THE COLLECTION OF VALUE ADDED TAX ON ONLINE CROSS-BORDER TRADE IN DIGITAL GOODS

by

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I declare that **THE COLLECTION OF VALUE ADDED TAX ON ONLINE CROSS-BORDER TRADE IN DIGITAL GOODS** is my own work and that all the sources I have used or quoted have been indicated and acknowledged by means of complete references.

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SP van Zyl 16 April 2013

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ABSTRACT

Technological advances have had a major impact on traditional retail shopping changing it from a physical undertaking to a completely digitised experience where consumers buy digital media online. VAT systems that do not specifically provide for, or which have not been adapted to cope with, technology-driven advances, generally do not provide for the adequate levying and collection of VAT on cross-border digital trade. The South African VAT system is no different. The taxation of e-commerce should not artificially advantage or disadvantage e-commerce over comparable traditional commerce, or unnecessarily hinder the development of e-commerce. This thesis determines whether the South African VAT Act 89 of 1991 in its current form, can be applied adequately to raise and collect VAT on cross-border digital transactions. Where shortcomings in the VAT Act are identified, the harmonised VAT rules of the European Union (EU), together with the Organisation for Economic Cooperation and Development (OECD) proposals on consumption taxes, are analysed and discussed to seek possible solutions and make recommendations.

KEYWORDS

anonymising technology; B2B transactions; B2C transactions; banker-customer confidentiality; BIT-rate tax; blocked VAT account; consumption taxes; Cross-border digital trade; destination principle; digital technology;electronically supplied services; European Union; exempt supplies; fractionated VAT; General Sales Tax; goods and services; intangible goods; multi-purpose voucher; OECD; origin principle; payment method; place of consumption; place of supply; real-time VAT; reverse-charge mechanism; self-assessment; single-purpose voucher; standard rated supplies; tangible goods; taxable entity; taxable supplies; time of supply; use-and-enjoyment principle; utilised and consumed; Value Added Tax; value of supply; VAT collection model; vendor registration; voucher; webpage; website; withholding tax; zero-rated supplies; representative taxpayer; tax free.

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List of abbreviations

ARPA	Advanced Research Projects Agency
B2B	Business-to-Business transaction
B2C	Business-to-Consumer transaction
CERN	European Laboratory of Particle Physics
CFA	Committee on Fiscal Affairs
CTPA	Centre for Tax Policy and Administration
CPU	Central Processing Unit
ECJ	European Court of Justice
EEC	European Economic Community
EFT	Electronic Funds Transfer
EU	European Union
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GST	Goods and Services Tax (General Sales Tax in the South African context)
IP	Internet Protocol
MPV	Multi-purpose voucher
NSFNET	National Science Foundation
OECD	Organisation for Economic Cooperation and Development

OEEC	Organisation for European Economic Cooperation
RAM	Random Access Memory
SACU	South African Customs Union
SARS	South African Revenue Service
SCA	Supreme Court of Appeal
TCP	Transmission Control Protocol
WTO	World Trade Organisation
SPV	Single-purpose voucher
TAG	Technical Advisory Group
URL	Uniform Resource Locator
USA	United States of America
USSR	Union of Soviet Socialist Republics
VAT	Value Added Tax
XML	Extensible Markup Language

CHAPTER 1:

INTRODUCTION

1.1 Introduction

Ever since the early commercial exploitation of inter-connected digital computers in the early 1980s, it has been clear that man would enter an era of 'the connected world'[1] However, it was not until 24 October 1995 that the Internet was formally defined as

> the global information system that -- (i) is logically linked together by a globally unique address space based on the Internet Protocol (IP) or its subsequent extensions/follow-ons; (ii) is able to support communications using the Transmission Control Protocol/Internet Protocol (TCP/IP) suite or its subsequent extensions/follow-ons, and/or other IP-compatible protocols; and (iii) provides, uses or makes accessible, either publicly or privately, high level services layered on the communications and related infrastructure described herein.[2]

Since its inception, the Internet has continued to expand in use, size, reach, and impact. This has reached the point where we can no longer imagine an existence without the Internet.[3] It is estimated that the world's Internet population will increase to three billion users by 2016.[4] This growing phenomenon is not restricted to developed countries. Developing G-20 countries already have 800 million Internet

[1] Leiner BM, Cerf VG, Clark DD, Kahn RE, Kleinrock L, Lynch DC, Postel J, Roberts LG, Wolf S *A Brief History of the Internet* http://www.internetsociety.org/internet/internet-51/history-internet/brief-history-internet [accessed on 14 March 2013].

[2] Leiner BM, Cerf VG, Clark DD, Kahn RE, Kleinrock L, Lynch DC, Postel J, Roberts LG, Wolf S *A Brief History of the Internet* http://www.internetsociety.org/internet/internet-51/history-internet/brief-history-internet [accessed on 14 March 2013].

[3] Dean D, DiGrande S, Field D, Lundmark A, O'Day J, Pineda J, Zwillenberg P (2012) *The Internet Economy in the G-20* [accessed on 14 March 2013].

[4] Dean D, DiGrande S, Field D, Lundmark A, O'Day J, Pineda J, Zwillenberg P (2012) *The Internet Economy in the G-20* https://www.bcgperspectives.com/content/articles/media_entertainment_strategic_planning_4_2_trillion_opportunity_internet_economy_g20/ [accessed on 14 March 2013].

users 80% of whom use the Internet to access social networks.[5] The introduction of mobile devices such as smart phones, tablets, and notebooks will dramatically influence the expansion of the Internet in developing countries.[6] Retailers, service providers, and governments cannot afford to ignore the rapid impact the use of Internet applications has on society.

The South African retail industry has seen a vigorous upturn in online sales and online business since the commercial exploitation of the Internet was introduced.[7] From 2000 to 2009, South Africa's Internet population grew from 5,5% to 10,8% of the total population.[8] In 2011, online shopping accounted for 1,9% of the South African economy.[9] Online shopping is expected to account for at least 2,5% of South Africa's total economy by 2016.[10] With conventional retailers investing in online shopping, it is anticipated that an increasing number of Internet users is likely to use the Internet for online shopping, banking, and e-billing.

Technological advances have had a major impact on traditional retail shopping changing it from a physical undertaking to a completely digitised experience where consumers buy digital media online. In a society where digital media is readily available, it is trite that consumer behaviour will ultimately adapt to a digitised world. Digital files are entirely intangible, and the transfer of these files from one device to another can be effected through the Internet or Bluetooth technology. No physical presence or physical form of delivery is required.

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[5] Dean D, DiGrande S, Field D, Lundmark A, O'Day J, Pineda J, Zwillenberg P (2012) *The Internet Economy in the G-20* https://www.bcgperspectives.com/content/articles/media_entertainment_strategic_planning_4_2_trillion_opportunity_internet_economy_g20/ [accessed on 14 March 2013].

[6] Dean D, DiGrande S, Field D, Lundmark A, O'Day J, Pineda J, Zwillenberg P (2012) *The Internet Economy in the G-20* https://www.bcgperspectives.com/content/articles/media_entertainment_strategic_planning_4_2_trillion_opportunity_internet_economy_g20/ [accessed on 14 March 2013].

[7] Goldstuck A and Ambrose S (2007) *Big Upturn for Online Retail* http://www.worldwideworx.com/?p=58 [accessed on 11 October 2010].

[8] Internet World Stats (2012) *South Africa Internet Usage and Marketing Report* http://www.internetworldstats.com/af/za.htm [accessed on 23 May 2012].

[9] Mawson N (2012) *SA's Internet Economy to Double* http://www.itweb.co.za/index.php?option=com_content&view=article&id=52797:sas-internet-economy-to-double&catid=69 [accessed on 23 May 2012].

[10] Mawson N (2012) *SA's Internet Economy to Double* http://www.itweb.co.za/index.php?option=com_content&view=article&id=52797:sas-internet-economy-to-double&catid=69 [accessed on 23 May 2012].

Value Added Tax (VAT) systems were designed in an era pre-dating digital technology and the Internet. In addition, VAT systems operate based on tax policy, tax administration and the law. If any of these are inadequate, difficult technical issues will not be manageable. As a result, VAT systems that do not specifically provide for, or which have not been adapted to cope with, technology-driven advances, generally do not provide for the adequate levying and collection of VAT on cross-border digital trade. The South African VAT system is no exception.

This study will determine whether the VAT Act[11] in its current form can be applied adequately to raise and collect VAT on cross-border digital transactions. Where shortcomings in the VAT Act[12] are identified, the harmonised VAT rules of the European Union (EU), together with the Organisation for Economic Cooperation and Development (OECD) proposals on consumption taxes, will be analysed and discussed to seek possible solutions and make recommendations.

The principal deficiency in modern VAT systems is their inability to levy VAT on affected transactions through a simplified collection mechanism that does not overburden taxable entities charged with VAT collection, or is not inefficient from an economic point of view. The inadequacies of the reverse-charge and registration mechanisms will be discussed with a view to proposing a modern technology-driven VAT collection mechanism to be applied by financial institutions.

1.2 Purpose of the study

The Internet is one of the fastest growing media in the world and has integrated many of the world's early inventions like radio, television, and the telephone.[13] It has had so major an impact on society that many people are completely dependent on it. The rapid expansion of the Internet has led us to the point at which we now need to deal with its consequences. Three major factors have hampered - and will continue to hamper - our ability to gain more information on the Internet, and to address the problems created by use of the Internet.

[11] Act 89 of 1991.
[12] Act 89 of 1991.
[13] Slevin J (2000) *The Internet and Society* at 1.

The first factor is new media or new technology.[14] This factor is born out of the fear of new technology, or a lack of understanding of complicated technological advances. This fear can be easily overcome if the phenomenon of new technology is treated like any other problem: in other words, by applying existing theories and knowledge before rushing to create new theories, regulations, or laws.[15]

The second factor is that, despite the fact that the Internet and technology have become a significant part of the modern world,[16] governments, lawmakers, and politicians have long ignored its social and economic impact on modern day lives, including, but not limited to, the taxation of cross-border online transactions. For this reason further research is needed into the impact and problems associated with technological advances, and more literature should be made available.

The third factor relates to the specialised nature of the literature in the field of information technology.[17] A common misconception is that academic research into computers, technology, and the Internet should be left to technophobes. A fact that cannot be ignored is that each and every research field is either directly or indirectly affected by technology. Accordingly, a study into the levying of VAT on cross-border digital trade cannot be left to technophobes alone.

As a result of these three factors, no complete study currently exists that comprehensively deals with the levying and collection of VAT on digital imports in South Africa. The aim of this study is, therefore, to provide a thorough analysis of the levying and collection of VAT on cross-border digital trade in South Africa with the object of proposing amendments to the VAT Act that will lead to a modern VAT collection policy that ensures the accurate levying of VAT on cross-border transactions, and the effective collection of the VAT so levied.

[14] Slevin J (2000) *The Internet and Society* at 3.
[15] Slevin J (2000) *The Internet and Society* at 4.
[16] Slevin J (2000) *The Internet and Society* at 4.
[17] Slevin J (2000) *The Internet and Society* at 4.

1.3 Research question(s)

The nature of this project does not lend itself to any single ‘question’. Consequently the following related questions will be examined.

1.3.1 What features of digital online shopping pose problems for VAT collection?

1.3.2 Which of these problems arise from the South African VAT collection system?

1.3.3 Do the current South African VAT laws apply to online digital imports into South Africa, and to what extent do these laws adequately protect against fiscal losses?

1.3.4 Have foreign jurisdictions with similar problems come up with proposals or solutions, and to what extent can these be applied in South Africa?

1.3.5 What solutions - and problems associated with these solutions - have been raised in the international arena, and to what extent can the solutions be implemented in South Africa or globally?

1.4 Methodology

The importance of the study is emphasised by the interpretation of statistical data on Internet use and online retail growth in South Africa. This data was published in 2012, and collected from a variety of sources. Given the variety of the sources, the currency of the data, and correspondence between the statistical results, there is no need for independent fieldwork to verify the data. For the purposes of this study it is accepted that all statistical data are accurate. It should further be noted that digital technology is constantly changing and expanding and possibilities are endless. For this reason, certain of the solutions, ideas and scenarios might seem futuristic or unrealistic. The majority of this study will, however, be based on a literature study

drawn from legislation, text books, professional subject journals, publications by government departments, and case law. This study cannot be confined within borders as the problems associated with the collection of consumer taxes on digital online shopping, are a worldwide phenomenon. For this reason a comparative analysis is undertaken. This comparative study will be limited to the application of the harmonised VAT rules in the EU and the OECD proposals on consumption taxes. While more modern VAT systems exists in Australia, Canada, New Zealand, and Singapore, these will not be reviewed here to keep the scope of this inquiry manageable. Furthermore, the VAT systems in Australia, Canada, and New Zealand are not more advanced in the present context than the South African system, which renders a comparative review of little value.

1.5 Limitations

The limitations inherent to each chapter are set out below in section 6.

1.6 Organisation of the study

The study is divided into seven chapters arranged as follows:

Chapter 1: Introduction, research question(s), methodology and organisation

This chapter serves as in introduction in which the background to and need for the study are examined. The research question(s) are defined, and the scope and methodology of the study are discussed.

Chapter 2: The rise of the Internet and e-commerce

Here a concise history of the development of the Internet and digital technology is presented. The social changes that the Internet and digital technology have occasioned and their impact on traditional retail shopping are also addressed. VAT revenue statistics are compared to e-commerce growth statistics to determine whether or not failure adequately to levy and collect VAT on cross-border digital sales leads to an erosion of the tax base. Based on these statistics, current technological trends, and consumer behaviour, predictions are made with an emphasis on the fact that technological advances will continue to impact on social behaviour and retail shopping trends.

Limitations

The following aspects are specifically excluded from the discussion in Chapter 2.

- A technical analysis of the operation of the Internet and digital technology.
- A psychological examination of human behaviour and social standards in respect of new technology, the Internet, and e-commerce.
- Theories, calculations, random tests, or any other test to determine the authenticity and accuracy of statistical information.

Chapter 3: The collection of VAT on cross-border digital trade in South Africa

In this chapter an extensive analysis is made of the ability of the provisions in the VAT Act, as it currently reads, to

(i) levy VAT on cross-border digital transactions; and

(ii) enable SARS effectively to collect VAT charged on cross-border digital transactions.

In order fully to comprehend this analysis, a short history of the introduction of VAT in South Africa and the characteristics of a VAT system are presented. In the analysis answers to the following questions are sought:

- Is there a supply of goods or services?
- Where is the supply made?
- When is the supply made?
- What is the value of the supply?
- Is it made by a taxable entity?
- Is it made in the course or furtherance of an enterprise?
- Is the supply taxable?
- How is VAT on the transaction collected?

Limitations

The following aspects are specifically excluded from the discussion in Chapter 3:

- A thorough analysis of the differences between a VAT system and a General Sales Tax (GST) system.
- An analysis of the characteristics of 'good' and 'bad' VAT systems.
- An in-depth discussion of the levying and collection of VAT on goods that are ordered electronically but delivered physically, while acknowledging that some discussion of the tax collection methods in respect of such goods is necessary for an understanding of the problems associated with the tax collection mechanisms applied in cross-border digital trade.
- An analysis of the taxation of illegal file sharing and copyright infringement.
- A discussion on the constitutionality of the provisions in the Tax Administration Act.[18]
- A complete analysis into the different provisions in respect of what constitutes standard rated, zero-rated, and exempt supplies.

Chapter 4: The collection of VAT on cross-border digital trade in the EU

Since VAT as a consumption tax originated in Europe, a comparative study between the application of VAT in the EU and in South Africa is necessary if possible solutions for the problems associated with the levying and collection of VAT on cross-border digital trade are to be identified. This chapter provides a thorough analysis of the application of the harmonised VAT rules on cross-border digital trade.

[18] Act 28 of 2011.

The discussion focuses not only on the position under the Sixth Council Directive 77/388/EEC, but includes a discussion of the amendments brought about by Council Directives 2002/38/EC and 2008/8/EC (which should be read with reference to Directive 2006/112/EC), as well as the amendments that will apply as from 1 January 2015 as envisaged by Council Directive 2008/8/EC. The discussion will centre around the following questions.

- Is there a supply of goods or services?
- Where is the supply made?
- When is the supply made?
- What is the value of the supply?
- Is it made by a taxable entity?
- Is it made in the course or furtherance of an enterprise?
- Is the supply taxable?
- How is VAT on the transaction collected?

Limitations

The following are specifically excluded from the discussion in Chapter 4:

- An in-depth discussion of the application of the EU harmonised VAT rules in each of the 27 EU Member States.

- An in-depth discussion of the levying and collection of VAT on electronically ordered but physically delivered goods. However, some discussion of the tax collection methods in respect of such goods is necessary to determine the effectiveness of the VAT collection mechanisms applied in the case of cross-border digital trade within the EU.

- A full discussion of place-of-establishment and place-of-effective-management rules in the case of a controlled foreign company.

- An analysis of the taxation of illegal file sharing and copyright infringement.

Chapter 5: The OECD proposals on consumption taxes

This chapter presents a thorough analysis of the OECD proposals in respect of the levying and collection of VAT on cross-border digital trade. Considerable emphasis is placed on the proposed guidelines for the identification and location of customers by taxable entities burdened with the task of tax collection. Alternative VAT collection mechanisms are also critically examined with a view to establish an effective VAT collection model that does not overburden suppliers and which can be applied with the least cost to the *fiscus.* The discussion focuses on the following questions:

- Is there a supply of goods or services?
- Where is the supply made?
- When is the supply made?
- What is the value of the supply?
- Is it made by a taxable entity?
- Is it made in the course or furtherance of an enterprise?
- Is the supply taxable?
- How is VAT on the transaction collected?

Limitations

The following are specifically excluded from the discussion in Chapter 5:

- The difference between business income and income derived from the exploitation of intellectual property for purposes of income (personal) taxes.
- A technical discussion of technology-driven identification and location tools.

Chapter 6: VAT collection by financial institutions

This chapter offers an analysis of a real-time VAT (RT-VAT) collection model for the collection of VAT by financial institutions. The operation of an RT-VAT collection model is considered based on a schematic diagram. The benefits of this collection model are discussed to identify solutions to the problems faced under the registration and reverse-charge mechanisms. The main objections to this model - concentrating

specifically on the breach of the banker's duty of confidentiality and the customer's right to privacy - are examined. Arguments against these objections are proffered.

Limitations

The following aspects are specifically excluded from the discussion in Chapter 6:

- A full discussion of the historical development and application of the banker's duty of confidentiality in South Africa.
- An in-depth examination of the customer's right of recourse (either in contract or in delict) in the case of breach of the banker's duty of confidentiality.
- A discussion of a person's right to privacy, its limitations, and the right of recourse in the case of infringement.
- An analysis of cross-border money laundering, exchange control, and the banker's statutory duty to report irregular transactions.
- A discussion of online banking fraud and a customer's possible right of recourse against the bank.
- An in-depth analysis of the rights of SARS (or any other revenue authority), as either a statutory preferent or concurrent creditor, against the estate of an insolvent taxpayer.

Chapter 7: Conclusion and recommendations

This chapter centres around a summary of the main findings in respect of the levying and collection of VAT on cross-border digital trade. Recommendations are made for the amendment of the current VAT Act to provide for the adequate taxation of cross-border digital trade.

1.7 Conceptualisation

In this study various concepts will be used. For ease of reference, definitions of the main concepts are provided here.

'**business-to-business'** – the cross-border transactions in either services or digital products where the supplier is a registered VAT vendor in the country where he is

established, and the recipient is a registered VAT vendor in the country where he is established;[19]

'**business-to-consumer'** – the the cross-border transactions in either services or digital products where the supplier is a registered VAT vendor in the country where he is established, and the recipient is not registered as a VAT vendor in the country where he resides or is established;[20]

'cloud computing' - computing resources (such as storage, monitoring, and software) are delivered as a service over a network - for example, the storage of information on various servers across the globe and linked to a network;[21]

'consumption tax' - the generic term for the indirect taxation (sales tax or VAT) of money spent on the consumption of goods and services;[22]

'cross-border digital trade' - transactions concluded electronically over a network between a customer who resides or is physically present in one jurisdiction, and a supplier which is established or physically present in another jurisdiction, for the supply of digital products that can be delivered electronically by means of a network;

'digital product' - an intangible product or thing capable of being transferred from one electronic device to another via a network, infrared transmission, or Bluetooth;[23]

'e-commerce' - the generic term used to describe the phenomenon when business or transactions is conducted by electronic means through the application of digital technology;[24]

'e-tailer' - the supplier who supplies tangible or intangible goods at retail level through the application of an e-commerce platform;[25]

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[19] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 373.
[20] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 373.
[21] Carrol M, Kotzè P, and van der Merwe A (2012) "Securing Virtual and Cloud Environments" in Ivavnov I, ShishkovB, and Van der Sinderen M (eds) (2012) *Cloud Computing and Services Sciences* at 73.
[22] Weidenbaum ML, Raboy DG, and Christian ES (1989) *The Value Added Tax: Orthodoxy and New Thinking* at xii; Westin RA (2006) *WG & L Tax Dictionary* at 138.
[23] Cambridge Online Dictionary http://dictionary.cambridge.org/dictionary/british/e-tailer [accessed on 30 April 2013].
[24] International Fiscal Association (2001) *Taxation of Income Derived from Electronic Commerce* at 24-25.

'fractionated VAT' - a VAT system where part of the total amount of VAT due by the final consumer is collected in stages;[26]

'identification and location tools' - the methods applied in e-commerce transactions by a taxable entity to identify a customer and to locate that customer's presence or residence for VAT purposes;[27]

'IP address' - the numerical label assigned to an electronic device (eg, computer, mobile phone) interacting with a computer network that uses the Internet Protocol for communication;[28]

'packet-switching technology' - is a digital networking communications method that groups all transmitted data – regardless of content, type, or structure – into suitably sized blocks;[29]

'trusted third party' - an agent that is required by law to collect taxes on behalf of a revenue authority.[30]

'RT-VAT' - a real-time VAT collection model in terms of which VAT is charged and collected simultaneously and remitted to revenue authorities at 24 hour intervals;[31]

'turnover tax' - a tax imposed on gross receipts. Before the introduction of VAT, turnover taxes on alcohol sales were popular to raise revenue.[32]

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[25] Cambridge Online Dictionary http://dictionary.cambridge.org/dictionary/british/e-tailer [accessed on 30 April 2013].
[26] Van Arendonk H, Jansen S, and Van der Paard R (2011) *VAT in an EU and International Perspective* at 92.
[27] OECD *Verification of Customer Status and Jurisdiction* http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[28] Defense Advanced Research Projects Agency (1980) *DOD Standard Internet Protocol* at 1 http://tools.ietf.org/html/rfc760 [accessed on 30 April 2013].
[29] Roberts LG (1978) *The Evolution of Packet Switching* http://www.packet.cc/files/ev-packet-sw.html [accessed on 30 April 2013].
[30] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 25 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[31] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 2 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].
[32] Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 3.

1.8 Conclusion

In this introductory chapter the purpose of the study, the research questions, organisation, and delimitations have been set out. It should be noted that major sources of erosion of the VAT base in most countries are due to exemptions, non-export zero rating and other concessions such as teax incentive schems. Technical issues such as e-commerce remain second order in nature. In order fully to grasp the urgent need to modernise the South African VAT system, the effect that the Internet and the advances in digital technology have on society's retail shopping trends need to be examined. In the next chapter, the development of the Internet and its impact on shopping trends are discussed with specific reference to the possible erosion of the tax base.

CHAPTER 2:

THE RISE OF E-COMMERCE

> Only six electronic digital computers would be required to satisfy the computing needs of the entire United States.
>
> - Howard H Aiken (1947)

2.1 Introduction

Many people hold different views on the Internet and digital technology. Some find it so challenging that they avoid it at all costs, while others find it fascinating and have reached a point in their lives where they can no longer live without the Internet and digital technology. There are also some who believe that the Internet is just another phase in history that will soon pass. Most governments and politicians hold this latter view and they often follow a “head in the sand” approach, completely unaware of the world that the Internet has created. In this chapter I give a brief history of the development of digital technology and the Internet. I further discuss the social changes that the Internet and digital technology have brought about, and the impact they have had on retail shopping behaviour in South Africa. The nature of digital technology will be examined with a futuristic glimpse of the possibilities it holds and how these will affect e-commerce. I further examine VAT collection statistics from 2006-2011 and compare these to statistics on the growth of e-commerce in South Africa. These statistics will be applied to determine if the change in consumer behaviour – the change from tangible in-store to intangible online shopping - could erode the tax base if the current VAT collection mechanisms are not amended to adapt to new technological trends.

2.2 A brief history on the introduction of the Internet

2.2.1 From ARPANET to INTERNET

Unlike the history of other media tools such as the telephone and radio, the history of the Internet is just beginning to be written.[33] Due to the rapid changes in and expansion of technology, the Internet is constantly developing and its history is far from complete. It is thus inevitable that any literature on the history of the Internet will, by its very nature, be outdated from the outset.

Like most modern communication tools, the development of the Internet as a communication medium was a product of war. The cold war between the USSR and the USA, and the subsequent launch of Sputnik 1 (an orbital satellite) on 4 October 1957 by the USSR, created immediate global danger.[34] This contributed to the establishment of the USA Advanced Research Projects Agency (ARPA).[35] One of ARPA's most important projects was to investigate and develop technologies for computers to interlink on a network.[36] The two-fold objective of this research was to enable the transfer of information from different centres within ARPA, and to allow participants to share scarce computer resources.[37] This first computer network was created in 1969 and was christened ARPANET. ARPANET is generally accepted as the origin of the Internet.[38]

The idea of sharing information through a network or remotely operating a machine via a network of some sort, did not originate within the realm of ARPA. George Stibitz, a well-known researcher in Boolean logic digital circuits, invented the Complex Number Calculator in 1940.[39] When he wished to demonstrate this calculator at the American Mathematical Society in September 1940, he realised that

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[33] Slevin J (2000) *The Internet and Society* at 27.

[34] Slevin J (2000) *The Internet and Society* at 28; Ryan J (2010) *A History of the Internet and the Digital Future* at 11-16 and 23-24; Winston B (1998) *Media Technology and Society: A History: From the Telegraph to the Internet* at 325; Abbate J (1999) *Inventing the Internet* at 8-9; Norman JM (ed) (2005) *From Gutenberg to the Internet: A Sourcebook on the History of Information Technology* at 39.

[35] Slevin J (2000) *The Internet and Society* at 28; Ryan J (2010) *A History of the Internet and the Digital Future* at 24-25; Norman JM (ed) (2005) *From Gutenberg to the Internet: A Sourcebook on the History of Information Technology* at 41.

[36] Slevin J (2000) *The Internet and Society* at 28-29; Ryan J (2010) *A History of the Internet and the Digital Future* at 26-27; Norman JM (ed) (2005) *From Gutenberg to the Internet: A Sourcebook on the History of Information Technology* at 41.

[37] Slevin J (2000) *The Internet and Society* at 29; Ryan J (2010) *A History of the Internet and the Digital Future* at 28-30.

[38] Slevin J (2000) *The Internet and Society* at 29; Schell BH (2007) *The Internet and Society* at 1 and 144; Ryan J (2010) *A History of the Internet and the Digital Future* at 30.

[39] Crosby K (1995) *George Stiblitz* http://ei.cs.vt.edu/~history/Stibitz.html [accessed on 31 May 2012]; Winston B (1998) *Media Technology and Society: A History: From the Telegraph to the Internet* at 322; Norman JM (ed) (2005) *From Gutenberg to the Internet: A Sourcebook on the History of Information Technology* at 39.

the computer was too large, heavy, and fragile to transport.[40] To avoid damage to the machine, Stiblitz set up a teletype terminal enabling him to control the computer remotely via a telegraph connection.[41] This was the first time that an object was remotely controlled using a telecommunication tool.

Without the inventions and research by persons and institutions outside of ARPA, ARPANET would not have got off the ground. One such invention was the development of packet-switching technology communication.[42] Packet-switching technology involves the breaking up of digitised information into labelled packets or blocks indicating their origin and destination.[43] This technology allowed the transfer of digitised information from one computer to another.[44] As the information is broken up into blocks or packets, it can be sent through multiple routes shortening the transfer time if one route is busy or not functioning.[45]

These inventions, and the then futuristic concept advanced by some scientists that computers should be applied as communication tools and not just to solve difficult mathematical formulae, led to collaboration between ARPA and BOLT (a consulting firm in Cambridge, Massachusetts) in the development of the ARPANET.[46]

At the end of 1969 ARPANET was launched creating the first long distance computer network connecting the University of California in Los Angeles, the Stanford Research Institute in Menlo Park, California, the University of California, Santa Barbara, and the University of Utah.[47] The network soon grew to over 10 sites with

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[40] Crosby K (1995) *George Stiblitz* http://ei.cs.vt.edu/~history/Stibitz.html [accessed on 31 May 2012]*;* Slevin J (2000) *The Internet and Society* at 29.
[41] Crosby K (1995) *George Stiblitz* http://ei.cs.vt.edu/~history/Stibitz.html [accessed on 31 May 2012]*;* Slevin J (2000) *The Internet and Society* at 29; Winston B (1998) *Media Technology and Society: A History: From the Telegraph to the Internet* at 322.
[42] Slevin J (2000) *The Internet and Society* at 29; Winston B (1998) *Media Technology and Society: A History: From the Telegraph to the Internet* at 322-323; Abbate J (1999) *Inventing the Internet* at 15-41.
[43] Slevin J (2000) *The Internet and Society* at 29; Schell BH (2007) *The Internet and Society* at 37; Abbate J (1999) *Inventing the Internet* at 15-41.
[44] Slevin J (2000) *The Internet and Society* at 29; Schell BH (2007) *The Internet and Society* at 37; Abbate J (1999) *Inventing the Internet* at 15-41.
[45] Slevin J (2000) *The Internet and Society* at 29; Schell BH (2007) *The Internet and Society* at 37.
[46] Slevin J (2000) *The Internet and Society* at 30; Ryan J (2010) *A History of the Internet and the Digital Future* at 29; Winston B (1998) *Media Technology and Society: A History: From the Telegraph to the Internet* at 328; Norman JM (ed) (2005) *From Gutenberg to the Internet : A Sourcebook on the History of Information Technology* at 6.
[47] Slevin J (2000) *The Internet and Society* at 31.

an estimated 2000 users.[48] During October 1972, a public demonstration of APRANET was held at the first International Conference on Computer Communications in Washington. This sets in motion discussions on the expansion of APRANET to a global network.[49] The first international connection was set up at a conference in Brighton, UK in 1973.[50] Data was sent via satellite to Goonhilly Downs in Cornwall, from there by cable via the University of London to the Information Sciences Institute in California, USA, enabling delegates to experience APRANET as if they themselves were in the USA.[51] While the transfer of information on ARPANET was very reliable due to the Network Control Protocol, the expansion of the infrastructure caused information to get lost or compromised due to weak connections or unreliable networks.[52] In 1972, Bob Kahn and Vin Cerf, who were initially involved in setting up the Network Control Protocol, collaborated to set up a Transmission Control Protocol (TCP) and an Internet Protocol (IP).[53] The TCP organised digital data in packets and put them in the correct order at the desired destination.[54] The IP routed the packets through the network.[55] By 1983, the APRANET and all networks connected to APRANET were required to make use of the TCP/IP Protocol.[56] This was soon to be dubbed the Internet. During these early years of ARPANET, the network was reliant on its own network (cable) and/or satellite system. Two Chicago students developed the telephone modem in the late 1970s and this allowed users to connect to the ARPANET via normal telephone lines.[57] The introduction of the modem and the invention of personal computers, were the most significant contributing factors to the world wide proliferation, bulletin

[48] Slevin J (2000) *The Internet and Society* at 31.
[49] Slevin J (2000) *The Internet and Society* at 31; Abbate J (1999) *Inventing the Internet* at 79.
[50] Slevin J (2000) *The Internet and Society* at 31.
[51] Slevin J (2000) *The Internet and Society* at 31.
[52] Slevin J (2000) *The Internet and Society* at 32.
[53] Slevin J (2000) *The Internet and Society* at 32; Schell BH (2007) *The Internet and Society* at 5; Ryan J (2010) *A History of the Internet and the Digital Future* at 37-40.; Abbate J (1999) *Inventing the Internet* at 127-133; Norman JM (ed) (2005) *From Gutenberg to the Internet: A Sourcebook on the History of Information Technology* at 6.
[54] Slevin J (2000) *The Internet and Society* at 32; Norman JM (ed) (2005) *From Gutenberg to the Internet*: *A Sourcebook on the History of Information Technology* at 6.
[55] Slevin J (2000) *The Internet and Society* at 32; Abbate J (1999) *Inventing the Internet* at 140-142.
[56] Slevin J (2000) *The Internet and Society* at 32.
[57] Slevin J (2000) *The Internet and Society* at 32.

board systems, and electronic discussion fora.[58] In 1983, the open nature of ARPANET became a security risk and it was split into ARPANET (to be used for research), and MILNET (exclusively for military use).[59] Since 1980, the ARPANET's role as long distance network was gradually taken over by supercomputing centres set up by the National Science Foundation (NSFNET), and by 1990 ARPANET had been decommissioned.[60] The NSFNET was, however, exclusively used for research and education.[61] The National Science Foundation initiated the privatisation and commercial exploitation of the Internet in 1988, and gradually privatised key parts of the Internet to companies like IMB and Merit Network Inc, until the NSFNET was finally shut down in 1995 after all operations had been privatised.[62]

Most Internet networks are now provided and maintained by commercial enterprises.[63] This conceals huge legal barriers with expanding the reach of VAT, including property rights, commercial law, privacy, et cetera. From the mid 1990s, various enterprises initiated the use of TCP/IP protocols within their own organisations creating mini Internet networks (Intranet).[64] These systems are for exclusive use within the organisations, and are protected by firewalls.[65] Communication between these networks and the Internet is effected through Internet gateways.[66]

2.2.2 E-mail and the World Wide Web

[58] Slevin J (2000) *The Internet and Society* at 32; Schell BH (2007) *The Internet and Society* at 5-7; Ryan J (2010) *A History of the Internet and the Digital Future* at 51; Norman JM (ed) (2005) *From Gutenberg to the Internet: A Sourcebook on the History of Information Technology* at 40.
[59] Slevin J (2000) *The Internet and Society* at 33; Ryan J (2010) *A History of the Internet and the Digital Future* at 90; Abbate J (1999) *Inventing the Internet* at 142-143.
[60] Slevin J (2000) *The Internet and Society* at 33.
[61] Slevin J (2000) *The Internet and Society* at 33.
[62] Slevin J (2000) *The Internet and Society* at 33.
[63] Slevin J (2000) *The Internet and Society* at 33.
[64] Slevin J (2000) *The Internet and Society* at 34; Schell BH (2007) *The Internet and Society* at 2.
[65] Slevin J (2000) *The Internet and Society* at 34; Abbate J (1999) *Inventing the Internet* at 161-166.
[66] Slevin J (2000) *The Internet and Society* at 34; Abbate J (1999) *Inventing the Internet* at 161-166.

Communication and accessing information on the Internet required specialised skills.[67] These skills required participants to remember and type difficult commands or transcribe complicated network addresses.[68] This hampered the commercialisation of the Internet from the outset. In 1971, Ray Tomlinson created electronic mail (e-mail) in its user friendly form as it is known today by introducing the universal mail address format like johnsmith@gmail.com.[69] From 1990 onwards, a whole range of user-friendly applications were introduced to make communication on the Internet easier.[70] These included better interface, a range of buttons, and pull down menus from which commands could be chosen.

Before the introduction of the World Wide Web, users of the Internet had to trace difficult routes and links to access information on the system.[71] If the location of the information was not known to a user, he was unable to access it. Tim Berners-Lee and Robert Cailliau of the European Laboratory of Particle Physics (CERN), developed a system within CERN for storing, retrieving and communicating information using hyperlinks and hypertext.[72] Today the World Wide Web can be accessed by any person with an Internet connection. Information can be accessed by means of a browser, and users are merely required to type the World Wide Web address or Uniform Resource Locator (URL) to gain access to the webpage. Even if the URL is not known to the user, search engines like Google can be accessed to search for keywords in hyperlinks and hypertext to route the user to the correct URL or web address. Today the terms Internet and World Wide Web are used interchangeably. The world's first "website" was registered in 1985 as www.symbolics.com.[73] Although the World Wide Web was open for business in

[67] Slevin J (2000) *The Internet and Society* at 36; Abbate J (1999) *Inventing the Internet* at 84.
[68] Slevin J (2000) *The Internet and Society* at 36; Abbate J (1999) *Inventing the Internet* at 86-87.
[69] Schell BH (2007) *The Internet and Society* at 4; Ryan J (2010) *A History of the Internet and the Digital Future* at 77; Abbate J (1999) *Inventing the Internet* at 106.
[70] Slevin J (2000) *The Internet and Society* at 36; Ryan J (2010) *A History of the Internet and the Digital Future* at 77.
[71] Slevin J (2000) *The Internet and Society* at 37; Abbate J (1999) *Inventing the Internet* at 204.
[72] Slevin J (2000) *The Internet and Society* at 37; Schell BH (2007) *The Internet and Society* at 12-13.; Ryan J (2010) *A History of the Internet and the Digital Future* at 107; Abbate J (1999) *Inventing the Internet* at 212-216.
[73] Schell BH (2007) *The Internet and Society* at 9.

1992, it was not until 1995 that the backbone of the Internet was finally handed over to private telecommunication companies Sprint, Ameritech, and Pacific Bell.[74]

Internet browsers are constantly being improved to allow users not only to access information or webpages, but also to send and receive e-mail, listen to radio, watch television, make and receive video calls, and play interactive video games without having to switch between browsers/applications. This commercialisation and rapid expansion of the Internet has had a major impact on society at large.

Another important development was the invention of an index system termed XML (Extensible Markup Language).[75] Before the development of XML, the Internet was one big disorganised reference book.[76] XML allows computer programmers to attach "tags" or unified codes, which distinguish between a business name or telephone number.[77] Today, XML is the backbone of electronic commerce as it is this system which allows purchase orders be read universally and routed correctly.[78]

2.3 What is digital technology?

It is often difficult for non-technically trained persons to understand what digital technology entails. The purpose of this paragraph is not to explain digital technology in technical terms. In this paragraph I attempt to explain how a digital computer and some digital technology operate. This basic understanding of digital technology will form a vital part of the discussion on VAT collection on digital online sales which is discussed in the remainder of this thesis.

The very first computers were developed as mere calculating machines.[79] Computing technology underwent dramatic development and changes to become the miracle machines that we operate today.[80] Digital computers fall in two categories, namely, general or multi-purpose computers, and special-purpose

[74] Winston B (1998) *Media Technology and Society: A History: From the Telegraph to the Internet* at 333.
[75] Schell BH (2007) *The Internet and Society* at 16.
[76] Schell BH (2007) *The Internet and Society* at 16.
[77] Schell BH (2007) *The Internet and Society* at 17.
[78] Schell BH (2007) *The Internet and Society* at 17.
[79] Abbate J (2000) *Inventing the Internet* at 1.
[80] Abbate J (2000) *Inventing the Internet* at 1; Nashelsky L (1983) *Introduction to Digital Technology* 3rd edition at 3.

computers.[81] Special-purpose computers are designed to perform a specific task - for example, to guide a missile or weld two pieces of metal together. Multi-purpose computers, on the other hand, are designed to perform multiple tasks - for example, play music, do financial bookkeeping, play games, et cetera.[82] In order for a computer to perform the tasks it was designed to perform, it must be pre-programmed to read and process the command inputs by the user.[83] Special computer language has been developed over years to programme the computer to perform its tasks. These languages consist of arithmetic and algorithmic codes.[84] These codes are programmed into a Central Processing Unit (CPU) which reacts on input commands to produce output units (see figure 2.1).[85]

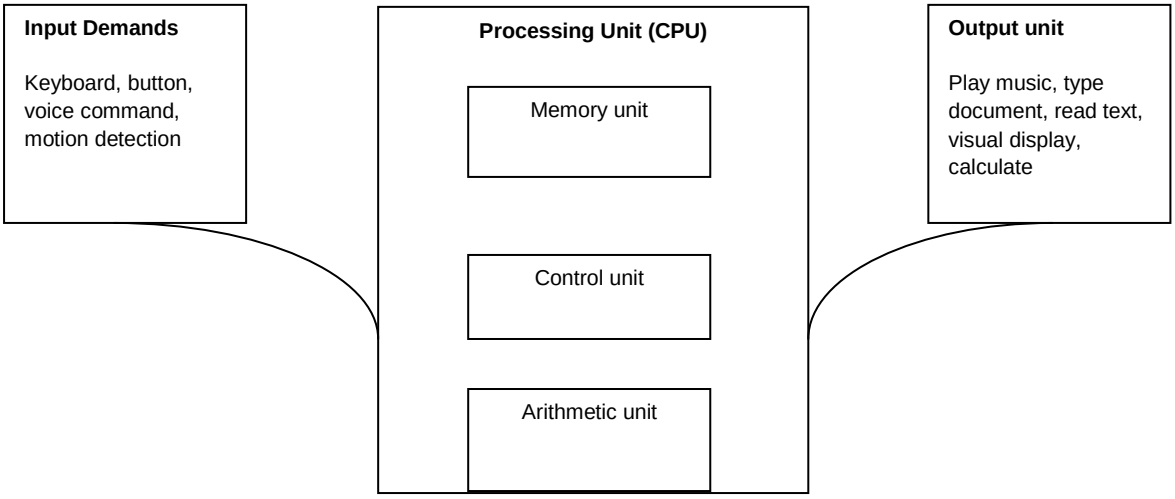

Fig 2.1

Early computers demanded complex skills – the user was required to type commands in computer language to achieve the desired output. This process has been simplified by computer programmes, and can now be achieved at the touch of an actual button - like the play button on your radio - or by clicking or touching a command reflected on a screen. As computer language is universal, most computer programmes can run on different computers, and a command can be punched into

[81] Nashelsky L (1983) *Introduction to Digital Technology* 3rd edition at 3.
[82] Nashelsky L (1983) *Introduction to Digital Technology* 3rd edition at 3.
[83] Nashelsky L (1983) *Introduction to Digital Technology* 3rd edition at 4.
[84] Nashelsky L (1983) *Introduction to Digital Technology* 3rd edition at 6-8.
[85] Nashelsky L (1983) *Introduction to Digital Technology* 3rd edition at 4-5.

one computer while the output is processed by another computer. A simple example is the remote control of your television. By pressing a button on your remote control (computer 1), a command is sent to your television (computer 2) to perform a task, for example changing a channel or increasing the volume.

Early computers stored information, arithmetic code, and algorithms in vacuum tubes which were not only extremely large, but also dangerous.[86] These tubes were prone to overheat and explode.[87] These were soon replaced by magnetic strip, CD, DVD, and advanced hard drives (comprising magnetised material) that can store more information on smaller devices.[88] As the need for smaller storage devices with a higher storage capacity increases, researchers are constantly exploring new digital storage methods and improving the storage capacity of hard drives.[89] These digital storage methods include, but are not limited to, MP3, MP4, AAC, and DivX file formats.

2.3.1 MP4, MP3, AAC and Divx

In the early years of digital technology development, it was often difficult to send information from one device to another due to the size of the information and the limitations of the Internet network. It often required the transfer of the physical storage device from one machine to another. For example, Audio and Video files were stored on magnetic tape. Without an intelligent super computer, it would have been impossible to transfer Audio or Video files without transferring the magnetic tape from one device to another. As a result of the complexity of Audio and Video, these files take up a great deal of storage space. The widespread use of computers, and an increasing availability of faster Internet connectivity at Universities and

[86] Nashelsky L (1983) *Introduction to Digital Technology* 3rd edition at 4.
[87] Nashelsky L (1983) *Introduction to Digital Technology* 3rd edition at 4.
[88] Nashelsky L (1983) *Introduction to Digital Technology* 3rd edition at 5; Kryder MH and Kim CS (2009) "After Hard Drives what Comes Next" *IEE Transactions on Magnetics* vol 45 no 10 at 3406 http://ieeexplore.ieee.org/stamp/stamp.jsp?tp=&arnumber=5257331 [accessed on 6 June 2012].
[89] Kryder MH and Kim CS (2009) "After Hard Drives what comes next" *IEE Transactions on Magnetics* vol 45 nr 10 at 3412 http://ieeexplore.ieee.org/stamp/stamp.jsp?tp=&arnumber=5257331 [accessed on 6 June 2012].

businesses, have led to the development of digital encoding technology.[90] Mpeg 1-layer 3, Mpeg 1-layer 4, Mpeg 2 Advanced Audio Coding (AAC), and Divx are all encoding formats used for Audio and or Video files allowing the user to encode the file into smaller packets (BITS), transfer the packets from one device via a network and decode the file using a decoding programme, like an Mpeg-player, on another device (see fig 2.2).[91] Files can be permanently encoded using Mpeg or lossy compression encoding without significant loss in audio or video quality.

