not members of the UN.

law-making process is an open and participatory process. It allows all member states to participate in the negotiations before the convention is presented for ratification. This inclusivity and equality of members through the one-country-one vote system, as well as the participatory nature of the convention-making process would give the convention a measure of international legitimacy. The OECD could serve as the technical committee in the negotiation of tax conventions. The final text of the proposed tax conventions would thereafter be presented to the UN for approval and ratification as per the existing UN treaty ratification process.

Digital trade has a format that knows no boundaries. A global tax convention can only be effective if it is binding and applicable on all nations of the world. Tax conventions require cooperation and reciprocity which can only be realised if the tax laws are ratified under an international law system that is binding on member states. Placing the international tax convention-making process under the UN would therefore be the best way of bringing the international community to develop conventions that are applicable and enforceable across the entire globe. It is proposed that shifting tax convention-making authority from the OECD to the UN could be the first step in obtaining an effective international tax convention that can help reduce cases of BEPS.

Moreover, the fear of UN-based sanctions could be sufficient to persuade some MNEs to limit their profit-shifting practices. The application and implementation of the two pillar-tax proposals anticipate that both the source and the market jurisdiction would cooperate to share tax revenue from a digital transaction. It is submitted that the cooperation between the source ad market jurisdiction countries can be best realised if the two-tier tax proposal is enforced as a UN Convention. Failure to implement this proposal could result in situations where, for example, an OECD member state trades with a non-OECD member who is not obliged to cooperate with the OECD member state in sharing revenue.

The OECD member state would therefore lack a model or method of compelling the MNE resident in the non-member state to surrender the revenue earned from trade or services offered within the jurisdiction of the OECD non-member state. This would result in loss of revenue for the OECD member state. The situation would have been different if the tax convention was embedded in a UN tax treaty because they have a persuasive effect even on countries that have not ratified them. This is more so if such a convention eventually morphs into a general practice that is accepted as part of customary international law which can exist independently of treaty law. Indeed, the UN Security Council has on many occasions-imposed sanctions on countries like Iraq and Pakistan for breaching UN conventions like non-refoulment which have over time morphed from international conventions to customary international law.

Using the UN General Assembly to approve tax treaties would thus be generally beneficial to the international community because they would be binding on the states that have ratified it. The UN, therefore, offers the best forum for negotiations, discussion, signature and ratification of tax conventions. It is therefore, recommended that South Africa join hands with ATAF and like-minded members of the international community to push for the inclusion of the OECD as a technical tax committee of the UN. The power to conclude international tax conventions should, however, be placed within the remit of the UN.

Considering that the UN is not mandated to intervene in matters which are within the domestic jurisdiction of its member states,[1092] the success of this proposal would require the ratification of such a treaty by all the countries that have confirmed their support for these global tax reforms.

6.3.3 Recommendation on Amendment of the Income Tax Act and Bilateral Tax Treaties

The adoption of the OECD's Two Pillar approach to the taxation of international and digital transactions would require the amendment to the Act and OECD's Model Tax Convention. It will also require South Africa to revisit, renegotiate, sign and ratify new treaties that reflect the new global model of taxing international trade

[1092] Article 2(7) of the Charter of the United Nations, 1945.

transactions to replace the current treaties that are largely based on PE and PEM principles.[1093]

The ratification of the final Multilateral Convention (MC) is expected to make the two-tier digital tax proposal operational by 2023.[1094] The approval of the MC by the South African parliament would thereafter make it applicable and operational as part of the country's domestic tax laws.[1095] It is thus recommended that South Africa's bilateral tax treaties should be re-negotiated and aligned with this new tax system.

The principle of PE has also been domesticated in some provisions of the Act. For example, section 9 of the Act provides that the source of revenue will be attributed to having been sourced in South Africa if the revenue in question or the asset that gives rise to the revenue is attributable to a South African PE of the non-resident.[1096]

Secondly, the PE concept has been directly included in section 1 of the Act where it has been defined with reference to Article 5 of the OECD Model Tax Convention. This alone shows that the concept is applied through the Act to create source income for non-residents or MNEs in cases where their income can be attributed to a PE within South Africa. This means that any changes made by the OECD on the place of the PE concept in the international tax law arena will affect the Act directly.

Thirdly, the definition of the local currency is significant in determining gains or losses in foreign exchange transactions. For purposes of such transactions involving a foreign currency, a local currency has been defined as including any exchange item which is attributable to a PE of a person outside South Africa and the currency used by that PE for financial reporting.[1097] This means that a PE will play a vital part when SARS decides whether a specific transaction involving a non-

[1093] South Africa's has tax treaties with Gabon, Malaysia, and Lesotho which have not expanded the definition of PE to reflect the current two-tier OECD proposals.
[1094] African Tax Administration Forum 'The Inclusive Framework's Two-Pillar Solution to Address the Tax Challenges Arising from The Digitalisation of the Economy' Technical Note 08 of 2021 <ATAF_Technical_Note_ENG_v3 (1).pdf> accessed 4 November 2021.
[1095] Section 231(2) read with section 108 of the Constitution of the Republic of South Africa, 1996.
[1096] Section 9(2)(*b*) of the Act.
[1097] Sections 24I(1) read with s 9D(2A)(*h*) of the Act.

resident amounts to the use of a local currency for tax purposes. This would have significant revenue consequences both for the taxpayer and for SARS in a situation where a determination has to be made as to whether the transaction in question was concluded using the local or foreign currency.

Fourthly, PE also plays a significant role in determining taxable income in respect of international transactions. For tax purposes, the Act has defined international agreements to mean agreements between non-residents for the supply of goods or services to or by a PE located in the Republic;[1098] or an agreement between residents for the supply of goods or services to or by a PE located outside the Republic.[1099] The definition of PE, therefore, plays a pivotal role in determining whether taxable income would accrue to SARS in respect of international transactions.