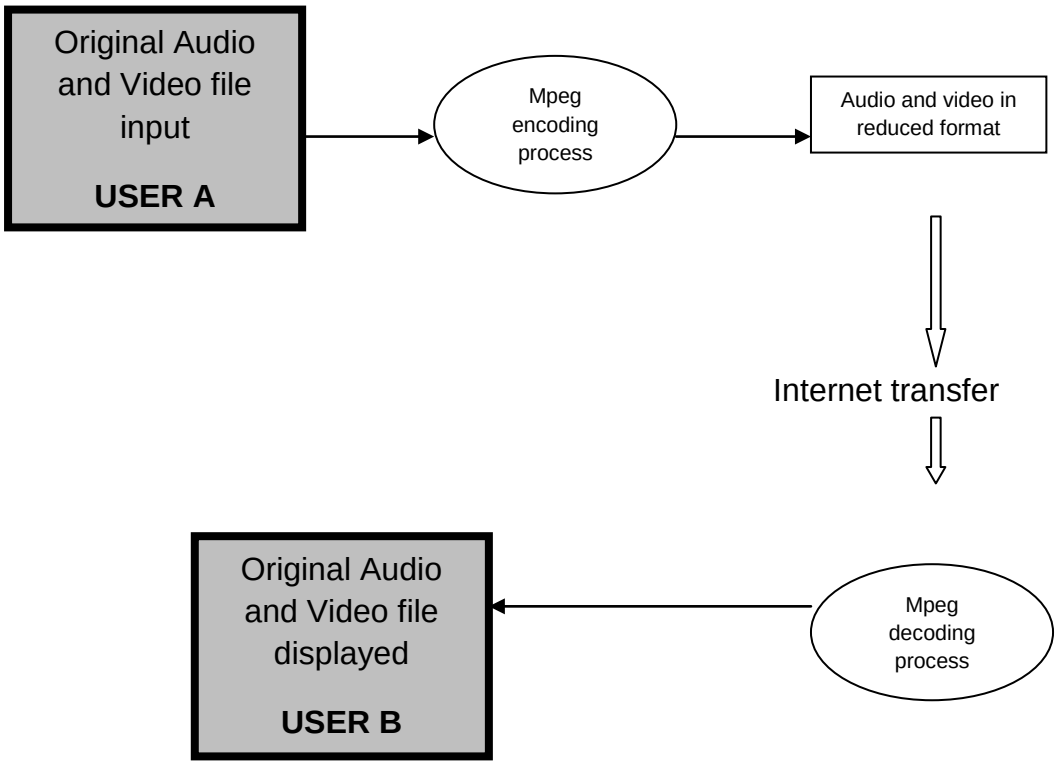

Fig 2.2

Sharing video and audio files no longer requires the physical sharing of magnetic tapes, CDs, or DVDs. User A can encode the original file in smaller chunks and transfer it via an Internet network to user B, who can decode and enjoy the original (in this case an exact copy of the original) file as can be seen in figure 2.2. Digital

[90] Brandenburg K (2009) "MP3 and AAC Explained" *AES 17th International Conference on High Quality Audio Coding* at 1 http://telos-systems.com/techtalk/hosted/Brandenburg_mp3_aac.pdf [accessed on 7 June 2012].

[91] Brandenburg K (2009) "MP3 and AAC Explained" *AES 17th International Conference on High Quality Audio Coding* at 1-2http://telos-systems.com/techtalk/hosted/Brandenburg_mp3_aac.pdf [accessed on 7 June 2012]; McCandles M (1999) "The MP3 Revolution" *IEEE Intelligent Systems* May/June at 8.

encoding technology has had a tremendous impact on Internet user profiles and e-commerce (see the discussion below).

2.4 The impact of the Internet on society

In order to understand transformations in society, one must recognise the role that transformation plays and the impact it has.[92] The Internet has expanded at a rapid rate and has integrated various forms of traditional communication methods including, but not limited to, letter writing (e-mail being the Internet version), radio (streaming audio), newspapers, telephone (Skype and Google voice call), and television (Youtube).[93] In a digital Internet-driven world, society has become completely dependent on an Internet connection - so much so that it affects the way we live, what we do, what we decide, and what we will become. That said, many rural third world societies do not have access to the Internet and will probably never be able to reap the benefits of the Internet during their lifetime. In examining the impact of the Internet and its future capabilities, one should be careful not to be over futuristic and keep rural Internet-less people and countries in mind. This should, however, not distract us from the potential that the Internet holds or the problems associated with that future. The unpredictability of the information technology environment requires an active approach in anticipating its consequences, problems and uncertainties, and the capacity actively to deal with this.[94] If this is not done at an early stage, massive problems can be created which crisis management will not be able to deal with. In order to develop and exploit the Internet positively, an informed understanding and firmer grasp of what it involves is required.[95]

The Internet has the potential to create a globalised community that can instantly connect strangers around the world. It has no boundaries. The difference between real time and space, versus virtual time and space, cannot be determined. That said, without people a virtual world cannot exist.[96]

[92] Slevin J (2000) *The Internet and Society* at 1.
[93] Slevin J (2000) *The Internet and Society* at 1.
[94] Slevin J (2000) *The Internet and Society* at 3.
[95] Slevin J (2000) *The Internet and Society* at 3.
[96] Slevin J (2000) *The Internet and Society* at 7.

2.4.1 Rapid growth in users

The global scope of the Internet means that user statistics are, at best, an estimate and by no means accurate. These statistics are often negatively impacted by the anonymity of Internet users at Internet cafés and public WIFI spots. Nevertheless, on the whole, these statistics fairly reflect user trends and growth.

By 1999, the total number of Internet users was estimated at between 150 and 180 million compared to the 2000 users in 1969, and 90 000 users in 1989.[97] The majority of these users were based in the USA.[98] By 1999, Finland's Internet penetration rate was the largest in the world at 35 per cent, while the USA ranked second at 30 per cent.[99] By 31 December 2011, the world's Internet population was estimated at 2 267 233 742 users of whom 44,8 per cent were based in Asia.[100] In South Africa alone, Internet usage has grown by 25 per cent from 6,8 million users in 2010, to 8,5 million users in 2011.[101] This equates with an Internet penetration rate of seventeen per cent.[102] Despite the rapid growth, South Africa's Internet penetration rate is low compared to other African countries like Nigeria (49 million users: 29 per cent penetration),[103] Egypt (21,6 million users: 26 per cent penetration),[104] and Kenya (10,4 million: 24 per cent penetration).[105] The availability of smart phones is the principal reason for higher Internet penetration rates in

[97] Slevin J (2000) *The Internet and Society* at 31 and 40; Schell BH (2007) *The Internet and Society* at 12.
[98] Slevin J (2000) *The Internet and Society* at 40-41.
[99] Slevin J (2000) *The Internet and Society* at 41.
[100] Internet World Stats (2011) *World Usage and Population Statistics* www.internetworldstats.com [accessed on 4 June 2012].
[101] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012]; Central Intellegence Agency (2012) "Africa: South Arica" in *World Factbook* https://www.cia.gov/library/publications/the-world-factbook/geos/sf.html [accessed on 18 September 2012].
[102] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[103] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[104] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[105] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 .http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

developing countries.[106] That said, the physical infrastructure and Internet connection in these countries are limited to major centres.[107] South Africa's relatively low penetration rate can be attributed to high broadband costs and a lack of infrastructure in rural areas.[108] Despite the exorbitant/prohibitive cost of Internet devices and services, and an undeveloped rural cabling network and poor mobile coverage, it is anticipated that a fifth of all Internet traffic in Africa will be carried by mobile networks by 2015.[109] This is a conservative estimate considering that Africa has the second largest mobile connection rate in the world with over 616 million subscriptions.[110] It should be noted, however, that not all mobile phone users are smart phone users. This notwithstanding, mobile networks across Africa are migrating to 3G and 4G networks increasing the demand for smart phones. This could dramatically increase the number of Internet users. Furthermore, mobile Internet device manufacturers like Huawei, are making more affordable smart phones available in Africa.[111]

2.4.2 Internet user profiles

When the APRANET was first introduced in 1969, its primary purpose was to store and share information over distance without compromising its integrity. In other words, the idea was that users would be able to communicate with each other and share information securely and instantly. Although the telegraph and telephone were instant, they were not secure. The postal service was neither instant nor secure. From these early days it was clear that e-mail would be the most valuable tool of the

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[106] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[107] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[108] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[109] Jotischky N (2011) *Press Release: Informa Telecoms and Media Report Examines the State of Broadband in Africa* http://blogs.informatandm.com/3515/press-release-informa-telecoms-media-report-examines-the-state-of-broadband-in-africa/ [accessed on 5 June 2012].
[110] Reed M (2011) *Press Release: Africa is the World's Second Most Connected Region by Mobile Subscriptions* http://blogs.informatandm.com/3485/press-release-africa-is-world%e2%80%99s-second-most-connected-region-by-mobile-subscriptions/ [accessed on 5 June 2012].
[111] News24 (2013) *Huawei Launches Africa-only Smartphone* http://www.news24.com/Technology/News/Huawei-launches-Africa-only-smartphone-20130205 [accessed on 31 March 2013].

Internet.[112] No cheaper, more efficient way of instant communication exists, especially when time-zones or working hours differ.[113] Even today, despite the various activities made possible by the Internet, e-mail is still the most commonly used Internet tool in the world.[114]

Apart from e-mail, the Internet was for most of its existence principally used for sharing information. Academics from various institutions, shared research findings and scholars were able to search the Internet for information. It operated much like a library. In 1990, the Internet was fast starting to shed its reputation of being an academic tool to search for information.[115] Soon chat rooms were created,[116] and the number of non-academic communications and file sharing increased dramatically. It was not until the second half of the 1990s that the Internet became the platform for commercial trade as commercial activity was forbidden under the National Science Foundation Acceptable Usage Policy.[117]

2.4.2.1 The start of e-commerce

The first item sold on eBay was a broken laser pointer.[118] The founder of eBay, Pierre Omidyar, was amazed that someone would buy something as mundane as a broken laser pointer until he found out that the buyer was a collector of laser pointers.[119] By the end of 1996, eBay's Internet sales turnover reached USD 7,2 million.[120] The high demand for goods sold on eBay, proved that the Internet is a valuable marketplace and that it can become a valuable tool for e-commerce.[121] Paul Baran, one of the pioneers of computer development, predicted as early as 1968, that people will someday day be able to connect to an electronic shop that sells

[112] Winston B (1998) *Media Technology and Society: A History: From the Telegraph to the Internet* at 335.
[113] Winston B (1998) *Media Technology and Society: A History: From the Telegraph to the Internet* at 335.
[114] Winston B (1998) *Media Technology and Society: A History: From the Telegraph to the Internet* at 335.
[115] Slevin J (2000) *The Internet and Society* at 41.
[116] Slevin J (2000) *The Internet and Society* at 49.
[117] Ryan J (2010) *A History of the Internet and the Digital Future* at 120.
[118] Ryan J (2010) *A History of the Internet and the Digital Future* at 120.
[119] Ryan J (2010) *A History of the Internet and the Digital Future* at 120.
[120] Ryan J (2010) *A History of the Internet and the Digital Future* at 120.
[121] Ryan J (2010) *A History of the Internet and the Digital Future* at 120.

virtually anything from the comfort of their own homes.[122] That said, critics like Brian Winston opine that -

> There is also little to support the idea that the net will become a crucial method of selling goods and services. Every system for avoiding shopping from the mail-order catalogue to the cable television shopping channel has never done more than provide, albeit often profitably, niche services. One of the sillier facets of Information Revolution rhetoric is the belief that technology is urgently required to help people avoid going shopping or travelling on business. People like shopping and travelling-just as they like being told, or reading, stories. So we do not need stories to be more 'interactive' than they have been since the dawn of time; a liking for travel is why business people have avoided the lure of the video-conference phone for nearly two-thirds of the twentieth century; and we so love shopping we have made the shopping mall…[123]

To some extent, Winston is correct that we love shopping and we love travelling. However, the convenience of an instant meeting via video-conference, and the increasing cost (including the cost to the environment) of long distance travel, together with the time wasted in travelling, has made video and audio streaming a popular business tool in recent years. Although shopping is often seen as pleasurable leisure activity, the very lack of time to shop during actual shopping hours has made e-commerce an attractive alternative where shopping is not restricted to specific business hours or geographical areas. For example, A who lives in a rural area at least three hours drive from the nearest mall, can now order and purchase goods from an online shop and have it delivered. Not only does e-commerce save him the time of driving to a mall, but it also saves him the disappointment of not finding what he was looking for at the mall.

The biggest frustration that e-commerce creates (although the phenomenon is not limited to e-commerce) is the lack of timely and secure delivery.[124] Three main reasons exist why e-commerce has not evolved into the only or main form of shopping namely -

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[122] Ryan J (2010) *A History of the Internet and the Digital Future* at 120.
[123] Winston B (1998) *Media Technology and Society: A History: From the Telegraph to the Internet* at 335-336.
[124] Lee HL and Wang S (2001) "Winning the Last Mile of E-commerce" *MIT Sloan Management Review* Summer at 54.

(i) consumers still enjoy an interactive shopping experience where products can be looked at, touched and tested before it is purchased

(ii) shopping malls offer instant delivery whereas delivery via e-commerce is dependent on courier or postal service which is not only slow and unreliable, but also costly

(iii) the non existence of an Internet infrastructure, poor connections, and high broadband costs has deprived many possible e-consumers from the market.

Nevertheless, technological advances in digital media can alter shopping patterns dramatically to increase the demand for e-commerce.[125] With the introduction of Mpeg, Divx, and other digital encoding processes, physical delivery of items is no longer the only form of delivery. Books, video, audio, games, software and similar items can now be purchased and instantly downloaded by the purchaser without receiving any tangible item. Dematerialisation has numerous benefits including close to zero delivery costs, instant delivery, and greater consumer choice.[126] For example, a traditional music store sells music compilations on CD. Although it might stock a wide variety, the consumer is still limited to the compilations compiled by the retailer/manufacturer. The same consumer can compile his own compilation when purchasing music song for song online. Dematerialised goods do not require packaging (postage), printing (books), or magnetised storage devices (CD, DVD), and can be sold at a fraction of the cost of the materialised product. Dematerialised goods, furthermore, enable shoppers to purchase goods in foreign countries and import these to their home country without incurring shipment costs. Consumers are, as a result, exposed to products that they would normally not have been exposed to if it were not for the Internet and e-commerce.

In addition, encoding of files has made their transfer fast, easy and convenient. Depending on the type of media transferred, the smaller packets (bits) of digitally encoded files can be transferred to a mobile device without using excessive amounts

[125] Lee HL and Wang S (2001) "Winning the Last Mile of E-commerce" *MIT Sloan Management Review* Summer at 55.
[126] Lee HL and Wang S (2001) "Winning the Last Mile of E-commerce" *MIT Sloan Management Review* Summer at 57.

bandwidth. Bandwidth is the common term used in computing to refer to the amount of data communication consumed.

2.4.2.2 How does e-commerce work?

Many traditional transactions can be concluded online including retail shopping, banking, gambling, and the payment of accounts. For purposes of this thesis I shall limit the discussion to online retail shopping. Online retail shopping can be divided into two main categories: materialised e-commerce and dematerialised e-commerce.

2.4.2.2.1 Materialised e-commerce

The traditional shopping experience is characterised by a chain of events that can be summed up as follows -

- the consumer identifies his needs - for example, he wants to read a book
- the possible retail outlet is identified and the consumer drives to the store
- the consumer searches for the book he wants, finds it and reads the front and back covers or even pages through the book
- a decision is made and the book is purchased (in cash or by card) at the cashier and the consumer returns home to enjoy the book.

Although very similar, in the case of materialised e-commerce, the consumer and merchant are not in each other's presence. In fact, the merchant is often not even aware that a consumer is busy concluding a transaction with him, because the process is partially automated. In materialised e-commerce the chain of events can be summarised as follows -

- the consumer identifies his needs - for example, he wants to read a book

- the possible online store is identified based on the consumer's trust, word of mouth, or a search on the Internet
- the consumer browses through the online store, finds the book he is looking for, and reads through the product description or reviews
- a decision is made and the consumer places an order by clicking a button or dragging the item to his online shopping basket
- the merchant's system determines the availability of the item and calculates delivery costs to the consumer
- the consumer accepts the price and shipment costs and supplies his credit card details or makes an online electronic funds transfer (EFT) payment
- the merchant acknowledges receipt of payment and ships the book to the consumer.

Materialised e-commerce mostly delays the consumer's enjoyment of the product due to longer delivery times. That said, consumers are often exposed to a greater variety of goods not commonly available in-store or which the store is not willing to stock. Depending on the merchant's shipping policy, materialised e-commerce is not restricted to geographical areas and goods can be purchased from anywhere in the world.

2.4.2.2.2 Dematerialised e-commerce

While materialised e-commerce is partially automated, dematerialised e-commerce is fully automated. I refer to materialised e-commerce as partially automated because human interaction is still required to fulfil the order (package and ship the order). In the case of dematerialised e-commerce, the only human interaction required is when the consumer initiates the transaction process (that is, if the consumer is required to initiate the transaction). The characteristic chain of events is as follows:

- the consumer identifies his needs – for example, he wants to read a book;

- the online store is identified based on trust, previous experience, or an Internet search;
- the consumer browses through the online store finds the book and reads through the description or reviews, or pages through the electronic book;
- a decision is made and the consumer purchases the book by clicking on a button and entering his credit card details or by making an electronic funds transfer (EFT) payment;
- the merchant's system encodes the electronic book into smaller packets (Mpeg or similar file format) and sends it via a network to the consumer;
- the consumer decodes the file received and reads the electronic book on a device (Kindle or e-book reader).

Delivery of dematerialised goods is instantaneous, depending on the size of the file being transferred, network traffic, and the speed of the receiving device. Large files and heavy network traffic can reduce the delivery time to a few minutes or hours. It should, however, be noted that the delivery time may be delayed by these factors while the delivery process starts immediately after the sale has been concluded. Since no packaging or shipment is required, merchants can deliver dematerialised goods anywhere in the world at a fraction of the cost of traditional delivery methods. In addition, dematerialised goods like e-books are relatively cheaper than actual books because there is no printing cost. These factors make dematerialised e-commerce an attractive option for consumers. However, pricing does not always reflect the lower cost of production of dematerialised goods.

2.4.3 E-commerce in South Africa

E-commerce in South Africa is still in its infancy. This is partly due to high Internet costs and user trust issues. Fixed line Internet in South Africa is costly. Fixed line rental currently costs R140 per month which excludes data usage which is billed

separately.[127] The high cost of mobile bandwidth and line rental costs, are beyond the reach of most South Africans.[128] In 1990, only 3,5 per cent of households owned computers.[129] In 2011, the number of households in South Africa with computers rose to 7,5 per cent.[130] In addition, fixed line networks are mostly limited to urban areas, although several network operators are expanding their optic fibre networks in rural areas.[131]

Internet penetration is determined by the number of Internet users divided by the population.[132] An Internet user, in turn, is defined as a person of two years or older who accessed the Internet over a 30 day period.[133] A target has been set to attain 80 per cent Internet penetration across Africa by 2020.[134] This target will include connections in all major cities, towns, and villages bringing the Internet within reach of virtually all Africans.[135]

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[127] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012]; Fuchs C and Horak E (2006) "Africa and the digital divide" *Telematics and Informatics* vol 25 issue 2 at 102 http://www.sciencedirect.com/science/article/pii/S0736585306000359 [accessed on 13 June 2012] .

[128] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012]; Fuchs C and Horak E (2006) "Africa and the digital divide" *Telematics and Informatics* vol 25 issue 2 at 102 http://www.sciencedirect.com/science/article/pii/S0736585306000359 [accessed on 13 June 2012].

[129] Wilson EJ and Wong K (2003) "African Information Revolution: A Balance Sheet" *Telecommunications Policy* vol 27 issue 1-2 at 158-159 http://www.sciencedirect.com/science/article/pii/S0308596102000976 [accessed on 13 June 2012]; Darley WK (2003) "Public Policy Challenges and Implications of the Internet and Emerging E-commerce for sub-Saharan Africa: A Business Perspective" *Information Technology Development* vol 10 issue 1 at 5-6 http://onlinelibrary.wiley.com/doi/10.1002/itdj.1590100102/pdf [accessed on 13 June 2012].

[130] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 2 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012]; Fuchs C and Horak E (2006) "Africa and the digital divide" *Telematics and Informatics* vol 25 issue 2 at 110 http://www.sciencedirect.com/science/article/pii/S0736585306000359 [accessed on 13 June 2012].

[131] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

[132] Aguiar M, Boutenko V, Miceal D, Rastogi V, Subramanian A, and Zhou Y (2010) *The Internet's New Billion* http://www.bcg.com/documents/file58645.pdf [accessed on 13 June 2012].

[133] Aguiar M, Boutenko V, Miceal D, Rastogi V, Subramanian A, and Zhou Y (2010) *The Internet's New Billion* http://www.bcg.com/documents/file58645.pdf [accessed on 13 June 2012].

[134] SAPA (2012) "Pan African Connectivity by 2020-Pule" *News 24* 7 June 2012 http://www.news24.com/SciTech/News/Pan-African-connectivity-by-2020-Pule-20120607 [accessed on 13 June 2012].

[135] SAPA (2012) "Pan African Connectivity by 2020-Pule" *News 24* 7 June 2012 http://www.news24.com/SciTech/News/Pan-African-connectivity-by-2020-Pule-20120607 [accessed on 13 June 2012].

Despite the low Internet penetration, mobile penetration in South Africa is high.[136] Approximately 63 million SIM cards are in use, which translates to 126 per cent penetration.[137] At least 20 per cent of SIM connections are for dual SIM usage, switchboard systems, and asset management (to track vehicles).[138] Entirely accurate figures are not available, but the true user base is estimated at around 40 million users which translates to an 80 per cent penetration.[139] It should, however, be noted that these statistics reflect the number of SIM card users and not smart phone users (or users of phones which enable the user to connect to the Internet). Mobile SIM cards can also be used to connect to mobile Internet using a mobile modem.

While SIM registration statistics cannot reflect smart phone usage, it should be noted that smart phones are increasingly becoming more affordable and mobile Internet connections more readily available. Non-smart phones are being phased out, and the majority of new mobile contracts or mobile upgrades, include a smart phone or a phone capable of connecting to the Internet.

World Wide Worx has observed that rural South Africans are more likely to play games on their mobile phones and explore the connection capabilities of their phones, than urban South Africans.[140] At present, these users mainly connect to the Internet to connect to and use social networks.[141] However, a survey by Mobility reveals that, in 2011, 37 per cent of South Africans in urban and rural areas over the

[136] Wilson EJ and Wong K (2003) "African Information Revolution: A Balance Sheet" *Telecommunications Policy* vol 27 issue 1-2 at 159 http://www.sciencedirect.com/science/article/pii/S0308596102000976 [accessed on 13 June 2012]; Johnston G and Pienaar S (2013) "Value-Added Tax on Virtual World Transactions: A South African Perspective" *International Business and Economic Research Journal* vol 12 no 1 at 71 http://www.cluteinstitute.com [accessed 12 April 2013]; Central Intellegence Agency (2012) "Africa: South Arica" in *World Factbook* https://www.cia.gov/library/publications/the-world-factbook/geos/sf.html [accessed on 18 September 2012].

[137] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012]; Central Intellegence Agency (2012) "Africa: South Arica" in *World Factbook* https://www.cia.gov/library/publications/the-world-factbook/geos/sf.html [accessed on 18 September 2012].

[138] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

[139] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 1 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

[140] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 2 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

[141] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 2 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

age of sixteen used cellular phone banking on a regular basis.[142] If these mobile users continue the trend of exploring their mobile phones' capabilities, user trends will soon alter from social networking to online shopping, gaming, and gambling. In 2002, when mobile Internet or Internet enabled mobile phones were rolled out in South Africa, very few mobile users in fact used the facility.[143] The experimental nature of user trends has, however, resulted in an increase in mobile Internet usage. This is evident from the current mobile packages sold by Mobile Service Providers. These packages are made up of voice and data packages.

E-commerce in South Africa comprises of traditional retail carried on online (tangible goods delivered to consumers), dematerialised retail (software, music, video downloads), and other intangible sales of tangible services (flight tickets, entertainment tickets, car rental).[144] Online airline ticket sales make up most of South Africa's online sales, although statistics show a decline in growth.[145] Business-to-consumer online sales have shown a steady year on year growth of between 30-35 per cent from 2006 to 2011.[146] Figure 2.3 below shows the growth in online sales (excluding online airline ticket sales) expressed in millions of South African Rand for the period 1996 to 2011.[147]

[142] Jacks M (2011) "ABSA's CashSend boosts cell phone banking in SA" *The New Age* http://www.thenewage.co.za/16885-1025-53-Absa%E2%80%99s_CashSend_boosts_cellphone_ba... [accessed on 18 September 2012].
[143] Brown I, Cajee Z, Davies D, Stroebel S (2003) "Cell Phone Banking: Predictors of Adoption in South Africa-an Exploratory Study" *International Journal of Information Management* vol 23 issue 5 at 382 http://www.sciencedirect.com/science/article/pii/S0268401203000653 [accessed on 13 June 2012].
[144] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 3 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[145] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 3 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[146] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 2 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[147] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 3 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

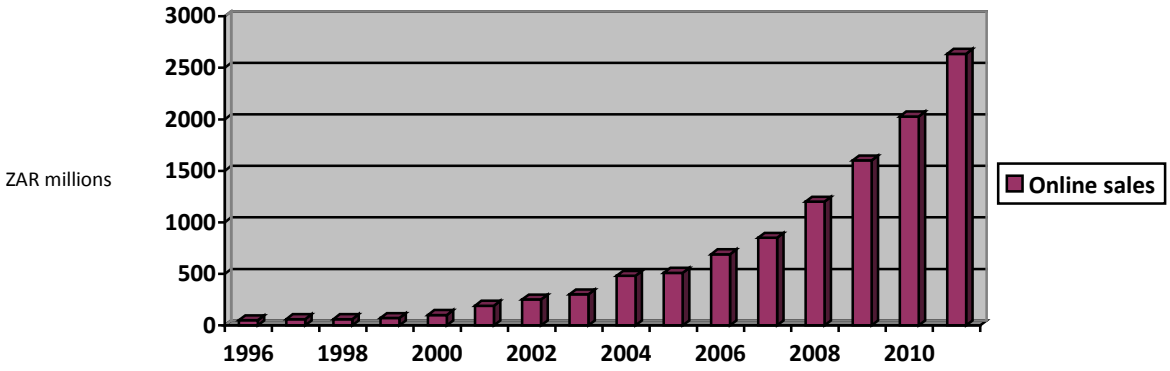

Fig 2.3[148]

These statistics, however, only indicate the growth in e-commerce, and do not break down the specific user trends - for example, whether the majority of online shoppers have shifted their traditional retail needs to online shopping, or whether an increase in dematerialised goods can be traced. Little to no research has been done to determine online shopping trends in South Africa.[149] According to a study by World Wide Worx, the increasing number of Internet users has had very little effect on the growth in e-commerce in South Africa.[150] Instead, the growth in e-commerce can largely be attributed to existing Internet users who have had an Internet connection since 1996.[151] This is partly due to users gaining confidence in the Internet, and their curiosity to explore gaining the upper hand. User trust is often gained by adopting secure payment systems and fast and efficient delivery.[152] Although the average Internet user would not be able to determine the trustworthiness of a payment system, he or she is likely to trust familiar information resources such as well known

[148] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 3 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[149] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 19 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[150] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 20 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[151] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 20 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[152] Barnard L and Wessen JL (2003) "Usibility Issues for E-commerce in South Africa: An Empirical Investigation" *SAICSIT Conference Proceedings* at 259 http://delivery.acm.org/10.1145/960000/954042/p258-barnard.pdf?ip=163.200.81.9&acc=ACTIVE%20SERVICE&CFID=110022166&CFTOKEN=84989978&__acm__=1339506495_0c2d5a65de9a68f6b780e05ba97e949a [accessed on 12 June 2012]; Brown I, Cajee Z, Davies D, Stroebel S (2003) "Cell Phone Banking: Predictors of Adoption in South Africa-an Exploratory Study" *International Journal of Information Management* vol 23 issue 5 at 382 http://www.sciencedirect.com/science/article/pii/S0268401203000653 [accessed on 13 June 2012].

emblems.[153] Gaining the consumer's trust and confidence takes time and is often only established by word of mouth. Many users will adopt a certain user profile like online shopper, gamer, or banker, based on the user's self-confidence and ability to operate as such.[154] Some users are reliant on the confidence of others, and are more likely to explore the Internet and e-commerce if their role models or influential persons are confident e-commerce users, or have persuaded them to become e-commerce users.[155] Thus, there is a direct relation between the length of time that a person has been an Internet user, and his or her willingness to engage in social networks, online banking, and online shopping.[156] Statistics created by World Wide Worx show that it takes approximately five years for the average Internet user to establish a network connection and become confident enough to take part in social media and e-commerce.[157] This means that the rapid growth in Internet connections from 2008-2011 will result in a rapid growth in e-commerce from 2013-2016. The increasing number of smart phone users will inevitably result in even greater growth in e-commerce in years to come. That said, this prediction only indicates the potential or readiness of current Internet users to take part in social networks and e-commerce in future, but does not mean that all of the current users will in fact do so. Online shopping should still be compatible with the Internet user's lifestyle before the user will engage in it.[158] For example, if the Internet user has the time to shop in a

[153] Barnard L and Wessen JL (2003) "Usibility Issues for E-commerce in South Africa: An Empirical Investigation" *SAICSIT Conference Proceedings* at 259 http://delivery.acm.org/10.1145/960000/954042/p258-barnard.pdf?ip=163.200.81.9&acc=ACTIVE%20SERVICE&CFID=110022166&CFTOKEN=84989978&__acm__=1339506495_0c2d5a65de9a68f6b780e05ba97e949a [accessed on 12 June 2012].

[154] Brown I, Cajee Z, Davies D, Stroebel S (2003) "Cell Phone Banking: Predictors of Adoption in South Africa-an Exploratory Study" *International Journal of Information Management* vol 23 issue 5 at 383 http://www.sciencedirect.com/science/article/pii/S0268401203000653 [accessed on 13 June 2012].

[155] Brown I, Cajee Z, Davies D, Stroebel S (2003) "Cell Phone Banking: Predictors of Adoption in South Africa-an Exploratory Study" *International Journal of Information Management* vol 23 issue 5 at 382 http://www.sciencedirect.com/science/article/pii/S0268401203000653 [accessed on 13 June 2012]; Uzoka FME, Shemi AP, Seleka GG (2007) "Behavioural Influences on E-commerce Adoption in a Developing Country Context" *The Electronic Journal on Information Systems in Developing Countries* vol 31 issue 4 at 4.

[156] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 20 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012]; Brown I, Cajee Z, Davies D, Stroebel S (2003) "Cell Phone Banking: Predictors of Adoption in South Africa-an Exploratory Study" *International Journal of Information Management* vol 23 issue 5 at 385 http://www.sciencedirect.com/science/article/pii/S0268401203000653 [accessed on 13 June 2012].

[157] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 21 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

[158] Brown I, Cajee Z, Davies D, Stroebel S (2003) "Cell Phone Banking: Predictors of Adoption in South Africa-an Exploratory Study" *International Journal of Information Management* vol 23 issue 5 at 384 http://www.sciencedirect.com/science/article/pii/S0268401203000653 [accessed on 13 June 2012]; Uzoka

mall and prefers to touch, feel and explore a product before buying it, he or she will most likely not engage in online shopping. Similarly, a person who works long hours and who has usually relied on others to buy goods according to his needs, is more likely to engage in e-commerce for the sheer convenience thereof. Additional factors include the complexity of e-commerce websites and whether goods can be used for a trial period, and can, if found unsuitable, be returned or exchanged.[159] For example, software users are more likely to purchase and download software if the manufacturer/seller allows the user to try out the software for a trial period.

During the 2006 e-commerce boom, most South African corporations were not ready to serve their online customer base.[160] This e-commerce boom was specific to South Africa and can largely be attributed to five factors: a dramatic increase in the use of smartphones, and the ability to access the Internet on these phones; the growth in ADSL connections in small and medium enterprises; an increase in new types of services and service providers which resulted in better competition; the popularity of social networking among South Africans; and the development and rapid increase in local content on the Internet.[161] Some of the retailers that were operating an online shop were found to be inefficient or not user-friendly, or did not offer the same variety of goods as the brick and mortar retailer.[162] Many of the consumers were confident enough to use the Internet to find other corporations that were able to meet their needs.[163] These corporations were mainly foreign - Amazon.com, for example. If South African corporations will again not be ready from

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FME, Shemi AP, Seleka GG (2007) "Behavioural Influences on E-commerce Adoption in a Developing Country Context" *The Electronic Journal on Information Systems in Developing Countries* vol 31 issue 4 at 4.

[159] Brown I, Cajee Z, Davies D, Stroebel S (2003) "Cell Phone Banking: Predictors of Adoption in South Africa-an Exploratory Study" *International Journal of Information Management* vol 23 issue 5 at 384 http://www.sciencedirect.com/science/article/pii/S0268401203000653 [accessed on 13 June 2012].

[160] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 21 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

[161] Goldstuck A (2012) Internet Matters: The Quiet Engine of the South African Economy at 21 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

[162] Barnard L and Wessen JL (2003) "Usibility Issues for E-commerce in South Africa: An Empirical Investigation" *SAICSIT Conference Proceedings* at 261-266 http://delivery.acm.org/10.1145/960000/954042/p258-barnard.pdf?ip=163.200.81.9&acc=ACTIVE%20SERVICE&CFID=110022166&CFTOKEN=84989978&__acm__=1339506495_0c2d5a65de9a68f6b780e05ba97e949a [accessed on 12 June 2012].

[163] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 21 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

2013 onwards to meet the online demand, consumers will find services elsewhere, most likely in foreign jurisdictions.[164]

In a survey compiled by Lunchboxmedia to determine the gay and lesbian consumer profile for 2012, it was found that 99 per cent of the respondents were connected to the Internet.[165] The survey revealed that 81 per cent of the respondents were regular online shoppers.[166] Some 26 per cent of these purchases were computer software, 37 per cent were music, eighteen per cent were games, 40 per cent were videos, and 54 percent were books.[167] The survey does not indicate whether these goods were purchased as materialised or dematerialised goods, thus making it difficult to determine if materialised goods are more popular than dematerialised goods, or vice versa.

These surveys highlight an important consumer trend for the purpose of this study: Online shopping is a growing phenomenon in South Africa.

2.5 The future of e-commerce

Many e-commerce critics, for example Winston, are of the view that e-commerce is a mere phase that society is going through, that it will not last long, or that it will remain a niche market for a few select individuals. If world e-commerce statistics are anything to go by, such critics have already been proven wrong. Does that mean that e-commerce will in future replace traditional forms of retail? I do not think so. Winston correctly points out that we enjoy shopping and travel. E-commerce is a convenient alternative to traditional shopping and can be used to purchase goods that would normally not be available in-store or even in the country, but online

[164] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at 21 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].
[165] Luncboxmedia (2012) *Consumer Profile 2012* http://gallery.mailchimp.com/dfa1cdd21fdb981ee645eff3d/files/LBM_Gay_Consumer_Profile_2012.pdf [accessed on 20 June 2012].
[166] Luncboxmedia (2012) *Consumer Profile 2012* http://gallery.mailchimp.com/dfa1cdd21fdb981ee645eff3d/files/LBM_Gay_Consumer_Profile_2012.pdf [accessed on 20 June 2012].
[167] These results are not mutually exclusive and some overlap may occur. See Luncboxmedia (2012) *Consumer Profile 2012* http://gallery.mailchimp.com/dfa1cdd21fdb981ee645eff3d/files/LBM_Gay_Consumer_Profile_2012.pdf [accessed on 20 June 2012].

shopping will not replace traditional retail shopping in its entirety. For example, although it takes less time and effort to purchase a mattress online, the only way to find the right mattress for your body contour and sleeping patterns is to try it in-store. What does the future of e-commerce then hold? Will it always merely be a convenient alternative? The answer to these questions lies in current trends.

2.5.1 Materialised e-commerce

While materialised e-commerce creates the convenience of shopping from the comfort of your home or office, it often lacks the immediate availability of goods that traditional shopping offers. Materialised e-commerce and traditional shopping are therefore regarded as competing markets. To compete with traditional shopping, materialised e-commerce must offer a wider variety or better pricing to make up for the delay in delivery. The convenience of unlimited shopping hours, a wider variety, and cheaper pricing (including shipping fees), are the three main reasons why a consumer would choose materialised e-commerce above traditional retail shopping. These reasons do not outweigh the convenience of immediate delivery especially when goods are urgently required. I can therefore safely surmise that, although materialised e-commerce will become increasingly popular, it will not replace traditional retail shopping.

2.5.2 Dematerialised e-commerce

Unlike materialised e-commerce, dematerialised e-commerce is not put at a disadvantage to traditional retail shopping because of time-consuming, costly delivery. Instant delivery, lower prices (because no packaging and shipment are required), and shopping that is not confined to trading hours, make dematerialised e-commerce an attractive alternative to traditional retail shopping.
Information and entertainment goods that were traditionally printed or stored on vinyl or magnetised storage devices (tape or CD), are now increasingly generated

electronically.[168] The cost of storage devices, printed books, and packaging has contributed to the need for dematerialised versions of books, music, software, and information. In addition, the carbon footprint of manufacturing books and delivering these to the consumer has resulted in environmentally conscious consumerism.

Early reactions to the Internet were characterised by predictions that the Internet would, in future, replace printed books.[169] These reactions were based on statistics showing that television had resulted in a major decline in newspaper sales.[170] Despite the decline in newspaper sales, to date neither television nor e-newspapers has replaced printed newspapers. The main reason could be attributed to low Internet penetration rates and poor television signals. That said, early predictions can resurface as a result of the increasing availability of mobile Internet, Internet-enabled telephones, and other Internet-enabled personal portable devices (PDA, Tablet, Kindle). Does this mean that dematerialised goods will replace their materialised counterparts? Again, I do not think so - at least not in the near future. While it can be predicted that dematerialised goods will gain in popularity, it will still take many years for them to completely replace the materialised form of the same goods. Goldstuck correctly points out that it takes some years for consumers to gain confidence in the use of technology and applications to their full potential.[171] Dematerialised and materialised goods will co-exist for many years before a transition from materialised to dematerialised goods will take place.

At present, electronic transactions are mostly initiated by the consumer. In other words, the consumer decides what he requires and then purchases it online. Many digital devices often require software updates to increase their capabilities and to ensure that they operate smoothly. These devices are programmed to determine if they require an update and they then prompt the user to initiate the update. Users

[168] Norman JM (ed) (2005) *From Gutenberg to the Internet: A Sourcebook on the History of Information Technology* at 17.
[169] Norman JM (ed) (2005) *From Gutenberg to the Internet: A Sourcebook on the History of Information Technology* at 17.
[170] Norman JM (ed) (2005) *From Gutenberg to the Internet: A Sourcebook on the History of Information Technology* at 17.
[171] Goldstuck A (2012) Internet Matters: The Quiet Engine of the South African Economy at 20 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

can also preset their device to run and install updates automatically whenever an Internet connection is available. I refer to this as machine-initiated e-commerce.

As technology progresses, machine-initiated e-commerce will become more common. When purchasing a device, the user either enters into a licencing agreement with the manufacturer-seller that future updates will be made available free of charge, or a pre-determined payment method is agreed upon. For example, the user's credit card details can be recorded on the device and the card is debited whenever the device orders goods or downloads and installs dematerialised goods. Alternatively, the user can be invoiced for every transaction for which payment must be made. Machine-initiated e-commerce will enable vehicles to run software updates automatically, make service appointments, and order faulty or worn parts before the next service is due. Medical equipment similar to pace makers, can determine certain illnesses in users, like low or high blood pressure, and order medication to be delivered at the user's home or place of business. Music playing devices like IPods, can determine the user's music interest and automatically download new releases from artists. This does not mean that machines will take over our lives; machines do not have brains to think – a machine must still operate on pre-programmed formulas created by man.

Nobody can predict exactly how big e-commerce will become.[172] Technological advances, as discussed above, allow retailers to showcase their goods to the whole world. Digital technology, especially in the music, print, and video industry, enhances global trade even further as delivery is not hampered by customs, slow or unreliable postal services, or local transport and import regulations.[173] Digital information is unlimited in its scope and diversity, and we cannot imagine what forms it will take in future.[174] However, it can safely be anticipated that e-commerce across the globe will increase in popularity. International trade through e-commerce will inevitably be enhanced and will become the retail shopping method of choice for many consumers.

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[172] Macdonald J and Tobin BE (1998)"Customer Empowerment in the Digital Economy" in Tapscott D (1998) *Blueprint of the Digital Economy* at 204.

[173] Macdonald J and Tobin BE (1998) "Customer Empowerment in the Digital Economy" in Tapscott D (1998) *Blueprint of the Digital Economy* at 204.

[174] Norman JM (ed) (2005) *From Gutenberg to the Internet: A Sourcebook on the History of Information Technology* at 46.

2.6 Impact of cross-border digital trade on VAT collection

Since the 2006/2007 year of assessment, VAT has accounted for 27 per cent of South Africa's tax revenues.[175] This figure showed a decline to 24,7 per cent during the 2009/2010 year of assessment which could be attributed to the global recession.[176] Figure 2.4 below shows the Rand value in millions of VAT collection since the 2006/2007 year of assessment. Despite the decline during the 2009/2010 year of assessment, VAT collection shows a steady growth.

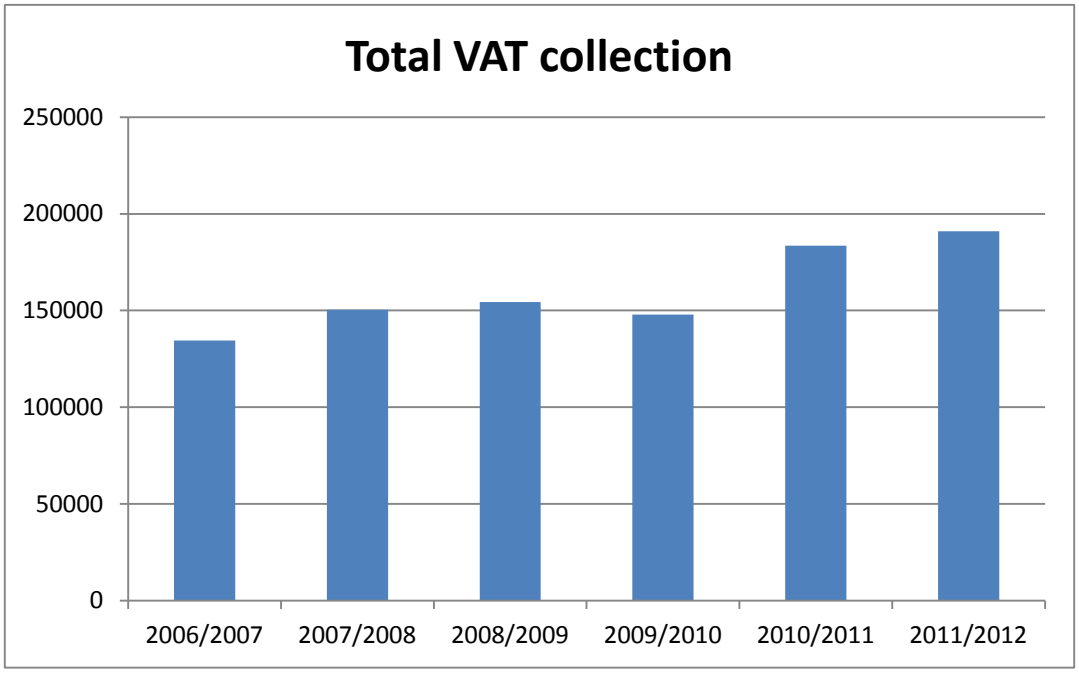

Figure 2.4[177]

[175] National Treasury and SARS (2012) *2011 Tax Statistics* at 9 http://www.treasury.gov.za/publications/tax%20statistics/2011/2011%20Tax%20Statistics.pdf [accessed on 18 September 2012].
[176] National Treasury and SARS (2012) *2011 Tax Statistics* at 9 http://www.treasury.gov.za/publications/tax%20statistics/2011/2011%20Tax%20Statistics.pdf [accessed on 18 September 2012].
[177] National Treasury and SARS (2012) *2011 Tax Statistics* at 9 http://www.treasury.gov.za/publications/tax%20statistics/2011/2011%20Tax%20Statistics.pdf [accessed on 18 September 2012].

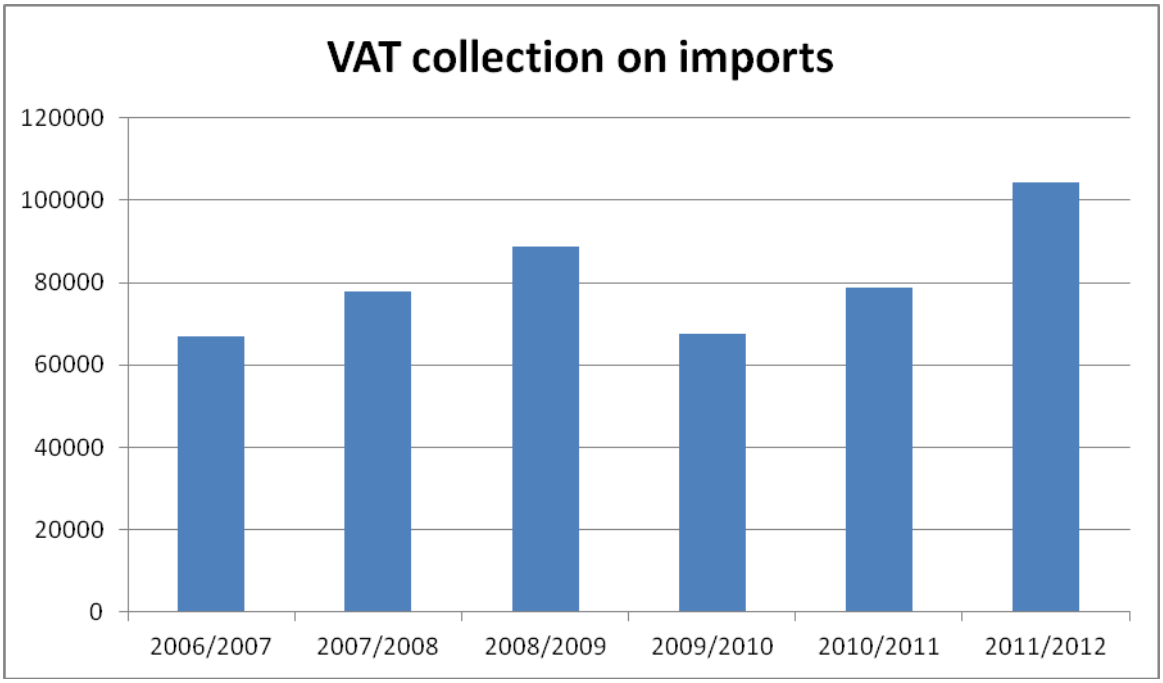

Fig 2.5[178]

Figure 2.5 shows the Rand value in millions of the VAT collected on imports. These figures include the import of tangible goods that were purchased online, and the import of intangibles that were duly reported by taxpayers in terms of the self-assessment mechanism. It should be noted that the VAT collection on domestic supplies shows a year on year increase as can be seen in figure 2.6 below.[179] In contrast, VAT collection on imports showed a dramatic decline during the 2009/2010 year of assessment which can be attributed to the global recession. Although VAT collection on imports recovered during the 2010/2011 year of assessment, the figure is still lower than the 2008/2009 figure. Whether this could be attributed to the global recession and greater dependence on domestic products is uncertain. That said, economists believe that it is no recovery at all, but it could be attributed to the

[178] National Treasury and SARS (2012) *2011 Tax Statistics* at 22 http://www.treasury.gov.za/publications/tax%20statistics/2011/2011%20Tax%20Statistics.pdf [accessed on 18 September 2012]; National Treasury and SARS (2013) *2012 Tax Statistics* at 135 http://www.treasury.gov.za/publications/tax%20statistics/2012/2012%20Tax%20Statistics.pdf [accessed on 4 April 2013].

[179] National Treasury and SARS (2012) *2011 Tax Statistics* at 22 http://www.treasury.gov.za/publications/tax%20statistics/2011/2011%20Tax%20Statistics.pdf [accessed on 18 September 2012]; National Treasury and SARS (2013) *2012 Tax Statistics* at 135 http://www.treasury.gov.za/publications/tax%20statistics/2012/2012%20Tax%20Statistics.pdf [accessed on 4 April 2013].

weaker Rand and the higher cost at which goods are imported.[180] It is difficult to predict whether the 2010/2011 figure is the start of a gradual decline in VAT collection on imports as a result of an increase in digital imports and a failure to collect VAT on these imports. The 2011/2012 figure shows a dramatic increase which could, instead of a recovery, be attributed to the weaker Rand and higher costs. While the global recession has had an impact on South Africa's demand for imported products, I believe that it is possible that the increase in digital imports, and the failure of the self-assessment mechanism to tax these imports, have also contributed to the decline, although it might at this stage be minimal.

SARS currently has no statistics relating to digitally imported goods, primarily because SARS has no control over these types of transaction.[181]

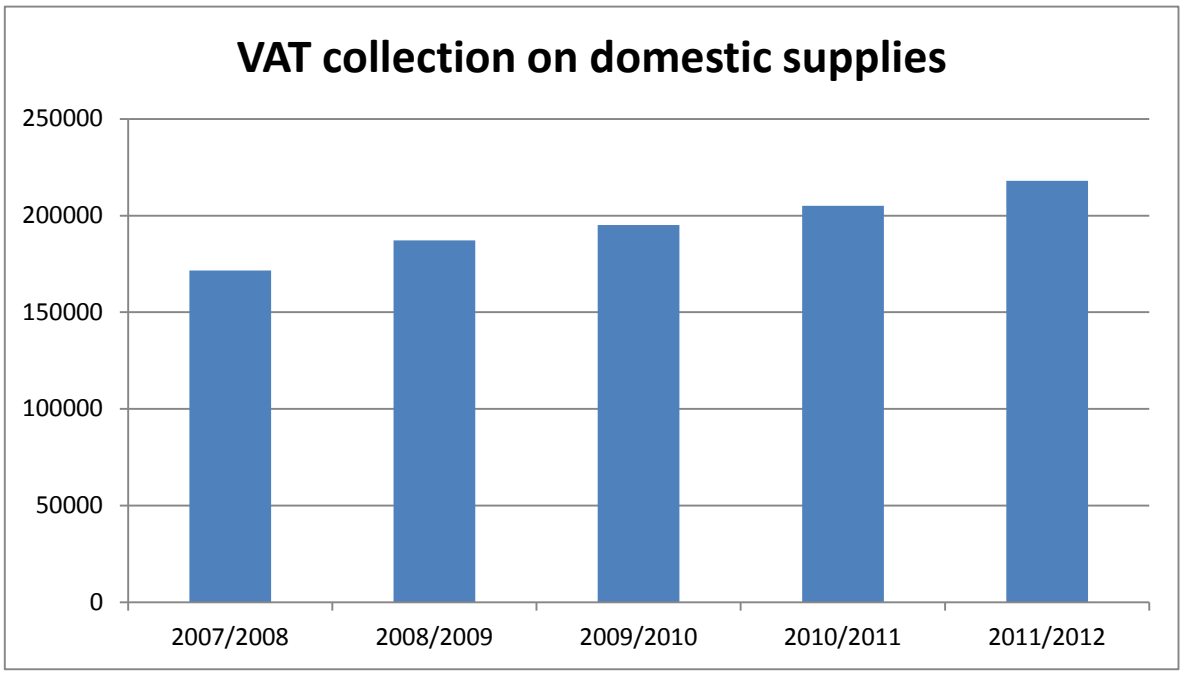

Fig 2.6[182]

[180] Michaletos J (2011) "The Falling VAT Collection Mystery" *Moneywebtax* 26 October 2011 http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page267?oid=62711&sn=Detail&pid=267 [accessed on 18 September 2012].
[181] Seeger D "Internet Books and Goodies not so Cheap after all" *Sunday Times Business Times* http://www.btimes.co.za/98/1129/btmoney/money07.htm [accessed on 18 September 2012].
[182] National Treasury and SARS (2012) *2011 Tax Statistics* at 22 http://www.treasury.gov.za/publications/tax%20statistics/2011/2011%20Tax%20Statistics.pdf [accessed on 18 September 2012]; National Treasury and SARS (2013) *2012 Tax Statistics* at 135

As a result, the impact of digital imports on the tax base cannot be accurately determined or predicted. It is clear from my findings in paragraph 2.5.2, that e-commerce currently operates as a parallel trade to traditional trade. As consumer confidence grows, e-commerce will gradually shift from a parallel trade to a dominant trade. In other words, e-commerce does not create a new market; instead the current market is shared between e-trade and traditional trade. E-commerce will gradually take up a larger slice of the market. I therefore suggest that the current statistics and predictions of the impact of e-commerce on the domestic market, should be applied to calculate an estimate of the impact that e-commerce will have on the VAT collection on imports.

The Internet economy currently contributes two per cent of GDP standing at R59 billion of which R2,636 billion is accounted for by B2C e-commerce (retail sales).[183] Retail e-commerce contributes 0,009 per cent of GDP.[184] It is trite that not all e-commerce transactions involve cross-border trade in digital products. However, the findings in paragraph 2.4.3 above clearly indicate that South African retailers fall short in serving the e-commerce market. Consumers, therefore, resort to international retailers. If it is assumed that cross-border trade of digital goods follows the same ratio to the total imports, as domestic e-commerce follows to GDP, VAT on digital imports could amount to R1,8 million per annum.[185] This figure is rather low, and could be even lower if the small digital download exemption in terms of section 14(5)(*e*) of the VAT Act[186] is considered. Nevertheless, retail e-commerce in South Africa has shown a 30 per cent growth year on year since 2006.[187] This growth could increase dramatically from 2014 to 2016 as consumer confidence in e-commerce increases.[188]

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http://www.treasury.gov.za/publications/tax%20statistics/2012/2012%20Tax%20Statistics.pdf [accessed on 4 April 2013].

[183] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at iii and 3 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

[184] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at iii and 3 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012].

[185] Calculated as the percentage of E-commerce to GDP multiplied by the total VAT revenue on imports for the 2011/2012 year of assessment.

[186] VAT Act 89 of 1991.

[187] Goldstuck A (2012) *Internet Matters: The Quiet Engine of the South African Economy* at iii and 3 http://internetmatters.co.za/report/ZA_Internet_Matters.pdf [accessed on 18 September 2012]

[188] See the confidence-theory discussed in paragraph 2.4.3 above.

While it could be argued that VAT collection on digital imports is insignificant and could be negated, it should be noted that the gradual growth in e-commerce will in the long run steadily erode the tax base as VAT collection on traditional retail will decrease. As the Internet connectivity rate increases and consumers become aware that digitally imported products can (effectively) be purchased tax free,[189] the growth in digital e-commerce can effectively cripple traditional retail. In the global music industry 32 per cent of all music purchased in 2011 was delivered to the recipient in digital form.[190] These figures will rise dramatically as electronic devices become more readily available and consumer confidence in e-commerce grows.

2.7 Conclusion

In this chapter the history of the Internet and the events leading to the birth of e-commerce were discussed. Traditional retail shopping, materialised online shopping, and dematerialised online shopping methods were compared. This required a discussion on how digital technology and encoding methods operate and how they are applied in dematerialised e-commerce.

Statistics on South Africa's e-commerce trends and predicted future trends show that e-commerce in South Africa has the potential to blossom. This e-commerce boom in B2C transactions is anticipated to materialise between 2013 and 2016. While it is obvious that most South African retailers will not be ready to serve the consumer e-market by 2013, international e-trade is set to benefit most from the South African e-commerce boom. This means that more goods will be imported to South Africa by consumer end users (B2C).

With the endless possibilities of digital technology in mind, it is clear that future technological advances will divide e-commerce into user-initiated e-commerce and machine-initiated e-commerce. While it is already difficult to monitor and determine

[189] "Tax free" in this sense is used as a layman's term to connote the situation where the consumer knowingly or innocently fails to pay VAT in terms of the self-assessment mechanism.
[190] Danaher B, Smith MD, Telang R, Chan S (2012) *IFPI Digital Music Report* http://www.ifpi.org/content/section_resources/dmr2012.html [accessed on 18 September 2012].

the monetary value of dematerialised imported goods to South Africa, it will be even more difficult to do so with machine-initiated dematerialised imports. It is trite that the shift from traditional shopping to e-commerce will be a gradual process that could take between five and 25 years. It is further trite that e-commerce will not replace traditional shopping in its entirety. But, if history and the statistics are anything to go by, e-commerce has become a major international trade tool and will become even more so in future. With this as backdrop, it is clear that the time is now ripe for governments and regulators to determine the threats that e-commerce poses on various levels, and to act now to eliminate future chaos. One of these problems posed by international dematerialised e-commerce (B2C in particular), is the possibility of revenue losses for the *fiscus* because VAT on these transactions cannot be levied and collected adequately. As these transactions can sometimes occur completely anonymously (especially in the case of machine- initiated e-commerce), it is often difficult to trace the transaction and tax it appropriately. In Chapter 3, the South African Value Added Tax system will be discussed with specific reference to the ability to collect Value Added Tax on digital products imported into South Africa by end users.

CHAPTER 3

SOUTH AFRICA

3.1 Introduction

In Chapter 2 the history of the Internet and digital technology were discussed. Consumer trends in online shopping were also discussed, and emphasis was placed on the rapid growth that online shopping, in particular online shopping for digital products, has shown over the past decade. It was also highlighted that if these trends are anything to go by, many traditionally corporeal goods will in future mainly be purchased online in their incorporeal digital form.

This change in technology could ultimately lead to a change in consumer behaviour in that traditional shopping methods will gradually give way to online shopping.

Moreover, this change inevitably means that an increasing number of traditionally tangible retail products will be purchased and delivered in their intangible form from anywhere in the world. The question arises whether modern day consumer taxes, which were developed primarily to tax the consumption of tangible goods and services, can be applied to tax the consumption of intangibles.

In this Chapter I examine the current South African VAT system to determine whether it can be applied in its current form adequately to tax cross-border transactions involving intangible goods. First, I give a brief historical outline of the South African VAT system, before discussing the basic characteristics of a VAT system. This is followed by the main discussion in which I critically discuss the current VAT Act[191] and its ability to tax cross-border transactions involving both tangible and intangible goods.

3.2 The history of VAT in South Africa

Since the 1980s, VAT has been introduced in many industrialised countries, and since 1990 a number of developing countries have followed suit.[192] The majority of the developing countries adopted VAT on the advice of and with assistance from the International Monetary Fund and the World Bank.[193]

On 24 November 1967, the then State President Jozua Naudé appointed the Commission of Enquiry into Fiscal and Monetary Policy in South Africa.[194] This Commission was tasked to investigate the state of the South African tax system, and, *inter alia,* to make recommendations on the implementation of a sales tax system.[195] The Commission investigated the feasibility of a VAT system as an indirect tax system for South Africa, but, it found that the high administrative burden

[191] Act 89 of 1991.
[192] James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 17.
[193] James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 17; Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 5-13.
[194] *First Report of the Commission of Enquiry into Fiscal and Monetory Policy in South Africa* at iii.
[195] *First Report of the Commission of Enquiry into Fiscal and Monetory Policy in South Africa* at iii.

of the implementation of a VAT system, would render it unsuitable for South Africa.[196]

Based on the recommendations of the Franzsen Commission, on 1 July 1978, General Sales Tax (GST) was introduced at a rate of four per cent[197] on a limited range of goods and services.[198] The GST system, as it was applied in South Africa, was a single stage collection system.[199] Accordingly, tax was levied in the last stage of the production-distribution chain. In other words, tax was levied when goods and services were sold to a consumer. This system was open to abuse. Retailers, in their capacity as final consumers, were able to avoid paying GST by merely producing proof of their business status when making purchases.

Under the GST system, business paid GST on capital goods.[200] The tax paid on such items were costed into the final price paid by the consumer.[201] This ultimately resulted in tax on tax. The cascading effect of GST had an increasingly negative effect on the South African economy since 1980, and the well-known European pattern of tax on value added based on an invoice system,[202] was an attractive alternative by which the South African government could raise revenue.[203] On 5 February 1988, the then Minister of Finance, Barend du Plessis, announced that a VAT system would replace the GST system in South Africa as from 30 September 1991.[204] Although many concerns were raised about the appropriateness of a VAT system for South Africa, the legislator contended that it would effectively remove the cascading effect of the GST system.[205] The view was expressed that the benefits of the VAT system would be realised if the VAT base were applied as broadly as

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[196] *First Report of the Commission of Enquiry into Fiscal and Monetory Policy in South Africa* at paras 203-204.
[197] Sales Tax Act 103 of 1978. The tax rate was subsequently increased to thirteen per cent.
[198] Silver M and Beneke C (2013) *VAT Handbook* 9th ed at para 1.1.
[199] Silver M and Beneke C (2013) *VAT Handbook* 9th ed at para 1.2.
[200] Silver M and Beneke C (2013) *VAT Handbook* 9th ed at para 1.2.
[201] Silver M and Beneke C (2013) *VAT Handbook* 9th ed at para 1.2
[202] See paragraph 3.3.2 below.
[203] Morris JRP, Huxham K, Haupt P (1988) *Getting to know VAT- A Practical Approach* at 1.
[204] Huxham K and Haupt P (1991) *South African VAT- The Book* at A-1; Morris JRP, Huxham K, Haupt P (1988) *Getting to know VAT- A Practical Approach* at 1; James A (1991) *VAT Demystified* at 1; Ferguson S and Rubin RRR (1991) *Handy Guide to VAT* at 1; Go DS, Kearney M, Robinson S, Thierfelder K (2005) "An Analysis of South Africa's Value Added Tax" *World Bank Policy Research Working Paper no 3671* at 2.
[205] Huxham K and Haupt P (1991) *South African VAT- The Book* at A-1; Go DS, Kearney M, Robinson S, Thierfelder K (2005) "An Analysis of South Africa's Value Added Tax" *World Bank Policy Research Working Paper no 3671* at 2.

possible to all goods and services, and if a uniform rate was applied.[206] This approach was in line with the recommendations of the Margo Commission.[207] As a result, VAT was introduced at a rate of ten percent on 30 September 1991 by the Value Added Tax Act[208] as a broad-based indirect tax on the domestic consumption of goods and services.[209] On 7 April 1993, the tax rate was increased to fourteen percent by section 23(1)(*a*) of the Taxation Laws Amendment Act.[210]

3.3 The basic design of a VAT system

3.3.1 VAT: A consumption tax

Most VAT systems, including that of South Africa, are based on the principle of consumption.[211] Consequently, the person who consumes the goods and services is the person who ultimately carries the burden of paying the tax due on them.[212] Although the South African VAT system levies VAT on production, it is still the final consumer who carries the burden of tax as intermediaries (wholesalers, distributors, and retailers) receive tax credits on the VAT paid on input.[213] Despite the fact that

[206] Margo Commission (1986) *The Report of the Commission of Inquiry into the Tax Structure of the Republic of South* Africa at 69-70; Huxham K and Haupt P (1991) *South African VAT- The Book* at A-1.
[207] Margo Commission (1986) *The Report of the Commission of Inquiry into the Tax Structure of the Republic of South* Africa at 69-70; Huxham K and Haupt P (1991) *South African VAT- The Book* at A-1.
[208] Act 89 of 1991.
[209] Huxham K and Haupt P (1991) *South African VAT- The Book* at A-1; Go DS, Kearney M, Robinson S, Thierfelder K (2005) "An Analysis of South Africa's Value Added Tax" *World Bank Policy Research Working Paper no 3671* at 2.
[210] Act 97 of 1993.
[211] Go DS, Kearney M, Robinson S, Thierfelder K (2005) "An Analysis of South Africa's Value Added Tax" *World Bank Policy Research Working Paper no 3671* at 2; Doussy E (2001) *The Taxation of Electronic Commerce and the Implications for Current Taxation Practices in South Africa* at 89; Botes M (2011) "South African VAT and non-Resident Business" *International VAT Monitor* vol 22 no 6 at 396; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 31-33.
[212] Bird RM and Gendron PP (2007) *The VAT in Developing and Transitional Countries* at 71-77; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 4; Millar R (2008) "Jurisdictional Reach of VAT" in Krever R (ed) (2008) *VAT in Africa* at 178.
[213] Kearney M (2003) *Restructuring Value-Added Tax in South Africa: A Computable General Equilibrium Analysis* at 24; James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 17; Go DS, Kearney M, Robinson S, Thierfelder K (2005) "An Analysis of South Africa's Value Added Tax" *World Bank Policy Research Working Paper no 3671* at 2; Bird RM and Gendron PP (2007) *The VAT in Developing and Transitional Countries* at 10; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 38-46; Millar R (2008) "Jurisdictional Reach of VAT" in Krever R (ed) (2008) *VAT in Africa* at 179.

the final consumer carries the burden of paying tax, the effect of VAT is often felt by companies whose outputs are being taxed.[214] The effective incidence of taxes (and also VAT) is not always determined by the nature of the tax, but also by the interplay of demand and competition between suppliers.[215]

Under a VAT system, output VAT is charged on the value added at each stage in the production-distribution chain.[216] To ensure that only the final consumption is taxed, the tax paid on all goods and services acquired to render the supply for final consumption, should be refunded in the hands of such purchasers as inputs.[217] In other words, the tax rolls forward from each intermediary transaction until the final point of consumption. This ensures tax neutrality.[218] To ensure that tax credits relate to production and not the consumption of goods and services, certain restrictions must be imposed on input credits.[219] For example, input credits are fully or partly denied on motor vehicles and entertainment.[220] Motor vehicles and entertainment, despite their application in the production stages, are mainly used as consumption goods and not necessarily in the production of income or in the making of taxable supplies.

If VAT is not appropriately levied and recovered at each level of the production chain, it will no longer be a consumption tax.[221] Breaks in the tax chain can lead to the failure to collect VAT by revenue authorities. Breaks in the tax chain can also lead to the failure to recover VAT paid by intermediaries, which would ultimately lead to double taxation.[222]

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[214] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 15.
[215] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 15.
[216] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 16; Huxham K and Haupt P (1991) *South African VAT- The Book* at A-2; James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 17; Bird RM and Gendron PP (2007) *The VAT in Developing and Transitional Countries* at 10; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 17.
[217] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 16; Bird RM and Gendron PP (2007) *The VAT in Developing and Transitional Countries* at 10.
[218] Cnossen S (1991) "Design of the Value Added Tax: Lessons from Experiences" in Khalilzadeh-Shirazi Jand Shah A (eds) (1991) *Tax Policy in Developing Countries* at 73.
[219] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 16.
[220] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 16; also see section 17(2)(*a)* and (*c*) of the VAT Act.
[221] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 18.
[222] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 18; Cnossen S (1996) "VAT Treatment of Immovable Property" in Thuronyi (ed) (1996) *Tax Law Design and Drafting* vol 1 at 231-232.

3.3.2 VAT: An invoice-based tax

To avoid breaks in the tax chain, a VAT system is based on an invoice system.[223] The invoice forms the basis for input and output taxes.[224] The invoice-based system not only creates a good audit trail, but also allows for cross checking with the income tax system.[225] For example, where an input tax deduction is sought based on an invoice for goods or services rendered by a supplier, the supplier's financial statements should reflect the amount received on the invoice as part of its gross income. Under an invoice system, the amount of tax paid for goods or services can be determined with precision.[226] In addition, each trader charges VAT on the sale of goods or services to the purchaser and delivers an invoice to the purchaser reflecting the VAT paid.[227] The purchaser is, in turn, able to credit the VAT as an input against the output VAT charged on its own sales. The balance is paid to revenue authorities, while any excess credits are refunded.[228]

3.3.3 VAT: A broad-based tax

Ideally, VAT should be applied on a broad range of both goods and services.[229] Taxing one commodity and excluding another distorts consumer choice and negatively affects revenue potential.[230] Some concessions based on policy can be

[223] Huxham K and Haupt P (1991) *South African VAT- The Book* at A-2; Cnossen S (1991) "Design of the Value Added Tax: Lessons from Experiences" in Khalilzadeh-Shirazi J and Shah A (eds) (1991) *Tax Policy in Developing Countries* at 72.
[224] Huxham K and Haupt P (1991) *South African VAT- The Book* at A-2; Go DS, Kearney M, Robinson S, Thierfelder K (2005) "An Analysis of South Africa's Value Added Tax" *World Bank Policy Research Working Paper no 3671* at 7.
[225] Huxham K and Haupt P (1991) *South African VAT- The Book* at A-2.
[226] Huxham K and Haupt P (1991) *South African VAT- The Book* at A-2.
[227] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 20.
[228] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 20.
[229] Cnossen S (1991) "Design of the Value Added Tax: Lessons from Experiences" in Khalilzadeh-Shirazi J and Shah A (eds) (1991) *Tax Policy in Developing Countries* at 78.
[230] Cnossen S (1991) "Design of the Value Added Tax: Lessons from Experiences" in Khalilzadeh-Shirazi J and Shah A (eds) (1991) *Tax Policy in Developing Countries* at 78.

made, for example, to redistribute wealth, or to protect domestic produce from cheaper imports.[231]

3.3.4 Destination v origin-based tax

VAT can be levied on the basis of either destination or origin. In terms of the destination basis, VAT is levied at the level of consumption based on the location of the consumption.[232] Put simply, VAT is levied at the domestic level. This means that imports are taxed while exports are zero-rated.[233] Some economists are of the view that the destination-based VAT system discourages imports and encourages exports.[234] This argument is based on the fact that domestic goods and services can enter the international market stripped of VAT, while imported goods are subject to import taxes. This may be true in a transition when the VAT replaces a predecessor tax, such as a manufacturer's sales tax. On its own, however, the VAT does not exhibit those properties. Actually, if all countries apply the destination principle, the VAT should be close to neutral on trade.

In terms of the origin basis, VAT is levied at the consumption level based on the origin of the goods, irrespective of where the goods are finally consumed.[235] This means that imports are not taxed while exports are taxed. This system could be seen

[231] Cnossen S (1991) "Design of the Value Added Tax: Lessons from Experiences" in Khalilzadeh-Shirazi J and Shah A (eds) (1991) *Tax Policy in Developing Countries* at 78; Go DS, Kearney M, Robinson S, Thierfelder K (2005) "An Analysis of South Africa's Value Added Tax" *World Bank Policy Research Working Paper no 3671* at 6-7.

[232] Metcalfe GE (1995) "Value Added Taxation: A Tax Whose Time has Come?" *The Journal of Economic Perspectives* vol 9 no 1 at 130; OECD (2011) *International VAT/GST Guidelines on Neutrality* at 4 http://www.oecd.org/tax/consumptiontax/48331948.pdf [accessed on 18 March 2013]; Grandcolas C (2007) "VAT on the Cross-Border Trade in Services and Intangibles" *Asia-Pacific Tax Bulletin* vol 13 no 1 at 39; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 20-21; Millar R (2008) "Jurisdictional Reach of VAT" in Krever R (ed) (2008) *VAT in Africa* at 176-177.

[233] OECD (2011) *International VAT/GST Guidelines on Neutrality* at 4 http://www.oecd.org/tax/consumptiontax/48331948.pdf [accessed on 18 March 2013].

[234] Metcalfe GE (1995) "Value Added Taxation: A Tax Whose Time has Come?" *The Journal of Economic Perspectives* vol 9 no 1 at 130.

[235] Metcalfe GE (1995) "Value Added Taxation: A Tax Whose Time has Come?" *The Journal of Economic Perspectives* vol 9 no 1 at 130; OECD (2011) *International VAT/GST Guidelines on Neutrality* at 4 http://www.oecd.org/tax/consumptiontax/48331948.pdf [accessed on 18 March 2013].

to encourage imports as imported goods from low VAT jurisdictions, are placed at an advantage over domestic goods in jurisdictions with a high VAT rate.[236]

Since VAT is primarily characterised as an indirect tax on consumption, the destination-based system can be classified as an out and out VAT system. The destination base ensures greater tax neutrality in cross-border transactions.[237] This can be attributed to the fact that imported goods are taxed on par with domestic goods and services.[238] In the case of the origin base, imported goods are taxed in the country of origin. These goods often compete with domestic goods, especially where the foreign VAT rate is lower than the domestic rate.[239] Tax neutrality is not achieved and market distortions occur frequently.

Under the destination base, imports are fully taxed either at the border, or in terms of the "deferred payment" or "postponed accounting" method commonly referred to as a reverse-charge mechanism.[240] Here imports are taxed at the time of the importer's next periodic VAT return.[241] This allows for the tax free movement of goods and services across borders and international trade is not distorted.[242]

However desirable in theory, problems in applying and administering the destination principle inevitably occur.[243] The destination principle is primarily designed to tax domestic consumption and where international trade is heavily regulated. Advances in transportation, communication, and technology have, in recent decades had an important impact on the way businesses and consumers do business. Cross-border trade is no longer restricted to an elite group of import and export companies. Many consumers can now engage in international trade without the assistance of import and export agents. In Chapter 2 it was shown how the Internet has changed

[236] Metcalfe GE (1995) "Value Added Taxation: A Tax Whose Time has Come?" *The Journal of Economic Perspectives* vol 9 no 1 at 130; OECD (2011) *International VAT/GST Guidelines on Neutrality* at 4 http://www.oecd.org/tax/consumptiontax/48331948.pdf [accessed on 18 March 2013].
[237] Cnossen S (1991) "Design of the Value Added Tax: Lessons from Experiences" in Khalilzadeh-Shirazi J and Shah A (eds) (1991) *Tax Policy in Developing Countries* at 73; OECD (2011) *International VAT/GST Guidelines on Neutrality* at 5 http://www.oecd.org/tax/consumptiontax/48331948.pdf [accessed on 18 March 2013].
[238] Cnossen S (1991) "Design of the Value Added Tax: Lessons from Experiences" in Khalilzadeh-Shirazi J and Shah A (eds) (1991) *Tax Policy in Developing Countries* at 73.
[239] Where the foreign VAT rate is higher than the domestic VAT rate, there is, of course, no such competition.
[240] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 177.
[241] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 177.
[242] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 177.
[243] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 184.

consumer behaviour. Technological advances now allow consumers to trade on an international level without leaving the comfort of their homes. These transactions often go undetected and unregulated.

3.4 The rise of e-commerce and the South African VAT system

The tax implications of the Internet and e-commerce have not been felt in many countries outside Asia, the USA, and Europe.[244] This can be attributed to slow or virtually no Internet connections, and/or a lack of confidence among consumers. In Chapter 2, it was indicated that e-commerce will become more popular in developing countries as consumer confidence grows. Technological advances will make e-commerce an inevitable part of daily life. Although the future of technology cannot be predicted with absolute certainty, some key issues relating to VAT and the Internet are fairly certain.[245]

During 1997, the Katz Commission received evidence that international trade will increasingly be influenced by technological advances.[246] The Commission stated:

> There is no doubt that these developments will greatly impact some of the basic tenets of international taxation as they exist today. Examples include the irrelevance of physical presence in order to trade (impacting on "permanent establishment" concepts), the ease with which current residence notions can be manipulated through hyper-mobility of an entire office and trading or management capacity, and the manner in which goods or services can be contracted for, advertised and even delivered via electronic means.[247]

Clearly, the South African VAT system will be affected by e-commerce, technological advances, and changes in online consumer patterns. The Katz Commission correctly stated that it would be premature to suggest changes to existing VAT rules before

[244] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 186.
[245] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 186.
[246] Katz Commission (1997) *Fifth Interim Report of the Commission of Inquiry into Certain Aspects of The Tax Structure of South Africa* at par 7.4.1.
[247] Katz Commission (1997) *Fifth Interim Report of the Commission of Inquiry into Certain Aspects of The Tax Structure of South Africa* at par 7.4.1.

the exact impact of these influences can be determined.[248] Politicians are often of the view that e-commerce is a phenomenon of the current age, and bears no real risk for the *fiscus.* In the main, a wait and see policy is adopted with grave results. In Chapter 2 the fast rate at which e-commerce is gaining in popularity among consumers, was highlighted. If these consumer trends are anything to go by, the time is now ripe to determine the effect of these online consumer trends on the ability of SARS to collect VAT on the these transactions within the ambit of existing VAT legislation. Concerns that the Internet may have the effect of shrinking the tax base are legitimate.[249] In the absence of any definitive rulings or policy statements from SARS, we can assume that existing VAT principles will apply to e-commerce transactions in South Africa.[250] The following should be considered to determine the VAT treatment of online cross-border transactions:

- Is there a supply of goods or services?
- Where is the supply made?
- When is the supply made?
- What is the value of the supply?
- Is it made by a taxable entity?
- Is it made in the course or furtherance of an enterprise?
- Is the supply taxable?
- How is VAT on the transaction collected?

From the outset, it should be noted that these issues should be addressed in no particular order. Some of the issues will overlap. While I have attempted to keep these issues separate, some overlapping and repetition could not be avoided.

3.4.1 Is there a supply of goods or services?

[248] Katz Commission (1997) *Fifth Interim Report of the Commission of Inquiry into Certain Aspects of The Tax Structure of South Africa* at par 7.4.1.
[249] *Green Paper on Electronic Commerce for South Africa* (2004) http://www.westerncape.gov.za/Text/2004/6/green_paper_on_electronic_commerce.pdf [accessed on 18 March 2013]; also see paragraph 2.6 above.
[250] Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 109.

Subject to exemptions, exceptions, deductions, and adjustments provided for in the VAT Act[251], VAT shall be levied:

> *(a)* on the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him;
> *(b)* on the importation of any goods into the Republic by any person on or after the commencement date; and
> *(c)* on the supply of any imported services by any person on or after the commencement date,
>
> calculated at the rate of 14 per cent on the value of the supply concerned or the importation, as the case may be.[252]

For purposes of VAT, it is important to distinguish between the supply of goods and of services as the two are treated differently.[253] In addition, the place of supply and VAT collection mechanisms differ depending on whether one is dealing with goods or services. It is difficult, if not impossible, correctly to classify electronically supplied goods (incorporeal goods) because VAT legislation was designed to cater for tangible goods and predominantly physically rendered services in an era before e-commerce.

The VAT Act[254] defines "goods" as:

> Corporeal movable things, fixed property, any real right in any such thing or fixed property, and electricity, but excluding-
>
> *(a)* money;
> *(b)* any right under a mortgage bond or pledge or of any such thing or fixed property; and
> *(c)* any stamp, form or card which has a money value and has been sold or issued by the State for the payment of any tax or duty levied under any Act of Parliament, except when subsequent to its original sale or issue it is disposed of or imported as a collector's piece or investment article.[255]

[251] Act 89 of 1991.
[252] Section 7(1) of the VAT Act 89 of 1991.
[253] See section 13 of the VAT Act that deals with the importation of goods, and section 14 that deals with the importation of services.
[254] Act 89 of 1991.
[255] Section 1 of the VAT Act 89 of 1991.

A distinction must be drawn between commodities that are ordered and delivered on the Internet by electronic means, and commodities that are ordered on the Internet and delivered by traditional means.[256] In the latter case, administrative procedures already in place for traditional cross-border trade continue to apply.[257] A sound invoicing system is, therefore, of cardinal importance.

The supply of tangible goods ordered over the Internet is fairly easy to monitor because tangible corporeal goods must be cleared through customs at a border post before entering the country.[258] Goods delivered by airmail are monitored by the central international post offices at OR Tambo International Airport, Durmail in eThekwini, and Capemail in Cape Town, where the value for VAT purposes is determined, and where VAT is levied at the appropriate rate.[259] These goods, accompanied by a VAT declaration, are posted to the recipient. The recipient must pay VAT (as indicated on the VAT declaration form) at the post office where the package is collected. The fact that tangible goods, which are ordered electronically, are delivered to a designated physical address simplifies the task of ensuring that appropriate VAT is levied and collected.[260]

In the case of Internet deliveries of incorporeal goods such as software, music, and videos, two issues arise. In the first instance, it is often difficult to determine whether or not a transaction has occurred.[261] As delivery cannot be intercepted as in the case of corporeal goods that must enter a customs area, it is difficult to track and trace the occurrence of these transactions.[262]

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[256] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 186.
[257] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 186; OECD (2011) *International VAT/GST Guidelines on Neutrality* at 5 http://www.oecd.org/tax/consumptiontax/48331948.pdf [accessed on 18 March 2013].
[258] Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 233; Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 382, Classen L (2012) "E-commerce and Value Added Tax" in Papadopoulos S and Snail S (eds) (2012) *Cyberlaw@SAIII* at 113; Naicker K (2010) "The VAT Implications of E-commerce" *Taxtalk* January/February 2010 at 8.
[259] Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 233.
[260] Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 234; Naicker K (2010) "The VAT Implications of E-commerce" *Taxtalk* January/February 2010 at 8.
[261] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 187.
[262] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 186; OECD (2011) *International VAT/GST Guidelines on Neutrality* at 5 http://www.oecd.org/tax/consumptiontax/48331948.pdf [accessed on 18 March 2013].

Secondly, the classification of digitised products as either goods or services can be problematic. Electronically delivered goods or digitised products are incorporeal movable goods, and their provision would not qualify as the supply of goods for purposes of section 7(1)(*a*). Similarly, where digitised products are imported by the taxpayer, this would not qualify as the importation of goods in terms of section 7(1)(*b*).

"Services" are defined to mean:

> Anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money or any stamp, form or card contemplated in paragraph (*c*) of the definition of 'goods'[263]

The definition of "services" is particularly wide so as to include any form of intangible thing, service, or right. Electronically delivered products should, in principle, qualify as the supply of services. It is, however, not certain whether the payment for digitally downloaded products constitutes payment for the use of, or for the right to use copyright, or payment for the purchase of goods or services.[264] In the *Green Paper on Electronic Commerce for South Africa* the question is posed whether the amounts paid for digital products should be classified as royalties or as the purchase price for intangible products.[265]

3.4.1.1 Payment for the use of, or the right to use, intellectual property

In the case of electronically ordered, physically delivered goods (for example, music), the purchaser makes payment in exchange for a tangible thing (CD, tape, or vinyl). Generally, the purchaser receives ownership of the tangible item but, depending on the express or tacit agreement between the seller and the purchaser, the rights to the music stored on the tangible item are limited. Generally, music sold

[263] Section 1 of the VAT Act 89 of 1991.
[264] Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 236.
[265] *Green Paper on Electronic Commerce for South Africa* (2004) http://www.westerncape.gov.za/Text/2004/6/green_paper_on_electronic_commerce.pdf [accessed on 18 March 2013].

as such, is subject to conditions reserving the rights of the producers or owners of the work. In addition, the copying of the music, hiring out thereof, and the recording thereof are prohibited. Subject to these restrictions, the purchaser may do with the tangible item as he wishes, including disposing of it or destroying it. It could therefore be argued that the purchase price paid for the music consists of payment for the tangible item (CD, tape, or vinyl) and the right to use the intellectual property (music) stored on the tangible item. That said, in the absence of an agreement to this effect, the sale of the music stored on disc is generally treated as the sale of goods for VAT purposes.

In the case of electronically ordered and delivered goods (for example, digital music ordered and delivered through a network), no tangible goods can be identified. It can be argued that the purchase price paid constitutes payment for the right to use the intellectual property (music) that was electronically delivered because there is no tangible storage device or object.

However, the VAT treatment of intellectual property is no different from that of any other service. The definition of “services” clearly includes “the granting, assignment, cession or surrender of any right...”. The granting of a right to use intellectual property constitutes “services” as defined.

It is, however, not as uncomplicated as it at first glance appears, as can be seen from the examples below:

> **Example 3.1:** X purchases music from Y online. Y delivers the music to X electronically. Y is the owner of and rights holder in the music. The transaction is subject to the condition that all rights in the music are reserved. The purchase price, therefore, constitutes the right to use the intellectual property (the music).
>
> **Example 3.2:** Y owns a database of electronically stored music. Y has developed software that allows him to sell the music stored in his database to online consumers. X purchases the database and software from Y. The software and music database are delivered to X electronically. Ownership

in the database and software is assigned to X. X uses the database and software to sell and distribute music.

In example 3.1 the right to use the intellectual property constitutes the rendering of a service as defined.

In example 3.2 the rights assigned to X amount to the sale of a business or enterprise, and might comply with the requirements for the sale of a going concern and qualify for zero rating.[266] In this case, although intangibles were sold, this cannot constitute the rendering of a service as defined.

Each transaction should therefore be treated individually to determine the type/form of supply. This would, however, place a tremendous administrative burden on tax authorities and suppliers.

3.4.1.2 Electronic products equal to services?

To date, SARS has issued no ruling, Interpretation Note, or policy document reflecting its views on the treatment of electronically delivered intangible products. In the *Green Paper on Electronic Commerce for South Africa,* emphasis was placed on the fact that tax systems should be characterised by certainty and simplicity.[267] Yet, it was further recommended in the *Green Paper* that South Africa's tax system should be protected so as not to erode the tax base by international decisions

[266] In terms of section 11(1)(*e*) of the VAT Act 89 of 199, the supply by a registered vendor of an enterprise or part of an enterprise that is capable of separate operation where the supplier and the recipient have agreed in writing that the enterprise will be disposed of as a going concern will be subject to VAT at zero percent provided that:

i) Both the seller and purchaser are registered VAT vendors;
ii) The parties agreed that the enterprise will be an income-earning activity on the date of transfer;
iii) The assets necessary for the carrying on of such enterprise is transferred to the seller;
iv) The parties have agreed in writing the transaction is subject to VAT at zero percent.

Also see Interpretation Note 57; Huxham and Haupt (2013) *Notes on South African Income Tax* at 958-959; Stiglingh M (ed), Koekemoer AD, Van Schalkwyk L, Wilcocks JS, De Swardt RD (2013) *Silke: South African Income Tax* 1030-1031.

[267] *Green Paper on Electronic Commerce for South Africa* (2004) http://www.westerncape.gov.za/Text/2004/6/green_paper_on_electronic_commerce.pdf [accessed on 18 March 2013].

favouring sophisticated and developed nations.[268] Despite the fact that the *Green Paper* favours the OECD proposal that electronically delivered products should be treated as services, it is also advised that:

> The blanket characterisation of all on-line deliveries as supplies of services, even where a similar product can be delivered physically at a zero or reduced rate, does not appear to be fair. Unless rates and other differences in treatment are equalised, this will result in the heavier consumption taxation of many electronic commerce transactions.

This hedged approach is not a phenomenon restricted to South Africa. Tax uncertainties can negatively affect cross-border trade. Steyn suggests that a general and internationally acceptable approach to the characterisation of digital products should be developed.[269] In the light of the fact that jurisdictions place the protection of their own tax base above harmonisation of world tax laws, a general internationally acceptable approach might not be feasible. Furthermore, the lack of clear classification rules adds to the confusion in practice. In a study compiled by De Swardt and Oberholzer, it was found that seventeen percent of respondents thought that digitised products were classified as "goods", while eight percent were of the view that they could be classified as both "goods" and "services".[270] This study confirms that the hedged approach is not really feasible.

The demand for digitised products will increase whether or not SARS can deal with electronic transactions adequately. Bagraim is of the opinion that SARS will follow the OECD recommendation that digital products should be treated as "services", despite the *Green Paper's* hedged recommendations.[271] In any event, it is clear from the definition of "goods", that digitised products do not qualify as "goods".[272] To classify digitised products as "goods" would require an amendment to the definition. Van der Merwe opines that the archetypal VAT is a tax on consumption, irrespective

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[268] *Green Paper on Electronic Commerce for South Africa* (2004) http://www.westerncape.gov.za/Text/2004/6/green_paper_on_electronic_commerce.pdf [accessed on 18 March 2013].
[269] Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?"*SA Merc LJ* vol 22 no 2 at 237.
[270] De Swardt RD and Oberholzer R (2006) "Digitised Products: How Compliant is South African Value Added Tax?" *Meditari Accountancy Research* vol 14 no 1 at 19.
[271] Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 111.
[272] Johnston G and Pienaar S (2013) "Value-Added Tax on Virtual World Transactions: A South African Perspective" *International Business and Economic Research Journal* vol 12 no 1 at 73 http://www.cluteinstitute.com [accessed 12 April 2013].

of whether the consumption amounts to the consumption of goods or of services.[273] The fact that traditional tangible goods can be converted to intangible goods, does not change the nature of the goods; it is merely the way in which the goods are delivered that is altered.[274] Van der Merwe correctly asks whether it is at all necessary to distinguish between goods and services in jurisdictions where there is no differentiation between the rate at which goods and services are taxed.[275] Different VAT rates often dictate the taxpayer's choice of product.[276] For example, where services are taxed at a lower rate than goods, the taxpayer would likely order music delivered electronically as opposed to a thing that is delivered physically.

Historically, different rates have been applied to the supply of goods and of services because of legal or technical constraints that prevented international trade, or rendered international trade uneconomical.[277] The historical reasons for differentiation are fading, and the spread of e-commerce demands that the differentiation should be reconsidered.[278] Since goods and services are taxed at the same rate in South Africa, the historical differentiation serves no purpose. That said, the importation of goods is treated differently from the importation of services.[279]

The importation of goods by *any*[280] person is subject to VAT.[281] The nature of the goods, the use to which they are put, and the importer's VAT registration status, are irrelevant. The importation of services in terms of section 7(1)(*c*) is subject to the definition of "imported services".

"Imported services" mean:

> A supply of services that is made by a supplier who is a resident or carries on business outside the Republic to a recipient who is a resident of the Republic to the extent that

[273] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 381.
[274] De Wet C and du Plessis R (2004) "Taxation (VAT)" in Buys R (ed) (2004) *CyberLaw@SAII* at 279; Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 381.
[275] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 381.
[276] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 381.
[277] Fitzgerald G (1999) "The GST and Electronic Commerce in Australia" *Murdoch University Electronic Journal of Law* vol 6 no 3 at 6 http://www.austlii.edu.au/au/journals/MurUEJL/1999/32.html [accessed on 18 March 2013].
[278] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 381.
[279] See paragraph 3.4.4.1 below.
[280] My emphasis.
[281] Section 7(1)(*b*) of the VAT Act 89 of 1991.

such services are utilized or consumed in the Republic otherwise than for the purpose of making taxable supplies.[282]

This means that where services are imported for purposes of making taxable supplies (in other words, not for final consumption), no VAT is payable. The differentiation can best be illustrated by way of examples:

Example 3.3: X imports music CDs to be sold in retail outlets across the Republic. X must account for output VAT on the value of the CDs when they are imported into the Republic. The output VAT paid by X upon importation, may be claimed as input VAT against X's output VAT liability when the CDs are sold in the retail outlets.

Example 3.4: X imports music in digital format which X will either burn onto CDs and sell in retail outlets, or distribute to customers through X's online retail portal. As the imported music is intangible, it should be treated as "services" for VAT purposes. X will therefore not account for output VAT on the importation of the music because it is imported for the purposes of producing taxable supplies. X will account for output VAT on the music when it is sold at retail level.

As the definition of "services" is wide enough to include all forms of intangibles, no immediate amendment is required to provide for the supply of digitised products. I therefore recommend that, while a differentiation between goods and services is required, digitised products should, as a general rule, be treated as "services" as defined. Although SARS has issued no official statement on the treatment of digitised products, it can generally be accepted that it will treat digitised products as "services."[283] Therefore, for purposes of this thesis, digitised products will be deemed to be "services" as defined.

[282] Section 1 of the VAT Act 89 of 1991.
[283] See example 31 on "Imported Services" in *VAT 404: Value Added Tax for Vendors* (2010) http://www.sars.gov.za/home.asp?pid=4&cx=009878640050894574201%3Aku-btv50zym&cof=FORID%3A10%3BNB%3A1&ie=UTF-8&q=vat+decision+416 [accessed 18 March 2013].