Finally, the discussion of CFC rules in chapter 2 of this thesis showed that the current CFC rules in South Africa emphasise physical structures like shops, warehouses, factories, or other structures used by a CFC to conduct business.[1100] Indeed, the definition of business establishment in relation to CFCs is limited to physical and tangible assets such as land, vessels, buildings, a mine, and an office or a factory.[1101] This implies that CFC rules which are supposed to attribute the income of a low-taxed foreign subsidiary to its parent company did not anticipate that a controlled foreign subsidiary could employ the IoT by limiting its use of physical or tangible assets to shield it from taxation by the parent company's country of jurisdiction. Under the current law, subsidiaries controlled from South Africa would only be subject to CFC rules and taxation if they are an artificial or physical entity. Failure to amend section 9D of the Act to reflect today's reality where business establishments in the form of intangible assets like websites or servers would mean that transactions carried out by such intangible assets would fall outside the taxation ambit of section 9D of the Act.

[1098] Section 31(1)(*b*) of the Act.
[1099] Section 31(1)(*c*) of the Act
[1100] Section 9D (1) of the Act.
[1101] Section 9D(*a*)-(*e*) of the Act.

The principle of PEM has also been domesticated in South Africa's tax laws. For example, a resident is, for tax purposes, defined in section 1 of the Act by referring to the place where it has its PEM. SARS developed IN 6 to guide how the concept of PEM would be applied in determining the tax residency of a company in South Africa. The concept of PEM also plays a significant role in determining taxable income where the costs of inventions of intangibles by a person who has its PEM in countries neighbouring on South Africa are allowed as deductions.[1102]

This thesis recommends that the relevant definitions in section 1 of the Act,[1103] together with sections 9(2)(*b*), 9D(2A)(*h*), 11(gA)(*dd*), 24I(1), 31(1)(*b*) and 31(1)(*c*) of the Act which address taxation based on the PE and PEM principles require urgent amendment. The purpose of the amendment would be to replace the PE and PEM principles within the Act with the new *nexus* rule which reallocates profits of MNEs to market jurisdictions, and the introduction of the minimum global corporate tax rate as is envisaged in the two-tier digital tax proposal for which South Africa has signed up.

It is further recommended that a new section – section 9D(1)(f) – be introduced in the Act. This new section should define the meaning of business establishment to include non-tangible assets like servers, websites, or ISPs. This would ensure that all transactions conducted by controlled subsidiaries of parent companies using the IoT are taxed in South Africa.

6.3.4 Recommendation on the Need to Introduce a Temporary DST in South Africa

Countries like India and Kenya which have introduced a DST system affirm that it has helped them collect a new revenue stream from within their economy. This tax system generated an income of 3.4 billion INR in its first year of operation in India

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1102 Section 11(gA)(*dd*) of the Act.
1103 In particular the definition of PE and the residency which encapsulates the principle of PEM.

in the 2016/2017 financial year.[1104] In Kenya, the KRA further targeted to collected about 30 million dollars with a targeted revenue projection of 50 million dollars by the end of the 2021/2022 financial year.[1105] The EU also agreed, under the Rome Declaration of 27 March 2017, to permit its member states to implement the DST system at a maximum rate of 3% to deal with the challenges posed by the internet-based economy.[1106] This resolution has resulted in the introduction of DST in some of the EU countries like France, Germany, Spain, Italy, Norway, Switzerland, Poland, and Bulgaria. The United Kingdom, Hungary, and the Czech Republic have also introduced DST. The decision to adopt a temporary tax measure was informed by European Commission data which estimated that about 5 billion Euros in tax revenue could be collected by introducing DST at a minimum rate of 3%.[1107] The UK Treasury estimated that the DST would help it raise £400m in tax revenue in the 2022-2023 financial year and £440m in the 2023- 2024 financial year.[1108] France expected to raise some 400 million euros from DST in 2019. This would grow significantly in the following years.[1109] These estimations are an indicator that DST has the potential of helping countries expand their revenue bases.

The growing popularity of the DST system is a pointer that pending global consensus on final global digital taxation rules, DST remains the best alternative model which offers a rudimentary and imprecise means of taxing transactions

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1104 PricewaterhouseCoopers 'Economic and Policy Aspects of Digital Services Turnover Tax: A Literature Review' (December 2018) 5 <https://www.pwc.com/gx/en/tax/tax-policy-administration/assets/pwc-dtsg-literature-review-final.pdf> accessed 1 March 2021.

1105 Kenya Revenue Authority '8th Corporate Tax Plan 2021/2022-2023/2024' <file:///C:/Users/Admin/Desktop/KRA-8TH-CORPORATE-PLAN-.pdf> accessed 2 January 2022.

1106 EU Council Press Release 'The Rome Declaration – Declaration of the Leaders of 27 Member States and the European Council, the European Parliament and the European Commission' (25 March 2017) <http://www.consilium.europa.eu/en/press/press-releases/2017/03/25/rome-declaration/> accessed 9 March 2021.

1107 European Commission 'Fair taxation of the Digital Economy' <https://ec.europa.eu/taxation_customs/fair-taxation-digital-economy_en> accessed 7 October 2021.

1108 Congressional Research Service 'Digital Services Taxes (DSTs): Policy and Economic Analysis' <https://sgp.fas.org/crs/misc/R45532.pdf> accessed 9 November 2021.