3.4.2 Where is the supply made?

The VAT Act[284] does not provide for specific place-of-supply rules.[285] Where these rules have been incorporated in the Act, this has been couched in vague general terms not designed to meet the requirements of an electronic era.[286] The definition of "enterprise", and the provisions in section 7(1), should be read in conjunction to determine the place of supply.[287]

"Enterprise" is defined to connote:

> In the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for consideration, whether or not for profit, including any enterprise or activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature or in the form of an association or club;[288]

In principle, the location of the supplier's enterprise determines the location where the transaction is required to be taxed.[289] That said, cognisance should be taken of the proviso in the definition of "enterprise" in relation to a foreign branch of an enterprise situated in South Africa. A branch of the main enterprise which is situated outside the Republic and which:

i) can be identified as a separate entity from the main enterprise in the Republic; and
ii) has an independent system of accounting

[284] Act 89 of 1991.
[285] Compare the detailed place-of-supply rules published by the Canada Revenue Agency, available at http://www.cra-arc.gc.ca/placeofsupply/
[286] De Wet C and Du Plessis R (2004) "Taxation (VAT)" in Buys R (ed) (2004) *CyberLaw@SAII* at 279; Botes M (2011) "South African VAT and non-Resident Business" *International VAT Monitor* vol 22 no 6 at 396; Johnston G and Pienaar S (2013) "Value-Added Tax on Virtual World Transactions: A South African Perspective" *International Business and Economic Research Journal* vol 12 no 1 at 71 http://www.cluteinstitute.com [accessed 12 April 2013].
[287] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 376.
[288] Section 1 of the VAT Act 89 of 1991.
[289] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 376.

shall be deemed to be an enterprise separate and distinct from the main enterprise located in the Republic. In other words, supplies by a foreign branch of the main enterprise, which does not operate separately from the main branch, will be deemed to be supplies made by the main branch, irrespective of whether or not the supplies were made in a foreign jurisdiction. This provision contradicts the destination principle in terms of which exports are not subject to VAT, while imports are. As a result of the absence of clear and direct place-of-supply rules in the VAT Act,[290] the VAT treatment of different types of transaction should be examined to establish logical place-of-supply rules applicable to each of these types of transaction.

3.4.2.1 Place of supply: Exported goods

Section 11(1), read with the definition of "exported" in section 1, provides for the zero rating of goods exported to a country outside of the Republic. This provision emphasises the application of the destination principle. Van der Merwe states that neither section 11(1), nor the definition of "exported", provides a clear indication of where the supply is deemed to take place.[291] It goes without saying that the zero rating provision underpins the destination principle on the supposition that the goods will be taxed in the country to which they are exported. However, is it at all necessary to determine the place where the goods will be supplied in the case of goods exported from jurisdictions that follow the destination principle? Certainly, the country to which the goods are exported will apply its own place-of-supply rules to tax the imports. However, the movement of goods across South African borders, especially to neighbouring countries, is not always properly controlled.[292] Documents are falsified, and goods intended for export are often supplied locally instead of being exported.[293] It has been suggested that exported goods should be taxable at the standard rate, and that the exporter vendor should apply for a VAT refund upon submitting proof that the goods have actually been exported to a destination outside

[290] Act 89 of 1991.
[291] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 377.
[292] Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 75.
[293] Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 75.

of the Republic.[294] This suggestion could further exacerbate confusion as to the place of supply of exported goods. The goods will effectively be taxed in South Africa, giving the impression that the goods were supplied and taxed at the supplier's location in terms of the origin principle. As soon as the supplier applies for a VAT refund, the place of supply - or so it could be argued - shifts to the country of destination. The lack of clear place-of-supply rules in the case of exported goods creates tax uncertainty which could negatively affect cross-border trade.

3.4.2.2 Place of supply: Exported services

Services that are physically rendered outside of the Republic are zero-rated.[295] Services supplied to a person who is not a resident of the Republic while he is not physically present in the Republic, are also zero-rated.[296] It can, therefore, be deduced that where services are exported, to the extent that they are physically rendered outside of the Republic, the place of supply shall be the place where such services are physically rendered. Again, no clear place-of-supply rules exist, nor are there any clear provisions on where the place of supply is deemed to be. The place of supply is determined on the basis of assumption and interpretation, which interpretation, as explained below, often differs among taxpayers, academics, the courts, and tax authorities.

Dendy opines that on a strict interpretation of section 11(2)(*k*), the services themselves must be physically performed outside of the Republic to qualify for a zero rating.[297] In other words, the South African VAT vendor must be physically present outside of the Republic when the services are performed. It is not sufficient for the recipient alone to receive the services outside the Republic to shift the place of supply from South Africa to the place where the services are physically rendered. Therefore, should a South African VAT vendor deliver digital supplies (by delivering

[294] Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 75.
[295] section 11(2)(*k*) of the VAT Act 89 of 1991.
[296] Section 11(2)(*l*) of the VAT Act 89 of 1991; *Master Currency (Pty) Ltd v CSARS* (155/2012) [2013] ZASCA 17 (20 March 2013) at paras 12-19.
[297] Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 12.

the supplies either electronically or remotely by accessing a computer) to a person physically located outside of the Republic, the place of supply should be the place where the supplier is physically located when the supplies are delivered, i.e. South Africa. Should the digital supplies be rendered physically outside of the Republic by inserting a CDROM or other storage device into the recipient's device and copying the digital products onto that device in a foreign location, the place of supply shall be the place where the services are physically rendered at the location outside of the Republic.

Should the services be rendered to a person who is not a resident of South Africa and who is not physically present in South Africa when the services are rendered (whether physically or virtually), the services shall be subject to zero rating in terms of section 11(2)(*l*).[298] In other words, the place of supply shall be at a foreign location.

Dendy argues that the strict interpretation of section 11(2)(*k*) and the subsequent irrational application, were never intended by the legislator.[299] He further argues that "physically rendered" was not intended to mean that the supplier must be physically present in a foreign location where the services are being rendered, but that all that is required is that the service itself must be physically rendered outside of the Republic.[300] Again, it should be noted that, when it was drafted, the VAT Act[301] was not designed to provide for modern day e-commerce and the digital supply of products. Dendy's argument to include the supply of products delivered electronically within the meaning of "physically rendered", should be seen as an attempt to extend the meaning and application of section 11(2)(*k*) to cases for which it was not designed. Nevertheless, the wording of section 11(2)(*k*) does not specifically dictate that the supplier himself must physically render the services outside of the Republic. So, where an agent or any other person or entity acting on behalf of the supplier, physically renders such services outside of the Republic, the zero rating should, in principle, apply.

[298] *Master Currency (Pty) Ltd v CSARS* (155/2012) [2013] ZASCA 17 (20 March 2013) at para 17.
[299] Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 12.
[300] Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 12.
[301] Act 89 of 1991.

However, the word "physically" entails that some form of presence outside the Republic is required for section 11(2)(*k*) to come into play. Therefore, where the services are rendered by electronic means from a remote server located in or outside of South Africa, section 11(2)(*k*) cannot apply as neither the supplier nor its agent or representative, is physically present at the location outside of the Republic. Based on this interpretation, where digital products are delivered electronically at a foreign destination, the place of supply is the place where the supplier is located or established. This interpretation puts South African suppliers of digital products at a disadvantage to foreign suppliers whose supplies are excluded from national taxes before they enter the international market.

In *Master Currency (Pty) Ltd v CSARS,*[302] the court ruled that services supplied in a tax-free zone at the then Johannesburg International Airport, cannot be zero-rated in terms of section 11(2)(*l*) because the services are not physically rendered at a location outside of the Republic, nor were the services exported as defined.[303]

Cognisance should also be taken of the provisions relating to the export of intellectual property rights. Section 11(2)(*m*) provides for the zero rating of services in respect of intellectual property in so far as the intellectual property is used or applied outside of the Republic. These services include the filing, prosecution, granting, maintenance, transfer, assignment, licensing, enforcement or the incidental supply of intellectual property.[304] For purposes of section 11(2)(*m*), intellectual property includes patents, designs, trademarks, copyrights, know-how, confidential information, trade secrets, or similar rights. It could be argued that digital supplies, generally, constitute the granting, assignment or licensing of rights to intellectual property. On this basis, the supply of digital products by a South African vendor to any other person, should, to the extent that the digital products will be used and applied outside South Africa, be zero-rated. In other words, the place of supply will be the location outside of the Republic, where the intellectual property is used and applied. That said, as it is presumed that digital supplies are deemed to be services, the provision in section 11(2)(*m*) cannot apply unless the agreement specifically

[302] *Master Currency (Pty) Ltd v CSARS* (155/2012) [2013] ZASCA 17 (20 March 2013).
[303] *Master Currency (Pty) Ltd v CSARS* (155/2012) [2013] ZASCA 17 (20 March 2013) at paras 17 and 19.
[304] Section 11(2)(*m*) of the VAT Act 89 of 1991.

provides that the intellectual property rights are being sold, transferred, granted, or assigned, as opposed to the mere electronic delivery of digital products.

As with the provisions in section 11(1) in respect of exported goods, section 11(2) provides no clarity on the place of supply of exported services.[305] The onus is on the vendor to substantiate that the services have been exported, and that a zero rate should apply.[306] To this end, the vendor must obtain and retain documentary proof acceptable to the Commissioner substantiating the zero rating.[307] As a result of the anonymity of e-commerce, it is often difficult to determine if the services rendered were exported. The e-mail address or place of residence supplied by the consumer is not an indication of the actual place of consumption. Unless vendors have sophisticated software that identifies the consumer's location by tracing the IP address of the electronic device that is being used to purchase the digitised products, vendors will not be aware (or have any control over) whether the digitised products were actually exported. Many consumers could falsify the billing address or place of residence to qualify for zero-rated supplies, while the consumer downloads and uses the digitised products from a location within the Republic. Similarly, residents temporarily abroad can purchase digitised products from a foreign IP location with a false foreign address, and store these digitised products on a portable computer or other portable storage device. These products can enter the country undetected and untaxed. I do not foresee SARS officials scanning and recording the contents of the storage devices of every resident exiting and entering the country.

3.4.2.3 Place of supply: Imported goods

Generally, it is fairly uncomplicated to determine the place of supply where physical goods are consumed and where they should be taxed. This is usually the place

[305] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 374; De Wet C and du Plessis R (2004) "Taxation (VAT)" in Buys R (ed) (2004) *CyberLaw@SAII* at 281.
[306] Section 11(3) of the VAT Act 89 of 1991.
[307] Section 11(3) of the VAT Act 89 of 1991. See also Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 377; De Wet C and du Plessis R (2004) "Taxation (VAT)" in Buys R (ed) (2004) *CyberLaw@SAII* at 281.

where the goods are delivered or made available to the customer.[308] VAT must be levied on imported goods as soon as they enter the country for customs and excise purposes.[309] It can therefore be argued that the place of supply is the customs area where the goods first entered the country. Conversely, where they are imported into South Africa for domestic consumption, the place of supply will be South Africa.

3.4.2.4 Place of supply: Imported services

When section 7(1)(*c*) is read in conjunction with the definition of "imported services" in section 1, it becomes clear that the VAT Act[310] provides for two types of agreement, namely:-

i) Transactions in which services are supplied by a foreign non-resident vendor to a South African resident vendor. These transactions are commonly referred to as Business-to-Business or B2B transactions.
ii) Transactions where services are supplied by a foreign non-resident vendor to a South African resident non-vendor. These transactions are commonly referred to as Business-to-Consumer or B2C transactions.

3.4.2.4.1 Business-to-Business transactions

In terms of the definition of "imported services", no VAT will be levied on the supply of services by a non-resident vendor to a resident vendor in so far as the services are to be utilised and consumed in the making of taxable supplies. Where the resident vendor sells the services so acquired to final consumers, VAT will be levied on the supplies in terms of section 7(1)(*a*). Similarly, where the services so acquired are applied in the making of any other taxable supply, the supply will be subject to VAT in terms of section 7(1)(*a*). VAT is, therefore, deferred to the time and place when the vendor makes taxable supplies.

[308] OECD (2001) *Consumption Tax Aspects of Electronic Commerce* at 10 http://www.oecd.org/tax/consumptiontax/2673667.pdf [accessed on 18 March 2013].
[309] Section 13(1) of the VAT Act 89 of 1991.
[310] Act 89 of 1991.

It could be argued that determining the place of supply is irrelevant in these transactions in so far as the imported services are applied and utilised in the course and furtherance of an enterprise, and in the making of taxable supplies. The place of supply is determined when the recipient vendor of imported services makes subsequent taxable supplies. Generally, in the case of domestic supplies, the place of supply is determined by the place where the supplier is established or has its fixed place of business.[311] However, the place of supply must still be established to determine whether the imported services were utilised and consumed in the course and furtherance of an enterprise, and in the making of taxable supplies in the Republic.

In *CSARS v De Beers Consolidated Mines Ltd,*[312] the taxpayer was approached by a consortium which proposed a very complex transaction in terms of which the consortium would become the holding company of De Beers. In considering the proposal, De Beers sought financial and legal advice from NM Rothschild and Sons Ltd, a company based in London. At the same time, De Beers also appointed a set of South African advisors to finalise the agreement. On 7 June 2001 NM Rothschild issued an invoice to De Beers in the amount of USA $19 895 965. Between March 2001 and January 2002 the local suppliers issued invoices to De Beers reflecting VAT on the services rendered. De Beers treated the VAT payments as input VAT in making taxable supplies. In an assessment issued on 18 October 2004, the Commissioner determined that NM Rothschild's services amounted to "imported services" as contemplated in section 7(1)(*c*), and that they were, accordingly, subject to VAT at fourteen percent. In addition, the Commissioner denied an input VAT deduction on the locally supplied services on the basis that they were not applied in the furtherance of De Beers' enterprise. On appeal to the Tax Court, Davis J ruled that the services obtained from NM Rothschild were not "imported services" as defined since De Beers was legally obliged, as a JSE listed company, to obtain legal and financial advice when it was confronted with the complex business proposal.[313] In the light of this legal obligation, the services were obtained in the conducting of a

[311] Section 7(1)(*a*) of the VAT Act 89 of 1991.
[312] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012).
[313] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [6].

continuing enterprise and should not be subject to VAT.[314] Put simply, the transaction should be treated as a B2B transaction.

On appeal to the Supreme Court of Appeal, the court, *inter alia,* examined two important issues, namely: i) the place of supply in respect of the international services; and ii) whether NM Rothschild's services amounted to imported services.[315]

i) The place of supply in respect of international services

De Beers contended that the services acquired from NM Rothschild were consumed outside of South Africa and could, accordingly, not be classified as imported services.[316] It contended that the meetings with NM Rothschild took place outside of South Africa, hence the place of supply was outside of South Africa.[317] The court applied a practical test to determine the place of supply. On the facts it was held that only two of the five substantial meetings were held outside of South Africa.[318] The board of directors held meetings in Johannesburg where the advice obtained was considered and where the decisions were made on the strength of the recommendations.[319] The fact that some of the meetings were held outside of the Republic cannot justify the conclusion that the services were consumed outside of South Africa.[320]

Silver and Beneke are of the opinion that the phrase "utilised or consumed in the Republic" is not clear.[321] The issue arises whether services are utilised or consumed at the place where they are physically rendered or where the recipient conducts its business.[322] In certain cases services are, by their very nature, consumed or utilised where they are physically rendered.[323] For example, a South African gardener displays his exhibition at an international garden show in London and acquires the

[314] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [6].
[315] See paragraph 3.4.6 below.
[316] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [17].
[317] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [17].
[318] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [17].
[319] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [17].
[320] Vermaak A (2012) "VAT on Corporate Advice" *Legalbrief* 28 August 2012 http://www.legalbrief.co.za/article.php?story=20120228082656737 [accessed on 31 August 2012].
[321] Silver M and Beneke C (2009) *VAT Handbook* 7th edition at 73.
[322] Silver M and Beneke C (2009) *VAT Handbook* 7th edition at 73.
[323] Silver M and Beneke C (2009) *VAT Handbook* 7th edition at 73.

services of a carpenter to build the display. While the services are indeed beneficial to the South African gardener, it can be argued that they were utilised and consumed where they were physically rendered. Hull and Gibson state that services that were physically rendered outside of the Republic, are not subject to VAT in South Africa irrespective of where they are consumed or where the taxpayer benefits from them.[324]

In the case of intangible services such as repairs to computer software, or financial or legal advice, the place of consumption is not necessarily the place of physical delivery. It could be argued that the place where the result of the services is experienced, or where the benefit is felt, is the place of consumption. Where benefits from the services can be experienced in multiple jurisdictions, they will be subject to VAT in South Africa "to the extent that [they were] utilised or consumed in the Republic". In *CSARS v De Beers Consolidated Mines Ltd,*[325] the court was in the fortunate position of being able to determine the place where the meetings took place, and at which meetings decisions based on the internationally acquired recommendations were taken. Not all cases allow for a practical test to be applied as can be illustrated by the following example:

> **Example 3.5:** While X is touring in France, he attends a seminar on environmental building practices. Upon his return to South Africa, he applies the ideas and recommendations acquired at the seminar to build a new, environmentally friendly office complex. In this case, there are no board meetings or similar evidence to determine if X's ideas emanate from the internationally acquired recommendations. Unless it can be proven that the ideas were unique, and that persons who did not attend the seminar would have been unable to come up with similar ideas, it cannot be concluded that X utilised or consumed the internationally acquired ideas in South Africa.

But does "utilised and consumed in the Republic" necessarily translate into the experiencing or reaping the benefits of the service? I do not believe that these terms can be used as synonyms. For example, X undergoes plastic surgery while on

[324] Hull G and Gibson C (2012) *The VAT Handbook* at 114.
[325] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012).

holiday in France. She returns to South Africa after she has fully recovered. On her return she experiences the benefit of the services through various compliments and an offer of a modelling contract. Clearly, the services were physically rendered in France and although she benefits from the services in South Africa it cannot be said that the services are utilised and consumed in the Republic. Nevertheless, the Explanatory Memorandum of the Taxation Laws Amendment Bill of 1998 stated:

> When VAT was introduced, the intention was to levy VAT on the consumption in the Republic. To achieve this, those supplies where consumption does not take place in the Republic and the benefit of services is not enjoyed in the Republic, are subjected to VAT at a rate of zero per cent…[326]

It is clear that the place of supply of services is not only determined by the physical location where the supply is rendered, but also where the benefit of the service can be experienced. This position was confirmed on appeal in *Master Currency (Pty) Ltd v CSARS.*[327] Unless the place of consumption can be determined by an after sales relationship between the supplier and the customer, or through the application of a practical test, the actual place where the benefits of the services are experienced, cannot be determined.

In *Metropolitan Life Ltd v CSARS,*[328] the taxpayer, pursuant to its business activities, acquired international business advice and computer services. Since these services were physically rendered outside of the Republic, the taxpayer contended that they qualified as zero-rated supplies in terms of section 11(2)(*k*).[329] The zero rating provision in section 11(2)(*k*) applies in respect of services rendered by a South African registered vendor (or enterprise that is required to be registered as a vendor) outside of the Republic. Therefore, section 11(2)(*k*) applies to exported services. As a result, services rendered by a non resident vendor outside of the Republic, do not qualify for zero rating in terms of section 11(2)(*k*). Davis J ruled that the court *a quo,* therefore, had correctly held that the services do not qualify for zero rating under

[326] Clause 89 of the Explanatory Memorandum on the Taxation Laws Amendment Bill 1998.
[327] *Master Currency (Pty) Ltd v CSARS* (155/2012) [2013] ZASCA 17 (20 March 2013) at para 17.
[328] *Metropolitan Life Ltd v CSARS* 2009 (3) SA 484 (C).
[329] *Metropolitan Life Ltd v CSARS* 2009 (3) SA 484 (C) at para [2]. In terms of section 11(2)(*k*), services that are physically rendered outside of the Republic or at a customs control area would be zero-rated.

section 11(2)(*k*), and that the assessment was correct in taxing the supplies as "imported services."[330] He held further that the type of services provided would not have qualified for zero rating had they been rendered in the Republic, and could, accordingly, not qualify for zero rating under either section 11(2)(*k*) or section 14(5)(*b*).[331] Davis J confirmed that section 14(5)(*b*) provides for a zero rating on imported services if the services would qualify for zero rating had they been rendered in the Republic.[332] The court did not expressly deal with the place-of-supply rules where the goods were physically rendered outside of the Republic. It appears that the court came to the conclusion that the services, despite their having been physically rendered outside of the Republic, were imported into South Africa as they were applied by an enterprise resident in South Africa.

Dendy, in criticising Davis J's judgment, opines that section 11(2)(*k*) is not restricted to exported services, but also applies to supplies physically rendered outside of the Republic by any foreign vendor.[333] According to Dendy's interpretation, the place of supply is not determined so much by the place of utilisation, as by the location where the services are physically rendered. Despite various criticisms, until such time as the ruling by the SCA is overturned, or clear place-of-supply rules are incorporated, the current position stands and the place of supply is the location where the services are utilised and consumed in the Republic.

3.4.2.4.2 Business-to-Consumer transactions

Where services are supplied by a non-resident vendor to a resident non-vendor or to a resident vendor who does not apply the services in making taxable supplies, the transaction is subject to VAT to the extent that the services have been utilised or consumed in the Republic.[334] For purposes of the VAT Act,[335] "resident" as defined

[330] *Metropolitan Life Ltd v CSARS* 2009 (3) SA 484 (C) at para [4].
[331] *Metropolitan Life Ltd v CSARS* 2009 (3) SA 484 (C) at para [4].
[332] *Metropolitan Life Ltd v CSARS* 2009 (3) SA 484 (C) at para [32].
[333] Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 22-33.
[334] Section 7(1)(*c*) read with the definition of "imported services" in section 1 of the VAT Act 89 of 1991. Also see Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 377.
[335] Act 89 of 1991.

in section 1 of the Income Tax Act[336] shall apply.[337] It is further provided that any person or company that carries on any enterprise or other activity in the Republic, or has a fixed place of business or permanent place in the Republic relating to the enterprise, shall be deemed to be a resident.[338]

The South African VAT system relies on a reverse-charge mechanism requiring the recipient of the imported services (vendor or non-vendor) to account for VAT.[339] In contrast to other VAT systems which distinguish between a reverse-charge mechanism in the case of B2B transactions, and a self-assessment mechanism in the case of B2C transactions, the South African system applies the reverse-charge mechanism in both B2B transactions -in so far as the services are not applied in the making of taxable supplies- and B2C transactions.[340]

Determining the place of supply based on the utilised-and-consumed principle as developed by the courts, is often difficult. In addition, the reverse-charge mechanism relies on the recipient's interpretation of where the services were utilised and consumed. This can again best be illustrated by way of example:

> **Example 3.6:** While X is waiting for a flight in an international tax-free zone, his portable computer is infected with a virus. X purchases and

[336] Act 58 of 1962.

[337] In terms of section 1 of the Income Tax Act 58 of 1962, "resident" means any

"(a) Natural 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 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 preceding years of assessment,

in which case that person will be a resident with effect from the first day of that relevant year of assessment.

(b) 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;

but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the government of the Republic and that other country for the avoidance of double taxation".

[338] Section 1 of the VAT Act 89 of 1991.

[339] Section 14 of the VAT Act 89 of 1991. See paragraphs 3.4.6 and 3.4.8 below on the effectiveness of the reverse-charge mechanism as a tax collection method.

[340] For more information on the difference between the reverse-charge mechanism and the self-assessment mechanism in other VAT systems, see Van der Brederode R and Gendron PP (2013) "The Taxation of Cross-border Interstate Sales in Federal or Common Markets" *World Journal of VAT/GST Law* vol 2 issue 1 at 1-23.

downloads an anti-virus application and cleans his portable computer. X is of the opinion that the digital products were supplied in the international tax-free zone and were not utilised and consumed in South Africa.

It could be argued that the software application is applied continuously until the licence expires. Should the license only expire after X has returned to South Africa, it can be said that the digitised products were applied partly in South Africa and partly in the international tax free zone. The anonymity of online transactions relating to digitised products, makes the tracking and tracing of these transactions impossible. I do not foresee that SARS would scan portable computers and record the software loaded on them upon exit and entry of every person at border posts. Furthermore, in the case of example 3.6, it will be difficult to determine if X did in fact utilise and consume the software in South Africa from the date of his return until the expiry date of the software. However, where the services were rendered while X was physically present in the international tax free zone in an international airport in South Africa, the services would be subject to VAT since the services were physically rendered within the borders of the Republic.[341]

Example 3.7: While X is travelling through Japan by rail, he logs onto a video streaming service provider and pays an amount to watch a film (the so-called pay-per-view principle). The film is not downloaded to X's portable device, but is directly streamed to it. In other words, once viewed, X cannot recall the film from the device. If he wishes to view the film again, he must again pay.

In this case, it can be argued that, in applying section 11(2)(*k*), the service (entertainment) was rendered at the place where X physically found himself when the streaming commenced . Should X have found the film of any value, enabling him to apply the ideas in it upon his return to South Africa, it could be argued, by applying the definition of "imported services", that the service was utilised and consumed in South Africa. Practically, this would be impossible to detect.

[341] *Master Currency (Pty) Ltd v CSARS* (155/2012) [2013] ZASCA 17 (20 March 2013) at para 17.

From case law it is clear that in the case of intangible services, the phrase "utilised and consumed in the Republic", entails that the place of supply is the place where the services were applied and not where they were physically rendered.[342]

Similarly, in the case of digitised products, the actual place of delivery is irrelevant where the 'benefits' of the digitised products can be applied in multiple jurisdictions.

In the case of combined supplies, where the supply was partly rendered in the Republic and partly rendered in a foreign jurisdiction, determining the place of supply becomes troublesome.

> **Example 3.8:** X, a South African resident, acquires specialised software from Y (a South African resident and registered VAT vendor) who develops and installs the software on X's computer at a location in South Africa. The software requires configuration in the southern and northern hemispheres respectively. Y configures the software for the southern hemisphere at a location in South Africa and appoints Z, a foreign branch of Y, to configure the software at a location in Europe while X travels to Europe.

Can it be said that the supply was partly rendered in the Republic and partly in Europe? Furthermore, should the taxation of the supply be apportioned in accordance with the value of the supply that was rendered in the Republic and in Europe?

Section 8(15) of the VAT Act[343] provides that:

> For the purposes of this Act, where a single supply of goods or services or of goods and services would, if separate considerations had been payable, have been charged with tax in part at the rate applicable under section 7(1)(*a*) and in part at the rate applicable under section 11, each part of the supply concerned shall be deemed to be a separate supply...

Where the work necessary to produce a single supply was rendered by Y in the Republic, that part of the supply shall constitute the making of a taxable supply for

[342] *Metropolitan Life Ltd v CSARS* 2009 (3) SA 484 (C); *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012).
[343] Act 89 of 1991.

purposes of section 7(1)(*a*) and should be taxed in South Africa.[344] In applying section 8(15), it is clear that the part of the supply that was rendered outside of the Republic, would not be subject to South African VAT since it was rendered outside of the Republic.[345] What if the foreign part of the supply was rendered by Y, the South African VAT vendor, while both Y and X were abroad? Can it be said that the foreign part of the supply is subject to South African VAT at a zero rate in terms of section 11(2)(*k*)? In other words, could the supply be treated as an exported supply of services, and the place of supply be deemed to be the foreign location?

Dendy opines that on a proper interpretation of section 11(2)(*k*), services that are physically performed[346] outside of the Republic, irrespective of whether this is done by a South African vendor or a foreign non-vendor, should be zero-rated.[347] Consequently, the services are treated as an exported service in the case of supplies by a South African vendor, and as foreign supplied services, if supplied by a foreign non-vendor. In *ITC* 1812,[348] before it was taken on appeal in *Metropolitan Life Ltd v CSARS,*[349] Waglay J ruled that services which are physically rendered outside of the Republic by a VAT vendor to a person who consumes the services inside or outside of the Republic, should be subject to VAT at zero percent in terms of section 11(2)(*k*).[350] However, where the services were rendered by a foreign non-vendor to a South African resident, the services must be consumed at a foreign location to qualify for such zero rating.[351] Waglay J further ruled that section 11(2)(*k*) does not apply to imported services.[352] This was confirmed on appeal in *Metropolitan*

[344] Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 3.
[345] Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 3.
[346] Dendy is of the opinion that the word "rendered" should be interpreted to mean "performed" in the context of the supply to avoid an irrational result. Performed or performance of a supply refers to the actual deed of making the supply as oppose to the receipt of a supply as contemplated by the meaning of "rendered".
[347] Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 12-21.
[348] *ITC* 1812 68 SATC 208.
[349] *Metropolitan Life Ltd v CSARS* 2009 (3) SA 484 (C).
[350] *ITC* 1812 68 SATC at para 36.
[351] *ITC* 1812 68 SATC at para 36.
[352] *ITC* 1812 68 SATC at paras 18 and 38. Waglay J came to this conclusion after having consulted the pre-amended version of section 11(2)(*k*) which applied until 1997 at which point it was replaced by the current version of section 28(a) of the Taxation Laws Amendment Act 25 of 1997. Before it was amended, section 11(2)(*k*) applied only to the domestic supply of goods and services as contemplated in section 7(1)(*a*) which happened to be physically performed outside of the Republic. The amended section 11(2)(*k*) applies to services that were physically rendered outside of the Republic in terms of section 7(1). The deletion of the reference to subparagraph (a) in the amendment clearly indicates that section 11(2)(*k*) applies to section 7(1) as a whole,

Life Ltd v CSARS.[353] In other words, where services are rendered to a South African resident at a foreign location, the services are deemed to be supplied in South Africa in terms of the definition of "imported services" in so far as they are utilised and consumed within the Republic.

When the consumption principle, as established in case law, is applied to example 3.8, to establish the place of supply, practical evidence would be required to determine if X consumed the services in Europe or in South Africa. Where the services were consumed both in South Africa and abroad, the South African VAT portion should be apportioned in terms of section 8(15). Under the reverse-charge mechanism, what constitutes South African consumption and foreign consumption will in most cases rely on the interpretation of the consumer. Should an investigation be required when the matter is audited, it could require expert evidence and costly litigation which could amount to more than the VAT ultimately payable on the supplies. That is, if the transaction could be detected in the first place.

Dendy argues that where services were physically rendered at a location outside of South Africa, the place of supply should be the location where the services are physically rendered, where it is ultimately utilised or consumed is irrelevant because it was physically rendered outside of the Republic as contemplated in section 11(2)(*k*).[354] Where services are non-physically rendered outside of the Republic, in the case of digital supplies, section 11(2)(*k*) will not apply and such services, where rendered to a South African resident, could be construed as imported services.[355] The place of supply is deemed to be the place where the services are utilised and consumed by the recipient.

As a result of technological advances, the place of supply can be in different locations if the "physically rendered" and utilised-and-consumed principles are applied respectively. In an attempt to eliminate such variable results, SARS has considered the development of deeming provisions for specific types of service - such as telecommunication services and intellectual property rights.

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and not only section 7(1)(*a*). Dendy therefore correctly points out that Waglay J's ruling to exclude "imported services" from the application of section 11(2)(*k*) is incorrect.

[353] *Metropolitan Life Ltd v CSARS* 2009 (3) SA 484 (C) at paras 27 and 33.

[354] Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 59.

[355] Emslie T (2010) "Editorial Note" *The Taxpayer* vol 59 issue 1 at 2.

3.4.2.4.3 Telecommunication services

Section 23(1)(*e*) of the Taxation Laws Amendment Act[356] introduced subparagraph (iv) to the definition of 'enterprise' in section 1 which provides that any person who continuously or regularly supplies telecommunication services to any person who utilises those services in the Republic, is deemed to conduct an enterprise in South Africa. Conversely, where telecommunication services are utilised in the Republic, irrespective of the physical place of delivery, they are deemed to have been supplied in the Republic. This provision has, however, not yet been promulgated.[357] The reason for the non-promulgation is unknown.

It should be noted that the amendment was proposed as an exception to the general rule as an anti-avoidance measure to regulate and appropriately tax these transactions as they are "rarely brought to account".[358]

3.4.2.4.4 Intellectual property rights

SARS has proposed that where a foreign enterprise grants rights for the use of intellectual property to a South African enterprise or resident, the foreign enterprise must register as a South African VAT vendor if it receives royalties which exceed the VAT threshold.[359] Therefore, the place of supply of the right or licence to use intellectual property in South Africa is in the Republic, irrespective of the actual place of physical supply. SARS has, in the meantime, withdrawn this proposal to the extent that foreign vendor registration is not required where the foreign vendor does not

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[356] Act 27 of 1997.

[357] Classen incorrectly states that this provision is already enforced by SARS. See Classen L (2012) "E-commerce and Value Added Tax" in Papadopoulos S and Snail S (eds) (2012) *Cyberlaw@SAIII* at 119.

[358] Explanatory Memorandum on the Taxation Laws Amendment Bill 1997

[359] *VAT News 13-December 1999* http://www.sars.gov.za/tools/Printbody.asp?pid=47320 [accessed on 18 March 2013]; also see De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 8.10; Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 112.

have a fixed or permanent establishment in South Africa.[360] Nevertheless, SARS announced in *VAT News* 37[361] that it will again review the initial proposals made in *VAT News* 13. It is not certain when this deeming provision will be applied.

3.4.3 When is the supply made?

VAT vendors must account for VAT at the end of each tax period based on their type of vendor registration. It is therefore important to determine the time of supply to know which supplies must be accounted for in respect of a particular tax period.[362] In addition, when changes in the VAT rate occur, it is important to determine the time of supply so that VAT may be charged at the rate applicable to that particular transaction.[363] Generally, the time of supply is when an invoice is issued, or when payment is received - whichever is the earlier.[364] For purposes of this thesis, the discussion is limited to the determination of the time of supply in the case of goods and services being imported.

3.4.3.1 Time of supply: Imported goods

Where tangible goods are imported, the time of supply is deemed to be the date on which the goods are deemed to have been imported into South Africa in terms of the

[360] Temkin S (2003) "Attempt to Force VAT on Royalties may Encourage Disinvestments" *Businessday* http://www.taxtalkblog.com/?p=5221 [accessed on 18 March 2013].
[361] *VAT News 37-February 2011* http://www.sars.gov.za/home.asp?pid=4&cx=009878640050894574201%3Aku-btv50zym&cof=FORID%3A10%3BNB%3A1&ie=UTF-8&q=VAT+royalties&sa=%3CIMG+alt%3D%22Click+here+to+begin+your+search%22+src%3D%22images%2FsearchButtonBackground.gif%22%3E&siteurl=http%3A%2F%2Fwww.sars.gov.za%2F [accessed on 18 March 2013].
[362] Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 29; De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 10.1.
[363] De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 10.1.
[364] Section 9(1) of the VAT Act 89 of 1991. Also see Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 33; De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 10.1.

Customs and Excise Duty Act.[365, 366] Goods are deemed to be imported into South Africa:

> (*a*) in the case of goods consigned to a place in the Republic in a ship or aircraft, at the time when such ship or aircraft on the voyage or flight in question, first came within the control area of the port or airport authority at that place, or at the time of the landing of such goods at the place of actual discharge thereof in the Republic if such ship or aircraft did not on that voyage or flight call at the place to which the goods were consigned or if such goods were discharged before arrival of such ship or aircraft at the place to which such goods were consigned;
>
> (*b*) in the case of goods not consigned to a place in the Republic but brought thereto by and landed therein from a ship or aircraft, at the time when such goods were so landed;
>
> (*c*) in the case of goods brought to the Republic overland, at the time when such goods entered the Republic;
>
> (*d*) in the case of goods brought to the Republic by post, at the time of importation in terms of paragraph (*a*), (*b*) or (*c*) according to the means of carriage of such goods; and
>
> (*e*) in the case of goods brought to the Republic in any manner not specified in this section, at the time specified in the General Notes to Schedule No. 1 or, if no such time is specified in the said General Notes in respect of the goods in question, at the time such goods are considered by the Commissioner to have entered the Republic.[367]

Where goods are imported into South Africa for home consumption, the time of supply is deemed to be the date on which the goods entered the Republic for home consumption.[368]

[365] Act 91 of 1964.
[366] Section 13(1) of the VAT Act 89 of 1991.
[367] Section 10(1) of the Customs and Excise Duty Act 91 of 1964.
[368] Section 13(1)(i) of the VAT Act 89 of 1991. See also Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 111.

3.4.3.2 Time of supply: Imported services

The time of supply in the case of the imported services, is deemed to be the date on which an invoice is issued by the supplier or the recipient in respect of the supply, or the date on which any payment is made by the recipient in respect of that supply - whichever is the earlier.[369]

In the case of e-commerce, it is often difficult to verify whether a transaction has occurred. When dealing with software updates, the recipient is often unaware that the electronic device has downloaded software from a local or foreign service provider. Invoices are rarely issued when updates are downloaded. These transactions often stem from a prior agreement with a service provider, seller, or manufacturer of the device, or with the software developer. Depending on the agreement, the recipient either pays a lump sum prior to commencement of the service from which the value of each upgrade or update is then deducted, or, the costs of the updates are deducted from the recipient's credit card account. In the case of a prepaid agreement, the payment was not made in respect of a specific service or digitised product. Instead, it could be argued that the payment constitutes a mere deposit of money into an account which the supplier may debit upon delivery of services or goods. The time of supply should, accordingly, be construed as the actual date on which the prepaid account is debited. In the absence of account statements or debit notifications, the recipient would be unaware of the time of supply. In many cases service providers merely inform users of a low account balance. Records of actual transactions are not disclosed to users unless they are requested by the user, often at a fee.

The word "invoice" is defined to mean "a document notifying an obligation to make payment".[370] An invoice need not constitute a tax invoice to determine the time of supply.[371] A contract, document, or detailed statement indicating the amount payable should, in principle, qualify as an invoice. De Koker and Kruger opine that the legal

[369] Section 14(2) of the VAT Act 89 of 1991; De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 8.10; Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 74.
[370] Section 1 of the VAT Act 89 of 1991.
[371] De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 10.2.

position of conditional contracts should be considered before a document is classified as an invoice.[372] For example, where X and Y conclude an agreement in terms of which X will pay Y R1000 when Y has completed painting X's roof, the obligation to pay is deferred until Y completes the service. The agreement in itself cannot constitute an invoice because it does not reflect an obligation to pay since the obligation it reflects is conditional.[373] Only when the service has been completed (the condition fulfilled) can it be said that the agreement constitutes an invoice.[374]

Similarly, where payment was made in terms of a prepaid agreement, the payment was not made to fulfil an obligation to pay. The recipient of the service could, in principle, cancel the agreement and have his money returned. The supplier would only be entitled to debit the account once it had commenced with service. It could, therefore, be argued that the agreement could constitute an invoice once the condition that would allow the service provider to debit the account has been fulfilled. The recipient is required to request account statements on a regular basis to allow him to determine the time of supply. The cost of acquiring these statements could in certain cases exceed the actual VAT liability.

In the case of credit cards, unless the card holder is regularly informed of transactions on his credit card via e-mail or sms, he would only become aware of them once he receives and examines his credit card statement. The credit card holder could, in principle, be completely unaware that software was downloaded to a device and that he paid for this. The time of supply is deemed to be the date when the payment was made or when the invoice was issued - whichever is the earlier -, irrespective of whether or not the recipient was aware of such payment. Since the recipient of the services must account for VAT in terms of the reverse-charge mechanism, this could place a compliance burden on him to examine his credit card statements regularly, or to scan all electronic devices in search of evidence reflecting payments for downloads or updates, if he is to determine the date of supply. Failure to do so could result in non-compliance or late submission of VAT returns, which could, in turn, result in the levying of penalties and interest.

[372] De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 10.2.
[373] De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 10.2.
[374] De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 10.2.

Although delivery notifications are not treated as invoices and cannot be used to determine the time of supply,[375] in the case of automatic software updates, delivery or update notifications can prompt the recipient to search for payment evidence or request an invoice. While the compliance burden is not completely eliminated, this practical approach could simplify the recipient's VAT declaration.

3.4.3.3 Time of supply: Vouchers

In a competitive market, suppliers often reward customers for their loyal and continued support by either issuing vouchers or adding additional products to the original supply at no cost. In the case of vouchers, the question arises whether the time of supply for VAT purposes, is when the voucher was issued and imported into South Africa, or, when it is exchanged for digital products? The issuing of a voucher does not amount to a supply of goods or services, but merely constitutes the issuing of a payment method that can be utilised by the recipient when he chooses.[376] Accordingly, when the voucher is used as payment for digital products, the time of supply would still be determined by the date of the issuing of an invoice or the date of any payment – whichever is earlier.

What happens where the voucher entitles the recipient to a right to goods and services? Can the voucher still be classified as a payment method? Is the time of supply the date of issue of the vouchers, or when the vouchers are exchanged for the goods or services? The VAT Act[377] provides no clear rules on the treatment of such vouchers. Two arguments can be raised. The voucher should be treated as a payment method and VAT must be levied when the voucher is exchanged for the goods and services, or, the issuing of the voucher constitutes the supply of goods (the tangible voucher) or services (the intangible voucher) and must be taxed when the voucher is issued.

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[375] De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 10.2.

[376] "Money" is excluded from the definitions of "goods" and "services" in section 1. Any bill of exchange, promissory note, bank draft, postal order, or money order is deemed to be "money" in terms of the definition of "money" in section 1 of the VAT Act 89 of 1991.

[377] Act 89 of 1991.

3.4.4 What is the value of the supply?

VAT is levied on the value of the supply. It is, therefore, essential that the correct value, as calculated in terms of the VAT Act,[378] is determined.[379] As a general rule, the value to be placed on goods or services in determining the VAT on the supply is the "consideration" for the supply, less that portion of the consideration that represents tax itself.[380] Simply put, the value for VAT purposes is consideration minus tax. In so far as payment is made in a form other than money, the open market value of that consideration will be applied.[381] It is important to note that the open market value of the consideration is to be used, and not that of the supplies. This ensures that VAT is appropriately levied on the value added to the supplies. Consequently, VAT is levied on the value that the purchaser is willing to pay for the goods or services. Where no consideration is paid, or where the consideration paid is less than the open market value, the open market value of the supplies is used to determine the value where the transaction was concluded between connected persons.[382, 383] As was explained in 3.4.1 above, when it comes to the taxation of

[378] Act 89 of 1991.

[379] De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 11.1; Doussy E (2001) *The Taxation of Electronic Commerce and the Implications for Current Taxation Practices in South Africa* at 96.

[380] Section 10(2) of the VAT Act 89 of 1991. Also see De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 11.1; Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 29.

[381] Section 10(3)(*b*) of the VAT Act 89 of 1991. Also see De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 11.2; Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 30.

[382] Section 10(4) of the VAT Act 89 of 1991. Also see De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 11.3; Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 39-41.

[383] "connected persons" means:

"(*a*) any natural person (including the estate of a natural person if such person is deceased or insolvent) and:

(i) any relative of that natural person (being a relative as defined in section 1 of the Income Tax Act) or the estate of any such relative if the relative is deceased or insolvent; or

(ii) any trust fund in respect of which any such relative or such estate of such relative is or may be a beneficiary; or

(*b*) any trust fund and any person who is or may be a beneficiary in respect of that fund; or

(*c*) any partnership or close corporation and:

(i) any member thereof; or

(ii) any other person where that person and a member of such partnership or close corporation, as the case may be, are connected persons in terms of this definition; or

(*d*) any company (other than a close corporation) and:

(i) any person (other than a company) where that person, his spouse or minor child or any trust fund in respect of which that person, his spouse or minor child is or may be a beneficiary, is separately interested or two or more of them are in the aggregate interested in

imports, the VAT Act[384] differentiates between imported goods and imported services.

3.4.4.1 Imported goods

The VAT Act[385] differentiates between goods imported from a Southern African Customs Union (SACU) area, and goods that are imported from areas other than the SACU area.

3.4.4.1.1 Goods imported from the SACU

Members of SACU are, apart from South Africa, Botswana, Lesotho, Namibia, and Swaziland. The value on which VAT will be levied on goods imported into South Africa from these countries is the value that would have been used for customs duty purposes had the goods been subject to such duty.[386] The transaction value of the goods is generally applied to determine the value of the goods for custom duty

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10 per cent or more of the company's paid-up capital or 10 per cent or more of the company's equity share capital (as defined in section 1 of the Income Tax Act) or 10 per cent or more of the voting rights of the shareholders of the company, whether directly or indirectly; or
(ii) any other company the shareholders in which (being shareholders as contemplated in the definition of "shareholder" in section 1 of the Income Tax Act) are substantially the same persons as the shareholders in the first-mentioned company, or which is controlled by the same persons who control the first-mentioned company; or
(iii) any person where that person and the person referred to in subparagraph (i) or his spouse or minor child or the trust fund referred to in that subparagraph or the other company referred to in subparagraph (ii) are connected persons in terms of this definition; or
(*e*) any separate enterprise, branch or division of a vendor which is separately registered as a vendor under the provisions of section 50 and any other such enterprise, branch or division of the vendor; or
(*f*) any branch, division or separate enterprise of an association not for gain which is deemed by subsection (5) of section 23 to be a separate person for the purposes of that section and any other branch, division or separate enterprise of that association, whether or not such other branch, division or separate enterprise is a vendor; or
(*g*) any person and any superannuation scheme referred to in section 2 (2) (vii), the members of which are mainly the employees or office holders or former employees or office holders of that person."

[384] Act 89 of 1991.

[385] Act 89 of 1991.

[386] Section 13(2)(*b*) of the VAT Act 89 of 1991. Also see De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 8.3; Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 69; Stiglingh M (ed), Koekemoer AD, Van Schalkwyk L, Wilcocks JS, De Swardt RD (2013) *Silke: South African Income Tax* at 1021.

purposes.[387] The Commissioner may, in writing, determine the value of the goods irrespective of the presence of a transaction value.[388]

3.4.4.1.2 Goods imported from countries outside the SACU

The value on which VAT is payable on goods imported from countries other than SACU members is:

i) the value of the goods for customs purposes;
ii) *plus* the amount of any customs duty, surcharge, or tax (other than VAT);
iii) *plus* an amount equal to ten per cent (mark-up) of the value of the goods for customs purposes.[389]

Where the Minister has issued a regulation determining the value of goods for purposes of determining the VAT on their importation, the greater of such value or the value as determined on the import thereof, shall apply.[390]

In the case of electronically ordered and physically delivered goods, the goods will enter a customs area before being despatched to the recipient. The GATT Valuation Agreement, in terms of which international guidelines for the valuation of imported goods for the purpose of taxation are set out, was adopted in 1979 and implemented in South Africa on 1 July 1983.[391] The WTO Agreement on the Implementation of Article VII of the GATT 1994, replaced the GATT Valuation Agreement, but the fundamental valuation principles did not change.[392] Six methods are prescribed to determine the value, in strict hierarchical order:

[387] Section 65(1) of the Customs and Excise Duties Act 91 of 1964.
[388] Section 65(4) of the Customs and Excise Duties Act 91 of 1964.
[389] Section 13(2) of the VAT Act 89 of 1991. Also see De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 8.2; Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 68; Stiglingh M (ed), Koekemoer AD, Van Schalkwyk L, Wilcocks JS, De Swardt RD (2013) *Silke: South African Income Tax* at 1021-1023.
[390] Section 13(2) of the VAT Act 89 of 1991.
[391] *Customs Valuation Guide* (February 2002) www.sars.gov.za [accessed on 18 March 2013].
[392] *Customs Valuation Guide* (February 2002) www.sars.gov.za [accessed on 18 March 2013].

i) the transaction value of the goods which is often determined by the accompanying invoice or the insured value of the parcel;[393]
ii) the transaction value of identical goods;[394]
iii) the transaction value of similar goods;[395]
iv) the "deductive" method where the value is derived from the selling price of identical or similar goods within the Republic;[396]
v) the "computed" method where the value is determined based on the build-up costs of the goods;[397]
vi) the "fall-back" method where one of the methods above are applied more flexibly.[398]

The existing valuation principles and methods can still be applied, despite the fact that e-commerce will increase the workload of customs officials at designated ports because of the increase in imported packages via post.

3.4.4.2 Imported services

The value to be placed on imported services, is the value of the consideration paid as determined in section 10(3) of the VAT Act,[399] or the open market value of the supply - whichever is the greater of the two.[400]

Where an invoice was issued, or the actual amount can be determined through account statements, the determination of the value for VAT purposes would be fairly

[393] Section 66(1) of the Customs and Excise Duties Act 91 of 1964.
[394] Section 66(4) of the Customs and Excise Duties Act 91 of 1964.
[395] Section 66(5) of the Customs and Excise Duties Act 91 of 1964.
[396] Section 66(7) of the Customs and Excise Duties Act 91 of 1964.
[397] Section 66(8) of the Customs and Excise Duties Act 91 of 1964.
[398] Section 66(9) of the Customs and Excise Duties Act 91 of 1964.
[399] Act 89 of 1991.
[400] Section 14(3) of the VAT Act 89 of 1991. Also see De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 8.10; Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 74; De Wet C and du Plessis R (2004) "Taxation (VAT)" in Buys R (ed) (2004) *CyberLaw@SAII* at 281.

uncomplicated, provided that the actual payment reflects the open market value of the digitised products.

It does, however, become problematic when invoices are not issued, payments cannot be traced because there are no account statements, or there is a prepaid agreement. It has been established above that the payment made in terms of a prepaid agreement, does not constitute a payment in respect of the said service or digital products until such time that the actual service or download has begun.[401] Therefore, despite the fact that the full prepaid amount can, in principle, be used to purchase digital products, the value of the products can only be determined once the actual supply takes place.

A further question that arises, is what value should be used where payment is made by a voucher issued by the supplier or by a third party - such as a credit card company - in terms of a loyalty scheme? Where the voucher was issued by a supplier vendor and subsequently used by the consumer to make payment, the vendor supplier should only account for VAT on that part of the consideration that was not paid for by the voucher.[402] Can this provision be applied where the foreign vendor is not registered as a vendor in the Republic, and is furthermore not required to register as such? In terms of section 10(1), the provisions in the whole of section 10 shall apply to *any*[403] supply of goods and services. Accordingly, where the foreign supplier issues a voucher to a recipient who subsequently uses the voucher to make payment or partial payment for the delivery of digitised products, only that portion of the value of the digitised products that is not paid for by the voucher would be subject to VAT. Similarly, where a voucher was issued free of charge entitling the recipient to digitised products, the value of the digitised products so exchanged shall be disregarded.[404]

Where a voucher was issued by a person other than the supplier, the issue becomes more problematic. The value of the voucher issued by a vendor is deemed to be part

[401] See paragraph 3.4.3.2 above.
[402] Section 10(19) of the VAT Act 89 of 1991; Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 32-33; SARS (2013) *Draft Interpretation Note: Vouchers Supplied at a Discount* at 2 http://www.sars.gov.za/home.asp?pid=677 [accessed on 4 April 2013].
[403] My emphasis.
[404] Section 10(18) of the VAT Act 89 of 1991.

of the consideration.[405] In other words, the value of the goods or services so acquired, would be equal to the amount paid in money and vouchers.[406] Section 10(20) only applies to vouchers issued by vendors, i.e. persons or enterprises registered as such in the Republic, or persons and enterprises who are required to register as such in the Republic. I believe that the legislator did not intend to limit the scope of this provision to resident vendors. The word "any" preceding the word "vendor" should be construed to mean any such entity that issued the voucher.

Where a voucher was issued for consideration, and the holder is, on surrender, entitled to goods or services specified on the voucher, the intrinsic value of the voucher is taxed.[407] The value of subsequent supplies is deemed to be nil to avoid double taxation. Vouchers or tokens which entitle the holder to multiple goods and services which cannot be determined at the time of issue of the voucher, are increasingly being issued. In addition, the supplier of such goods or services cannot be determined upfront. These vouchers fall outside the scope of section 10(19) since the goods and services to which the holder is entitled are not specified on the voucher. Where these vouchers are redeemed for purposes other than a discount or rebate, the value of the goods and not the consideration paid for the voucher must be used to calculate and levy VAT.[408] For example, where the voucher was issued for consideration of R100 which entitles the holder to goods and services to the value of R120, the vendor must account for VAT on R120.

Where consideration cannot be established, the open market value of the supplies should be used as the value for VAT purposes. It is, however, uncertain whether the open market value should be used where no consideration is paid. Generally, the open market value is used where no consideration is paid or where the consideration paid is less than the open market value where the supplier and the recipient are connected persons.[409] In the case of imported services where it cannot be established that the supplier and the recipient are connected persons, it is not certain whether section 14(3) will prevail over section 10(3). In other words, can the open

[405] Section 10(20) of the VAT Act 89 of 1991.
[406] Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 32-33.
[407] Section 10(19) of the VAT Act 89 of 1991.
[408] Section 10(18) of the VAT Act 89 of 1991; SARS (2013) *Draft Interpretation Note: Vouchers Supplied at a Discount* at 2-4 http://www.sars.gov.za/home.asp?pid=677 [accessed on 4 April 2013].
[409] Section 10(4)(*a*) and (*b*) of the VAT Act 89 of 1991.

market value be applied in the case of imported services where no consideration is paid and where the parties are not connected persons? For example, where digitised products are delivered to the recipient at no cost as reward for loyal and continued support, should the supply be taxed at the open market value? It should be noted that the provision in section 10(3) is essentially an anti-avoidance provision. It is aimed at combating transactions entered into at a cost lower than market value with the intention of avoiding VAT or donations tax. As a result, where the supplier delivers digital products to the recipient at no cost, and the parties are not connected persons, the transaction should be treated as a gift. This means that the value for VAT purposes should be nil.

In the case of file sharing or torrent downloads, the recipient receives digital files from a server at a nominal subscription fee, or at no charge at all. Generally, no payment is made for the actual digital product being downloaded. In most cases, the files shared are in breach of international copyright laws, and are commonly referred to as illegal downloads. While the VAT Act[410] does not specifically provide for the taxation of illegal supplies, no section prohibits the levying of VAT on illegal supplies.[411] In applying the principles of tax neutrality, no differentiation should be made between legal and illegal supplies.[412] Therefore, where the supply in the form of illegal downloads connotes "imported services" as defined, VAT should be levied in terms of section 7(1)(*c*). The problem, however, arises in determining the value. Should the value of the illegal download be used, or should the value of a legal equivalent of it be used? It could be argued that the open market value of illegal downloads is nil for two reasons. In the first instance, because the files are distributed free of charge, no value can be attached to them. Secondly, in an open market, where the files are available at no cost, no one would be willing to pay for them. It could, accordingly, be argued that the value of the legal equivalent should be applied. This should, however, be done with caution, so as not to tax the transaction

[410] Act 89 of 1991.
[411] Van Zyl SP (2011) "The Value Added Tax Implications of Illegal Transactions" *PELJ* vol 14 no 4 at 342-343 http://www.nwu.ac.za/webfm_send/4734 [accessed on 18 March 2013].
[412] Zyl SP (2011) "The Value Added Tax Implications of Illegal Transactions" *PELJ* vol 14 no 4 at 342-343 http://www.nwu.ac.za/webfm_send/4734 [accessed on 18 March 2013].

as a pure punitive measure to eliminate illegal downloads, especially as there is usually legislation prohibiting such actions.[413]

Occasionally, file sharing is done legally or is even encouraged. For example, where an artist who is trying to establish a market, allows his music to be shared freely on the Internet in order to promote himself. In cases where these files are stored on CD and distributed at no charge, the supply would not be subject to VAT based on the open market value, unless it can be proven that the supplier and recipient are connected persons.[414] Similarly, where the files are distributed or seeded[415] on the Internet and downloaded by a resident recipient, the value of the supply should be nil.

The VAT Act[416] provides no calculation method where payment is effected in foreign currency. Where a foreign supplier is required to register for VAT in South Africa, he would be required to levy VAT on the Rand value of the supply. This would be difficult, especially in cases where the supplier operates from a foreign location or in cloud. Differing transaction, commission, and conversion costs between financial institutions could result in different conversion rates at the same time on the same day.

Van der Merwe correctly points out that where an item can be supplied as a tangible thing (goods), or an intangible thing (services), it should, in principle, be taxed at the same rate.[417] It is clear from the discussion above that the VAT Act[418] differentiates between the taxation of digitised products that are imported in a tangible form (which are classified and taxed as imported goods), and the same digitised products that

[413] All Members of the World Trade Organisation are bound to implement the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS). In terms of article 9.1 of TRIPS, all members must give effect to Articles 1 to 21 of the Berne Convention for the Protection of Literary and Artistic Works. Article 9 of the Berne Convention, in turn, reserves for the author the exclusive right to reproduce a copyright work. As a download involves making a copy of the downloaded work, the legality of the download is determined by copyright law. See also the Agreed Statement concerning article 1(4) of the WIPO Copyright Treaty: it confirms that '[t]he reproduction right, as set out in Article 9 of the Berne Convention, and the exceptions permitted thereunder, fully apply in the digital environment, in particular to the use of works in digital form'.

[414] Section 10(4) of the VAT Act 89 of 1991.

[415] Seeding connotes the action of sharing downloaded files on the Internet by uploading file particles or torrents onto a server. The more seeds available, the faster downloaders (leechers) can download files.

[416] Act 89 of 1991.

[417] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 380-381.

[418] Act 89 of 1991.

are imported in an intangible form by electronic delivery (should they be classified and taxed as imported services). This differentiated treatment violates the principle of tax neutrality. In addition, it could lead to market distortions where the demand for cheaper digital supplies will replace and exceed the demand for physically stored digital products. In the USA the demand for digitally delivered music is increasing, and it is anticipated that the demand will, in the near future, exceed that for actual CDs.[419] This can be attributed to the reduced cost of digitally supplied music, and the non-taxation of cross-border digital supplies.[420] If this trend continues, music stores will be forced to scale down or even close in certain areas where CD sales have dropped below profitable levels. The fact that digital imports are, in principle, taxable in South Africa - unlike the case in the USA - does not immunise the South African music industry from similar market distortions or even possible collapse. The differentiated tax calculation method resulting in a lower product value being used for imported digital supplies as opposed to imported goods, can have the same distorting effect, however prolonged.

3.4.5 Was the supply made by a taxable entity?

In a VAT system based on consumption, the burden of VAT must be carried by the person or entity that ultimately uses or consumes the supply. To require consumers (non-vendors) to account for VAT on each and every purchase in terms of a reverse-charge mechanism is nonsensical from both an administrative and an economic point of view. VAT systems, therefore, provide for deemed taxable entities to collect VAT on behalf of revenue authorities. Unless otherwise indicated in the Act, the VAT Act[421] primarily provides for the following taxable entities:

[419] Koranteng J (2003) "Value Added Tax Poses Problems for EU Digital Sales" *Billboard* vol 115 issue 26 at 61.
[420] Koranteng J (2003) "Value Added Tax Poses Problems for EU Digital Sales" *Billboard* vol 115 issue 26 at 61.
[421] Act 89 of 1991.

a) In the case of the supply of goods and services by a registered VAT vendor, the VAT vendor making the supplies must collect VAT as the deemed taxable entity.[422]
b) In the case of imported goods, the person who imports such goods shall be the deemed the taxable entity charged with the burden of collecting tax.[423] In practice, VAT will be levied and collected by customs officials or agents appointed by customs. The person who imported the goods is only burdened with the payment of VAT to customs or to the appointed agent.
c) In the case of imported services, the recipient of the service must collect and pay VAT thereon in terms of section 14(1).[424]

Determining the taxable entity is fairly uncomplicated under the deeming provisions. However, in the case of imported services it is often difficult to establish whether the recipient of the goods or services must account for VAT in terms of the reverse-charge mechanism, or whether the foreign supplier is required to register as a VAT vendor in the Republic, and collect VAT on the supplies as if they constituted a domestic supply in terms of section 7(1)(*a*) read with section 7(2).[425]

3.4.5.1 Registration: Requirements

Every person who carries on an enterprise, and who makes taxable supplies that exceed or are likely to exceed R1 million in a twelve month period, is required to register as a VAT vendor.[426]

In terms of the definition of "enterprise", the following elements must be present before it can be concluded that a person is carrying on an enterprise:

i) a continuous or regular activity;
ii) carried on within the Republic;
iii) for the supply of goods and/or services;

[422] Section 7(2) of the VAT Act 89 of 1991.
[423] Section 7(2) of the VAT Act 89 of 1991.
[424] Section 7(2) of the VAT Act 89 of 1991.
[425] See further discussions below on the feasibility of registration at paras 3.4.8.1; 4.3.8.3.3; 5.3.8.1; and 7.8.2.
[426] Section 23(1)(*a*) of the VAT Act 89 of 1991.

iv) for consideration.

It is trite that a foreign supplier would supply either goods or services to a resident recipient against payment. For that reason, the elements of "supply" and "consideration" will not be discussed.

3.4.5.1.1 A continuous or regular activity

The concept "continuous or regular" is not defined and it has not been judicially considered in the context of VAT.[427] A continuous activity is an activity that is prolonged over a period of time without interruption.[428] SARS interprets a "continuous" activity as an ongoing activity (i.e. the duration of the activity has neither ceased in a permanent sense, nor has it been interrupted in a substantial way), or a progression of separate and continuous steps to bring an activity to conclusion.[429] A regular activity is an activity that is carried on at periodical or frequent intervals.[430] Once-off imports, or imports that take place infrequently, would thus not qualify as a continuous or regular activity for purposes of vendor registration. It is not clear how the word "regular" should be interpreted, or whether an activity that is performed three or four times annually would qualify as a regular activity.

De Koker and Kruger state that where a person comes to South Africa regularly to procure wool, despite that person not being resident in the Republic, he partially carries on an enterprise as defined.[431] SARS interprets "regular" as an activity that takes place repeatedly at reasonably fixed intervals.[432] The term "regular", therefore, excludes a transaction or transactions that happen by chance, and should be

[427] Botes M (2011) "South African VAT and non-Resident Business" *International VAT Monitor* vol 22 no 6 at 397.
[428] *Collins English Dictionary* (2004) 6th edition; Soanes C and Stevenson A (eds) (2008) *Concise Oxford English Dictionary.*
[429] SARS (2011) *Guide for Fixed Property and Construction* (VAT409) at 9; Stiglingh M (ed), Koekemoer AD, Van Schalkwyk L, Wilcocks JS, De Swardt RD (2013) *Silke: South African Income Tax* at 1019.
[430] *Collins English Dictionary* (2004) 6th edition; Soanes C and Stevenson A (eds) (2008) *Concise Oxford English Dictionary.*
[431] De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 12.2.
[432] SARS (2011) *Guide for Fixed Property and Construction* (VAT409) at 9; Stiglingh M (ed), Koekemoer AD, Van Schalkwyk L, Wilcocks JS, De Swardt RD (2013) *Silke: South African Income Tax* at 1019.

construed to mean something that happens more than once and is likely to happen again.

3.4.5.1.2 Carried on within the Republic

The South African VAT system is not restricted to supply of goods and services rendered in South Africa.[433] Exported goods and services are zero-rated.[434] Although zero-rated supplies are often confused with non-taxable supplies, attention should be drawn to the fact that zero-rated supplies are, in principle, taxable supplies.[435] This means that a supply that is made from South Africa to any place in the world, is, in principle, subject to VAT.[436] It is often unclear to what extent a foreigner's business activities in South Africa constitute conducting an enterprise wholly or partly in South Africa.[437] Silver and Beneke suggest that the mere export of goods and services to South African customers from any foreign country by a foreign supplier, does not constitute an enterprise carried on wholly or partially in the Republic.[438] Wagley J, however, is of the opinion that where such services are regularly supplied to South Africans, the foreign supplier could be deemed to be carrying on an enterprise in South Africa, and should register here as a VAT vendor.[439]

As there are no definitive place-of-supply rules in the Act, this issue cannot be finally resolved.[440] Furthermore, the position adopted by SARS as to what does and does not constitute an "enterprise", often changes, or is not implemented consistently.[441]

[433] Silver M and Beneke C (2009) *VAT Handbook* 7th edition at 25; De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 12.2.
[434] Section 11(1)(*a*) of the VAT Act 89 of 1991.
[435] A vendor is entitled to claim input VAT on the goods and services acquired in its enterprise in so far as the goods and services are acquired to make taxable supplies. Where the vendor makes exempt supplies only, it will not be entitled to claim input VAT credits. It can therefore be deduced that zero-rated supplies are taxable supplies. The supplies are taxed at zero percent.
[436] Silver M and Beneke C (2009) *VAT Handbook* 7th edition at 25; De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 12.2.
[437] Silver M and Beneke C (2009) *VAT Handbook* 7th edition at 25.
[438] Silver M and Beneke C (2009) *VAT Handbook* 7th edition at 25.
[439] *ITC* 1812 SATC 207 at para 14; Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 34.
[440] Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 244; Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 110; De Swardt RD and Oberholzer R (2006) "Digitised Products: How Compliant is South African Value Added Tax?" *Meditari Accountancy Research* vol 14 no 1 at 20.
[441] Silver M and Beneke C (2009) *VAT Handbook* 7th edition at 26.

In recent years, according to the commentators Silver and Beneke, SARS has indicated that a foreigner would be deemed to be carrying on an enterprise in the Republic if:

- the foreigner leases goods to a resident and receives regular rental income in exchange;[442]
- the foreigner grants the use or licence to a resident in respect of any patent, trademark, copyright, know-how, trade secret, or similar intellectual property right and as a result receives royalties from a person in South Africa;[443]
- The foreigner supplies telecommunication services to be used by a South African resident and as a result receives consideration.[444]

This confusion is exacerbated by the fact that SARS has not yet implemented section 23(1)(*e*) of the Taxation Laws Amendment Act[445] requiring foreign suppliers of telecommunication services to register as vendors in the Republic. In addition, SARS has withdrawn its position on foreign suppliers of intellectual property issued in 1999. SARS has recently announced its intention to review its initial position and re-implement it.[446] A survey by De Swardt and Oberholzer, reveals that this hedged approach by SARS has caused confusion among tax practitioners.[447] Half of the respondents believed that a foreign supplier of digital goods is conducting an enterprise in the Republic, while the other half believed the opposite.[448] Furthermore, should these amendments be promulgated, additional multi-lateral treaties would

[442] Silver M and Beneke C (2009) *VAT Handbook* 7th edition at 25.
[443] *VAT News 13-December 1999* http://www.sars.gov.za/tools/Printbody.asp?pid=47320 [accessed on 18 March 2013]; also see De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 8.10; Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 112.
[444] Section 23(1)(*e*) of the Taxation Laws Amendment Act 27 of 1997.
[445] Act 27 of 1997.
[446] *VAT News 37-February 2011* http://www.sars.gov.za/home.asp?pid=4&cx=009878640050894574201%3Aku-btv50zym&cof=FORID%3A10%3BNB%3A1&ie=UTF-8&q=VAT+royalties&sa=%3CIMG+alt%3D%22Click+here+to+begin+your+search%22+src%3D%22images%2FsearchButtonBackground.gif%22%3E&siteurl=http%3A%2F%2Fwww.sars.gov.za%2F [accessed on 18 March 2013].
[447] De Swardt RD and Oberholzer R (2006) "Digitised Products: How Compliant is South African Value Added Tax?" *Meditari Accountancy Research* vol 14 no 1 at 20.
[448] De Swardt RD and Oberholzer R (2006) "Digitised Products: How Compliant is South African Value Added Tax?" *Meditari Accountancy Research* vol 14 no 1 at 20.

have to be negotiated to afford SARS extra-territorial powers to enforce these provisions. This could prove impossible.

In the 2013 Budget Speech, Finance Minister Gordhan proposed that foreign suppliers of e-books, music, and other digital products, must be required to register for VAT.[449] How and when the proposal will be implemented is not certain.

3.4.5.2 Duty to register?

Every person who conducts an enterprise becomes liable to register as a VAT vendor:

> *(a)* At the end of any month where the total value of taxable supplies made by that person in the period of 12 months ending at the end of that month in the course of carrying on all enterprises has exceeded R1 million;
> *(b)* At the commencement of any month where there are reasonable grounds for believing that the total value of the taxable supplies to be made by that person in the period of 12 months reckoned from the commencement of the said month will exceed the abovementioned amount.[450]

Where a person becomes liable to register as a vendor in terms of section 23(1), he must apply for registration no later than 21 days after having become liable to register.[451]

The words "every person" in section 23(1), and "persons" in the heading of section 23, clearly indicate that residency is not a requirement to register as a VAT vendor, provided that supplies were made in the course and furtherance of an enterprise. This said, section 23(2) requires a non-resident to furnish the Commissioner with the particulars of a representative vendor in South Africa. In addition, particulars of the non-resident person's bank account at a bank registered as such in terms of the

[449] Gordhan P (2013) *2013 Budget Speech* at 21 http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf [accessed on 27 February 2013].
[450] Section 23(1) of the VAT Act 89 of 1991.
[451] Section 23(2) of the VAT Act 89 of 1991.

Banks Act,[452] must also be submitted.[453] In other words, the non-resident person must have a South African bank account. Failure to submit the required particulars or documentation could see the Commissioner deeming that the person as not having applied for registration.[454] Although the requirements in section 23(2)(ii) do not demand that the non-resident applicant have a fixed abode or establishment in South Africa, the only inference that can be drawn is that he should have some sort of physical presence in the Republic.[455] This physical presence can either be through a representing vendor, or by an establishment of some sort. Botes opines that the fact that a non-resident business does not have a fixed establishment in South Africa for income tax purposes, does not necessarily mean that it does not carry on an enterprise in South Africa for VAT purposes.[456]

It is not clear whether a person must have a physical presence before he is required to register, or, because the person is required to register, he is required to have a physical presence. This confusion stems from the inconsistent position taken by SARS with regard to the meaning of a "regular and continuous activity carried on within the Republic" as set out above. I am of the view that once it has been established that the non-resident person is carrying on a regular activity in the Republic and is then required to register as a vendor, he should have a physical presence in the Republic as a result of this registration requirement. Bagraim notes that there is no requirement that a vendor must have a fixed or permanent establishment to conclude that it is conducting an enterprise.[457] This view is supported by Van der Merwe.[458]

It is clear that the physical presence requirement serves as no more than an administrative aid to the Commissioner. The lack of a physical presence does not mean that the non-resident person has not carried on regular activity in the Republic. Steyn states that the mere fact that a non-resident supplier does not have a fixed

[452] Act 94 of 1990.
[453] Section 23(2)(ii)(*bb*) of the VAT Act 89 of 1991.
[454] Section 23(2)(ii) of the VAT Act 89 of 1991.
[455] Naicker K (2010) "The VAT Implications of E-commerce" *Taxtalk* January/February 2010 at 9.
[456] Botes M (2011) "South African VAT and non-Resident Business" *International VAT Monitor* vol 22 no 6 at 397.
[457] Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 110.
[458] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 385.

place of business in the Republic, does not mean that he is relieved of the obligation to register as a South African VAT vendor.[459]

Section 23(3)(*d*) provides for voluntary vendor registration where:

> that person is continuously and regularly carrying on an activity which, in consequence of the nature of that activity, can reasonably be expected to result in taxable supplies being made for a consideration only after a period of time and where the total value of taxable supplies to be made can reasonably be expected to exceed R50 000 in a period of 12 months.

The Commissioner may refuse or cancel the applicant's registration where the applicant:

(i) does not have a fixed place of business or abode;[460]
(ii) does not keep proper accounting records relating to the enterprise;[461]
(iii) has not opened a bank account for purposes of the enterprise;[462]
(iv) has previously registered as a VAT vendor in terms of the VAT Act 89 of 1991, or as enterprise under the General Sales Tax Act 103 of 1978, and has failed to perform his duties in terms of either of the Acts.[463]

In the case of voluntary vendor registration, the vendor is required to have a fixed place of business or abode in the Republic. A mere physical presence of some sort, as is required by compulsory registration, is not sufficient. Still, if one considers the other requirements in section 23(7), the impression is created that the requirements were introduced as an administrative tool to assist the Commissioner in combating VAT fraud. This position is further emphasised by the practice as regards registration applied by SARS officials since 2009. In terms of this procedure, interviews are held with applicant vendors (voluntary and compulsory registrations) or representative vendors.[464] The procedure was implemented to guarantee that applicant registrants

[459] Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 244.
[460] Section 23(7)(*a*) of the VAT Act 89 of 1991.
[461] Section 23(7)(*b*) of the VAT Act 89 of 1991.
[462] Section 23(7)(*c*) of the VAT Act 89 of 1991.
[463] Section 23(7)(*d*) of the VAT Act 89 of 1991.
[464] Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 245; Anon (2008) "SARS Act to Protect Taxpayers from VAT Abuse" *The Professional Accountant* at 31.

have a genuine place of business from which an enterprise is conducted.[465] The self-assessment and reverse-charge mechanisms open the South African VAT system to to VAT fraud. It is common practice to register a fictitious enterprise as a VAT vendor and then claim input VAT based on false and irregular tax invoices. To further eliminate fraud, SARS officials are also entitled to inspect the business premises or establishment to confirm that an actual enterprise is being conducted, or to require vendors to undergo biometric tests, such as fingerprint verification.[466] This is in line with international best practice to eliminate VAT fraud.[467] As a result of the VAT registration clean-up process, VAT vendor registration has declined by 0,89% since 2009.[468] In addition to the registration requirements provided for in the VAT Act,[469] section 22(3) of the Tax Administration Act[470] provides that SARS may require the applicant registrant to produce biometric evidence if it is required to identify him or to combat fraud. Where the taxpayer is obliged to register as a VAT vendor under the VAT Act[471] but has failed to do so, SARS may register the taxpayer as such unilaterally where it is found to be appropriate.[472]

E-commerce is characterised by anonymity and the convenience that a fixed place of business or physical establishment provides is not required. In the case of electronically ordered and physically delivered goods, the supplier can operate its enterprise from a server located anywhere in the world. Essentially, no physical presence - in the form of a shop, warehouse, or office - is required. Orders can be executed by instructing a third party to collect the items ordered from its warehouse and dispatch them to the recipient. The third party then acts as dispatch agent on behalf of the supplier.

This virtual or non-physical existence is even more prevalent in the case of electronically ordered and delivered goods. Digitised products can be stored on

[465] Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 245; Anon (2008) "SARS Act to Protect Taxpayers from VAT Abuse" *The Professional Accountant* at 31.
[466] Anon (2008) "SARS Act to Protect Taxpayers from VAT Abuse" *The Professional Accountant* at 31.
[467] Anon (2008) "SARS Act to Protect Taxpayers from VAT Abuse" *The Professional Accountant* at 31.
[468] National Treasury and SARS (2012) *2011 Tax Statistics* http://www.treasury.gov.za/publications/tax%20statistics/2011/2011%20Tax%20Statistics.pdf [accessed on 18 March 2013].
[469] Act 89 of 1991.
[470] Tax Administration Act 28 of 2011. This Act came into force on 1 October 2012.
[471] Act 89 of 1991.
[472] Section 22(5) of the Tax Administration Act 28 of 2011.

multiple servers open to remote access. Orders are executed by connecting the recipient's device to the nearest server and starting to download. The enterprise can be operated from these multiple servers or from a portable device. Save for the initial setup of servers, and the occasional upload of merchandise on the server, no human intervention is required in conducting the actual transactions.

Where it has been established that the e-commerce supplier "regularly and continuously" makes taxable supplies to recipients in the Republic in excess of R1 million, the supplier is required to register as a VAT vendor in terms of section 23(1). The supplier should, consequently, in compliance with the requirement to register as a VAT vendor, open a South African bank account, appoint a representative vendor, or establish some sort of physical presence in South Africa. These requirements will frustrate e-commerce suppliers and eliminate the convenience of virtual trade. Foreign suppliers could terminate trade with South African residents which could result in market distortions. Silver and Beneke's opinion that the mere export of goods and services to South Africa does not amount to the carrying on of an enterprise, should be more closely considered.[473] Where the foreign supplier *exports*[474] goods and services to South Africa, he acts as mere dispatcher of the goods, and does not actively take part in any business-like activities in the Republic. This should be contrasted with a person who imports goods and services to be distributed for home consumption. The importer actively engages in activities in the Republic that resemble the conducting of trade. According to Bargraim, where the supplier's server, or one of its servers, is located in South Africa, or where the supplier has a warehouse in South Africa from which supplies are dispatched, the supplier is conducting an enterprise in South Africa and should register as a vendor.[475] She further holds the position that some form of physical presence is required before it can be said that the supplier is carrying on an enterprise in the Republic.[476] It could, therefore, be argued that where digitised products are ordered by South African residents from a foreign supplier, the delivery (by export to South Africa) of the products does not amount to the making of a supply in the hands of the

[473] Silver M and Beneke C (2009) *VAT Handbook* 7th edition at 25.
[474] My emphasis.
[475] Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 110.
[476] Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 110.

foreign supplier. The supplier would not be carrying on an enterprise in the Republic. The recipient importer, so it could be argued, carries the burden of collecting VAT. Due to a lack of clear rules or policy statements from SARS, the supplier is likely to make an incorrect tax decision.[477]

3.4.5.3 The non-resident non-vendor importer as taxable entity

De Swardt and Oberholzer pose the question whether a foreign supplier of digitised products should levy South African VAT on the supplies, irrespective of whether the supplier is registered or ought to be registered as a VAT vendor.[478] This would be the case where it is found that the supplier is carrying on an enterprise within the Republic.[479] In such an eventuality, the supplier would have to verify the residency status of the recipient before it could levy South African VAT on the transaction.[480] De Swardt and Oberholzer opine that the complex residency rules applied in South Africa place an enormous compliance burden on such vendors.[481] This would, however, be no different for resident suppliers who are registered as VAT vendors and who supply digital products. They, too, must determine the residency status (or at least the location where the recipient finds himself at the time of supply) of the recipient to determine if VAT should be levied at the standard rate (in the case of domestic supplies), or at the zero rate (in the case of exported supplies). Furthermore, there is no indication in the VAT Act[482] that a foreign vendor whose taxable supplies do not reach the R1 million threshold, is obliged to register as a VAT vendor in South Africa. Since non-vendors do not levy VAT on supplies, the non-vendor supplier is deemed to be the final consumer of the goods supplied. In

[477] De Swardt RD and Oberholzer R (2006) "Digitised Products: How Compliant is South African Value Added Tax?" *Meditari Accountancy Research* vol 14 no 1 at 21; Botes M (2011) "South African VAT and non-Resident Business" *International VAT Monitor* vol 22 no 6 at 399.
[478] De Swardt RD and Oberholzer R (2006) "Digitised Products: How Compliant is South African Value Added Tax?" *Meditari Accountancy Research* vol 14 no 1 at 20.
[479] De Swardt RD and Oberholzer R (2006) "Digitised Products: How Compliant is South African Value Added Tax?" *Meditari Accountancy Research* vol 14 no 1 at 21.
[480] De Swardt RD and Oberholzer R (2006) "Digitised Products: How Compliant is South African Value Added Tax?" *Meditari Accountancy Research* vol 14 no 1 at 21.
[481] De Swardt RD and Oberholzer R (2006) "Digitised Products: How Compliant is South African Value Added Tax?" *Meditari Accountancy Research* vol 14 no 1 at 21.
[482] Act 89 of 1991.

other words, the VAT paid by the non-vendor supplier cannot be recovered from its customers. Similarly, where a foreign supplier is not registered as a VAT vendor in South Africa, it cannot collect (nor is it required to collect) VAT from its customers. In this case, however, the foreign supplier cannot be deemed to be the final consumer as it never paid VAT. In this case, the burden to account for VAT shifts to the person who imported the digitised products (services).[483] The importer recipient is, accordingly, construed to be the taxable entity in terms of the reverse-charge mechanism.

This poses the question of whether a non-resident person who imports digitised products to South Africa while he is physically present in the Republic, should account for VAT on the importation thereof? In terms of the definition of "imported services", imports by non-residents for their own consumption while physically present in the Republic, do not amount to imported services. The non-resident importer will, therefore, not be a taxable entity in so far as the digitised products so imported are not utilised and consumed by a resident.

3.4.6 In the course or furtherance of an enterprise

Where goods and services are imported in the course and furtherance of an enterprise, the VAT Act[484] differentiates between the import of goods and of services. In the case of imported goods, the importer must account for output VAT on the value of the imported goods, irrespective of whether or not the goods are to be applied in the course and furtherance of its enterprise.[485] The output VAT accounted for by the importer may be claimed as input VAT in so far as the goods will be applied in the making of taxable supplies. In practice, this amounts to a mere accounting exercise.

[483] Section 7(1)(*c*) of the VAT Act 89 of 1991.
[484] Act 89 of 1991.
[485] Section 7(1)(*b*) read with section 7(2) of the VAT Act 89 of 1991. Also see Silver M and Beneke C (2012) *VAT Handbook* 8th edition at 67; De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 8.1.

The definition of imported services provides that the import of services will not attract VAT in so far as they will be utilised and consumed in the course and furtherance of an enterprise. In other words, VAT is deferred to the actual taxable supplies made by the importer vendor. Many authors and tax practitioners are of the view that the supply of digitised products between businesses (B2B transactions) will not attract VAT.[486] This view is, strictly speaking, incorrect. The mere fact that digitised products are imported by a registered VAT vendor, does not justify the conclusion that the transaction will not attract VAT. It is required that the vendor must apply the imported services (digitised products) in the making of taxable supplies if the transaction is not to attract VAT.[487]

In *CSARS v De Beers Consolidated Mines Ltd,*[488] De Beers obtained financial advice from NM Rothschild and Sons, a company based in London. The advice was obtained to assist its board of directors in making critical decisions on a transaction proposed to De Beers by a consortium that would eventually change the company from a public to a private entity. De Beers contended that the services obtained from NM Rothschild were necessarily linked and concomitant to its mining business.[489] As De Beers elected to trade as a public company, it was required by the Securities Regulation Code imposed by section 440C of the Companies Act,[490] and the listing requirements of the Johannesburg Stock Exchange, to obtain the advice in question to protect its shareholders.[491]

The Commissioner contended that NM Rothschild's services did not relate to the core business of De Beers, namely, mining and selling diamonds.[492] Instead, the services sought were in the interest of the departing shareholders.[493] The court ruled that a clear distinction exists between the execution of the enterprise's business, and

[486] De Swardt RD and Oberholzer R (2006) "Digitised Products: How Compliant is South African Value Added Tax?" *Meditari Accountancy Research* vol 14 no 1 at 22.
[487] Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 243; Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 111; De Wet C and du Plessis R (2004) "Taxation (VAT)" in Buys R (ed) (2004) *CyberLaw@SAII* at 281.
[488] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012).
[489] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [23].
[490] Act 61 of 1973 (repealed).
[491] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at paras [23-25].
[492] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [26].
[493] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [26].

the special duties imposed on a company in the interests of its shareholders.[494] *In casu,* the duty imposed on De Beers was found to be too far removed from the advancement of the enterprise to justify that the services were acquired for the purposes of making taxable supplies.[495] Southwood AJA (Leach JA and McLaren AJA concurring) ruled that not all services acquired by an enterprise are necessarily applied in the making of taxable supplies.[496] The nature of the taxpayer's enterprise must be examined to determine whether the services acquired were used in the making of taxable supplies.[497] *In casu,* the taxpayer's enterprise did not involve the trading of shares or the holding of shares and the receipt of dividends - it involved diamond mining and trading.[498] It can, therefore, not be said that the services acquired from NM Rothschild were utilised in the furtherance of its enterprise and in the making of taxable supplies. As the services were applied for purposes other than the making of taxable supplies, they should be treated in the same way as B2C transactions. Consequently, the importer is required to pay VAT on the imported services in terms of the reverse-charge mechanism.

This finding is based on a very restrictive understanding of what "the making of taxable supplies" in pursuit of the taxpayer's enterprise as a public listed company involves.[499] There are numerous costs that a publicly listed company is bound to incur in fulfilment of its duties towards shareholders, which arise purely from the fact that the business is operated as a certain entity, and which do not directly relate to the operational requirements of the business.[500] The SCA's judgment threatens the deduction of all of these expenses.[501]

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[494] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [27].
[495] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [27].
[496] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [50].
[497] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [51].
[498] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012) at para [52].
[499] Editorial Note (2012) "Case Law: *CSARS v De Beers Consolidated Mines Ltd* Supreme Court of Appeal, 1 June 2012, Case no 503/11"*The Taxpayer* vol 61 no 6 at 107; Moss-Holdstock C (2012) "There be Dragons: The VAT Implications arising from De Beers SCA judgment" *World Journal of VAT/GST Law*l vol 1 issue 2 at 211-216.
[500] Editorial Note (2012) "Case Law: *CSARS v De Beers Consolidated Mines Ltd* Supreme Court of Appeal, 1 June 2012, Case no 503/11" *The Taxpayer* vol 61 no 6 at 107; Moss-Holdstock C (2012) "There be Dragons: The VAT Implications arising from De Beers SCA judgment" *World Journal of VAT/GST Law*l vol 1 issue 2 at 211-216.
[501] Editorial Note (2012) "Case Law: *CSARS v De Beers Consolidated Mines Ltd* Supreme Court of Appeal, 1 June 2012, Case no 503/11" *The Taxpayer* vol 61 no 6 at 107; Moss-Holdstock C (2012) "There be Dragons: The VAT Implications arising from De Beers SCA judgment" *World Journal of VAT/GST Law*l vol 1 issue 2 at 211-216.

A blanket conclusion that imported services by VAT vendors (B2B transactions) are applied to make taxable supplies by virtue of the vendor's registration status, cannot be supported. Each case should be examined on its merits. In a self-assessment regime, the interpretation of what constitutes "in the making of taxable supplies" lies with the taxpayer. As can be seen from *CSARS v De Beers*, the taxpayer's interpretation can often be incorrect despite the existence of clear factual indications that invalidate the taxpayer's views. These transactions could therefore go undetected and untaxed unless a VAT audit is done on the taxpayer. But does SARS have the manpower and will to conduct regular VAT audits? And how many VAT vendors should be audited and how often? Will the VAT, interest, and penalties so levied justify the cost and effort involved in a VAT audit or subsequent litigation?

3.4.7 Is the transaction taxable?

Goods that are listed in Schedule 1 to the VAT Act,[502] and which are imported in terms of section 7(1)(*b*), are exempt from VAT.[503]

In the case of imported services where the services are taxed in terms of section 7(1)(*a*), these will not also be subject to VAT in terms of section 7(1)(*c*).[504] This provision prevents the double taxation of imported services.

Where the supply of imported services would, if they were supplied in the Republic, be subject to VAT at a zero rate in terms of section 11, or exempted from VAT in terms of section 12, the imported supply would equally be subject to VAT at zero percent or be exempt from VAT.[505] This provision underpins the principle of tax neutrality so as not to differentiate between services rendered in the Republic, and services imported into the Republic. Dendy is of the opinion that the court's[506] application of section 14(5)(*b*) – in so far as it applies to foreign supplied services

[502] Act 89 of 1991.
[503] Section 13(3) of the VAT Act 89 of 1991.
[504] Section 14(5)(*a*) of the VAT Act 89 of 1991.
[505] Section 14(5)(*b*) of the VAT Act 89 of 1991.
[506] As well as the interpretations by Emslie in *The Taxpayer* vol 59 issue 1 at 2, and De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 8.1

that would have been zero-rated or exempt had they been rendered in South Africa - is incorrect.[507] He interprets section 14(5)(*b*) to mean that where a foreign supplier of services supplies services in South Africa while he is physically present in South Africa, such services will either be zero-rated or be exempt if the services would have been zero-rated or exempt had they been rendered by a South African VAT vendor.[508]

Where a foreign supplier is required to register as a VAT vendor in South Africa, it will have to avail itself of Schedule 1 and the provisions of sections 11 and 12 to avoid the incorrect taxation of supplies. While the same burden applies to resident vendors, it should be noted that foreign vendors do not necessarily supply goods and services to South African residents exclusively. In the case of e-commerce, suppliers ship their goods or deliver their supplies worldwide. Determining the VAT status and rate of the supply would place an additional compliance burden on the supplier. The South African VAT rate system is fairly uncomplicated as it provides only for standard rated, zero-rated, and exempt supplies. It does not provide for multiple rates. This does not, however, prohibit the legislator from introducing multiple rates at some future date. This would place an even greater compliance burden on foreign suppliers. While software applications can easily be applied to determine the country and product-specific VAT rates, the development and implementation cost of software could negatively impact on the viability of trade with South Africa. The unreliability of software could further lead to an incorrect tax application, which could then further result in bad customer relations, or even tax penalties and interest. These factors could deter foreign suppliers from trading with South African residents and lead to market distortions.

3.4.8 Collection mechanisms

The anonymity of e-commerce transactions often creates a situation where the recipient of the goods or services is an unidentifiable private consumer or

[507] Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 61-63.
[508] Dendy M (2012) *The VAT Treatment of 'Imported Services'* at 61-63.

unregistered business. It is therefore virtually impossible to enforce VAT payments on these transactions, even if they are found to be taxable.[509] Where it is assumed that the supplier bears the burden of collecting and accounting for VAT, the enforcement becomes difficult if the supplier is situated beyond the fiscal jurisdiction of SARS.[510]

In the case of physically imported goods, tax collection can be administered at border posts. VAT collection at border posts is dependent on adequately trained custom officials. Unskilled, undedicated, and careless custom officials could lead to inconsistent VAT collection or, in some cases, the failure to tax parcels. As e-commerce becomes more popular among South African residents, an increase in parcels could lead to a bottleneck at border posts.[511] This bottleneck may be exacerbated by a shortage of staff or a slow valuation, taxing, and clearing process. This could, in turn, frustrate consumers and suppliers which could result in a loss in confidence in e-commerce. In addition, the transaction charge currently levied by SARS on the valuation of the supply, often exceeds the VAT payable. This could lead to market distortions.

The VAT Act[512] currently provides a VAT exemption for small parcels containing books, newspapers, journals, or other printed material with a value of less than R100 that are imported into South Africa.[513] It is not certain whether this provision was introduced to avoid a potential bottleneck resulting from an increase in imports as a result of an increased popularity in e-commerce. Van der Merwe states that the small parcel exemption could be applied to prevent such bottlenecks.[514] She warns, however, that in the light of the relatively weak currency, inflation, and other rising costs, consideration should be given to increasing the amount allowed under the small parcel exemption to prevent future bottlenecks.[515] In the Draft Taxation Laws Amendment Bill of 2011, an increase in the small parcel exemption to R500 was

[509] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 381.
[510] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 381.
[511] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 382.
[512] Act 89 of 1991.
[513] Section 13(3) read with para 2 of Schedule 1 of the VAT Act 89 of 1991.
[514] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 382.
[515] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 382.

proposed.[516] The proposal has, however, not been included in subsequent amending legislation. Goods with a customs value of under R500, and which are exempt from duties under Schedule 1 of the Customs and Excise Act,[517] are exempted from VAT.[518]

In the case of digital imports, no physical parcels can be examined, valued and taxed by customs officials. Based on the discussion of the different taxable entities in paragraph 3.4.5, different scenarios can be identified.

3.4.8.1 B2C transactions: Supplies by foreign registered VAT vendors

SARS has in the past, in cases where compliance levels were low, attempted to make vendor registration compulsory through the implementation of deeming provisions. For example, SARS has indicated that a foreigner would be deemed to be carrying on an enterprise in the Republic if:

- the foreigner grants the use or licence to a resident in respect of any patent, trademark, copyright, know-how, trade secret or similar intellectual property and as a result receives royalties from a person in South Africa;[519]
- the foreigner supplies telecommunication services to be utilised by a South African resident and as a result receives consideration.[520]

These deeming provisions are yet to be implemented. I am unaware of the reason for the delay. It is also yet to be seen whether the proposal that foreign suppliers of e-books, music, and other digital products will be required to register, will be implemented.

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[516] Section 144(1) of the Draft Taxation Laws Amendment Bill of 2011.
[517] Customs and Excise Act 91 of 1964.
[518] Paragraph 1(v) of Schedule 1 of the VAT Act 89 of 1991.
[519] *VAT News 13-December 1999* http://www.sars.gov.za/tools/Printbody.asp?pid=47320 [accessed on 18 March 2013]; De Koker A and Kruger D (2008) *Value Added Tax in South Africa: Commentary* at para 8.10; Bagraim P (2003) "Another Taxing Task" *Juta's Business Law* vol 9 part 3 at 112.
[520] Section 23(1)(*e*) of the Taxation Laws Amendment Act 27 of 1997.