1109 Deloitte 'The French Digital Service Tax an Economic Impact Assessment' (22 March 2019) <https://taj-strategie.fr/content/uploads/2020/03/dst-impact-assessment-march-2019.pdf> accessed 9 November 2021.

supported by the IoT.[1110] The universal rationale for its adoption by many countries is that it can help generate sufficient revenue to support depleted public revenue, reduced revenue collection, and rising public debt and increasing public expenditure.[1111]

For its part, South Africa has adopted a risk-averse position by not introducing any form of DST. It argues that DST contradicts the principle of PE and the existing double tax agreements which allow the source jurisdiction to impose tax on a resident who conducts business through a PE in the source country.[1112] The Constitution also prohibits it from overriding its treaty obligations with new principles that it has not ratified.[1113] The National Treasury also feared that introducing a DST system could attract negative retaliatory action from some of its trading partners like the USA who oppose this tax system.[1114]

South Africa's intention to introduce DST was halted by the Davis Tax Committee Report which recommended that it await the conclusion of the OECD-led digital tax negotiations.[1115] During this period, South Africa has possibly lost tax revenue that it could have obtained from its highly-digitalised economy as it awaits the international community reaching consensus on digital taxation. This thesis recommends that South Africa should consider introducing an interim DST system should the OECD-led global digital tax forum fail to reach consensus on how to tax the digital economy by the end of 2023. This should be seen in the context of the current predictions which estimate that South Africa's e-commerce value stands at

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[1110] Mpofu FY and Molo T 'Direct Digital Services Taxes in Africa and the Canons of Taxation' (2022) 11(57) *Laws* 7 <file:///C:/Users/user/Downloads/laws-11-00057%20(1).pdf> accessed 12 September 2022.
[1111] ibid.
[1112] Parliamentary Monitoring Group 'Digital Economy and Taxation Policy: National Treasury, PBO & SARS input' (9 June 2020) <https://pmg.org.za/committee-meeting/30416/> accessed 20 December 2021.
[1113] Sections 231, 232 and 233 of the Constitution of the Republic of South Africa, 1996.
[1114] Parliamentary Monitoring Group 'Digital Economy and Taxation Policy: National Treasury, PBO & SARS input' (9 June 2020) <https://pmg.org.za/committee-meeting/30416/> accessed 20 December 2021.
[1115] Davis Tax Committee 'Second Interim Report on Base Erosion and Profit Shifting in South Africa' (2016) <www.taxcom.org.za> accessed 8 April 2022.

10.5 billion dollars.[1116] Taxation of this huge economic sector would definitely help the government of South Africa to protect and expand its tax base in the short term while the OECD-led global digital tax rules are tested and adapted.

It is further recommended that South Africa could adopt the Kenyan DST model as both countries are in Africa and could, therefore, be facing similar tax challenges. Kenya's DST is also simple, easy to administer, and was adapted to achieve tax "equity, fairness and neutrality" between digital and non-digital businesses.[1117] Moreover, the DST template issued by ATAF in October 2020 as a response to growing interest within Africa to enact unilateral DSTs is largely similar to Kenya's DST.[1118] ATAF also affirmed that DST has several benefits including simplicity, rectifying under-taxation of MNEs, and increasing voluntary compliance by ensuring the public perceives the tax system as fair.[1119] ATAF's assertion that many African countries are losing millions of dollars in tax by relying on the current international rules on profit allocation and *nexus* which do not address the emergence of digital transactions should be a wake-up call for South Africa urgently to consider this recommendation which offers the possibility of taxing this new revenue stream.[1120]

Alternatively, the government could affect an amendment to extend the scope-of-source rules in section 9 of the Act to cover revenue generated from the supply of digital services originating from a source in South Africa if it is not keen to introduce a direct DST system. Such an amendment would make it mandatory for all internet users including consumers, viewers, service providers, and any entity with a digital presence in the country to be liable to taxation by SARS. This amendment would

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1116 Accenture Strategy 'Unlocking Digital Value for Business and Society in South Africa (2018) <file:///C:/Users/user/Downloads/Accenture-Unlocking-Digital-Value-Business-Society-South-America.pdf> 3 accessed 12 September 2022. See also Herbert G and Loudon L 'The Size and Growth Potential of the Digital Economy in ODA-eligible Countries' (December 2020) <file:///C:/Users/user/Downloads/915_size_and_growth_potential_of_the_digital_economy_in_ODA-eligible_countries.pdf> 16 accessed 12 September 2022.
1117 Connor (2022) 63(5) *Boston College Law Review* 1828-1829.
1118 See Press Release, Afr Tax Admin F 'ATAF Publishes an Approach to Taxing the Digital Economy' (1 October 2020) <https://www.atafax.org/ataf-publishes-an-approach-to-taxing-the-digital-economy> accessed 10 September 2022.
1119 Connor (2022) 63(5) *Boston College Law Review* 1829.
1120 See Press Release, Afr Tax Admin F 'ATAF Publishes an Approach to Taxing the Digital Economy' (1 October 2020) <https://www.atafax.org/ataf-publishes-an-approach-to-taxing-the-digital-economy> accessed 10 September 2022.

also be in sync with the general recommendations in the two-tier digital tax proposal which support the reallocation of a portion of an MNEs profit to market jurisdictions, regardless of its physical presence.

This recommendation for adoption of the DST system does not suggest that DSTs are the best solution or better than the OECD Agreement as a means by which to resolve the challenges of taxing digital MNEs. It is irrefutable that the global solution which Pillars 1 and 2 embody remains preferable as it reduces tax uncertainty, harmonises national tax mechanisms, and improves the global model for taxing international transactions.

This recommendation has been proposed as a temporary measure of helping South Africa to protect and expand its tax base. It should be adopted as a last resorted, and only in the event that the OECD-led global digital tax forum discussions do not yield results or consensus by the end of the projected implementation date of December 2023.

6.3.5 Recommendation on the Utilisation of the Withholding Tax System

The OECD has proposed that withholding tax be levied on payments made for goods and services supplied or purchased online by a non-resident provider.[1121] This tax system could be an efficient, effective, and simple way of levying tax on all online transactions. The reason is that the absence of physical jurisdictional presence for most digital companies in market jurisdictions means that using a direct tax to collect tax from such entities would virtually be impossible. Application of a withholding tax is the only practical way of collecting tax from a company that has no physical presence in the country. This is more so in cases where the prevailing law does not provide for effective taxation of intangible assets, or where MNEs can manipulate the IoT to move their tax jurisdiction to a tax haven.