Should a foreign supplier be required to register in terms of existing registration requirements discussed above,[521] VAT must be levied on supplies made by it in terms of section 7(1)(*a*). In other words, the supply will be treated as a domestic supply. The recipient of the imported services would, therefore, not be required to account for VAT.

The current VAT registration process applied by SARS in conjunction with the physical presence requirement, or through the appointment of a representative vendor, places an unacceptable compliance burden on foreign suppliers. Even if the foreign supplier is willing and able to overcome the VAT vendor registration hurdle, the duties associated with vendor status could further hamper the supplier's business efficacy. This is especially evident in cases where the foreign supplier makes supplies in multiple jurisdictions.

The duties that would be imposed on a foreign supplier, generally, include:

- to provide SARS with correct and accurate information;[522]
- to submit VAT returns on time and make VAT payments in a timely fashion;[523]
- to include VAT on all prices and advertisements;[524]
- to keep accurate accounting records for five years.[525]

Each of these duties will now be discussed.

[521] See paragraphs 3.4.5.1-3.4.5.2 above.
[522] *VAT 404: Value Added Tax for Vendors* (2011) at 93 http://www.sars.gov.za/home.asp?pid=4&cx=009878640050894574201%3Aku-btv50zym&cof=FORID%3A10%3BNB%3A1&ie=UTF-8&q=vat+decision+416 [accessed 18 March 2013].
[523] *VAT 404: Value Added Tax for Vendors* (2011) at 93 http://www.sars.gov.za/home.asp?pid=4&cx=009878640050894574201%3Aku-btv50zym&cof=FORID%3A10%3BNB%3A1&ie=UTF-8&q=vat+decision+416 [accessed 18 March 2013].
[524] *VAT 404: Value Added Tax for Vendors* (2011) at 93 http://www.sars.gov.za/home.asp?pid=4&cx=009878640050894574201%3Aku-btv50zym&cof=FORID%3A10%3BNB%3A1&ie=UTF-8&q=vat+decision+416 [accessed 18 March 2013].
[525] *VAT 404: Value Added Tax for Vendors* (2011) at 93 http://www.sars.gov.za/home.asp?pid=4&cx=009878640050894574201%3Aku-btv50zym&cof=FORID%3A10%3BNB%3A1&ie=UTF-8&q=vat+decision+416 [accessed 18 March 2013].

3.4.8.1.1 Provide SARS with correct and accurate information

The cost and effort of compliance could deter foreign suppliers from trading with South African residents. Submitting accurate tax returns would require a foreign vendor to invest in complex computer software that would rely on external factors and information. These systems cannot operate accurately. For example, the foreign supplier would rely on the IP address of the prospective customers to locate the jurisdiction of supply so as to be able to tax the supply at the correct South African VAT rate. What if the recipient is a foreign resident who happens to find himself in South Africa at the time of the transaction when he is purchasing software for a mobile device using a South African sim card to avoid roaming costs? Since the software will be utilised and consumed by a non-resident, the supply should, strictly speaking, not be subject to South African VAT. The supplier's software will be unable to detect this. It could be argued that the wrongful taxation (over taxation) of these types of transaction would be minimal and could be overlooked. That said, the supplier could be subject to penalties and interest charges if it is found that it did not accurately and correctly levy VAT on its supplies.

3.4.8.1.2 Submit VAT returns on time and make VAT payments on time

If one considers that the foreign VAT vendor possibly makes taxable supplies to customers all over the world, and must submit tax returns in each of the countries where the customers reside, a complicated paper-based submission service can overburden the supplier. Depending on the supplier's customer base and their location, the supplier could spend more time and money in completing and filing tax returns, than selling and distributing its products. While in South Africa it is possible to submit VAT returns electronically on the e-filing system, the same cannot be said of all tax jurisdictions.

Since 28 June 2010, the VAT 201 form requires a separate declaration in respect of the import and export of goods into and from South Africa.[526] As a result, vendors' accounting systems required reconfiguration to reflect the value of imports and exports.[527] The purpose of the change is to ensure more accurate compliance, and to enable SARS to identify possible import and export fraud cases that should be investigated. No separate declaration is required for imported services. This could, however, obstruct the ability of SARS to track and trace transactions and tax undeclared and untaxed imports.

3.4.8.1.3 Include VAT in all prices and advertisements[528]

This duty presupposes that the supplier can identify the customer's location, or at least make provision for South African customers. In addition to this duty imposed by the VAT Act, section 43(1)(*i*) of the Electronic Communications and Transactions Act[529] provides that the supplier must display, on its website, the full price of the goods and services, including a breakdown of what proportion of the price constitutes taxes, transport, packaging and insurance. This provision has extra-territorial application despite any foreign law that might apply to the transaction.[530] It is not certain whether the scope of the provision applies to potential transactions between South African residents and foreign suppliers, or, only to suppliers that have an established South African customer base. Either way, the supplier must reflect its prices in South African Rand and also indicate how much of that amount constitutes South African VAT.

The supplier can identify the customer's location in two ways: The customer can choose his location from a drop down list (or other method) after which the version of the website applicable to that country will be displayed; or the supplier can apply

[526] Delport K (2010) *The New VAT Return Form has Arrived* http://www.ens.co.za/News/news_article.aspx?iID=373&iType=4 [accessed on 18 March 2013].
[527] Delport K (2010) *The New VAT Return Form has Arrived* http://www.ens.co.za/News/news_article.aspx?iID=373&iType=4 [accessed on 18 March 2013].
[528] Section 65 of the VAT Act 89 of 1991.
[529] Act 25 of 2002.
[530] Section 47(1) of the Electronic Communications and Transactions Act 25 of 2002.

complex software that can identify the customer's location through locating the IP address or GEO location. Both methods require costly software that can take a long time to develop. This could deter foreign suppliers from trading in South Africa.

3.4.8.1.4 Keep accurate accounting records for five years

Section 29 of the Tax Administration Act[531] provides that any person who has submitted, or should have submitted, a tax return, or would have submitted a tax return but as a result of a threshold did not do so, must keep records for a period of five years. Where records are kept in an electronic form they must be stored at a location physically in South Africa,[532] in a form that will not distort the integrity of the documents,[533] and which can be easily accessed by SARS.[534] A senior SARS official may grant permission for the records to be kept at a location outside of South Africa if the official is satisfied that:

(a) the electronic system used by the person will be accessible from the person's physical address in South Africa for the duration of the period that the person is obliged to retain 'records';
(b) the locality where the 'records' are proposed to be kept will affect access to the electronic records;
(c) there is an international agreement for reciprocal assistance in the administration of taxes in place between South Africa and the country in which the person proposes to keep the electronic 'records';
(d) the form in which the 'records' are maintained satisfies all the requirements of these rules apart from the issue of physical locality of the storage; and
(e) the person would be able to provide an 'acceptable electronic form' of the 'record' to SARS on request within a reasonable period.[535]

These requirements place an additional compliance burden on foreign suppliers. The supplier or its accountants/auditors, are often better equipped to retain the integrity of records where they are stored under their control at the location of establishment.

[531] Act 28 of 2011.
[532] Item 4.1 of *Government Gazette* no 787 of 1 October 2012.
[533] Item 3.2 (*a*) of *Government Gazette* no 787 of 1 October 2012.
[534] Item 3.2 (*b*) of *Government Gazette* no 787 of 1 October 2012.
[535] Item 4.2 of *Government Gazette* no 787 of 1 October 2012.

Storing documents at a physical location in South Africa would be costly and in most cases impractical. In the absence of a reciprocal tax administration agreement between the country where the taxpayer is established and South Africa, the supplier would not be able to keep records in the country where it is established.

The compliance burden and the cost of compliance would in most cases outweigh the convenience of e-commerce and the prospective profits for suppliers. Any proposal requiring foreign suppliers to register as VAT vendors in South Africa should be approached with caution. The current strict registration requirements are not in line with international best practice. In addition, the compliance burden associated with registration may well deter foreign investors. This raises the question of whether South Africa's already volatile economy can afford diminishing foreign trade. It has been recommended that a less burdensome registration process be adopted in these cases.[536] These vendors should be exempted from complex and cumbersome duties generally associated with resident vendors. The principle of tax neutrality dictates that differentiation between taxpayers should be avoided. Finding the balance between foreign and domestic vendor registration without causing market distortions and unfair differentiation between taxpayers, remains a difficult task.

3.4.8.2 B2C transactions: Supplies by foreign non-vendors

In the case of B2C transactions where the foreign supplier is not required to register as a VAT vendor, the recipient (customer) must account for VAT under the reverse-charge mechanism within 30 days of such import by completing a VAT201 form.[537] Tax compliance under the reverse-charge mechanism in the case of B2C transactions is generally considered low. It is generally accepted that the self-

[536] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 384; Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 245.

[537] Section 14(1) of the VAT Act 89 of 1991; Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 383; Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 243; *VAT 404: Value Added Tax for Vendors* (2011) at 70 http://www.sars.gov.za/home.asp?pid=4&cx=009878640050894574201%3Aku-btv50zym&cof=FORID%3A10%3BNB%3A1&ie=UTF-8&q=vat+decision+416 [accessed 18 March 2013].

assessment procedure is more effective in the case of imports by VAT vendors.[538] Statistics, nevertheless show that tax compliance among individuals has increased since 1994.[539] It may be argued that this could be as a result of stricter income tax collection mechanisms and a general fear of SARS by individuals.[540] The fear of a tax audit with possible penalties and interest resulting from non-compliance, is known to coerce taxpayers into submitting regular and timeous tax returns.[541] This fear is incited by the fact that SARS has certain mechanisms in place to cross check information supplied by taxpayers. For example, payments received by one taxpayer can be verified by information supplied by the issuer of the payment. However, these verification mechanisms can seldom be applied in e-commerce transactions which are characterised by anonymity and a general lack of a paper trail such as invoicing. The coercion-theory is, as a result, ineffective in collecting VAT on cross-border e-commerce transactions. Taxpayers generally adopt the attitude that "What SARS does not know about, SARS cannot Tax".[542] A relatively small number of taxpayers are diligent, and believe that they have a moral obligation towards the government they voted for and believe in.[543]

It is believed that digital imports by individuals would generally be of small value.[544] The average cellular phone consumer is likely to download applications that would enhance the phone's capabilities which are either available free of charge, or at a

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[538] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 350-352.
[539] Charalambous L (2012) *Magashule Decribes South Africa's Tax Compliance Trends* *http://www.thesait.org.za/news/93631/Tax24.mobi---Daily-News-Magashule-Describes-South-African-Tax-Complian.htm* [accessed on 18 March 2013].
[540] Misra R (2004) *The Impact of Taxpayer Education on Tax Compliance in South Africa* MCom Thesis UKZN at 9-11 http://researchspace.ukzn.ac.za/xmlui/bitstream/handle/10413/2505/Misra_Roshelle_2004.pdf?sequence=1 [accessed on 18 March 2013]
[541] Misra R (2004) *The Impact of Taxpayer Education on Tax Compliance in South Africa* MCom Thesis UKZN at 9-11 http://researchspace.ukzn.ac.za/xmlui/bitstream/handle/10413/2505/Misra_Roshelle_2004.pdf?sequence=1 [accessed on 18 March 2013]
[542] Misra R (2004) *The Impact of Taxpayer Education on Tax Compliance in South Africa* MCom Thesis UKZN at 11 http://researchspace.ukzn.ac.za/xmlui/bitstream/handle/10413/2505/Misra_Roshelle_2004.pdf?sequence=1 [accessed on 18 March 2013]
[543] Misra R (2004) *The Impact of Taxpayer Education on Tax Compliance in South Africa* MCom Thesis UKZN at 11 http://researchspace.ukzn.ac.za/xmlui/bitstream/handle/10413/2505/Misra_Roshelle_2004.pdf?sequence=1 [accessed on 18 March 2013]
[544] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 384.

nominal fee. These would include ringtones, wallpaper, or similar enhancements. A smaller number of individuals would be interested in sophisticated (often expensive) software applications.

The cost and effort involved in reporting such transactions and paying VAT thereon, and the administrative cost to SARS in receiving such payment, could outweigh the actual VAT payments as illustrated below.

> **Example 3.9:** X, who lives in a township some 20 km from Mokopane, owns a smart phone. X downloads a new ringtone for his smart phone bi-monthly from a foreign supplier. X pays R5 per download. X is a diligent taxpayer who feels a moral obligation to pay taxes to the government. X accounts for VAT on the download in terms of section 14 of the VAT Act by completing a VAT 201 form at the nearest SARS office which is located at the Magistrate's Court in Mokopane. To get to the SARS office takes 1 hour by bus at a cost of R15 per trip one way. The VAT on the bi-monthly transaction is R1.40.

Section 136(1) of the Taxation Laws Amendment Act 2011,[545] introduced an exemption in respect of imported services similar to the small parcel exemption contemplated in section 13(3). The insertion of paragraph (*e*) in section 14(5) provides for an exemption of imported services where the value of such services is less than R100 per invoice. Unlike the small parcel exemption on books, journals and printed media, the imported services exemption is not limited to e-books, e-journals, or other electronic reading material. This small download exemption will prevent the time and cost consuming compliance issues outlined in example 3.9 above.

Van der Merwe warns that exemption should not be seen as a quick solution to compliance issues and costly administration.[546] The predictions by Goldstuck[547] show that consumer confidence in e-commerce will grow over the next 4 to 5 years. This would encourage foreign suppliers to market digital products in South Africa

[545] Act 24 of 2011.
[546] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 383.
[547] See Chapter 2 in general.

where South African suppliers are lacking. The number of digital imports by non-vendors could increase dramatically. Despite the low value of such imports, the increasing number of imports could erode the tax base if compliance figures remain low.

The small download exemption in section 14(5)(*e*) could, accordingly, effectively erode the tax base. While costly delivery has in the past deterred consumers from purchasing physical goods from foreign suppliers, digital downloads from foreign suppliers will become increasingly popular, especially where supplies are produced at lower prices than local supplies. If the local market - which is effectively taxed - shifts to a foreign market - which is ineffectively taxed or not taxed at all - the tax base will erode. National Treasury should decide to what extent the self-assessment process and the small download exemption would be cost effective to implement without eroding the tax base.[548] Van der Merwe suggests that SARS should implement a simpler consumer self-assessment process that would make it easier to collect small amounts from a larger base of taxpayers.[549]

Irrespective of the existence of consumer friendly self-assessment mechanisms, self-assessment remains dependent on the honesty and morality of taxpayers.[550] In a society where the government is notorious for corrupt activities and failure to deliver services, confidence in the state shrinks and its subjects are likely to be reluctant to pay taxes.

3.4.8.3 B2B transactions: Supplies by a foreign registered vendor

In the case of B2B transactions where the supplier is registered, or is required to register, as a VAT vendor in the Republic, the supplier must collect VAT on the supplies as a domestic supply in terms of section 7(1)(*a*). The business recipient would be entitled to an input VAT deduction in so far as the supplies are applied in the course and furtherance of an enterprise, and in the making of taxable supplies.

[548] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 384.
[549] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 384.
[550] Naicker K (2010) "The VAT Implications of E-commerce" *Taxtalk* January/February 2010 at 9.

The supplier would not be required to determine the vendor status of the customer as the supply will be taxed regardless.

The objections raised in paragraph 3.4.8.1 above, apply.

3.4.8.4 B2B transactions: Supplies by foreign non-vendor

In the case of B2B transactions where the foreign supplier is not required to register as a VAT vendor, the business customer must account for VAT on the supplies in so far as the supplies were utilised and consumed by it for purposes other than in the course and furtherance of an enterprise.[551] This must be done by completing a VAT201 form within 30 days after such import.[552]

It is generally accepted that the self-assessment procedure is more effective in the case of imports by VAT vendors.[553] Registered vendors are required to declare self-assessed VAT when filing their VAT returns.[554] These vendors are known to SARS and can easily be audited to prevent VAT fraud. In addition, the failure to self-assess and general compliance irregularities, can be detected.[555] Furthermore, information on VAT compliance practices can be communicated regularly to VAT vendors or tax practitioners acting on behalf of vendors in completing tax returns. Through regular communication, good relations can be established between SARS and vendors which will create a VAT-compliance driven environment.

As the business customer must only account for VAT on imported services that it utilises and consumes for purposes other than in the course and furtherance of an enterprise, the effectiveness of the reverse-charge mechanism in detecting fraud and compliance irregularities is diminished. Since the VAT201 form only provides for the

[551] Section 7(1)(*c*) read with the definition of 'imported services' in section 1.
[552] Section 14(1) of the VAT Act 89 of 1991; Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 383; Steyn T (2010) "VAT and E-commerce: Still Looking for Answers?" *SA Merc LJ* vol 22 no 2 at 243; *VAT 404: Value Added Tax for Vendors* (2011) at 70 http://www.sars.gov.za/home.asp?pid=4&cx=009878640050894574201%3Aku-btv50zym&cof=FORID%3A10%3BNB%3A1&ie=UTF-8&q=vat+decision+416 [accessed 18 March 2013].
[553] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 350-352.
[554] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 383.
[555] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 383.

disclosure of imported services that were utilised and consumed for purposes other than in the course and furtherance of an enterprise, compliance relies, in the main, on the honesty and integrity of the taxpayer. Even where the taxpayer has made a *bona fide* mistake in its interpretation of the nature of the supplies, in the absence of tip-offs, imports by vendors (as final consumers) would go undetected.

The amount and value of B2B cross-border digital transactions could lead to a serious erosion of the tax bases if these transactions go undetected and untaxed. This is evident from the facts in *CSARS v De Beers Consolidated Mines Ltd*[556] and *Metropolitan Life Ltd v CSARS*.[557]

3.5 Conclusion

The South African VAT system was clearly designed in an era when electronic commerce was the futuristic brainchild of computer technicians and dreamers. This does not justify a conclusion that a VAT system is outdated per se, as many tax systems are designed around the trends current to the era. Regular amendments are required to keep VAT legislation up to date and able to tax consumption effectively. Yet, too many amendments could negatively affect the principle of tax certainty. In addition, amendments are often costly to develop and implement and the tax benefit that they hold does not outweigh the overall cost of implementation. In this chapter I have addressed whether the South African VAT Act[558] in its current form, can be applied to tax cross-border digital transactions, and whether the current VAT collection mechanisms could be applied to tax and collect VAT on digital imports adequately. From the outset it was evident that the taxation of cross-border digital transactions is limited by uncertainties in the VAT Act.[559]

In the first instance, the classification of intangible products as either goods or services has proved problematic. Despite the wide meaning of “services”, SARS has

[556] *CSARS v De Beers Consolidated Mines Ltd* (503/2011) [2012] ZASCA 103 (1 June 2012).
[557] *Metropolitan Life Ltd v CSARS* 2009 (3) SA 484 (C).
[558] Act 89 of 1991.
[559] Act 89 of 1991.

not yet issued any policy statement as to whether or not it will treat digital products as goods or services. That said, by the examples given in explanatory memoranda issued by SARS, it appears likely that digital products will be classified as services for purposes VAT collection.

Secondly, the absence of clear place-of-supply rules makes it difficult to establish the place where digital products are supplied and to determine the jurisdiction where they should be taxed. In addition, the phrase “utilised and consumed in the Republic” in terms of the definition of “imported services”, is not clear and adds to the confusion. This is particularly evident where intangible products or services are physically delivered (downloaded) outside of the Republic, but where the benefit of the service or product is experienced in the Republic.

Thirdly, determining the time of a supply in the case of automated or continuous e-commerce transactions is cumbersome. In these cases invoices are seldom issued and the actual date of payment cannot be determined with certainty.

Fourthly, it is uncertain whether a foreign supplier of digital products to residents in the Republic, is required to register as a VAT vendor in the Republic. The attempts by SARS to compel foreign vendor registration in certain economic sectors, indicate that foreign vendors could be required to register as vendors if the supplies made in South Africa exceed the R1 million threshold. It is further uncertain when (and under what terms) the proposed compulsory registration of foreign suppliers of e-books, music, and other digital products will be implemented. It is also not clear if the proposal will follow the existing vague place-of-supply rules. Moreover, the cumbersome VAT vendor registration process, and the requirement that the vendor must have a fixed address in South Africa could discourage foreign vendor registrations which could further lead to market distortions.

Fifthly, the self-assessment method relies chiefly upon the interpretation of the transaction by the taxpayer, as well as the honesty of the taxpayer. The taxpayer can, for example, be of the view that the products were physically downloaded outside the Republic and should therefore not be taxed. Taxpayers can also avoid taxes by failing to assess the transaction and file the assessment. The self-assessment method is by far the largest contributor to VAT fraud and the erosion of

the tax base. The anonymity of e-commerce and the absence of physical evidence of supplies, can further facilitate the abuse of the self-assessment procedure by taxpayers. The question is posed whether alternative VAT collection measures should be explored at all? Will the market for digital imports have a significant impact on the VAT collection mechanisms that could ultimately lead to the erosion of the tax base? Based on the findings in paragraph 2.6 above, e-commerce could lead to the erosion of the tax base in the next 4 to 5 years. Alternative tax collection methods should be explored before this happens.

In Chapter 4, I examine the VAT treatment of cross-border e-commerce in the European Union with the aim of seeking possible solutions to the issues raised above.

CHAPTER 4

THE EUROPEAN UNION

4.1 Introduction

The European Union (EU) is an economic and political union[560] consisting of 27 Member States[561] which originated from the European Coal and Steel Community (established in 1951),[562] and the European Economic Community (established in 1958).[563] The EU has established a single market through the standardisation of laws that apply to all Member States. EU policies are aimed at the free movement of people, goods, services, and capital between Member States.[564] Harmonised trade rules and the use of a single currency (the Euro) in Euro-zone countries ensure regular and virtually trouble free cross-border trade between Member States.[565] However, the EU VAT model is seriously underminded by numerous exemptions and derogations of all sorts.

The EU offers a favourable environment for the proliferation of e-commerce. In this Chapter, I examine the VAT treatment of e-commerce by the harmonised consumption tax policies applied in the EU. Since VAT as a consumption tax originated in Europe, I consider it necessary to discuss the history of VAT in the EU. The purpose of this historical discussion is to highlight the issues associated with the taxation of e-commerce, and further indicate how EU harmonised consumption tax rules have developed to address or circumvent these issues. In this discussion I focus on finding possible solutions in the EU VAT rules that can be applied to the current issues faced under the South African VAT Act[566] as discussed in Chapter 3.

[560] Ginsberg RH (2007) *Demystifying the European Union* at 2-3.
[561] At the time of writing the 27 Member States consisted of Austria (1995); Belgium (founder); Bulgaria (2007); Cyprus (2004); Czech Republic (2004); Denmark (1973); Estonia (2004); Finland (1995); France (founder); Germany (founder); Greece (1981); Hungary (2004); Ireland(1973); Italy(founder); Latvia(2004); Lithuania (2004); Luxembourg (founder); Malta (2004); Netherlands (founder); Poland (2004); Portugal (1986); Romania(2007); Slovakia(2004); Slovenia (2004); Spain (1986); Sweden (1995); United Kingdom (1973).
[562] Ginsberg RH (2007) *Demystifying the European Union* at 39-40; Staab A (2008) *The European Union Explained* at 8-9.
[563] Ginsberg RH (2007) *Demystifying the European Union* at 40
[564] Cameron DR (1992) "The 1992 initiative: Causes and Consequences" in Sbragia AM (1992) *Euro-Politics: Institutions and Policy Making in the 'New' European Community* at 24; European Union *How the EU Works* http://europa.eu/about-eu/index_en.htm [accessed on 6 March 2013].
[565] The European community evolved from its initial purpose as a purely economic union to an organisation spanning policy areas from development to human rights, welfare and environmental matters. Everything that it does stems from treaties that were voluntarily and democratically agreed upon by Member States. These agreements set out the European Union's goals in all the areas of its activities.
[566] Act 89 of 1991.

4.2 The history of VAT in Europe

VAT is a relatively modern tax that originated in the early twentieth century. Before VAT was introduced, indirect taxes were limited to certain products like excise on tobacco and alcohol.[567] In addition to these taxes, very few countries also levied sales tax or turnover taxes.[568] Most sources differ on the exact year in which VAT was introduced for the first time in the world. The basic idea of a VAT system can be attributed to two sources:[569] the writings of the German businessman Wilhelm von Siemens in 1918,[570] and the writings of the American economist Thomas S Adams from 1910-1921.[571] Von Siemens's technical innovation brought improvements to turnover taxes that can today be regarded as some of the key ideas of VAT.[572] As VAT allows for the recovery of taxes on business inputs, it eliminates the cascading problems created by turnover taxes.[573] In Adams's case there was no national sales tax to improve and, unlike von Siemens's technical innovation, he was interested in a major alteration of the federal tax system.[574]

Germany and the rest of Europe saw VAT as a technical alternative to sales tax which ultimately led to the current widespread implementation of VAT in Europe.[575] By contrast, in the USA VAT has never been introduced, mainly because policy makers wished to introduce VAT as a substitute for federal income tax.[576] It is

[567] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 4.
[568] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 4.
[569] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 4; James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 15; Metcalfe GE (1995) "Value Added Taxation: A Tax Whose Time has Come?" *The Journal of Economic Perspectives* vol 9 nr 1 at 127; Terra BJM and Kajus J (1992) *Introduction to Value Added Tax in the EC after 1992* at 3; Owens JO, Battiau P, Alain C (2011) "VAT's Next Half Century: Towards a Single Rate System? *OECD Observer* no 284 Q 1 http://www.oecdobserver.org/news/fullstory.php/aid/3509/VAT_s_next_half_century:_Towards_a_single-rate_system_.html [accessed on 6 March 2013].
[570] Von Siemens CF (1921) *Veredelte Umsatzsteuer* who cites his brother, Wilhelm von Siemens, as originator of the proposal.
[571] Adams TS (1921) "Fundamental Problems of Federal Income Taxation" *The Quarterly Journal of Economics* vol 35 issue 4 at 527-556.
[572] James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 15; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 4.
[573] Metcalfe GE (1995) "Value Added Taxation: A Tax Whose Time has Come?" *The Journal of Economic Perspectives* vol 9 nr 1 at 127-128; ; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 4.
[574] James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 16.
[575] James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 16.
[576] James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 16.

interesting to note that the USA, in later years, assisted many developing countries to adopt a VAT system but failed to adopt a VAT system itself.[577] VAT was first introduced in France in 1948 with limited scope and application.[578] The tax system was converted to a consumption-type VAT system in 1958.[579] It was not until 1968 that France would implement VAT on a broader spectrum of transactions.[580] In 1967, Denmark was the first European country to introduce a thoroughbred VAT system, although it was not a Member State of the then European Community.[581] Denmark became a member of the European Community in 1973.[582] After Denmark, many European countries followed by each introducing its own version of VAT systems.[583] The spread of VAT in Europe can, in the main, be attributed to the European Union Council Directives[584] and the harmonisation of VAT rules.[585] In 1960 the EEC Treaty tasked the EEC Commission to consider the implementation of a harmonised consumption tax for Europe.[586] The Commission's report highlighted the cascading effect of turnover taxes and the limiting effect this has on cross-border trade in a single market.[587] As a result, the EEC adopted the First Council Directive[588]

[577] James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 17.
[578] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 4; James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 16; James A (1991) *VAT Demystified* at 1; Metcalfe GE (1995) "Value Added Taxation: A Tax Whose Time has Come?" *The Journal of Economic Perspectives* vol 9 nr 1 at 128; Williams D (1998) "Value-Added Tax" in Thuronyi V (ed) (1998) *Tax Law Design and Drafting* vol 1 Chapter 6 at 1; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 19.
[579] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 4; James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 16; James A (1991) *VAT Demystified* at 1.
[580] James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 16.
[581] Kearney M (2003) Restructuring Value-Added Tax in South Africa: A Computable General Equilibrium Analysis at 22; James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 16.
[582] Kearney M (2003) Restructuring Value-Added Tax in South Africa: A Computable General Equilibrium Analysis at 22.
[583] Kearney M (2003) *Restructuring Value-Added Tax in South Africa: A Computable General Equilibrium Analysis* at 22; James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 16; [583] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 5; Metcalfe GE (1995) "Value Added Taxation: A Tax Whose Time has Come?" *The Journal of Economic Perspectives* vol 9 nr 1 at 128.
[584] The Council Directives of the EU serve as legislative acts which require Member States to arrive at a specific outcome or result without dictating the means by which the outcome or result should be achieved. Council Directives are voluntarily and democratically agreed upon by Member States. The text of a draft directive is prepared by the Commission after consultation with its own and national experts. The draft is presented to the Parliament and the Council for evaluation and comment and then for approval or rejection. Council Directives are binding on the Member State(s) to which they are addressed. The VAT Directives are binding on all 27 Member States.
[585] James K (2011) "Exploring the Origins and Global Rise of VAT" *Tax Analysts* at 16; Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 5; Bird RM and Gendron PP (2007) *The VAT in Developing and Transitional Countries* at 11.
[586] Terra BJM and Kajus J (1992) *Introduction to Value Added Tax in the EC after 1992* at 3-4.
[587] Terra BJM and Kajus J (1992) *Introduction to Value Added Tax in the EC after 1992* at 4.

instructing Member States to replace their existing turnover taxes with a common VAT system based on the consumption of goods and services, by no later than 1 January 1970.[589] The Third,[590] Fourth,[591] and Fifth[592] Directives repeatedly extended the January 1970 deadline.[593]

The First and Second[594] Directives permitted Member States so wide ranging a discretion, that nine separate and different systems of national laws existed by 1973.[595] National rules in Member States differed dramatically as to when and where services were deemed to be performed, whether a supply was deemed to be a supply of goods or services, and whether a supply was exported or imported.[596]

As a result, the Sixth Directive[597] was adopted further to harmonise the different national laws.[598] The new rules introduced by the Sixth Directive cover the areas where national laws dramatically differed on territorial application, taxable transactions, place of supply, rates and exemptions, deductions, persons liable to collect or pay VAT, and vendor registration.[599]

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[588] First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes.

[589] Terra BJM and Kajus J (1992) *Introduction to Value Added Tax in the EC after 1992* at 6; Ward BT, Sipior JC, Bremser W, McGinty DB (2006) "A Comparison of United States and European Union Taxation of E-commerce" ICEC '06 Proceedings of the 8th International Conference on Electronic Commerce at 345; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 59-60.

[590] Third Council Directive 69/463/EEC of 9 December 1969 on the harmonisation of legislation of Member States concerning turnover taxes - Introduction of value added tax in Member States.

[591] Fourth Council Directive 71/401/EEC of 20 December 1971 on the harmonization of the laws of the Member States relating to turnover taxes - Introduction of value added tax in Italy.

[592] Fifth Council Directive 72/250/EEC of 4 July 1972 on the harmonisation of legislation of Member States concerning turnover taxes – Introduction of value added tax in Italy.

[593] Terra BJM and Kajus J (1992) *Introduction to Value Added Tax in the EC after 1992* at 6-7.

[594] Second Council Directive 67/228/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes - Structure and procedures for application of the common system of value added tax.

[595] Ward BT, Sipior JC, Bremser W, McGinty DB (2006) "A Comparison of United States and European Union Taxation of E-commerce" ICEC '06 Proceedings of the 8th International Conference on Electronic Commerce at 345.

[596] Terra BJM and Kajus J (1992) *Introduction to Value Added Tax in the EC after 1992* at 8.

[597] Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment.

[598] Terra BJM and Kajus J (1992) *Introduction to Value Added Tax in the EC after 1992* at 8; Ward BT, Sipior JC, Bremser W, McGinty DB (2006) "A Comparison of United States and European Union Taxation of E-commerce" ICEC '06 Proceedings of the 8th International Conference on Electronic Commerce at 345; Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* 27-33.

[599] Terra BJM and Kajus J (1992*) Introduction to Value Added Tax in the EC after 1992* at 9

When the Sixth Directive was implemented, e-commerce was unheard of and the rules were designed to fit the retail trends common to that era.[600] With the advent of e-commerce, many non-EU suppliers were able to circumvent the application of VAT on supplies made in the EU, placing these suppliers at an advantage over EU vendors whose supplies were subject to VAT in Member States.[601] It was feared that consumption patterns would be distorted which would further induce EU vendors to establish their e-commerce enterprises in VAT-free countries to retain their market share.[602] This forced the EU to review and amend the VAT legislative base to take account of greater international collaboration.[603] In collaboration with the OECD, the EU adopted a set of guidelines in 1998 and the first true attempt to finalise a solution was published in the *Proposal for a Council Directive* amending *Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic mean.*[604] This proposal was not well supported and was replaced by the proposal of 7 May 2002 which contained many of the basic objectives of the June 2000 proposal.[605]

The first amendment to the Sixth Directive to provide for the taxation of cross-border e-commerce transactions, and to eliminate the competitive disadvantages created by the Sixth Directive, came in the form of Council Directive 2002/38/EC[606] adopted on 7 May 2002. This was followed by Council Directive 2006/58/EC,[607] Council Directive

[600] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" 16 *SA Merc LJ* at 577.
[601] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" 16 *SA Merc LJ* at 578.
[602] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" 16 *SA Merc LJ* at 578-579; Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 429-430.
[603] *Interim Report on the implications of electronic commerce on VAT and Customs* 98/0359, 3/4/98 http://ec.europa.eu/taxation_customs/resources/documents/interim_report_on_electric_commerce_en.pdf [accessed on 3 October 2012].
[604] Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic mean COM (2000) 349 Final http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2000:0349:FIN:en:PDF [accessed on 3 October 2012].
[605] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" 16 *SA Merc LJ* at 579.
[606] Council Directive 2002/38/EC of 7 May 2002.
[607] Council Directive 2006/58/EC of 27 June 2006.

2006/138/EC,[608] Council Directive 2006/112/EC,[609] and Council Directive 2008/8/EC.[610]

Member States are obliged to follow EC law and ensure that harmonised rules are correctly applied on a national level.[611] Despite a harmonised tax base, differences in national VAT legislation exist between Member States in respect of rates and exemptions.[612] To determine the exact tax treatment of the supply of digital products in a particular jurisdiction, several questions need to be answered:

a) Is there a supply of goods or services?
b) Where is the supply made?
c) When is the supply made?
d) What is the value of the supply?
e) Is it made by a taxable entity?
f) Is it made in the course or furtherance of an enterprise?
g) Is the supply taxable?
h) How is VAT on the transaction collected?

4.3 The VAT treatment of e-commerce in the EU

4.3.1 Is there a supply of goods or services?

Where tangible goods are ordered electronically by private consumers, and where these goods are delivered by traditional means, existing rules in respect of distance selling (telephone or postal orders) apply.[613] There are well-established channels in

[608] Council Directive 2006/138/EC of 19 December 2006.
[609] Council Directive 2006/112/EC of 28 November 2006.
[610] Council Directive 2008/8/EC of 12 February 2008.
[611] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 65.
[612] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 66.
[613] Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic mean COM (2000) 349 Final at 3 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2000:0349:FIN:en:PDF [accessed on 3 October 2012]; Jenkins P (2000) "The EU Proposals for the Effective Application of VAT in the Internet Age" *Tax Planning*

the Sixth Directive to tax these transactions adequately. However, problems occur when intangible goods are ordered and delivered electronically.

Uncertainty with regard to the classification of supplies causes difficulties for the supplier who is required to levy and account for VAT on cross-border digital transactions.[614] It is likely to increase the administrative burden on suppliers and may have an adverse economic effect on these companies.[615] Ideally, suppliers should be able to classify supplies without difficulty to ensure smooth and fast cross-border trade.

Article 5(1) of the Sixth Directive defines the supply of goods as "the transfer of the right to dispose of tangible property as the owner". Electricity, gas, heat, refrigeration, and the like are regarded as tangible property.[616]

As a result of the intangible nature of digital supplies, they cannot be classified as goods. It has, however, been argued that digital supplies require some form of electrical current, and could accordingly be classified as goods if a strict textual interpretation of the definition of "goods" is applied.[617] This argument should not be accepted.[618] Electricity is traditionally classified as goods because authorities have greater control over its supply, unlike electronic deliveries.[619]

Article 6 of Sixth Directive defines the supply of services as "any transaction which does not constitute a supply of goods within the meaning of Article 5". Similar to the meaning of services under the South African VAT Act,[620] the meaning of services envisaged in the Sixth Directive allows for a wide scope of application. Digital products should, therefore, by default, be classified as services. On 17 June 1998,

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International E-commerce vol 2 no 12 at 3; Fairpo CA (1999) "VAT in the European Union-Where are we now" *Tax Planning International E-commerce* vol 1 no 9 at 17; Jeanmart FX (2001) "Taxation of Electronic Commerce Part II:VAT" *Tax Planning International: European Union Focus* vol 3 no 8 at 6; García AMD and Cuello RO (2011) "Electronic Commerce and Indirect Taxation in Spain" *European Taxation* vol 51 no 4 at 140.

[614] Rendahl P (2008) *Cross-Border Consumption Taxation of Digital Supplies* at 167.

[615] Rendahl P (2008) *Cross-Border Consumption Taxation of Digital Supplies* at 167.

[616] Article 5(2) Sixth Council Directive 77/388/EEC of 17 May 1977.

[617] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part III at 2 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].

[618] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part III at 2 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].

[619] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part III at 2 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].

[620] Section 1 of the VAT Act 89 of 1991.

the European Commission issued a set of guidelines in terms of which the EU policy on indirect taxes on e-commerce is set out.[621] In terms of these guidelines, it is a policy of the EU to consider "products ordered and delivered on networks" as services.[622] This means that all types of electronic transmission and all types of intangible product delivered by electronic transmission, are deemed to be services for EU VAT purposes.[623]

In contrast to the South African position, the taxation of the supply of goods and that of services differ in EU Member States. As e-commerce is a global phenomenon, Van der Merwe's question whether a differentiation between goods and services is at all necessary in jurisdictions where goods and services are taxed at a single rate, becomes irrelevant.[624] While a differentiation could be obsolete on a national level, trade with jurisdictions where differentiation is actively applied could cause market distortions.[625] Jurisdictions acting in isolation cannot resolve all the issues raised by e-commerce. As a result, a uniform global approach should be followed in the classification of digital products.

Article 1(a) of Council Directive 2002/38/EC,[626] amended Article 9(2)(e) of the Sixth Directive to provide for the inclusion of electronically supplied services in the definition of services. In addition, Annexure L to Council Directive 2002/38/EC, lists types of transaction that would be deemed to be electronically supplied services. It should be noted that transactions covered by the provision governing "electronically supplied services", are not restricted to the services listed in Annexure L. These services are the:

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[621] *Electronic Commerce and Indirect Taxes* COM (1998) 374 final http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:1998:0374:FIN:EN:PDF [accessed on 4 October 2012].
[622] *Electronic Commerce and Indirect Taxes* COM (1998) 374 final at 5 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:1998:0374:FIN:EN:PDF [accessed on 4 October 2012].
[623] *Electronic Commerce and Indirect Taxes* COM (1998) 374 final at 5 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:1998:0374:FIN:EN:PDF [accessed on 4 October 2012]; Henriques V, Azevedo L, Bonnet J, Carvalho P, Mathan L (2001) "Extending VAT to E-commerce: An Implementation of EU Proposals" *Euroweb 2001* at para 2.4.
[624] Van der Merwe B (2003) "VAT and E-commerce" 15 *SA Merc LJ* at 381.
[625] Imports from countries that apply a lower VAT rate for the intangible version of its tangible equivalent could flood local markets at the cost of local suppliers. Similarly, international trade with existing suppliers could be abandoned in favour of suppliers located in low VAT jurisdictions.
[626] Council Directive 2002/38/EC of 7 May 2002.

1. website supply, web-hosting, distance maintenance of programmes and equipment;[627]

2. supply and updating of software;[628]

3. supply of images, text, and information, and making databases available;[629]

4. supply of music, films, and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific, and entertainment broadcasts and events;[630]

5. supply of distance teaching.[631]

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[627] Annexure 1 to the Council Regulation of 17 October 2005 further defines item 1 as:
(a) Website hosting and webpage hosting;
(b) Automated, online and distance maintenance of programmes;
(c) Remote systems administration;
(d) Online data warehousing where specific data is stored and retrieved electronically;
(e) Online supply of on-demand disc space.

[628] Annexure 1 to the Council Regulation of 17 October 2005 further defines item 2 as:
(a) Accessing or downloading software (including procurement/accountancy programmes and anti-virus software) plus updates;
(b) Software to block banner adverts showing, otherwise known as Bannerblockers;
(c) Download drivers, such as software that interfaces computers with peripheral equipment (such as printers);
(d) Online automated installation of filters on websites;
(e) Online automated installation of firewalls.

[629] Annexure 1 to the Council Regulation of 17 October 2005 further defines item 3 as:
(a) Accessing or downloading desktop themes;
(b) Accessing or downloading photographic or pictorial images or screensavers;
(c) The digitised content of books and other electronic publications;
(d) Subscription to online newspapers and journals;
(e) Weblogs and website statistics;
(f) Online news, traffic information and weather reports;
(g) Online information generated automatically by software from specific data input by the customer, such as legal and financial data, (in particular such data as continually updated stock market data, in real time);
(h) The provision of advertising space including banner ads on a website/webpage;
(i) Use of search engines and Internet directories.

[630] Annexure 1 to the Council Regulation of 17 October 2005 further defines item 4 as:
(a) Accessing or downloading of music on to computers and mobile phones;
(b) Accessing or downloading of jingles, excerpts, ringtones, or other sounds;
(c) Accessing or downloading of films;
(d) Downloading of music on to computers and mobile phones;
(e) Accessing automated online games which are dependent on the Internet, or other similar electronic networks, where players are geographically remote from one another.

[631] Annexure 1 to the Council Regulation of 17 October 2005 further defines item 5 as:
(a) Automated distance teaching dependent on the Internet or similar electronic network to function and the supply of which requires limited or no human intervention, including virtual classrooms, except where the Internet or similar electronic network is used as a tool simply for communication between the teacher and student;
(b) Workbooks completed by pupils online and marked automatically, without human intervention.

This list is incorporated in the re-cast version of the EU VAT Directives under Annex II of Council Directive 2006/112/EC, and its later amendment by Council Directive 2008/8/EC. The guidelines further defining the items in the list as envisaged by Annexure 1 of the Council Regulation of 17 October 2005, are re-cast in Annexure I of Council Implemented Regulations (EU) no 282/2011.

The mere fact that the supplier and the recipient communicated by electronic means, does not mean that the transactions or the goods will be regarded as electronically supplied services.[632] However, where the supplier has created a portal providing relevant information to its clients at a subscription fee, the services would qualify as electronically supplied services.[633]

As a result of the evolving nature of e-commerce and technology, electronically supplied services should, at best, not be defined to result in a restrictive meaning or a meaning that would result in limited application.[634] It is trite that technological changes are far more advanced and frequent than legislative amendments. It often happens that by the time legislative amendments have been incorporated, technology has already advanced to render the amendments obsolete.[635] Save for the types of supply listed in Annexure L, Council Directive 2002/38/EC does not provide a general definition of what constitute electronically supplied services.[636] In reiterating that electronically supplied services are not limited to the services listed in Annexure L, the Council Regulation of 17 October 2005[637] provides for a general definition of electronically supplied services. Article 11 of the Council Regulation of 17 October 2005, defines electronically supplied services as:

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[632] Annexure L to Council Directive 2002/38/EC of 7 May 2002; also see Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 76.

[633] Lejeune I, Korf R, Grünauer A (2003) "New E-commerce Directives: A Move Towards e-Europe?" *Journal of International Taxation* vol 14 no 4 at 20.

[634] *Electronic Commerce and Indirect Taxes* COM (1998) 374 final at 3 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:1998:0374:FIN:EN:PDF [accessed on 4 October 2012]; Fridensköld E (2004) "VAT and the Internet: The Application of Consumption Taxes to E-commerce Transactions" *Information & Communications Technology Law* vol 13 no 2 at 184; De Campos Amorim J (2009) "Electronic Commerce Taxation in the European Union" *Tax Notes International* vol 55 no 9 at 774; Hinnekens L (2002) "An Updated Overview of the European VAT Rules Concerning Electronic Commerce" *EC Tax Review* vol 11 issue 2 at 69.

[635] Baron R (2001) "VAT- Where Next for Europe?" *Tax Planning International E-commerce* vol 3 no 1 at 12.

[636] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 69.

[637] Council Regulation (EC) 1777/2005 of 17 October 2005 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:288:0001:0009:EN:PDF [accessed on 4 October 2012].

> ...services which are delivered over the Internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and in the absence of information technology is impossible to ensure.

A definition in these general terms can be applied to cover all types of electronically supplied service, irrespective of the type of service and the technological delivery method used. It would be difficult to circumvent the application of article 9(2)(e) under the general definition. To further eliminate possible circumvention, the words "Indicative list" were added to the heading of the list in Annexure II by Council Directive 2008/8/EC and have applied since 1 January 2010.

The tax consequence of electronically supplied services differs from that of other services.[638] It is therefore not sufficient (when dealing with customers in the EU) to classify digital products as "services" based on a blanket classification method. The specific digital product should further be classified to determine if it is taxable under the provisions governing electronically supplied services, or any other provision.[639] A general broad definition of electronically supplied services could complicate the classification by vendors. The Council Regulation of 17 October 2005 provides for a list of services that would qualify as electronically supplied services,[640] and a list of services that would not qualify as such.[641] Rendahl opines that these guidelines,

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[638] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 69.

[639] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 69.

[640] (a) the supply of digitised products generally, including software and changes to or upgrades of software;
(b) services providing or supporting a business or personal presence on an electronic network such as a website or a webpage;
(c) services automatically generated from a computer via the Internet or an electronic network, in response to specific data input by the recipient;
(d) the transfer for consideration of the right to put goods or services up for sale on an Internet site operating as an online market on which potential buyers make their bids by an automated procedure and on which the parties are notified of a sale by electronic mail automatically generated from a computer;
(e) Internet Service Packages (ISP) of information in which the telecommunications component forms an ancillary and subordinate part (i.e. packages going beyond mere Internet access and including other elements such as content pages giving access to news, weather or travel reports, playgrounds, website hosting; access to online debates etc.);
(f) the services listed in Annex I.