It is further, recommended that a withholding tax system on MNEs be introduced pending the adoption of the two-tier global tax rules. The withholding tax system

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[1121] OECD 'Addressing the Tax Challenges of the Digital Economy' OECD/G20 Base Erosion and Profit Shifting Project' <http://dx.doi.org/10.1787/9789264218789-en> accessed 4 November 2021.

could be abandoned if or when the global tax rules are adopted by South Africa in 2023 and beyond. This is because withholding tax can only be applied as an alternative to the minimum digital tax. Applying both the minimum tax and withholding tax simultaneously could result in double taxation of the same digital revenue.

It is proposed that the country require all MNEs to register with SARS. Thereafter it could adopt and implement a low withholding tax rate of 3% so that taxpayers are discouraged from transfer-pricing practices and the MNEs are also not overburdened by local taxation requirements. In any event, SARS is already in possession of the relevant details such as identity, residency, nationality, and income earned from their online transactions. It is therefore likely to earn more in tax revenue from their business transactions.

The registration of users is necessary as it will make it possible for SARS to identify the MNEs that ought to pay DST easily without incurring extra expenses and infrastructural outlay in identifying the MNEs that ought to pay this tax. It is recommended that MNEs should not incur costs when they are registering with SARS or any other tax authority with regard to this proposed withholding tax system.

MNEs would also be at liberty to use agents who could represent them in specific jurisdictions from which they operate. It will thereafter be the responsibility of these agents to ensure that the withholding tax due from the MNE is paid. SARS would also be at liberty to recover any tax due by an MNE from its authorised country agent.

Non-registered service providers should however pay a higher withholding tax rate of 10% to discourage other entities from attempting to limit their tax liability by failing to register as non-resident service providers in South Africa. Local and foreign suppliers must be taxed at the same rate. This tax system is not intended to disrupt or replace the current income tax system in South Africa. All payments unrelated to digital transactions should therefore be exempted from withholding tax. This recommendation would be an improvement on the current position where withholding tax is only applied to transactions involving the sale of immovable property.[1122] This amendment would also bring digital transactions within the taxation ambit of section 35A of the Act which deals with amounts to be held when a non-resident sells immovable property in South Africa.

6.3.6 Recommendation for the Taxation of Crypto-Assets

Chapter 4 of this thesis showed how the anonymity, valuation difficulties, and lack of legitimacy as regards crypto assets have posed serious difficulties in their taxation. South Africa attempted to protect its tax base from crypto assets when it issued a crypto tax guide.[1123] Under these guidelines, income received or accrued from crypto-asset transactions can be taxed on revenue account under 'gross income'. The definition of the terms 'gross income' and 'amount' in section 1 of the Act supports the provisions in the guidelines which have prescribed that crypto assets can be taxed on revenue account.[1124] The value of the crypto assets will be determined using their spot rate value on the date when the amount was received or accrued, or expenditure or loss was incurred. The value determined is converted into Rands for purposes of taxation. South Africa's parliament also replaced the term 'cryptocurrency' with 'crypto asset' in 2021 to ensure the adoption of a uniform definition of crypto assets within the country's regulatory framework.[1125]

It is recommended that SARS continue taxing crypto assets within the current provisions of the Act. Creating legislation to tax crypto assets on their own or treating them as fiat currencies or securities for tax purposes is not appropriate at this point as their taxation has been appropriately and adequately provided for as subject to normal tax under the Act. Moreover, introducing a new legislation to tax each type of existing digital transaction would result in several pieces of income tax legislations which would be difficult to monitor and implement. SARS should, however, update

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1122 Section 35A of the Act.
1123 South African Revenue Services 'SARS Stance on the Tax Treatment of Cryptocurrency' <http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018> accessed 2 June 2020. See also SARS 'Crypto-Assets and Tax' <https://www.sars.gov.za/individuals/crypto-assets-tax/> accessed 2 June 2020.
1124 Section 5(1) as read with s 20A (2) of the Act.
1125 National Treasury 'Explanatory Memorandum on The Taxation Laws Amendment Bill, 2020' (20 January 2021) <sars.gov.za> accessed 2 December 2021.

the crypto assets guide regularly to ensure that its guidelines are in touch with the evolving character and nature of crypto assets.

Certain countries, El Salvador and Venezuela for example, have formally recognised crypto assets as legal tender.[1126] Approximately 27% of Americans also support the legalisation of bitcoin as a form of currency in the USA.[1127] This suggests that it is only a matter of time before many of the world economies consider the recognition of crypto assets as legal tender. The government of South Africa should, therefore, keep an eye on this development and consider appropriate legislative reform action should the situation call for it. The manner, content, and tenor of such reform proposals can only be recommended in the future if the predicted events occur.

6.3.7 Recommendation for the Taxation of Transactions Paid Using Central Bank Digital Currency

CBDC is legal tender in a digital format. It has been recognised as such by the Central Banks of India, China, and Sweden which have adopted it. Countries like South Africa and Kenya have shown an inclination to adopt it and also proposed that it be regulated by their respective Central Banks as a fiat currency. Apart from its digital form, the CBDC is similar in every respect to its physical counterpart. Its growing popularity can be attributed to the changing nature of today's commercial ecosystem where the use of cash has declined in favour of digital payment.

The world is changing fast. Most government are moving away from metallic and paper money to digital currencies. This portends a revolution that has the potential to prove far more significant than the invention of Automated Teller Machines or

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[1126] Gorjon S 'The Role of Crypto assets As Legal Tender: The Example Of El Salvador' (April 2021) Analytical Articles Economic Bulletin <https://repositorio.bde.es/bitstream/123456789/19051/1/be2104-art35e.pdf> accessed 4 November 2021. See also Fulbright NR 'Venezuela Issues General Legal Framework on Crypto Assets and the "Petro" cryptocurrency' <file:///C:/Users/Admin/Desktop/LA%20-20Venezuela%20issues%20general%20legal%20framework %20on%20cryptoassets%20and%20the%20petro%20cryptocurrency.pdf> accessed 4 of November 2021.

[1127] Information available at <https://today.yougov.com/topics/politics/survey-results/daily/2021/09/09/92f58/3> accessed 3 December 2021.

payment cards.[1128] South Africa should not lag behind in this technological revolution which is upending the financial world, the global banking system, and the models of payment preferred by taxpayers in settling claims. The advent of 5G and digitalisation of all aspects of life from smart cars to smart homes, to smart cities means that almost everything will in future be digitised. CBDC has the potential of helping the world to keep up with this transformative digital revolution that is likely to result in the death of physical cash. South Africa needs to keep pace with this digital transformation otherwise it will find it difficult to keep pace with the rest of the world or to conduct business with its international trading partners. A reduction in international trading activity is likely to erode the tax base of the country considering that the value of imports into South Africa stood at 963.9 billion Rands in 2019.[1129]

It is consequently proposed that South Africa consider adopting the use of CBDC as part of its fiat currency. Its use would provide a safe and stable model by which to settle claims in today's digital world. The government and taxpayers would also collect maximum tax from such transactions in that it avoids the expenses and losses in currency conversion and related transactional costs. It will also exclude the expense or precious time taken up in attempting to determine the arm's length or market value of a CBDC-based transaction for tax purposes. The receipt and taxation of payments made by digital MNEs which transact using digital currencies would also be for easier and more efficient. Successful implementation of the CDBC will help SARS to tax cross-border transactions that involve digital MNEs efficiently and effectively.

It is therefore proposed that the government should treat all transaction paid using CBDC in the same manner as a transaction paid using a fiat currency. This means that the normal tax consequences that would apply to a transaction paid using a fiat currency would also apply to all transactions settled using CBDC. Successful implementation of CBDC would, therefore, not require an amendment to the Act.

[1128] Wladawsky-Berger 'The Emergence of Central Bank Digital Currencies' (5 June 2021) <https://blog.irvingwb.com/blog/2021/06/central-bank-digital-currencies.html> accessed 10 February 2022.

[1129] See <https://www.statista.com/statistics/1121253/import-value-of-goods-and-services-in-south-africa/> accessed 10 February 2022.

6.3.8 Recommendation for the Disclosure of Financial Records

The financial statements or records of most MNEs are likely to disclose the location or country from which their revenue was earned. This could in turn be used by the countries with jurisdiction to demand their fair share of tax. It is recommended that section 70 of the Act be amended by inserting a section 70C compelling MNEs which could be deemed to have a digital presence in the country under the OECD-led Pillar One proposals, to disclose their financial records to SARS annually.[1130] It is instructive to note that the Tax Administration Act and the Act only provide for the taxation of persons who are physically present in the country. This excludes MNEs which may have a virtual presence in the country or those that offer goods and services in the country without ever setting foot in South Africa.

It is further proposed that only those companies whose annual group income exceeds 500 million Rand should be required to comply with these reporting requirements. This would resolve SARS the administrative nightmare of having to sort and keep records of companies with modest income and which are not likely to be engaged in transfer pricing or related tax-avoidance practices.

SARS would also be obliged to issue Interpretation Notes to guide the MNEs on how the proposed section 70C of the Act would be implemented. It would, for example, clarify that MNEs must disclose income in each of the countries in which they operate. This would enable SARS to determine the exact revenue earned from an MNE’s operations in South Africa. Disputes on how to allocate revenue owing to SARS from the total annual group revenue would be avoided if the MNEs abide by the proposed financial reporting formula.

This recommendation has the potential of enabling SARS easily to claim tax on revenue earned from South Africa or tax to which the country has jurisdictional rights. It would also provide SARS with useful statistical data on how it loses tax revenue, what MNEs are notoriously engaging in profit-shifting arrangements, and

[1130] The Pillar One proposal provides for a fair distribution of profits and taxing rights among countries where an MNE operates or has a presence.

which low-tax havens are benefiting from trade carried out in South Africa. This data could be used for the development of future tax legislation, regulations, and policies.

Furthermore, this proposal supports the implementation of the Pillar One proposal under the two-tier global tax proposal. Specifically, it would help South Africa easily to establish whether it qualifies as a market jurisdiction entitled to tax a formulaic apportionment of MNE revenue. Disputes that arise from disagreements between an MNE and a market jurisdiction, or between two countries which both claim rights to the revenue of an MNE as market jurisdiction, would either be reduced or completely resolved by this recommendation.

6.3.9 Recommendation for the Amendment of the Residence-Based Tax Rules

Chapter 3 discussed the residence-based system of taxation applied in South Africa. This thesis recommends that the country retain this tax system, albeit with a few amendments.

It is, however, proposed that South Africa should consider updating IN 3 and IN 4 which deal with the definition of residency of a natural person using the 'ordinarily resident' and the 'physical presence' tests. These two Interpretation Notes have been clearly inadequate in taxing residents who work in today's digital world. For example, IN 3 defines the term 'ordinarily resident' as the place where a person has his or her usual or principal residence – his or her 'real home'.[1131] The factors identified as beacons for use in determining whether a person is ordinarily resident in South Africa for tax purposes are all based on physical presence tests.[1132] These two examples shown that IN 3 relies on a physical presence test to determine whether a person is ordinarily resident in South Africa. On the other hand, IN 4

[1131] Articles 4.1 and 5 of SARS-IN 3 (Issue2) (20 June 2018) <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-03-Resident-definition-natural-person-ordinarily-resident.pdf> accessed 3 December 2021.