[641] 1. radio and television broadcasting services as referred to in the 11th indent of Article 9(2)(e) of Directive 77/388/EEC;
2. telecommunications services, within the meaning of the 10th indent of Article 9(2)(e) of Directive 77/388/EEC;
3. supplies of the following goods and services:

despite their extensive nature, are already obsolete in certain cases, and cannot be applied to correctly classify the type of service rendered.[642] As a result of the dynamic evolution of the Internet and e-commerce, many transactions that should in principle be taxed, escape the application of VAT as a direct consequence of the unsatisfactory list of electronically supplied services.[643] In the case of combined or bundled services, the general definition of electronically supplied services is inadequate to classify the type of services correctly. Furthermore, where the specific service is not provided for by specific inclusions, different views and applications of the classification between Member States can develop.[644] This can best be explained by way of example.

> **Example 4.1:** X plays a trial online video game in which X creates a character that has to complete a quest in a modern city. As part of the graphics, streets are lined with billboards with real-life advertisements. Any

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(a) goods, where the order and processing is done electronically;
(b) CD-ROMs, floppy disks and similar tangible media;
(c) printed matter, such as books, newsletters, newspapers or journals;
(d) CDs, audio cassettes;
(e) video cassettes, DVDs;
(f) games on a CD-ROM;
(g) services of professionals such as lawyers and financial consultants, who advise clients by e-mail;
(h) teaching services, where the course content is delivered by a teacher over the Internet or an electronic network, (namely via a remote link);
(i) offline physical repair services of computer equipment;
(j) offline data warehousing services;
(k) advertising services, in particular as in newspapers, on posters and on television;
(l) telephone helpdesk services;
(m) teaching services purely involving correspondence courses, such as postal courses;
(n) conventional auctioneers' services reliant on direct human intervention, irrespective of how bids are made;
(o) telephone services with a video component, otherwise known as videophone services;
(p) access to the Internet and World Wide Web;
(q) telephone services provided through the Internet.

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

[643] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012]; Hinnekens L (2002) "An Updated Overview of the European VAT Rules Concerning Electronic Commerce" *EC Tax Review* vol 11 issue 2 at 71; Buydens S, Holmes D, Owens J (2009) "Consumption Taxation of E-commerce: 10 Years after Ottawa" *Tax Notes International* vol 54 no 1 at 63.

[644] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 72; Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 8; Buydens S, Holmes D, Owens J (2009) "Consumption Taxation of E-commerce: 10 Years after Ottawa" *Tax Notes International* vol 54 no 1 at 63; De la Feria R (2006) *The EU VAT System and the Internal Market* at 110.

player can click on the advertisement to be linked to the advertiser's webpage. X purchases the executive gaming package which allows him to play all the online levels which includes free advertising space for 10 virtual billboards per level.

In this case the supply of the online gaming facility can be classified as electronically supplied services.[645] However, it is uncertain whether the sale of advertising space amounts to electronically supplied services,[646] or if it is specifically excluded from the definition of electronically supplied services.[647] Where the game itself is not hosted on a webpage but requires an Internet connection to be played, it could be argued that the advertising space falls under article 12(6), and should not be classified as electronically supplied services. Where the game is played by logging into a website, the advertising space falls under item 3(h) of Annex I and should be classified as electronically supplied services. Despite the difference in the distribution method, where the fundamental nature of the product is the same, the online and offline versions should be taxed the same.[648] This is currently not the case in Member States. Rendahl points out that the immediate difference between advertising services and pop-ups or banners, lies in the fact that the latter is the provision of advertising space as oppose to the supply of advertising services.[649] Even so, the difference cannot easily be determined and each case must be evaluated in its own right.[650]

Businesses, tax authorities and courts stand before rules that allow for multifarious interpretation and application. For example, traditional services rendered by attorneys and accountants are excluded from electronically supplied services because of the human intervention required to provide these services. Where technology, such as automated responses or self-help calculators, is applied, these traditional services require minimal human intervention and could be classified as

[645] Item 4(e) of Annex I to the Regulations of 17 October 2005.
[646] Item 3(h) of Annex I to the Regulations of 17 October 2005.
[647] Article 12(6) of the Regulations of 17 October 2005.
[648] Fridensköld E (2004) "VAT and the Internet: The Application of Consumption Taxes to E-commerce Transactions" *Information & Communications Technology Law* vol 13 no 2 at 184; Jones R and Basu S (2002) "Taxation of Electronic Commerce: A Developing Problem" *International Review of Law, Computers & Technology* vol 16 no 1 at 37.
[649] Rendahl P (2008) *Cross-Border Consumption Taxation of Digital Supplies* at 195.
[650] Rendahl P (2008) *Cross-Border Consumption Taxation of Digital Supplies* at 196.

electronically supplied services under the general definition.[651] Suppliers could effectively be taxed differently depending on the interpretation in the jurisdiction of supply.[652] In the example provided by Rendahl, she points out that the supply of generic building plans, which require minimum human intervention and which do not relate to specific immovable property, can be classified as either services related to immovable property,[653] or as electronically supplied services.[654] This results in alternating place-of-supply rules. Currently, suppliers are obliged to familiarise themselves with national rules and to develop and apply software that determines the jurisdiction of supply. This allows them to tax the supply correctly at the applicable rate. There is a clear risk of double taxation or failure to tax if supplies are taxed differently on the basis of differing applications in Member States.[655] Until 31 December 2014, in the case of supplies between EU suppliers and EU customers located in different Member States, the supplier has only to establish the VAT treatment of the supply in the country of origin.[656] From 1 January 2015 when the destination principle will apply to these transactions, the supplier will have to establish the VAT treatment of the supply in 28[657] different Member States.[658]

These definitional uncertainties create the risk of divergent application and increase the risk of double or non-taxation.[659] Fridensköld suggests that further guidance in the form of definitions and classifications, is required on a regular basis to guarantee

[651] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 46 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].
[652] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 73; Eriksen N and Hulsebos K (2000) "Electronic Commerce and VAT-An Odyssey towards 2001" *International VAT Monitor* vol 11 no 4 at 143.
[653] Article 45 read with article 9(2) of the Sixth Council Directive 77/388/EC.
[654] Rendahl P (2008) *Cross-Border Consumption Taxation of Digital Supplies* at 189-190.
[655] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 73.
[656] See place-of-supply rules in para 4.3.2 below.
[657] Crotia joined the EU on 1 July 2013.
[658] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 46 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].
[659] Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 114; Buydens S, Holmes D, Owens J (2009) "Consumption Taxation of E-commerce: 10 Years after Ottawa" *Tax Notes International* vol 54 no 1 at 63.

clarity and certainty.[660] Whether this approach is desirable may be questioned given the fast pace at which e-commerce and technology evolve. Bill and Kerrigan argue that the less than definitive list in itself allows for alternative interpretation once e-commerce evolves beyond the scope it offers.[661] They further argue that greater certainty is not achieved through extensive legislation, but rather through explanatory guidelines.[662] These guidelines are not subject to the long and complex legislative process and can be amended with greater ease. It should, however, be noted that guidelines do not share the same hierarchical binding nature as legislation, and can at best be applied as soft law.[663] Guidelines are in particular required for combined or bundled services where the combined services are difficult to separate, as was explained in example 4.1 above.[664] The general guidelines currently in place suggest a two-stage test to determine if a supply constitutes an electronically supplied service:[665]

i) The service must be delivered over the Internet or an electronic network. Therefore, the service is reliant on the Internet or similar network for its provision.[666]

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

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

[662] Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 76; also see Value Added Tax Committee, EC, VAT Information Sheet 04/03, *Electronically Supplied Services: A Guide to Interpretation* http://webarchive.nationalarchives.gov.uk/20120128212010/http:/customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_CL_000907 [accessed on 8 October 2012].

[663] Brandt U and Juul M (2005) "EU VAT Rules on Electronically Supplied Services" *Tax Planning International: European Union Focus* vol 7 nr 10 at 13.

[664] Jones R and Basu S (2002) "Taxation of Electronic Commerce: A Developing Problem" *International Review of Law, Computers & Technology* vol 16 no 1 at 37.

[665] Value Added Tax Committee, EC, VAT Information Sheet 04/03, *Electronically Supplied Services: A Guide to Interpretation* http://webarchive.nationalarchives.gov.uk/20120128212010/http:/customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_CL_000907 [accessed on 8 October 2012]; also see Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 76; Ward BT, Sipior JC, Bremser W, McGinty DB (2006) "A Comparison of United States and European Union Taxation of E-commerce" ICEC '06 Proceedings of the 8th International Conference on Electronic Commerce at 347.

[666] Value Added Tax Committee, EC, VAT Information Sheet 04/03, *Electronically Supplied Services: A Guide to Interpretation* http://webarchive.nationalarchives.gov.uk/20120128212010/http:/customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&prope

ii) The nature of the service is dependent on information technology for its supply. The service is essentially automated and involves little human intervention. Without information technology the service would not be viable.[667]

The two-stage test does not provide a clear outcome in all cases. In applying it to example 4.1, it could be argued that the service requires an initial network connection but is not dependent on a constant connection. The two-stage test does not state whether a constant network connection is required. As technology evolves, suppliers, tax authorities, and the courts would find it increasingly difficult to identify the type of supply correctly. In other terms, the current position that allows for various interpretations of what constitutes electronically supplied services, is not excluded by the two-stage test.

4.3.2 Where is the supply made?

Place-of-supply rules are designed to assign a taxing jurisdiction in cross-border trade. The Sixth Directive addresses this through the implementation of a dual place-of-supply regime.[668] The place of taxation in respect of goods is determined by the physical location of the goods, irrespective of where the parties reside.[669] In the case

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rtyType=document&columns=1&id=HMCE_CL_000907 [accessed on 8 October 2012]; also see Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 76; Ward BT, Sipior JC, Bremser W, McGinty DB (2006) "A Comparison of United States and European Union Taxation of E-commerce" ICEC '06 Proceedings of the 8th International Conference on Electronic Commerce at 347; Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 6.

[667] Value Added Tax Committee, EC, VAT Information Sheet 04/03, *Electronically Supplied Services: A Guide to Interpretation* http://webarchive.nationalarchives.gov.uk/20120128212010/http:/customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_CL_000907 [accessed on 8 October 2012]; also see Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 76; Ward BT, Sipior JC, Bremser W, McGinty DB (2006) "A Comparison of United States and European Union Taxation of E-commerce" ICEC '06 Proceedings of the 8th International Conference on Electronic Commerce at 347; Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 6.

[668] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 3 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].

[669] Article 8 of the Sixth Directive 77/388/EEC of 17 May 1977; also see Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 3 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].

of services it is often difficult to determine a physical location, and it often requires fictitious place-of-supply rules (proxies) to determine a tangible location.[670]

In 1996 the European Commission proposed the introduction of a common VAT system based on the origin tax principle.[671] It was believed that the cost of administering taxes in a foreign jurisdiction was between five and six times higher for similar transactions conducted in the supplier's home country.[672] An origin-based taxation model would do away with costly administration, multiple registrations, and burdensome/cumbersome procedures.[673] However, the implementation of an origin-based taxation model requires significant fundamental changes that are not easily realised:

i) given the elasticity and sensitivity of international electronic trade,[674] further standardisation of VAT rates, possibly into a single rate, would be required;[675]
ii) a uniform application which would require the VAT Committee to transform from an advisory body into a regulatory body;[676]
iii) the re-allocation of displaced VAT revenues between Member States to guarantee the same level of current revenue.[677]

Tax neutrality cannot be ensured by an origin-based taxation model. This was evident from the fact that many European telecommunication companies moved to non-European countries with the intention to avoid VAT, both in and outside of the EU, when the origin-based tax model was introduced for telecommunication services in the EU.[678]

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[670] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 3 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012]; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 209; Millar R (2008) "Jurisdictional Reach of VAT" in Krever R (ed) (2008) *VAT in Africa* at 177, 180.
[671] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 346.
[672] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 346.
[673] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 346.
[674] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 14 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012].
[675] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 346.
[676] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 347.
[677] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 347.
[678] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 347; Hinnekens L (2002) "An Updated Overview of the European VAT Rules Concerning Electronic Commerce" *EC Tax Review* vol 11 issue 2 at 67.

As a result, the European Commission endorsed the destination-based tax model in 1998 to ensure that:

- services, whether supplied via e-commerce or otherwise, which are supplied for consumption within the EU, are taxed within the EU, whatever their origin.
- such services, supplied by EU operators for consumption outside the EU, are not subject to VAT in the EU, but VAT on related inputs is eligible for deduction.[679]

These guidelines do not rule out the application of different rules within the EU in accordance with the European Commission's commitment to a common destination based VAT system.[680] The place-of-supply rules in respect of electronically supplied services can best be explained by a chronological discussion of the introduction of proxies by the various Council Directives adopted after the implementation of the general rule under the Sixth Directive.

4.3.2.1 Place of supply under the Sixth Directive

Generally, the place of supply in the case of services is the place where the supplier has established his business, or has a fixed establishment from which the services are supplied.[681] In the absence of a fixed place of business or establishment, the place where the supplier has its permanent address or where it usually resides, will be deemed to be the place of supply.[682] For administrative purposes, the Sixth Directive provides that the place-of-supply rules may differ in accordance with the type of supply.[683] These rules are contained in the exceptions to the general place-of-supply rules as listed in article 9(2). Locating the place of supply where the

[679] European Commission (1998) *E-commerce and Indirect Taxation* at 6 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:1998:0374:FIN:EN:PDF [accessed on 17 January 2013].
[680] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 348.
[681] Article 9(1) of the Sixth Directive 77/388/EEC of 17 May 1977.
[682] Article 9(1) of the Sixth Directive 77/388/EEC of 17 May 1977.
[683] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 3 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].

exceptions are applicable, is complex and difficult to apply.[684] In addition, these rules are not consistently applied by Member States.[685]

The general rule, based on the origin principle, is designed to tax B2C and B2B transactions on a national level.[686] It is further based on the assumption that, due to technical limitations, the supply and consumption of services normally takes place within a single country.[687] In other words, the supplier, recipient and consumption are all located in the same jurisdiction.[688] Where the general rule is primarily designed to tax consumption on a national level, the possible cross-border supply of services is taxed in terms of special supply rules provided for in article 9(2).[689] These special place-of-supply rules can, however, only be applied to services specifically listed as such.[690] If the transaction in question is not provided for in the *lex specialis*, it naturally falls within the scope of article 9(1) - the general rule.[691]

The application of the general provision in article 9(1) to electronic deliveries, has resulted in a number of undesirable consequences. The first of these appeared within the EU. Taxing supplies at the origin, led to the misallocation of VAT revenues among Member States, and further created the potential to distort consumer patterns.[692] As a result of the absence of border control measures in the case of

[684] Williams D (1998) "Value-Added Tax" in Thuronyi V (ed) (1998) *Tax Law Design and Drafting* vol 1 Chapter 6 at 31 fn 85.
[685] Williams D (1998) "Value-Added Tax" in Thuronyi V (ed) (1998) *Tax Law Design and Drafting* vol 1 Chapter 6 at 31 fn 85.
[686] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part III at 3 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012]; Wille P (2000) "Electronic Commerce and VAT burdens" *CESifo Forum* vol 1 issue 3 at 23 http://econpapers.repec.org/article/cesifofor/v_3a1_3ay_3a2000_3ai_3a3_3ap_3a17-23.htm [accessed on 11 October 2012].
[687] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 3 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].
[688] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 3 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].
[689] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part III at 3 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012]; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 213;
[690] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part III at 3 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012]; Millar R (2008) "Jurisdictional Reach of VAT" in Krever R (ed) (2008) *VAT in Africa* at 214.
[691] *Dudda v Finanzamt Bergisch Gladbach* Case C-327/94 (1996) ECR I-04595 at para 21; Van Doesum A, Van Kesteren H, van Norden GJ, Reiners I (2008) "The New Rules on the Place of Supply of Services in European VAT" *EC Tax Review* vol17 issue 2 at 79.
[692] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" 16 *SA Merc LJ* at 578; Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part

electronic deliveries, consumers can choose to buy in jurisdictions with the lowest VAT rate.

The second undesirable outcome of the origin principle, arose in the international arena. In the case of internationally imported electronic deliveries, the general rule provides that the place of supply is deemed to be outside of the EU.[693] Supplies of these products to businesses or consumers within the EU are not taxable under the Sixth Directive.[694] If the country of origin does not have a VAT system, or applies the destination principle, these supplies would remain untaxed. Outbound international supplies of the same services are, however, taxable under article 9(1).[695]

This created the potential for major market distortions where European suppliers, which are subject to EU VAT, compete against foreign suppliers which escape the tax net.[696] It further potentially distorts transaction patterns because European

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II at 5 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012]; Jones R and Basu S (2002) "Taxation of Electronic Commerce: A Developing Problem" *International Review of Law, Computers & Technology* vol 16 no 1 at 46; Harley G (1999) "VAT and the Digital Economy: How Can VAT Evolve to Meet the Challenges of E-commerce" *Tax Planning International E-commerce* vol 1 no 10 at 11; Bouwhuis PA (2002)"E-commerce; Het Einde van de BTW?" *Weekblad Fiscale Recht* vol131 no 6471 at 345; Brandt U and Juul M (2005) "EU VAT Rules on Electronically Supplied Services" *Tax Planning International: European Union Focus* vol 7 no 10 at 13; Lambourne M (2005) "On the Horizon: New EU VAT Place of Supply Rules for Services" *Tax Planning International: European Union Focus* vol 7 no 1 at 13; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 211.

[693] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 578; Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 5 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012]; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 211.

[694] Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic mean COM (2000) 349 Final at 6 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2000:0349:FIN:en:PDF [accessed on 3 October 2012]; Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 578; Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 5 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].

[695] Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic means COM (2000) 349 final at 6 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2000:0349:FIN:en:PDF [accessed on 3 October 2012]; Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 578; Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 5 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].

[696] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 155; Jensen P (2004) "VAT Levied on Digital Sales within EU" *International Tax Journal* vol 30 no 1 at 2; Harley G (1999) "VAT and the Digital Economy: How Can VAT Evolve to Meet the Challenges of E-commerce" *Tax Planning International E-commerce* vol 1 no 10 at 11; Fairpo CA (1999) "VAT in the European Union-Where are we now" *Tax Planning International E-commerce* vol 1 no 9 at 18; Bouwhuis PA (2002)"E-commerce; Het Einde van de BTW?" *Weekblad Fiscale Recht* vol131 no 6471 at 345; Jeanmart FX (2001) "Taxation of Electronic Commerce Part II:VAT" *Tax Planning International:*

suppliers are forced to establish a presence in a foreign jurisdiction to retain competitiveness.[697] For example, a supplier of digital products from the USA would not levy VAT on supplies made to European residents, while a supplier from Europe is required to levy VAT on supplies made to residents of the USA.[698]

In order to avoid double taxation, non-taxation, or the distortion of competition, Member States could consider the place of supply to be the place where the effective use and enjoyment of the services takes place - if that place of consumption is outside the European Community.[699] This provision is similar to the phrase "utilised and consumed within the Republic" in the definition of "imported services" in the South African VAT Act.[700] The difference lies in the application. In terms of the South African VAT Act,[701] exports are zero-rated by default.[702] The phrase "utilised and consumed in the Republic" is used to escape VAT on imported services where the taxpayer is of the view that the services were enjoyed outside of the Republic. In contrast, article 9(3) of the Sixth Directive is applied to exempt exported services from EU VAT in order to place the EU supplier on economic par with its international counterparts.

For example, article 9(3) was incorporated in the *Umsatzsteuergesetz*[703] (the German VAT Act) providing for the exemption of exported goods and services from VAT. Since the general place-of-supply rule in terms of article 9(1), applied to imported services, German suppliers exported digital products to a business partner

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European Union Focus vol 3 no 8 at 6; Brandt U and Juul M (2005) "EU VAT Rules on Electronically Supplied Services" *Tax Planning International: European Union Focus* vol 7 nr 10 at 13; Lejeune I, Korf R, Grünauer A (2003) "New E-commerce Directives: A Move Towards e-Europe?" *Journal of International Taxation* vol 14 no 4 at 20; García AMD and Cuello RO (2011) "Electronic Commerce and Indirect Taxation in Spain" *European Taxation* vol 51 no 4 at 137.

[697] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 5 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].

[698] Basu S (2002) "European VAT on Digital Sales" *The Journal of Information, Law and Technology* vol 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012]; Merrill PR (2001) "The Moving Target of E-commerce" *The CPA Journal* November at 32.

[699] Article 9(3) of the Sixth Directive 77/388/EEC.

[700] Section 1 of the VAT Act 89 of 1991.

[701] Act 89 of 1991.

[702] See zero rating provisions in general in section 11 of the VAT Act 89 of 1991.

[703] *Umsatzsteuergesetz* 1999.

in the USA and then re-imported the products to escape VAT.[704] This was essentially a domestic supply that was electronically routed to the consumer via the USA.

It is interesting to note that, prior to Council Directive 2002/38/EC, the Belgian VAT Act[705] provided that the place of supply in the case of intellectual property by a foreign entrepreneur, was deemed to be the place where the Belgian customer was established.[706] It further provided that the Belgian customer (taxable or non-taxable person) was required to account for VAT under a reverse-charge mechanism.[707] It is not certain whether the Belgian Tax authority treated digital products as the supply of intellectual property rights before the introduction of Council Directive 2002/38/EC.

4.3.2.2 Place of supply under Council Directive 2002/38/EC

Under Council Directive 2002/38/EC, a new *lex specialis* which specifically provides for place-of-supply rules in the case of electronically supplied services in article 9(2)(*f*), was incorporated in the Sixth Directive.

4.3.2.2.1 Differentiation between B2C and B2B transactions created

Where electronically supplied services are supplied to a non-taxable person who is established, has a permanent address, or normally resides in a Member State by a taxable person who is established, has a permanent address, or normally resides outside of the European Community,[708] the place of supply shall be the place in a Member State where the non-taxable person is so established, or has its permanent address, or normally resides.[709] The introduction of article 9(2)(*f*) essentially creates a distinction between the supply of electronically delivered goods by a business to a

[704] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 156.
[705] *De Wetboek van de BTW, Wet van 3 Julie 1969*.
[706] Boomsma A, Ermel A, Somers J, Tirard J (1989) *Ernst & Young VAT in Europe* at 20.
[707] Boomsma A, Ermel A, Somers J, Tirard J (1989) *Ernst & Young VAT in Europe* at 20.
[708] As it was then known.
[709] Article 9(2)(*f*) of the Sixth Directive 77/388/EEC as amended by article 1(*b*) of Council Directive 2002/38/EC.

consumer, and a business to a business.[710] This may prove problematic as suppliers would now be required to determine the vendor registration status of the customer.[711] Nevertheless, both EU and non-EU suppliers would be able to determine the VAT registration status of the customer from the VAT Information Exchange System (VIES) which contains a database of persons with VAT registration numbers.[712] The VIES is an online validation system available to all members of the public at no charge.[713] In order to verify the VAT vendor registration status, the supplier must be in possession of the VAT registration number. Therefore, unless the customer indicates his VAT registration status by producing a VAT registration number, the supplier would be unable to determine if the customer is a private consumer or a business. In addition, where the customer provides a VAT registration number, the supplier cannot, by using the VIES system, verify if the customer is who he says he is.[714] Verifying the customer's identity and VAT registration status, requires costly technology which is not widely accessible and which most suppliers simply cannot afford to implement.[715] Article 18 of Regulation no 282/2011, however, provides that a supplier may assume that the recipient is a

[710] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 580.

[711] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 580; Teltcher S (2000) "Tarriffs, Taxes and Electronic Commerce: Revenue Implications for Developing Countries" *Policy Issues in International Trade and Commodities Study Series No 5* at 11; Boullin L (2003) "B2C Services: Liability for European VAT" *World Internet Law Report* vol 4 issue 7 at 10; Zubeldia GE (2011) "Administrative Burdens on Cross-Border B2B Services under EU VAT" *International VAT Monitor* vol 22 no 4 at 221.

[712] Recital (5) of Council Regulation 792/2002 of 7 May 2002; Ward BT, Sipior JC, Bremser W, McGinty DB (2006) "A Comparison of United States and European Union Taxation of E-commerce" ICEC '06 Proceedings of the 8th International Conference on Electronic Commerce at 347; Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* vol 38 at 78; De la Feria R (2006) *The EU VAT System and the Internal Market* at 116; Bird RM and Gendron PP (2007) *The VAT in Developing and Transitional Countries* at 139.

[713] The VIES system is accessible at http://ec.europa.eu/taxation_customs/vies/; Bird RM and Gendron PP (2007) *The VAT in Developing and Transitional Countries* at 139. A similar system has existed in Singapore for some time.

[714] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 581; Henriques V, Azevedo L, Bonnet J, Carvalho P, Mathan L (2001) "Extending VAT to E-commerce: an Implementation of EU Proposals" *Euroweb 2001* at para 2.4; Zubeldia GE (2011) "Administrative Burdens on Cross-Border B2B Services under EU VAT" *International VAT Monitor* vol 22 no 4 at 221; Lejeune I, Kotanidis S, Van Doninck S (2009) "The New EU Place-of-Supply Rules from a Business Perpective" vol 20 no 2 at 101.

[715] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 581; Henriques V, Azevedo L, Bonnet J, Carvalho P, Mathan L (2001) "Extending VAT to E-commerce: an Implementation of EU Proposals" *Euroweb 2001* at para 2.4; Strunk G and Bös S (2003) "A German Perspective on Europe's E-commerce VAT Directive"*Tax Notes International* vol 29 no 2 at 199.

taxable person (vendor) in the EU, when the supplier has verified the supplied tax registration number, or where the customer has provided any other adequate proof that demonstrates that it has legitimately applied for such registration in the EU.[716] Where the supplier cannot verify the VAT registration number because it has not been correctly supplied, or not supplied at all, and no other reasonable proof exists indicating the VAT registration status of the customer, the supplier may assume that the customer is a non-taxable person.[717] When the customer is established outside of the EU, the supplier may treat the customer as a business entity or VAT vendor if:

a) the customer has issued the supplier with a certificate issued by the tax authority in the country where the customer is established, in terms of which it can be deduced that the customer is entitled to obtain a VAT refund;[718]
b) the customer has provided any number that would identify it as a business for tax purposes, or any other proof evidencing its taxable status.[719]

No criterion for establishing the meaning of "any other proof" is provided, which leads to legal uncertainty.[720] Lejeune and others opine that an EU supplier may, where a non-EU supplier has supplied a VAT number or any other proof, and where the EU supplier has reasonable grounds to believe that the information so supplied is correct and that the customer is acting in good faith, assume that the non-EU customer is a registered VAT vendor in the country of establishment.[721] Real-time verification of information is a prerequisite for effective online digital trade. While the real-time verification of a registration number might be possible, the verification of "any other

[716] Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF [accessed on 15 October 2012].
[717] Article 18(2) of Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF [accessed on 15 October 2012].
[718] Article 18(3)a) of Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF [accessed on 15 October 2012].
[719] Article 18(3)b) of Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF [accessed on 15 October 2012].
[720] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 84; Lejeune I, Cortvriend E, Accorsi D (2011) "Implementing Measures Relating to EU Place-of-Supply Rules: Are Business Issues Solved and is Certainty Provided?" *International VAT Monitor* vol 22 no 3 at 147.
[721] Lejeune I, Cortvriend E, Accorsi D (2011) "Implementing Measures Relating to EU Place-of-Supply Rules: Are Business Issues Solved and is Certainty Provided?" *International VAT Monitor* vol 22 no 3 at 148.

proof" will take longer.[722] Suppliers will accordingly need to make a significant effort to comply with the Regulations.[723] In all likelihood, suppliers would increasingly rely on the customer's good faith.

Ivanson points out that the VIES system requires human intervention as it cannot be accessed electronically.[724] Simply put, the VAT registration number supplied by the customer must physically be typed into the VIES system for verification to be successful. This could seriously hamper e-commerce transactions which are characterised by the fact that execution of transactions is automated. In a survey by PricewaterhouseCoopers, only 78% of UK respondents actually obtain their customer's VAT numbers, and of these, only 50% take the trouble to verify the VAT status with a reasonable degree of accuracy.[725] Furthermore, the VIES system can only be applied in respect of businesses registered in the EU.[726] Determining the VAT status of customers in other jurisdictions, would be more problematic as not all jurisdictions have an electronic database of VAT vendors.[727]

It has been pointed out that the type of supply could be indicative of the customer's VAT status.[728] Where films or photographs are purchased without the rights to the intellectual property therein, it is likely that the purchaser is a non-taxable

[722] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 84.
[723] Lejeune I, Cortvriend E, Accorsi D (2011) "Implementing Measures Relating to EU Place-of-Supply Rules: Are Business Issues Solved and is Certainty Provided?" *International VAT Monitor* vol 22 no 3 at 147.
[724] Ivanson J (2003) "Why the EU VAT and E-commerce Directive Does not Work" *International Tax Review* vol 14 issue 9 at 28; Ivanson J (2003) "Overstepping the Boundary-How the EU got it Wrong on E-commerce" *International Tax Report* October at 8.
[725] Lejeune I, Cortvriend E, Accorsi D (2011) "Implementing Measures Relating to EU Place-of-Supply Rules: Are Business Issues Solved and is Certainty Provided?" *International VAT Monitor* vol 22 no 3 at 147.
[726] Zubeldia GE (2011) "Administrative Burdens on Cross-Border B2B Services under EU VAT" *International VAT Monitor* vol 22 no 4 at 221; Lejeune I, Kotanidis S, Van Doninck S (2009) "The New EU Place-of-Supply Rules from a Business Perpective" vol 20 no 2 at 101.
[727] Zubeldia GE (2011) "Administrative Burdens on Cross-Border B2B Services under EU VAT" *International VAT Monitor* vol 22 no 4 at 221; Lejeune I, Kotanidis S, Van Doninck S (2009) "The New EU Place-of-Supply Rules from a Business Perpective" vol 20 no 2 at 101.
[728] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 59 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].

consumer.[729] Even if the customer is a taxable consumer, it is likely that the products will not be used in the making of taxable supplies.[730]

The place-of-supply proxy in the case of B2C transactions by non-EU suppliers to EU established customers provided for in article 9(2)(*f*), was incorporated in the re-cast version of the EU VAT rules in article 57(1) of Council Directive 2006/112/EC which was in force until 31 December 2006. The application of article 57(1) of Council Directive 2006/112/EC was extended until 31 December 2009 by article 1(2) of Council Directive 2008/8/EC. Article 57(1) of the Council Directive was replaced by an identical place-of-supply proxy in article 58 of Council Directive 2008/8/EC with effect from 1 January 2010.

4.3.2.2.2 B2C transactions: EU supplier (until 31 December 2014)

The *lex specialis* provided for by article 9(2)(*f*) of Council Directive 2002/38/EC (and the later article 59 of Council Directive 2008/8/EC which applies from 1 January 2010 until 31 December 2014), only applies to transactions concluded between a non-EU supplier and a non-taxable person who is established or resides in the EU. In other words, in so far as a taxable supplier, who is established or has a fixed business in a Member State, renders electronically supplied services to a non-taxable person who is established, or has a fixed address, or resides in the EU, the general place-of-supply rule applies.[731] This is the place where the supplier is established or has a

[729] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 59 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].
[730] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 59 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].
[731] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 42 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].

fixed address from where its business is operated.[732] This will lead to market distortions within the EU where consumers can seek digital products from suppliers established in jurisdictions with a low VAT rate. Suppliers can relocate to jurisdictions with a lower VAT rate and in so doing cause a VAT drain in the country of origin.[733] This could be further exacerbated by the relatively low cost of setting up and establishing a virtual platform from which supplies are produced and delivered.

4.3.2.2.3 B2C transactions: EU supplier (from January 2015)

From January 2015, the destination principle will apply to B2C transactions by suppliers who are established or have a fixed business in a Member State. Consequently, the place of supply in the case of electronically supplied services will be the Member State where the customer is established, or has a fixed address, or where he resides.[734] This amendment places a greater burden on EU suppliers to determine the exact location where the customer resides, and levy VAT on the transaction at the rate applicable to that jurisdiction.[735] It is no longer sufficient merely to establish whether the customer resides in or outside of the EU. This is especially problematic in cases where a customer has his permanent registered address in one country, but resides in another.[736] No official and verifiable elements

[732] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 42 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].
[733] In't Veld TFG (2007) "E-commerce en het Gebrek aan Fiscal Aanknopingspunten" *Weekblad Fiscale Recht* vol 136 no 6719 at 513; Bouwhuis PA (2002)"E-commerce; Het Einde van de BTW?" *Weekblad Fiscale Recht* vol 131 no 6471 at 345.
[734] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 43 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].
[735] Lamensch M (2012) ""Proposal for Implementing the EU One-Stop-Shop Scheme from 2015" *International VAT Monitor* vol 23 no 5 at 315; Minor R (2012) "The European Comission's VAT Regulation project for supplies of electronic services" *Tax Notes International* vol 67 no 3 at 242.
[736] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 84; Lamensch M (2012) ""Proposal for Implementing the EU One-Stop-Shop Scheme from 2015" *International VAT Monitor* vol 23 no 5 at 315.

of identification exist in respect of these customers.[737] However, the number of customers with a registered address in one country who reside in another country would presumably be limited.

4.3.2.2.4 B2C transactions: Non-EU suppliers

The place-of-supply proxy in terms of article 9(2)(*f*) of Council Directive 2002/38/EC upholds the consumption principle in terms of which electronically supplied services are taxed at the place where they are deemed to be consumed by the consumer.[738] In contrast to the vague meaning of "utilised and consumed in the Republic" as found in the definition of "imported services" in the South African VAT Act,[739] the place of consumption in terms of article 9(2)(*f*), is deemed to be the place where the consumer is established, or has a permanent address, or normally resides within the EU. The actual place of consumption is negated by the deeming provision. The deeming provision essentially eliminates problems associated with determining the actual place of consumption - as is the case with customers who are travelling (see example 3.5 above). In terms of this provision, it is unnecessary to find physical evidence of where the service was physically rendered and where the benefit of the service was applied in order to determine the place where it was utilised or consumed. Irrespective of where the EU resident finds himself when the service is delivered to him electronically, the service will be taxable in the Member State where he normally resides.[740]

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[737] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 84; Minor R (2012) "The European Comission's VAT Regulation project for supplies of electronic services" *Tax Notes International* vol 67 no 3 at 242.

[738] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 580; Ward BT, Sipior JC, Bremser W, McGinty DB (2006) "A Comparison of United States and European Union Taxation of E-commerce" ICEC '06 Proceedings of the 8th International Conference on Electronic Commerce at 347; Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 74.

[739] Section 1 of the VAT Act 89 of 1991.

[740] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 581; Henriques V, Azevedo L, Bonnet J, Carvalho P, Mathan L (2001) "Extending VAT to E-commerce: an Implementation of EU Proposals" *Euroweb 2001* at para 2.4; Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 10.

The new place-of-supply rules have fundamentally changed the Sixth Directive in respect of B2C transactions in two respects:

i) Supplies of electronically delivered services by EU registered vendors to consumers who are established, or have a fixed address or reside outside of the European Community, will no longer be subject to EU VAT.[741]

ii) Supplies of electronically delivered services by a supplier who is not established in the EU, to consumers who are established, or have a fixed address, or reside in a Member State are subject to VAT in the EU. This means a non-EU vendor is required to charge VAT on sales to private consumers in the EU, just as EU registered vendors must charge VAT on domestic supplies.[742]

These fundamental changes have eliminated the unfair competition that existed between EU registered and non-EU registered vendors. EU vendors no longer compete with untaxed supplies in the domestic market, and international supplies by EU vendors can enter the market free of EU VAT. This does not necessarily place EU suppliers at an unfair advantage in the international arena. This will depend on the domestic rules of the country to which the electronically delivered goods are exported or in which they are consumed. Where the domestic rules of the country of consumption do not provide for the taxation of the supply, or the supply is not properly taxed as a result of an ineffective reverse-charge mechanism, the supply from an EU supplier will be advantaged over supplies made by domestic suppliers which are subject to local taxes.

Article 1(*c*) of Council Directive 2002/38/EC further amended article 9(3) of the Sixth Directive (discussed in paragraph 4.3.2.1 above) to exclude the application of article 9(3) from electronically supplied services to non-taxable persons. Therefore, Member States cannot consider the place of actual consumption or enjoyment of electronically supplied services as the place of supply when these services are

[741] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 580.
[742] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 580; Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 10.

rendered to non-taxable persons.[743] This position was incorporated in article 59a of Council Directive 2008/8/EC which applies until 31 December 2014. It should, however, be noted that the use-and-enjoyment provision will continue to apply to telecommunication systems in terms of article 9(3). The amended article 59a of Council Directive 2008/8/EC which will apply from 1 January 2015, provides that, in order to prevent double taxation, no taxation and the distortion of competition, Member States may:

(a) consider the place of supply of any or all of those services, if situated within their territory, as being situated outside of the Community if the effective use and enjoyment of the services takes place outside of the Community;

(b) consider the place of supply of any or all of those services, if situated outside of the Community, as being situated within their territory, if the effective use and enjoyment of the services takes place within their territory.

This provision is similar to the use-and-enjoyment provision under the South African VAT Act.[744]

Van der Merwe points out that the place-of-supply proxies reflect the true nature of events more accurately than was previously the case.[745] It can be assumed that non-business consumers are likely to use and enjoy the services predominantly in the country in which they reside rather than elsewhere. Cases where the use and enjoyment of the services takes place exclusively in a jurisdiction outside of the consumer's normal place of residence, should be seen as the exception rather than the rule, and could, for VAT purposes, be negated. This would happen, for example, where an EU resident downloads a temporary map of Kuala Lumpur on a device while he travels through Malaysia. It should, however, be noted that the amendment of article 59a of Council Directive 2008/8/EC that will take effect from 1 January 2015, provides, in principle, that services could be taxed in the jurisdiction where they are actually utilised and enjoyed. In other words, where the EU resident

[743] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 581.
[744] Definition of 'imported services' in section 1 of the VAT Act 89 of 1991.
[745] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 581.

downloads a map while he travels through Malaysia, the transaction could, if article 59a is applied, be taxed in Malaysia (GST) where the map is used and enjoyed, irrespective of the fact that he has a fixed address in the EU. Similarly, where a South African resident downloads a map of Moscow while he is in transit in Europe, the transaction can be taxed in Russia where the map will be utilised and consumed. Although international experience shows that the place of real consumption of services is not an effective criterion for taxing services, the EU legislator increasingly relies on this criterion instead of adopting a more comprehensive and clear list of place-of-supply rules.[746] It is not certain to what extent Member States will implement the effective use-and-enjoyment provision, if at all. No definition of the expression "effective use and enjoyment" can be found in the Sixth Directive.[747] The exact meaning of the phrase is open to interpretation. While the actual place-of-consumption rules give effect to the fundamental VAT principle of taxing the supplies at the place of consumption, the desirability of its application in the case of digital products is questionable. This is evident from the interpretation of the phrase "utilised and consumed in the Republic" in the South African case law discussed in paragraph 3.4.2.4.1 above. Determining the actual place of consumption often relies on the interpretation of the taxpayer. In addition, the actual place of consumption can, at best, be determined after consumption has commenced and not during the transactional phase of the supply.[748] In the absence of a personal after-sale relationship with the customer (for example telecommunication services),[749] this would require some sort of tracking facility to enable the supplier to track the actual usage of the supplies. This could require a long, drawn out analysis that would most likely result in inaccuracies.[750] Given the nature of online services and the lack of guidelines in the EU VAT Directive, it would be impossible for suppliers to determine

[746] Ecker T (2012) "Place of effective use and enjoyment of services-EU History repeats itself" *International VAT Monitor* vol 23 no 6 at 407; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 215.
[747] Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 417; Anthony R (2000) "European VAT on E-commerce Services: Tax & VAT Planning of 'Place of Supply' Criteria" *Tax Planning International E-commerce* vol 2 no 5 at 20; De la Feria R (2006) *The EU VAT System and the Internal Market* at 107.
[748] Ecker T (2012) "Place of effective use and enjoyment of services-EU History repeats itself" *International VAT Monitor* vol 23 no 6 at 409.
[749] Hobbs C and Christie K (2011) "Cloud Computing and VAT" *Tax Notes International* vol 62 no 11 at 899.
[750] Jenkins P (1999) "VAT and Electronic Commerce: The Challenges and Opportunities" *International VAT Monitor* vol 10 no 1 at 4; De la Feria R (2006) *The EU VAT System and the Internal Market* at 107.

the actual place of consumption.[751] In addition, the interpretation of "effective use and enjoyment" differs in the different Member States.[752] As I stated earlier, the actual place of consumption and the place of residence are likely to coincide, and any difference should be treated as an exception under exceptional circumstances. In any event, the provision is rarely applied except to telecommunication services for which the rule was initially designed.[753] The general place-of-consumption rules governing electronically supplied services, that deem the customer's place of residence as the place of consumption, should prevail. To ensure that suppliers can properly comply with VAT rules, VAT legislation should predominantly rely on predetermined presumptions and proxies.[754] The use of these proxies is also the preferred approach of the OECD.[755] As the effective use-and-enjoyment rules have been laid down as optional provisions (from 1 January 2015), and given the difficulty with which they can be applied in practice, it is unlikely that Member States will implement them.[756] Member States are more likely to opt for a coordinated implementation of the general place-of-supply provisions rather than creating tax competition between Member States by implementing the use-and-enjoyment provision.[757] In addition, the main purpose behind the use-and-enjoyment provision,

[751] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 85; Lamensch M (2012) ""Proposal for Implementing the EU One-Stop-Shop Scheme from 2015" *International VAT Monitor* vol 23 no 5 at 315; Ecker T (2012) "Place of effective use and enjoyment of services-EU History repeats itself" *International VAT Monitor* vol 23 no 6 at 409.

[752] Anthony R (2000) "European VAT on E-commerce Services: Tax & VAT Planning of 'Place of Supply' Criteria" *Tax Planning International E-commerce* vol 2 no 5 at 20; De la Feria R (2006) *The EU VAT System and the Internal Market* at 107; Ecker T (2012) "Place of effective use and enjoyment of services-EU History repeats itself" *International VAT Monitor* vol 23 no 6 at 409.

[753] Anthony R (2000) "European VAT on E-commerce Services: Tax & VAT Planning of 'Place of Supply' Criteria" *Tax Planning International E-commerce* vol 2 no 5 at 20; Harley G (1999) "VAT and the Digital Economy: How Can VAT Evolve to Meet the Challenges of E-commerce" *Tax Planning International E-commerce* vol 1 no 10 at 11; Hinnekens L (2002) "An Updated Overview of the European VAT Rules Concerning Electronic Commerce" *EC Tax Review* vol 11 issue 2 at 68; Lambourne M (2005) "On the Horizon: New EU VAT Place of Supply Rules for Services" *Tax Planning International: European Union Focus* vol 7 no 1 at 14; Wille P (2009) "New EU Place-of-Supply rules for services" *International VAT Monitor* vol 20 no 1 at 15.

[754] Ecker T (2012) "Place of effective use and enjoyment of services-EU History repeats itself" *International VAT Monitor* vol 23 no 6 at 409; Millar R (2008) "Jurisdictional Reach of VAT" in Krever R (ed) (2008) *VAT in Africa* at 177, 180, 182-184.

[755] See paragraphs 5.3.2.1 and 5.3.2.2 below.

[756] Van Doesum A, Van Kesteren H, van Norden GJ, Reiners I (2008) "The New Rules on the Place of Supply of Services in European VAT" *EC Tax Review* vol 17 issue 2 at 86; Wille P (2009) "New EU Place-of-Supply rules for services" *International VAT Monitor* vol 20 no 1 at 15.

[757] Van Doesum A, Van Kesteren H, van Norden GJ, Reiners I (2008) "The New Rules on the Place of Supply of Services in European VAT" *EC Tax Review* vol 17 issue 2 at 86.

is to eliminate double taxation or unintended non-taxation under the general place-of-supply rules. Therefore, Member States can only apply the use-and-enjoyment criteria if it can be established that the general place-of-supply rules lead to double taxation or unintended non-taxation.[758]

The place-of-supply rules are founded on the premise that the supplier is able to determine the place where the consumer is established, or has a fixed address, or resides. In the case of tangible goods, the address of delivery is fairly indicative of the place of consumption.[759] In the absence of guidelines, determining the place of supply/consumption for digital deliveries is cumbersome.[760] The supplier could rely on the information supplied by the customer, but then runs the risk of incurring penalties or recourse being taken against it, for under or over taxing a customer as a result of false information obtained.[761] Most suppliers are not equipped to verify the customer's self-declared information and should, as a matter of principle, not be burdened with the obligation of verifying this information.[762] In the absence of physical contact between the parties, and given the speed and anonymity at which e-commerce is traded, the customer status and location would be difficult to determine.[763] Potential customers are likely to abandon the transaction where the supplier requests personal information, as this is often perceived as an invasion of

[758] Van Doesum A, Van Kesteren H, van Norden GJ, and Reiners I (2008) "The New Rules on the Place of Supply of Services in European VAT" *EC Tax Review* vol 17 issue 2 at 87.
[759] Fridensköld E (2004) "VAT and the Internet: The Application of Consumption Taxes to E-commerce Transactions" *Information & Communications Technology Law* vol 13 no 2 at 185; Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 11 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].
[760] Minor R (2012) "The European Comission's VAT Regulation project for supplies of electronic services" *Tax Notes International* vol 67 no 3 at 242.
[761] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 81; Hardesty D (2002) "European VAT on Digital Sales" *Tax Planning International E-commerce* vol 4 no 3 at 4; Ivanson J (2003) "Overstepping the Boundary-How the EU got it Wrong on E-commerce" *International Tax Report* October 2003 at 9; Lamensch M (2012) ""Proposal for Implementing the EU One-Stop-Shop Scheme from 2015" *International VAT Monitor* vol 23 no 5 at 315.
[762] Lamensch M (2011) "New Implementing Regulation 282/2011 for the 2006 VAT Directive" *EC Tax Review* vol 20 issue 4 at 171.
[763] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 81.

privacy.[764] Bleuel and Stewen suggest that two methods of identifying the customer exist: tracing the delivery path of the supply, or tracing the path of payment.[765]

Tracing the path of supply relies on the IP address of the computer or device to which the digital products will be delivered. It is trite that every computer is assigned an unambiguous address consisting of either 4 digits, or a corresponding sequence of signs.[766] Tracing the path of delivery using the sequence method, is indicative of the place where the customer finds himself when making the purchase.[767] This place could be very different from the customer's place of residence. For example, where the customer resides in Germany, but purchases digital products from his work computer in Switzerland, the places of purchase and consumption differ. Article 24 of Regulations 282/2011, provides that, as from January 2013, priority should be given to the place that best ensures taxation at the actual place of consumption. This puts an even greater burden on suppliers not only to determine the place of supply, but also to distinguish this from the actual place of consumption. Lamensch opines that the Regulations, just like the 1998 OECD guidelines on which they are modelled, are unconvincing.[768] Unless the digital products emit signals to the supplier every time they are accessed/used/enjoyed the supplier will have no control over where or when the customer consumes the supplies.