[1132] Article 4.1 of SARS-IN 3 (Issue 2) (20 June 2018) <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-03-Resident-definition-natural-person-ordinarily-resident.pdf> accessed 3 December 2021.

provides that a natural person can only be deemed a resident of South Africa for tax purposes if he or she has been physically present in South Africa.[1133]

It is submitted that the physical presence test used to determine residency under IN 3 and IN 4 is out of touch with the reality of today's digital economy. It can only lead to further erosion of South Africa's tax base because it does not anticipate or provide for the possibility that a person can create his or her residency in cyber-space, in a server, a website, or by manipulating other digital phenomena like the e-signature, e-contracts, or e-commerce to limit his or her tax liability. It is, therefore, recommended that IN 3 and IN 4 be revoked and new Interpretation Notes be issued which recognise a virtual space, digital space, or any form of space created by the IoT, as a place in which a natural person can be deemed to reside for tax purposes. Factors such as the number of times a person has accessed a server or performed a transaction using a digital gadget, could be used to determine residency. Frequent use and access of a server or a digital gadget could be used to impute residency to a natural person at the location of the server or the place where the digital gadget was used.

The definition of a natural person in section 1 of the Act should also be amended to include a natural person who has created his or her residency in cyberspace, in a server, a website, or by manipulating other digital phenomena like the e-signature, e-contracts, or e-commerce to limit his or her tax liability. The definition of a person other than a natural person should also be amended to include the residency created by a market jurisdiction under Pillar One of the two-tier digital taxation proposals. The current definition of residency proceeds from the premise that a resident can be either a natural person or a person other than a natural person. The definition of what constitutes residency or a natural person is, however, limited to physical aspects of the taxpayer’s presence in South Africa.[1134] The law failed to foresee the possibility that a taxpayer could conduct his or her trade and related

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[1133] SARS-IN 4 (Issue 5) (3 August 2018) <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-04-Resident-definition-natural-person-physical-presence.pdf> accessed 3 December 2021.

[1134] Section 1 of the Act.

activities over the internet and in so doing limit his or her physical presence and tax residency in South Africa.

On the other hand, the Act has recognised that persons other than natural persons can have a PEM in South Africa.[1135] The wider definition and application of the term PEM in South Africa as has been previously discussed in this thesis, could make it possible for SARS to levy tax on transactions carried out over the internet. These amendments could help South Africa widen its tax net even before 2023 when the two-tier digital tax proposal is expected to come into effect.

6.3.10. Recommendation for the Amendment of the Protection of Personal Information Act 4 of 2013

It is submitted that South Africa could fully and effectively benefit from the global tax transparency reform rules proposed by the Global Forum by amending section 33(1) of POPI Act which prohibits the processing of personal information save where criminal offences have been committed or as provided for in law. This means that there is currently no law which permits SARS to access data for purposes of taxation.

It is recommended that a new section 33A should be included in the Act. The new section 33A, which could be titled "authorisation concerning tax purposes", should provide that prohibition on processing personal information, as referred to in section 26 does not apply to disclosures made to SARS. The data shared with SARS should, however, be limited to investigations regarding tax avoidance or tax evasion by a taxpayer in which the taxpayer's personal information could be required to assist in this investigation. SARS would also be required to give a written undertaking that it will treat this information as confidential and will not share it with a third party without the consent of the taxpayer.

This amendment would go a long way in helping South Africa to honour its transparency and disclosure obligations as a member of the Global Forum. The

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1135 Section 1 of the Act.

legalisation of limited data intrusion into the affairs of taxpayers could also help SARS to expand the country's tax base because it would now be possible for it to lift the veil on tax avoidance and evasion schemes used by taxpayers.

6.3.11 Recommendation for the Amendment of the Income Tax Act 58 of 1962

Section 74A of the Act provides:

> The Commissioner or any officer may, for the purposes of the administration of this Act in relation to any taxpayer, require such taxpayer or any other person to furnish such information (whether orally or in writing) documents or things as the Commissioner or such officer may require.

The challenge here is whether the Commissioner of SARS can use this law to request a taxpayer's information from a bank to assist him in investigating tax evasion or avoidance schemes. This is more so because it is not clear whether the phrase 'or any other person to furnish such information' in section 74A of the Act include a bank. Schulze has argued that failure expressly to include the term 'bank' in this provision implies that banks are not included in this provision.[1136] The Commissioner of SARS is thus not permitted to access taxpayers' banking information for use by SARS.

This means that the current section 74A of the Act may cause difficulties for the South African government in its efforts to comply with its disclosure and transparency obligations as a member of the Global Forum. This thesis recommends that section 74A of the Act be amended and split into two parts. The current provision could be retained as section 74A(1). A new section – section 74A (2) – could be introduced to provide that banks may divulge a customer's details to the Commissioner of SARS if it is provided with sufficient information indicating that the taxpayer may have been involved in a tax-evasion and or tax-avoidance scheme. The bank would thus share this information with Commissioner of SARS to help it verify this suspicion.

[1136] Schulze (2007) 15 *Juta's Business Law* 125.

This amendment would also create fairness, equality, and equity among all taxpayers because everyone liable to pay tax shall pay his or her fair share without hiding behind the confidentiality and secrecy of banks to shield its profits from taxation. This amendment would also help South Africa abide by its transparency and disclosure obligations for tax purposes as a member of the Global Forum.

6.3.12. Recommendation for the Amendment of the South African Reserve Bank Act 90 of 1989

Section 33 of the SARB Act, titled 'Preservation of secrecy', provides in relevant part:

> 33. (1) No director, officer or employee of the Bank, and no officer in the Department of Finance, shall disclose to any person, except to the Minister or the Director-General: Finance or for the purpose of the performance of his duties or the 35 exercise of his functions or when required to do so before a court of law or under any law, any information relating to the affairs of the Bank or a shareholder or customer of the Bank acquired in the performance of his duties or the exercise of his functions, or any other information acquired by him in the course of his participation in the activities of the Bank.

This provision in SARB Act makes it clear that no one, including the employees of SARB, is permitted to share a customer's information with a third party. This confirms that it was not the intention of the legislator that a bank could share customers' information with Commissioner of SARS under section 74A of the Act. In fact, the SARB Act confirms that disclosure of such information can only be made with the written consent of the Minister and the Governor of SARB after consulting the customer concerned.[1137] In essence, this provision makes it virtually impossible for CSARS to obtain and or share a customer's bank details with SARS or an entity such as the Global Forum to improve global tax transparency and compliance.

This thesis recommends the addition of section 33(2)(*c*) to the SARB Act to include information shared with the Commissioner of SARS for tax purposes as one of the exceptions to the preservation-of-secrecy rule under section 33(1) of the SARB Act. This amendment enables SARS to eliminate tax avoidance and evasion schemes

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[1137] Section 33(1)(*b*) of the South African Reserve Bank Act 90 of 1989.

which are perfected by taxpayers who use the internet to limit their tax presence in South Africa and the preservation of secrecy rules to hide their profits from scrutiny and taxation by SARS. The amendment would also help South Africa to comply with its international obligations as a member of the Global Forum.

6.3.13 Recommendation for the Amendment of South Africa's Tax Incentive Regime

The objective of the proposed global minimum tax is to combat the race to the bottom. Countries like South Africa must therefore act to protect their tax bases from being collected elsewhere under the global minimum tax. One way of realising this target would be for South Africa to remove tax incentives targeted at MNEs from the Act. This is because tax incentives have been shown to have a limited effect in attracting direct foreign investment. [1138]

Pillar Two has proposed a 15% global minimum tax which would compel the global community to stop tax competition and the race to the bottom.[1139] The result is that Pillar Two will reduce profit shifting by MNEs[1140] as if the majority of MNEs agree to implement Pillar Two, there will be no incentive for companies to move their businesses to low-tax jurisdictions. Retention of a tax incentive regime would therefore serve no purpose for South Africa other than contributing to the erosion of its tax base by MNEs that are benefitting from the tax incentive regime.

An alternative to this proposal would be for South Africa to introduce a domestic minimum tax to ensure that no company resident in South Africa or with a PE in the country pays tax that is less than the new global minimum rate. This would be easier to design, legislate, and implement rather than repealing all tax incentives in law and contracts.

[1138] Barbour 'An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector' (2005) 23 *Economic and Statistic Analysis Working Paper No. 14.* <file:///C:/Users/user/Downloads/2515.pdf > accessed 10 September 2022.
[1139] Reuven, Yonah, and Young "Tax Harmony: The Promise and Pitfalls of the Global Minimum Tax" (2022) 223 *Law & Economics Working Paper* No. 38.
[1140] ibid.

This protectionist proposal could be significant in that the redistribution of taxation rights under the global tax rules will principally benefit the wealthy and populous countries with huge market sales.[1141] South Africa is not among those countries and it must therefore consider adopting this recommendation to it protect its tax revenue streams by taxing entities that have previously benefited from the tax exemption clauses in the Act and contracts.

6.4 Conclusion

These recommendations are intended to ensure that South Africa's digital economy is taxed in manner that is fair, effective, efficient, and equitable. It will also assist SARS to protect the country from BEPS. These recommendations – and in particular those on the adoption of the OECD/G-20 global tax proposal – should be adopted with caution to ensure that only those recommendations that have the potential to position South Africa as a preferred trade and foreign investment hub in the world are adopted.

The digital economy is dynamic, unpredictable, and is growing rapidly. This implies that the tax solutions that have been recommended for adoption in this thesis could be rendered irrelevant and ineffective within a few years of their enactment. This thesis, however, posits that its recommendations offer a firm base on which South Africa could rely to improve its income tax laws and its ability to tax the digital economy effectively and efficiently. The thesis also provides a firm foundation for future scholars wishing to undertake further research on better ways of protecting South Africa's tax base from complex tax avoidance schemes that are often supported and facilitated by the IoT. Although it may not be possible to come up with immutable recommendations able permanently to resolve all the challenges posed by the internet economy for the South African income tax regime, the practical recommendations drawn for the research could help the government of South Africa to improve its income tax regime.

[1141] Laudage S and Haldenwang C 'What the Global Tax Reform Means For Developing Countries' (10 November 2021) *Current Column*<file:///C:/Users/user/Downloads/German_Development_Institute_Laudage_von_Haldenwang_08.11.2021.pdf> accessed 12 September 2021.

CHAPTER 7

CONCLUDING REMARKS

7.1 Chapter Outcome Analysis and Key Points from the Thesis

Chapter 1 of the thesis argued that the efficiency of South Africa’s income tax legal regime and its ability to protect the country's tax base faces a severe challenge from today's digital economy. It explained that it is becoming increasingly difficult for SARS effectively to levy tax from cloud computing transactions, transactions that are settled using virtual currencies, transactions by traders who use various e-commerce platforms to disguise the source of their revenue, and transactions by non-residents who have used the internet to structure their transactions in a manner that places them beyond the reach of the Act, the PE concept, and CFC rules. It was argued that the absence of efficient rules or principles on which to tax these digital transactions will inevitably result in loss of revenue for SARS.

The chapter realised its objective – to establish whether section 5 and other enabling provisions in the Act can adequately and effectively tax all digital transactions performed in South Africa. The outcome of the chapter is that the ability of South Africa's income tax legal regime to protect the country's tax base from BEPS faces severe challenges from today's digital economy.

Chapter 2 discussed the growth of the internet and its implications for taxation. The chapter explained the history, meaning, and impact of common concepts like the internet, IoT, digital economy, and other terms commonly used in discussions about digital trade. It concluded by examining the history of South Africa's tax system from the Steyn Commission of 1951 to the Davis Tax Committee of 2018. This was intended to give a perspective on the strides that the country has made in the development of its income tax law and its recent views on whether it is ready to start taxing the digital economy. It concluded by identifying and discussing some of the challenges faced by the Act, SARS Interpretation Notes, and international tax-law principles such as PE and PEM in taxing digital transactions

The chapter achieved its objective of explaining to the reader the meaning, impact, and application of common terms like the internet, IoT, and the digital economy which have been used throughout this study. It also allows the reader appreciate the history of South Africa’s income tax system and how the government has attempted to tax the country’s digital economy by using the recommendations of different commissions. The specific challenges that the country’s income tax legal regime has faced in its attempts at taxing the internet economy were also identified and discussed.

Chapter 3 examined international tax law principles that have been adopted by South Africa to augment the Act as regards taxing digital transactions. It also undertook an in-depth investigation of the efficiency of the Act in taxing digital transactions in South Africa.

The objective of chapter 3 was achieved when it explained the legal framework used by South Africa to tax digital transactions. It also explained the challenges that this legal framework faces in this regard.

Chapter 4 entailed a critical discussion of how the global digital landscape has evolved over the years; and how or whether South Africa's income tax law has been updated to respond to this evolution. From the study it became apparent that the internet has made it possible for taxpayers to limit their tax liability using various strategies like reliance on the use of e-signatures, settling payments using virtual currencies, and creating artificial residency in cyberspace. Some of the proposals by the OECD and the G-24 on how to tax the digital economy were also critically examined.

The objective of this chapter was achieved in that it explains how the digital landscape has evolved. But it also observed that the country's income tax laws had not evolved sufficiently to support the taxation of all transactions within the country's evolving digital transactions.

Chapter 5 was a comparative study of how other countries have taxed the digital economy. The latest EU and OECD proposals on how to tax the digital economy were also discussed. The objective of this chapter, which was to explain the current trends and best practices on how to tax the digital economy, was achieved.

Chapter 6 detailed recommendations that the government could consider to enable it improve the efficiency of the Act in taxing internet-based transactions.

The thesis was premised on the hypothesis that the current South African income tax laws are not sufficiently effective and efficient in taxing digital transactions which have become commonplace in today's digital economy. Chapter 6 of this thesis has therefore addressed the concern raised in the hypothesis by proposing recommendations that could be adopted to help the country achieve an income- tax regime that is capable of taxing internet-based transactions effectively.

7.2 Response and Alignment of the Thesis to its Objectives, Aims, and Research Questions

The thesis set out its objectives, aims, and the research questions to be answered in the course of the research. This thesis realised its objective, aims, and also answered all the research questions raised in chapter1 to the extent that it:

a) discussed the country's income tax framework and its ability to tax internet-based transactions;

b) identified the gaps and areas of ambiguity in South Africa's income tax framework;

c) discussed the extent and nature of the challenges posed to the country's tax base by the internet economy;

d) analysed the latest developments and best practices adopted by the OECD, EU, and selected countries in dealing with similar challenges in taxing internet-based transactions;

e) proposed recommendations to answer the challenges surrounding the taxation of the internet economy.

7.3 Limitations and Questions for Further Research

The global tax reforms have not solved all the challenges of taxing the internet economy. For example, the high tax threshold of 20 billion and 750 million Euros in sales globally for Pillar One and Pillar Two respective proposals have excluded several MNEs from taxation. This is because most MNEs have a sales turnover lower than these prescribed thresholds. The logic of setting so high a threshold which excludes several large MNEs from taxation defeats the purpose of introducing this tax system which was intended to raise and protect the tax base of most countries. By default, therefore, the current PE and POEM *nexus* principles will continue to apply in the taxation of South Africa's internet economy. This means that the global tax rules have achieved little in helping South Africa to find a solution on how to tax its internet-based economy.

Moreover, banks and natural-resource companies have also been granted special carve outs in that their income will only be taxed by the country in which they are physically located. While the exemption may be justified for the latter, it fails to appreciate that banking has gone digital, and the physical presence of banks is not required in any country as a pre-requisite for offering services. The exemption of banking institutions from the global rules tax ought to be reconsidered as it leaves a sizeable incentive for profit-shifting tendencies.[1142]

These gaps in the global tax proposal leave room for uncertainty and incentives for the below-threshold MNEs to continue operating at their current gross sales level so as to continue benefiting from the low tax rates on offer in low-tax jurisdictions. It also defeats the purpose for which the rules were introduced which was to discourage nations from tax competition through lower tax rates which result in corporate profit shifting and tax-base erosion. The global community needs to find a formula or model for taxing the below-threshold MNEs that will include a reform of

[1142] Reuven, Yonah and Young (2022) 223 *Law & Economics Working Papers* 43.

the PE and POEM principles to make them more responsive and effective in taxing today's internet-based economy. It is anticipated that the OECD-led global digital tax forum will find a solution to these challenges before the end of 2023 when the rules are set to come into force. It would be best to commence with the implementation of these global tax rules once these identified challenges have been addressed.

7.4 Contribution of the Thesis to the Development of the Law and Way Forward

This thesis, in chapter 6 above, has come up with practical recommendations that could be adopted by South Africa to tax its internet-based economy. The recommendations proposed are practical and feasible as they have been made after carrying an incisive study of the country's income tax legal regime and best practice in the taxation of the internet economy in selected countries, the OECD, and the EU block. They consequently offer a sound springboard from which South Africa can start taxing its internet economy if and when it resolves to do so.

While recognising the contributions of previous commissions such as the Davis Tax Committee which recommended that the taxation of the country's digital economy should wait for the final outcome of the OECD-led global digital tax, this thesis has proposed practical solutions that could be adopted by South Africa in the interim as it awaits the conclusion of the OECD-led process.

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