Furthermore, where the destination computer is connected to an international service provider, such as Compuserve or AOL, the IP address attached to the computer could be shared on a limited network.[769] As the system can assign the same number to different computers at different times, it would not be possible correctly to identify

[764] Fridensköld E (2004) "VAT and the Internet: The Application of Consumption Taxes to E-commerce Transactions" *Information & Communications Technology Law* vol 13 no 2 at 185; Baron R (2002) "VAT on Electronic Services: The European Solution" *Tax Planning International E-commerce* vol 4 no 6 at 4; Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 5.
[765] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 158.
[766] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 158.
[767] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 158.
[768] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 81.
[769] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 158.

the location of the computer.[770] Digital products are also often delivered at one IP address (remote server in a low-tax jurisdiction) from where they are later further downloaded anywhere in the world.[771] It should further be noted that where a resident of Belgium uses a portable device, such as an iphone, across the border in Luxembourg, a different IP address is assigned to the device. The Belgian resident can therefore download a large volume of digital media while he is in Luxembourg and pay VAT at 15 per cent on the downloads, as opposed to the 21 per cent Belgian VAT that should apply as he resides in Belgium.[772] Baron notes that suppliers acting in good faith, should be allowed to assume that the location as determined at the time of purchase is a good enough proxy for the place of residence.[773]

While complex technology can in some cases be applied to trace the origin (however uncertain) of the computer used to make the purchases, it should be noted that it is not widely available and often expensive to acquire and apply. In addition, software exists that can obscure the transaction/delivery path, or even hack the IP address of another computer and display it as the purchaser's computer address. Lamensch points out that it would be unfair to require suppliers to obtain this expensive software to collect taxes on behalf of the *fiscus,* especially where the supplier receives no incentive for tax collection.[774]

Measures to protect internet users from identity theft and banking fraud, make identifying the purchaser by tracing the payment path even more cumbersome than

[770] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 158.
[771] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 11 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].
[772] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 44 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].
[773] Baron R (2002) "VAT on Electronic Services: The European Solution" *Tax Planning International E-commerce* vol 4 no 6 at 4; Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 7.
[774] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 87.

doing so by tracing the delivery path.[775] Credit cards contain an international country code in the card number that can easily identify the country where the card was issued.[776] This information can be verified against information supplied in the customer's self-declaration.[777] That said, credit card payments are increasingly completed under a secure electronic transaction protocol which hides the purchaser's identity and credit card number from the supplier.[778] Other payment methods such as Paypal or Digicash, are completely anonymous and there is no way that the supplier can identify the customer's country of residence.[779] Furthermore, a resident of the EU can be in possession of a credit card that was issued in the USA and use it as payment, and by so doing escape EU VAT where the credit card is used to identify him as a resident of the USA. Suppliers would therefore find it increasingly difficult to rely on payment information as a location tool.

It is not certain what criteria the European Commission will propose to determine the customer's location, but it has been suggested that a combination of criteria should be applied - especially in cases where different results from different criteria can be obtained.[780] It is also not certain to what extent the supplier must go to verify the purchaser's place of residence. Is it required to apply software that can track and trace the supply with absolute accuracy? Article 23 of Regulations 282/2011 merely provides that:

> ...the supplier shall establish that place based on factual information provided by the customer, and verify that information by normal commercial security measures such as those relating to identity or payment checks.

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[775] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 158.

[776] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 158.

[777] Hobbs C and Christie K (2011) "Cloud Computing and VAT" *Tax Notes International* vol 62 no 11 at 899.

[778] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 158; Fridensköld E (2004) "VAT and the Internet: The Application of Consumption Taxes to E-commerce Transactions" *Information & Communications Technology Law* vol 13 no 2 at 186.

[779] Fairpo CA (1999) "VAT in the European Union-Where are we now" *Tax Planning International E-commerce* vol 1 no 9 at 19; Lamensch M (2012) ""Proposal for Implementing the EU One-Stop-Shop Scheme from 2015" *International VAT Monitor* vol 23 no 5 at 315; Lamensch M (2011) "New Implementing Regulation 282/2011 for the 2006 VAT Directive" *EC Tax Review* vol 20 issue 4 at 171.

[780] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 44 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].

In the UK, a supplier should be able to show that it has applied a combination of location tools, including customer provided information, cross-checking of payment and delivery information for discrepancies, and geo-location software.[781]

The Council Directives do not provide a safe harbour to help vendors determine the residence of individual customers.[782] The vendor would not be protected in the case of discrepancies where inaccurate information is *bona fide* obtained.[783] Penalties can be imposed on suppliers for failing to establish the correct location of the customer and the subsequent failure to apply the appropriate VAT rate.[784] The European Commission is, however, engaged on a project to address the issue before the implementation of the 2015 amendments.[785] Lamensch opines that the 2015 provisions are not implementable at all.[786] This is because no official and verifiable elements of identification are available regarding private consumers.[787] Ultimately it is a question of good faith. Where the supplier has verified that the customer has provided a consistent set of information with a valid credit card, billing address, and IP address, all indicating the same address as residence, it can be said that the supplier has acquitted itself of its duty to determine the customer's location.[788]

4.3.2.2.5 B2B transactions: EU and non-EU suppliers

[781] HM Customs and Excise (2003) "Electronically supplied services: Evidence of Customer Location and Status" *Tax Planning International E-commerce* vol 5 no 5 at 14.
[782] Fitzgerald S (2002) "US Companies' Sales to EU Consumers Subject to VAT on Digital Downloads" *The Tax Adviser* June at 382.
[783] Fitzgerald S (2002) "US Companies' Sales to EU Consumers Subject to VAT on Digital Downloads" *The Tax Adviser* June at 382.
[784] Ivanson J (2003) "Why the EU VAT and E-commerce Directive Does not Work" *International Tax Review* vol 14 issue 9 at 28; Ivanson J (2003) "Overstepping the Boundary-How the EU got it Wrong on E-commerce" *International Tax Report* October at 9.
[785] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 43 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].
[786] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 84.
[787] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol4 issue 1 at 84; Lamensch M (2011) "New Implementing Regulation 282/2011 for the 2006 VAT Directive" *EC Tax Review* vol 20 issue 4 at 171.
[788] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 61 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].

As VAT systems are designed to tax supplies at the level of consumption, EU businesses that acquire goods or services from other EU businesses are entitled to a deduction on the VAT paid on the supplies.[789] VAT is again levied when the EU business renders supplies to consumers.[790] Where the EU business acquires digital products from a non-EU business for the purpose of making national supplies, no VAT is paid to the seller, but the buyer should impose VAT in terms of the rules of its own country in accordance with the reverse-charge mechanism.[791] Put simply, the place of supply is where the purchaser vendor is established, or has its fixed address. The position is well explained by the Dutch tax authorities where they clearly distinguish between supplies from EU and non-EU vendors.[792]

In the case of digital supplies by an EU vendor to another EU vendor, the EU supplier (German) will levy VAT at zero percent on the supplies made to the purchaser (Dutch). The Dutch purchaser will account for VAT in The Netherlands on the value of the supply. It will simultaneously be entitled to show a deduction in its VAT return for the VAT paid on the imported supplies, provided that the supplies are used in the making of taxable supplies in the Netherlands.[793]

Similarly, where digital services are imported from a non-EU vendor, the VAT is diverted to the EU purchaser (Dutch) who must account for output VAT on the

[789] Henriques V, Azevedo L, Bonnet J, Carvalho P, Mathan L (2001) "Extending VAT to E-commerce: an Implementation of EU Proposals" *Euroweb 2001* at para 2.4; Terra BJM and Kajus J (1992) *Introduction to Value Added Tax in the EC after 1992* at 14-15.

[790] Henriques V, Azevedo L, Bonnet J, Carvalho P, Mathan L (2001) "Extending VAT to E-commerce: an Implementation of EU Proposals" *Euroweb 2001* at para 2.4; Terra BJM and Kajus J (1992) *Introduction to Value Added Tax in the EC after 1992* at 14-15.

[791] Henriques V, Azevedo L, Bonnet J, Carvalho P, Mathan L (2001) "Extending VAT to E-commerce: an Implementation of EU Proposals" *Euroweb 2001* at para 2.4; Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 10; Butler B (2010) "Place of supply of services: New VAT rules applying in the European Union" *International Tax Journal* September-October at 14; Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* vol 38 at 78.

[792] De Nedelandse Belastingdienst http://www.belastingdienst.nl/wps/wcm/connect/bldcontentnl/belastingdienst/zakelijk/btw/zakendoen_met_het_buitenland/goederen_en_diensten_afnemen_uit_andere_eu_landen/goederen_en_diensten_afnemen_uit_andere_eu_landen [accessed on 11 October 2012]; Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 29 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].

[793] De Nedelandse Belastingdienst http://www.belastingdienst.nl/wps/wcm/connect/bldcontentnl/belastingdienst/zakelijk/btw/zakendoen_met_het_buitenland/goederen_en_diensten_afnemen_uit_andere_eu_landen/goederen_en_diensten_afnemen_uit_andere_eu_landen [accessed on 11 October 2012].

supplies but may simultaneously claim an input VAT deduction in so far as the supplies will be used in the making of taxable supplies.[794]

These provisions are similar to the South African position in so far as the VAT treatment of imported services by VAT vendors is concerned. The South African and EU (in particular, the Dutch) provisions only differ in respect of the reporting of the transactions. The South African system does not provide for the taxing of the imports (in the form of output VAT) and simultaneous input VAT deductions. Both systems rely on the interpretation by the taxpayer of the principle of "applied to make taxable supplies". As the South African system does not require output VAT to be paid on imports that are applied in the course and furtherance of an enterprise, many taxpayer vendors do not report digital imports on their VAT returns. These transactions go undetected, and SARS has limited scope to verify whether the services were acquired in the making of taxable supplies. The Dutch system, on the other hand, provides greater transparency for the *Belastingdienst* to audit transactions and verify whether the services were acquired in the making of taxable supplies. The administrative burden on taxpayers to account for VAT and claim an input VAT deduction on imports is no different from the administrative burden of reporting domestic transactions.

It should, however, be noted that from 1 January 2010, where the head office of the customer is established in the same Member State as that of the supplier, the reverse-charge mechanism shall not apply, irrespective of whether the head office has intervened in the transaction or not.[795] Since the terms "fixed establishments" and "intervention" are not clearly defined, different interpretations of the location of the supply can arise.[796] This could lead to the double or under taxation of transactions.

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[794] De Nedelandse Belastingdienst http://www.belastingdienst.nl/wps/wcm/connect/bldcontentnl/belastingdienst/zakelijk/btw/zakendoen_met_het_buitenland/goederen_en_diensten_afnemen_uit_andere_eu_landen/goederen_en_diensten_afnemen_uit_andere_eu_landen [accessed on 11 October 2012].

[795] Article 54 of Council Implementing Regulation (EU) no 282/2011 of 15 March 2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF [accessed on 10 October 2012].

[796] Merkx M (2012) "Fixed Establishments and VAT Liabilities Under EU VAT-Between Illusion and Reality" *International VAT Monitor* vol 23 no 1 at 25 http://www.empcom.gov.in/WriteReadData/UserFiles/file/No_1%20A-3%20European%20Union%20-

The amended article 44 of Council Directive 2006/112/EC which applies from 1 January 2010, provides that where services are supplied to the fixed establishment of a taxable person at a place other than the place where the taxable person has established its business, the place of supply shall be the place where the fixed establishment is located. Where this fixed establishment or place of established business cannot be located, the place where the taxable person has its permanent address or where it resides shall be the effective place of supply.[797]

The concept of "fixed establishment" is not defined in the Directive.[798] Before the publication of Implementing Regulation no 282/2011 of 15 March 2011, the meaning of "fixed establishment" as interpreted by the European Court of Justice (ECJ) was followed. In *Gunter Berkholz v Finanzamt Hamburg-Mitte-Altstadt*,[799] the ECJ ruled that:

> ...the establishment must be of a certain minimum size and both human and technical resources necessary for the provision of the services are permanently present.[800]

The primary point of reference is where the supplier has established his business because this is essentially the place from where the supplier conducts its business as headquarter.[801] Where this leads to conflicts between Member States or irrational results for tax purposes, the fixed establishment from where the services are supplied should be taken into account.[802] In applying this criterion, the court came to the

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%20Fixed%20Establishments%20and%20VAT%20Liabilities%20under%20EU%20VAT%20%E2%80%93%20Between%20Delusion%20and%20Reality%20Jan%20Feb%20page%2022-26.pdf [accessed on 22 October 2012].

[797] Article 44 of Council Directive 2006/112/EC as amended by Council Directive 2008/8/EC.

[798] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 75. Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 408; Terra BJM and Kajus J (2012) *A Guide to the European VAT Directives* vol 1 at 655-656.

[799] *Gunter Berkholz v Finanzamt Hamburg-Mitte-Altstadt* Case C-168/84 (1985) ECR I-02251.

[800] *Gunter Berkholz v Finanzamt Hamburg-Mitte-Altstadt* Case C-168/84 (1985) ECR I-02251 at para 18. This definition was also applied in *Faaborg Gelting Linien A/S v Finazamt Flensburg* Case 231/94 (1996) ECR I-2395 at para 17 and in *ARO Lease BV v Inspecteur van de Belastingdienst Groete Ondernemingen to Amsterdam* Case C-190/95 (1997) ECR I-4383 at para 15.

[801] *Gunter Berkholz v Finanzamt Hamburg-Mitte-Altstadt* Case C-168/84 (1985) ECR I-02251 at para 17; Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 75; Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 410.

[802] *Gunter Berkholz v Finanzamt Hamburg-Mitte-Altstadt* Case C-168/84 (1985) ECR I-02251 at para 17; Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 76; Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 410.

conclusion that gaming machines on board a ferry do not constitute a fixed establishment and the transaction should be taxed at the location where the supplying company has established its business.[803] Applying these principles laid down by the ECJ will exclude many modern day e-commerce suppliers from having a fixed establishment. So, for example, where a supplier operates its business by means of a server, the server itself cannot constitute a fixed establishment partly because of the lack of human involvement and possibly partly because of its size.[804] In these cases the amended article 44 should be applied to tax the supplies where the taxable entity has its fixed address or where it resides. That said, the place of business is not necessarily the registered offices, especially in cases where no significant business is carried on at the registered offices.[805] However, in *ARO Lease BV v Inspecteur van de Belastingdienst Groete Ondernemingen to Amsterdam*,[806] the ECJ concluded that the leasing of motor vehicles in Belgium by a company established in the Netherlands, did not amount to the supply of services from an establishment in Belgium. Despite the fact that the activities were carried on at an establishment other than the place of fixed establishment, the ECJ ruled that the place of consumption in the case of transport services, which can easily cross borders, is difficult to determine.[807] As a result, the place of fixed establishment should be deemed the place of supply.

In contrast, in *Commissioner of Customs and Excise v DFDS A/S*,[808] the ECJ ruled that the independent nature and the contractual obligations imposed by the parent company on the subsidiary, warrants the conclusion that the place where the economic activity is executed satisfies the requirements of a fixed establishment.[809] In this case, a fully independent subsidiary of a Danish tour operator parent company

[803] *Gunter Berkholz v Finanzamt Hamburg-Mitte-Altstadt* Case C-168/84 (1985) ECR I-02251 at para 18; Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 76.
[804] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 77.
[805] Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 408.
[806] *ARO Lease BV v Inspecteur van de Belastingdienst Groete Ondernemingen to Amsterdam* Case C-190/95 (1997) ECR I-4383 at para 27.
[807] *ARO Lease BV v Inspecteur van de Belastingdienst Groete Ondernemingen to Amsterdam* Case C-190/95 (1997) ECR I-4383 at para 18.
[808] *Commissioner of Customs and Excise v DFDS A/S* Case (1997) C-260/95 ECR I-01005.
[809] *Commissioner of Customs and Excise v DFDS A/S* Case C-260/95 (1997) ECR I-01005 at paras 26-29.

supplied tour packages in the UK. The ECJ ruled that the UK based subsidiary presented the requisite minimum level of human intervention and technical resources required to satisfy the features of a fixed establishment.[810]

The case law offers little guidance on the application or non-application of the fixed establishment rule.[811] It is clear from the judgments that the courts are reluctant to give effect to secondary fixed establishments.[812] Doernberg and others opine that a party can argue that the "main place of business"-test in the *Aro* case is appropriate in the interest of simplification, uniformity, and clarity.[813] On the other hand, the "fixed establishment"-test in the *DFDS* case, is more appropriate as the "place of business"-test lead to competitive disadvantages and does not accurately reflect the economic situation.[814] The concept of "fixed establishment" has not yet been reviewed in the context of e-commerce, and the outcome remains speculative. In the light of the *Berkholz* case, it is likely that a supplier of automated services can manipulate its business structures to avoid taxation in the country of supply and secure taxation in low-tax jurisdictions where it has established its headquarters. In this regard Farmer and Lyal have adopted the more effective view:

> It is submitted that, in a genuine case in which the supplier or customer has several business establishments all capable of performing services, the most appropriate method of determining the place of supply for the purposes of article 9(1) or 9(2)(e) would be to identify the establishment of the supplier whose resources were primarily used for supplying the services or the establishments of the customer which made primary use of the service.[815]

Merkx, however, points out that it is no easy task to determine where the recipient is established in the case of cross-border B2B transactions.[816] This can be

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[810] *Commissioner of Customs and Excise v DFDS A/S* Case C-260/95 (1997) ECR I-01005 at para 27.
[811] Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 415.
[812] Terra B and Kajus J (2012) *A Guide to the European VAT Directives* vol 1 at 659.
[813] Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 413.
[814] Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 413.
[815] Farmer P and Lyal R (1994) *EC Tax Law* at 160.
[816] Merkx M (2012) "Fixed Establishments and VAT Liabilities Under EU VAT-Between Illusion and Reality" *International VAT Monitor* vol 23 no 1 at 22 http://www.empcom.gov.in/WriteReadData/UserFiles/file/No_1%20A-3%20European%20Union%20-

exacerbated by the fact that "fixed establishment" may be interpreted differently in Member States.[817] In terms of article 11(3) of Council Implementing Regulation (EU) no 282/2011, a VAT identification number is in itself not sufficient to determine if the customer has a fixed establishment.[818] The term "fixed establishment" is defined as:

> ..any establishment, other than the place of establishment of a business... characterised by a sufficient degree of permanence and a suitable structure in terms of human and technical resources to enable it to receive and use the services supplied to it for its own needs.[819]

Merkx correctly points out that this definition lacks clarity as it does not demand that the physical presence of the customer is required to take part in economic activity.[820] Lamensch questions whether suppliers providing electronic services such as the supply of information from a database, have "a sufficient degree of permanence and a suitable structure in terms of human and technical resources to receive and use the service."[821] Furthermore, it does not state what degree of permanency is required to satisfy the requirement of "established".[822] In essence, the definition put forward by the Regulation, is a mere extension of the principles laid down in the *Berkholz* case.[823] The supplier, recipient, and the respective tax authorities could, in

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%20Fixed%20Establishments%20and%20VAT%20Liabilities%20under%20EU%20VAT%20%E2%80%93%20Between%20Delusion%20and%20Reality%20Jan%20Feb%20page%2022-26.pdf [accessed on 22 October 2012].

[817] Lejeune I, Cortvriend E, Accorsi D (2011) "Implementing Measures Relating to EU Place-of-Supply Rules: Are Business Issues Solved and is Certainty Provided?" *International VAT Monitor* vol 22 no 3 at 147.

[818] Council Implementing Regulation (EU) no 282/2011 of 15 March 2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF [accessed on 10 October 2012].

[819] Article 11(1) of Council Implementing Regulation (EU) no 282/2011 of 15 March 2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF [accessed on 10 October 2012].

[820] Merkx M (2012) "Fixed Establishments and VAT Liabilities Under EU VAT-Between Illusion and Reality" *International VAT Monitor* vol 23 no 1 at 22 http://www.empcom.gov.in/WriteReadData/UserFiles/file/No_1%20A-3%20European%20Union%20-%20Fixed%20Establishments%20and%20VAT%20Liabilities%20under%20EU%20VAT%20%E2%80%93%20Between%20Delusion%20and%20Reality%20Jan%20Feb%20page%2022-26.pdf [accessed on 22 October 2012].

[821] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 84.

[822] Merkx M (2012) "Fixed Establishments and VAT Liabilities Under EU VAT-Between Illusion and Reality" *International VAT Monitor* vol 23 no 1 at 22 http://www.empcom.gov.in/WriteReadData/UserFiles/file/No_1%20A-3%20European%20Union%20-%20Fixed%20Establishments%20and%20VAT%20Liabilities%20under%20EU%20VAT%20%E2%80%93%20Between%20Delusion%20and%20Reality%20Jan%20Feb%20page%2022-26.pdf [accessed on 22 October 2012].

[823] Minor R (2011) "New EU VAT Regulation: A Look at 'Place of Establishment' Regarding B2C Services" *Tax Notes International* vol 62 no 3 at 210.

principle, have different interpretations of what "established" means.[824] In addition, the rules are not clear where the company is established in one Member State and has branches in various other Member States. If purchases are centrally completed by head office, and then distributed to the individual branches, can it be said that the supply was made to head office or to the individual branches? The Council Implementing Regulations (EU) no 282/2011 sets out criteria for determining the customer and its location. These include: i) determining if the customer pays for the services; ii) the nature and the use of the service; and iii) verifying the VAT number of the customer.[825] Where these criteria have been applied and the place of supply cannot be established with certainty, the supplier can legitimately assume that the supply was made where the business (head office) is established.[826] As a result of the international phenomenon of centralising payments, the direction of the payment flows can, strictly speaking, not be applied to locate the customer.[827] Merkx points out that suppliers are undoubtedly aware of the nature and the use of their supplies, but the knowledge can hardly be applied to determine the actual place of supply unless it was physically rendered at the customer's business premises.[828] While these regulations are already burdensome on suppliers of conventional offline services, they may be virtually impossible to implement in the digital context.[829] Furthermore, the recipient can manipulate the information to indicate a certain branch or office as the location of the supplies to account for VAT in a low VAT-rate

[824] Merkx M (2012) "Fixed Establishments and VAT Liabilities Under EU VAT-Between Illusion and Reality" *International VAT Monitor* vol 23 no 1 at 22 http://www.empcom.gov.in/WriteReadData/UserFiles/file/No_1%20A-3%20European%20Union%20-%20Fixed%20Establishments%20and%20VAT%20Liabilities%20under%20EU%20VAT%20%E2%80%93%20Between%20Delusion%20and%20Reality%20Jan%20Feb%20page%2022-26.pdf [accessed on 22 October 2012].

[825] Article 22(1) of Council Implementing Regulation (EU) no 282/2011 of 15 March 2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF [accessed on 10 October 2012].

[826] Article 22(1) of Council Implementing Regulation (EU) no 282/2011 of 15 March 2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF [accessed on 10 October 2012].

[827] Lamensch M (2011) "New Implementing Regulation 282/2011 for the 2006 VAT Directive" *EC Tax Review* vol 20 issue 4 at 170.

[828] Merkx M (2012) "Fixed Establishments and VAT Liabilities Under EU VAT-Between Illusion and Reality" *International VAT Monitor* vol 23 no 1 at 23 http://www.empcom.gov.in/WriteReadData/UserFiles/file/No_1%20A-3%20European%20Union%20-%20Fixed%20Establishments%20and%20VAT%20Liabilities%20under%20EU%20VAT%20%E2%80%93%20Between%20Delusion%20and%20Reality%20Jan%20Feb%20page%2022-26.pdf [accessed on 22 October 2012].

[829] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 83; Lejeune I, Cortvriend E, Accorsi D (2011) "Implementing Measures Relating to EU Place-of-Supply Rules: Are Business Issues Solved and is Certainty Provided?" *International VAT Monitor* vol 22 no 3 at 149.

jurisdiction where it is established.[830] Taxing B2B cross-border transactions at destination, relies chiefly on the supplier's good faith in collecting tax and remitting it to the tax authorities.[831]

4.3.3 When is the supply made?

In terms of the Sixth Directive, VAT becomes chargeable when the tax authority becomes entitled to claim tax from the person liable to pay, notwithstanding that the time of payment may be deferred.[832] The chargeable event occurs when the goods are delivered or when the services have begun.[833] Where payment was received before the goods are delivered or the services performed, the chargeable event occurs when such payment is made.[834] Member States were allowed to derogate from the general rule under certain circumstances or in the case of certain transactions. This was achieved by deeming the date of issuing of an invoice or document serving as an invoice, to be the time of the supply.[835]

In the case of electronically ordered but physically delivered goods from a supplier outside of the Community, the time of supply is when the goods enter the European Community.[836] Where the goods so imported are subject to custom or similar duties, the chargeable event (time of supply) is the time when the chargeable event for such customs or similar duties occurs. In other words, VAT shall be levied at the same

[830] Merkx M (2012) "Fixed Establishments and VAT Liabilities Under EU VAT-Between Illusion and Reality" *International VAT Monitor* vol 23 no 1 at 23 http://www.empcom.gov.in/WriteReadData/UserFiles/file/No_1%20A-3%20European%20Union%20-%20Fixed%20Establishments%20and%20VAT%20Liabilities%20under%20EU%20VAT%20%E2%80%93%20Between%20Delusion%20and%20Reality%20Jan%20Feb%20page%2022-26.pdf [accessed on 22 October 2012].
[831] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 83.
[832] Article 10(1) of the Sixth Directive 77/388/EEC; also see re-casted version in article 62 of the Council Directive 2006/112/EC.
[833] Article 10(2) of the Sixth Directive 77/388/EEC; also see re-casted version in article 63 of the Council Directive 2006/112/EC
[834] Article 10(2) of the Sixth Directive 77/388/EEC; also see re-casted version in article 65 of the Council Directive 2006/112/EC.
[835] Article 10(2) of the Sixth Directive 77/388/EEC; also see re-casted version in article 66 of the Council Directive 2006/112/EC.
[836] Article 30 of the Council Directive 2006/112/EC.

time as customs or similar duties, i.e. when the goods enter a customs area for clearing and taxing. This is similar to the South African position.

Neither the Sixth Council Directive nor Council Directive 2002/112/EC provides rules for the treatment of prepaid vouchers or vouchers entitling the holder to a discount or goods or services at no charge. As a result, Member States have adopted their own rules which are described by the European Commission as being "inevitably uncoordinated".[837]

In the case of prepaid phone cards, there is no clarity on the time of supply. Should VAT be paid when the prepaid phone card is purchased or when the actual service has begun? It should be noted that in Europe, as is increasingly the case in the rest of the world, the credit on a prepaid phone card can be applied to purchase various other goods and services and is not restricted to the use of telecommunication services. In contrast to the South African VAT system, different VAT rates apply in the case of different supplies of goods or services in European Member States. To further complicate matters, different VAT rates apply in different Member States. The absence of harmonised rules has further forced Member States to develop their own rules on the treatment of vouchers, all unsynchronised.[838] The complexity of the issue can best be described by way of example -

> **Example 4.2:** X who is resident in the Netherlands, purchases a prepaid phone card voucher in the Netherlands. He uses some of the credit on the phone card on 1 December 2012 in Germany to inform his family of his safe arrival. From Germany, X travels to Luxembourg where he uses some of the credit on the phone card to inform his family of his safe arrival and to download various applications, games, and useful software for his phone. On his return to the Netherlands, the credit remaining on the phone card is used to make donations to charitable organisations by sending text messages to a short service number.

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[837] Cowly R (2012) "European Commission Review of VAT on Vouchers" *Irish Tax Review* vol 25 no 3 at 97.

[838] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers at 2* http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Van Vught YM and Edie M (2007) "That's the Card to Play to Treat Prepaid Telephone Cards" *International VAT Monitor* vol 18 no 3 at 166.

Should the value of the phone card be taxed when X purchased the card in the Netherlands or should the individual type of services acquired by the credit on the phone card, be taxed in the jurisdiction and at the time and rate applicable in the jurisdiction when the credit was exchanged for the specific services?

Similarly, where a consumer purchases vouchers in one country and redeems them in another country, the question arising is whether the voucher should be charged with VAT when it was issued or when it was redeemed?[839] Some Member States tax the most common vouchers on issue, whilst others tax them at redemption.[840] These mismatches between Member States could lead to double taxation or the failure to tax at all.[841] In example 4.2 above, X could be taxed in the Netherlands on issue of the phone card and taxed again on the redemption of the credit on the phone card in Germany, Luxembourg, and the Netherlands.

To address these issues, the European Commission has prepared a draft proposal amending the harmonised VAT rules to provide for time-of-supply rules in respect of vouchers.[842] The proposal draws a distinction between payment methods on the one hand, and single and multiple purpose vouchers on the other.

4.3.3.1 Payment methods

[839] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 44 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].

[840] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 44 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].

[841] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 44 http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].

[842] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

Innovation in payment methods has blurred the distinction between vouchers in the strict sense, and instruments akin to vouchers which are used to make payments. It is proposed that the instruments that are currently used to make payments at different unrelated outlets, and which are currently not treated as vouchers, should retain their current status.[843] So, for example, where a shopping mall voucher is issued entitling the user to spend the amount of credit on the voucher card at any of the shops in the mall, the voucher is treated as a payment instrument similar to a bank card. For VAT purposes, the intrinsic nature of the voucher should be determined in order to classify it as either a voucher or a mere payment instrument.[844] A stored value card or prepaid credit card, entitles the holder to goods and services upon the payment of such goods or services by means of the stored value card or prepaid credit card, thus rendering it a mere payment method.[845] In contrast, the redemption of a voucher is not a substitutive payment, but the exercise of a right to goods and/or services.[846]

Modern technology, in particular in the cellular phone industry, has made the distinction between vouchers and payment methods increasingly difficult to establish. Traditionally, prepaid airtime vouchers are treated as vouchers because the voucher entitles the holder to a right to claim airtime against the value of the voucher.[847] Currently, the holder of the voucher can use the airtime to purchase music, software,

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[843] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 4 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[844] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 6 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[845] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 6 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[846] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 6 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Van der Corput W (2010) "*Astra Zeneca- The VAT Treatment of Vouchers*" *International VAT Monitor* vol 21 no 5 at 368.

[847] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 7 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].; Van der Corput W (2010) "*Astra Zeneca- The VAT Treatment of Vouchers*" *International VAT Monitor* vol 21 no 5 at 368.

make money transfers, pay for parking, or purchase goods from a vending machine.[848] Where the voucher facilitates both the right to goods and services and is also a payment instrument, it becomes difficult to classify it as a voucher.[849] It is suggested that where an instrument carries the characteristics of a voucher but is predominantly designed as a payment system, it should not be treated as a voucher.[850]

4.3.3.2 Single-purpose vouchers (SPV)

A single-purpose voucher is a voucher that carries a right to receive the supply of goods or services where the supplier's identity, place of supply, and the applicable VAT rate for the supply of goods or services is known at the time of issue of the voucher.[851] In the case of an SPV, the issuing of the voucher and the supply of the goods and services, are regarded as a single transaction.[852] Simply put, the transaction is not taxed when the voucher is issued *and* when the voucher is

[848] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 6-7 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Van der Corput W (2010) "*Astra Zeneca- The VAT Treatment of Vouchers*" *International VAT Monitor* vol 21 no 5 at 368.

[849] European Commission (2012*) Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 7 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[850] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 7 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Van der Corput W (2010) "*Astra Zeneca- The VAT Treatment of Vouchers*" *International VAT Monitor* vol 21 no 5 at 368-369.

[851] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 20 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Rodrigues A and Lambourne M (2012) "Towards Clarification of the EU VAT Treatment of Vouchers" *International VAT Monitor* vol 23 no 4 at 239; Cowly R (2012) "European Commission Review of VAT on Vouchers" *Irish Tax Review* vol 25 no 3 at 98.

[852] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 20 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Shaw S (2012) "VAT on Face Value Vouchers- The Lebara-case" *Tax Planning International European Tax Service* vol 14 no 6 at 4 http://ibfd.ent.sirsidynix.net.uk/custom/web/SD_PDF/scans/2012/T/TPETS/6_22-25.zip [accessed on 23 January 2013].

exchanged for goods or services. The proposed amendment to article 65 of Council Directive 2006/112/EC, provides that the SPV shall be taxed when it is issued and paid for.[853] This means that when the voucher is exchanged for goods or services, the supply of the goods and services is not taxed as tax has already been levied when the voucher was issued. The proposal is consistent with the decision in *Lebara Ltd v The Commissioners for Her Majesty's Revenue and Customs*[854] where the ECJ ruled that in case of an SPV, the operator of telecommunications services does not carry out a second supply of services for consideration when the purchaser of the voucher exchanges it for telecommunication services.[855] This is a departure from the current treatment of SPVs in many Member States.[856]

Since SPVs are taxed upfront, any subsequent distribution thereof will not create any tax issues. Where the voucher and the subsequent goods and services are not supplied within the same organisation (for example a prepaid telecommunication voucher), the proposal could lead to double taxation: The voucher is taxed by the issuer and the supply is taxed by the supplier.[857] Should the voucher be treated as a payment method, only the subsequent goods or services will be taxed when the voucher is exchanged.[858] Revenue losses could, however, result where the voucher is never redeemed or is lost.[859] However, in these cases no goods or services were supplied and the result would be similar to when cash is lost or not exchanged for goods and services. The current proposal does not provide for an adjustment when

[853] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 20 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Rodrigues A and Lambourne M (2012) "Towards Clarification of the EU VAT Treatment of Vouchers" *International VAT Monitor* vol 23 no 4 at 238.
[854] *Lebara Ltd v The Commissioners for Her Majesty's Revenue and Customs* Case C520/10 (2012) (unpublished).
[855] *Lebara Ltd v The Commissioners for Her Majesty's Revenue and Customs* Case C520/10 (2012) (unpublished); Rodrigues A and Lambourne M (2012) "Towards Clarification of the EU VAT Treatment of Vouchers" *International VAT Monitor* vol 23 no 4 at 238.
[856] Cowly R (2012) "European Commission Review of VAT on Vouchers" *Irish Tax Review* vol 25 no 3 at 98.
[857] Van Vught YM and Edie M (2007) "That's the Card to Play to Treat Prepaid Telephone Cards" *International VAT Monitor* vol 18 no 3 at 170.
[858] Van der Corput W (2010) "*Astra Zeneca- The VAT Treatment of Vouchers*" *International VAT Monitor* vol 21 no 5 at 369.
[859] Van der Corput W (2010) "*Astra Zeneca- The VAT Treatment of Vouchers*" *International VAT Monitor* vol 21 no 5 at 368.

the voucher is lost or not redeemed.[860] Clearly, when the voucher is not redeemed, an adjustment should be allowed as the consideration received was not in respect of goods or services supplied.[861] Suppliers could rely on *Société thermale d'Eugénie-Les-Bains v Ministére de l'Économie, des Finances et de l'Industrie*[862] where the ECJ ruled that the forfeiture of a deposit for future services does not constitute consideration for goods or services for which VAT must be levied.[863]

4.3.3.3 Multi-purpose vouchers (MPV)

The proposed amendment to the Draft Council Directive defines a multi-purpose voucher as "any voucher, other than a discount or rebate voucher, which does not constitute a single-purpose voucher".[864] The holder of an MPV is entitled to a right to the supply of goods and services but, in contrast to an SPV, the supplier, place of supply, and applicable VAT rate cannot be identified upfront when the voucher is issued.[865] An example is a hotel chain that issues breakfast vouchers to patrons which can be redeemed at any of the hotels or restaurants within the chain.[866] A

[860] Rodrigues A and Lambourne M (2012) "Towards Clarification of the EU VAT Treatment of Vouchers" *International VAT Monitor* vol 23 no 4 at 240; Cowly R (2012) "European Commission Review of VAT on Vouchers" *Irish Tax Review* vol 25 no 3 at 99.

[861] Rodrigues A and Lambourne M (2012) "Towards Clarification of the EU VAT Treatment of Vouchers" *International VAT Monitor* vol 23 no 4 at 240; Cowly R (2012) "European Commission Review of VAT on Vouchers" *Irish Tax Review* vol 25 no 3 at 99.

[862] *Société thermale d'Eugénie-Les-Bains v Ministére de l'Économie, des Finances et de l'Industrie* Case C-277/05 (2007) ECR I-6415.

[863] *Société thermale d'Eugénie-Les-Bains v Ministére de l'Économie, des Finances et de l'Industrie* Case C-277/05 (2007) ECR I-6415 at para 36.

[864] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 20 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Cowly R (2012) "European Commission Review of VAT on Vouchers" *Irish Tax Review* vol 25 no 3 at 98.

[865] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 6 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[866] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 6 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

further example is where an airtime prepaid voucher is issued that can be redeemed for telecommunication services or for public transport.[867]

VAT will not be charged when the MPV is issued or during the supply chain when the voucher changes hands.[868] VAT is levied only when the voucher is redeemed or partially redeemed.[869] In other words, the goods and services supplied in redemption of the voucher, are taxed at the right place and at the correct rate when the goods or services are supplied. Any profit or margin during the distribution chain of the MPV will be subject to VAT each time a distribution service is supplied, i.e. each time the MPV changes hands.[870] The advantages of treating vouchers as money, are that retailers can account for VAT in accordance with the tax regime that applies to the supplies, and no adjustments are required if the vouchers are lost or used for goods or services that are subject to a different VAT rate than that envisaged when the voucher was issued.[871]

The proposal does not require that a physical voucher be issued to the customer. In other words, a voucher can be issued as a physical document or card, a text message, or a mere acknowledgement that the customer's account has been credited with a certain amount.

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[867] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 6 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[868] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 13 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Shaw S (2012) "VAT on Face Value Vouchers- The Lebara-case" *Tax Planning International European Tax Service* vol 14 no 6 at 4 http://ibfd.ent.sirsidynix.net.uk/custom/web/SD_PDF/scans/2012/T/TPETS/6_22-25.zip [accessed on 23 January 2013].

[869] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 13 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Van Vught YM and Edie M (2007) "That's the Card to Play to Treat Prepaid Telephone Cards" *International VAT Monitor* vol 18 no 3 at 168-169.

[870] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 13 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[871] Van der Corput W (2010) "*Astra Zeneca- The VAT Treatment of Vouchers*" *International VAT Monitor* vol 21 no 5 at 368.

In the case of B2C transactions, the non-EU supplier (and from January 2015 the EU supplier) must levy VAT on the digital supplies at the rate applicable in the country where the customer resides. This should be contrasted with the South African position where the onus is on the recipient (customer) to levy VAT on the transaction in terms of the reverse-charge mechanism. In the case of pre-paid automated transactions (for example, software updates) the customer is often unaware of the time when the supplies were made, especially where invoices are seldom issued. Compliance in terms of the reverse-charge mechanism becomes unduly complicated where the customer cannot determine the time of supply, or where the customer is often unaware that a supply has been rendered. Who better to know when the supplies were rendered than the supplier himself?

In the case of post-pay automated transaction, the general time-of-supply rules apply in that the supplier must levy VAT when the services are rendered. Here, too, the supplier is in the best position to determine when services are rendered.

From a compliance perspective, the general time-of-supply rules, and the draft amendments in respect of vouchers, are fairly simple to apply, provided that a reverse-charge mechanism is not enforced on consumers in the case of B2C transactions. That said, the proposals in their current form still do not resolve all the problems and contain too many loose ends.[872]

4.3.4 What is the value of the supply

The general rule in the case of the supply of goods and services provides that the taxable amount is everything that constitutes consideration obtained, or to be obtained, by the supplier in return for the supply to the customer or any third party, and shall include any subsidy directly linked to the price of the supply.[873] There are no special rules pertaining to imported services or electronically supplied services.

[872] Rodrigues A and Lambourne M (2012) "Towards Clarification of the EU VAT Treatment of Vouchers" *International VAT Monitor* vol 23 no 4 at 241; Cowly R (2012) "European Commission Review of VAT on Vouchers" *Irish Tax Review* vol 25 no 3 at 99.
[873] Article 73 of Council Directive 2006/112/EC.

The taxable amount shall include taxes, duties, levies and any other charges but excluding the VAT itself.[874] It is not certain whether the exclusion of VAT in article 78 refers to the VAT to be levied for VAT purposes in the applicable Member State, or if it also refers to VAT that might have been levied at the country of origin in the case of imported services where the origin principle applied. It is trite that, in order to avoid double taxation, the value to be used to calculate VAT is the value of the goods or services stripped from any VAT previously paid on the supply. To avoid unintended double taxation, therefore, VAT exclusion in article 78 should be interpreted to refer to any VAT that was previously levied, including the VAT still to be levied, on the supplies. However, where, during the supply chain the supplies were themselves exempt, VAT stripping will not occur. In these cases, VAT is likely to be shifted forward in higher prices.

Also included in the price, where such costs are incidental to the supply, is any commission, packing, transport or insurance charged by the supplier to the customer.[875] Where these costs are not intrinsic to the cost of the services acquired, they shall be treated as a separate transaction that will be subject to VAT in its own right.

4.3.4.1 Imported goods

The value in respect of electronically ordered but physically delivered goods shall be the value for customs purposes determined in accordance with the Community provisions in force.[876] Included in the value of the imported goods are any taxes, levies or charges due outside of the Member State, levies due as a result of importation, but excluding the VAT to be levied.[877] The exclusion of "VAT to be levied" potentially creates the opportunity for double taxation. It is clear that the

[874] Article 78(a) of Council Directive 2006/112/EC.
[875] Article 78(b) of Council Directive 2006/112/EC.
[876] Article 85 of Council Directive 2006/112/EC.
[877] Article 86(1)(a) of Council Directive 2006/112/EC.

phrase is intended to exclude from the value on which VAT will be levied, the VAT that is being calculated and levied on the value for present purposes. In other words, any VAT that was previously paid on the value of the goods in the country of origin where that country follows the origin principle, is included in the current value on which EU VAT is to be levied, thus allowing for VAT to be charged twice. Goods imported from countries applying the origin principle, or where exports are not exempted from VAT, are at a disadvantage to products imported from countries that are subject to EU VAT only. In the light of the fact that cross-border trade is becoming more accessible as a result of e-commerce, the potential double taxation regime could cause market distortions.

In addition, incidental expenses such as commission, packing, transport and insurance costs up to the first place of destination in a Member State, and such costs resulting from transportation to any other destination within the EU where that destination is known at the time when VAT is to be levied, shall be included in the value of the goods.[878] Where these costs are not incidental to the supply, in other words where the services are supplied separately, they shall be treated as separate supplies and shall be subject to VAT in their own right.

4.3.4.2 Vouchers

At present neither the Sixth Directive nor Council Directive 2006/112/EC provides for rules determining the value for VAT purposes where vouchers are used. For example, where a telecommunication voucher was issued to a customer for consideration of Euros 80, but the intrinsic value of the voucher is Euros 100, which value should be used to determine VAT? Similarly, where the credit on the voucher can be exchanged for different goods and services, should the value of the voucher be taxed, or should the value of the goods and services that were acquired be

[878] Article 86(1)(b) of Council Directive 2006/112/EC.

taxed? In this case it is necessary to discuss the proposals on the VAT treatment of vouchers in the Draft Council Directive 2006/112/EC.[879]

In the case of an SPV, VAT is levied on the amount paid for the voucher at the time of issue irrespective of the intrinsic value of the voucher.[880] Where the voucher is further distributed against a fee or commission, the value of the fee or commission is subject to VAT.[881]

In the case of an MPV, the type of supply and applicable VAT rate cannot be determined upfront when the voucher is issued. The value of the goods and services acquired in exchange for the voucher are used to calculate VAT.[882] This can, however, create a problem when the MPV reaches the customer through a distribution chain. Each time that the voucher changes hands, a taxable service occurs. The distribution can be spread over several Member States, and calculating the value of the added service in the absence of an intrinsic value for the voucher (the value of which is determined on redemption) is extremely cumbersome. For this reason, the European Commission proposes that a nominal value be established when the voucher is issued.[883] The value of the goods and services acquired when the voucher is redeemed, is then limited to the nominal value attached to the

[879] European Commission (2012) *Draft proposal a Council Directive amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of vouchers* http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[880] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 20 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[881] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 20 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[882] European Commission (2012) *Draft proposal a Council Directive amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of vouchers* at 5 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[883] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 5 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Cowly R (2012) "European Commission Review of VAT on Vouchers" *Irish Tax Review* vol 25 no 3 at 98.

voucher when it was first issued.[884] Simply put, the nominal value represents the taxable value irrespective of the value of the goods and services supplied in exchange for the voucher. The value of the margin/commission or service fee added to the voucher, is taxable in its own right when the voucher exchanges hands.[885]

4.3.4.3 Discount vouchers

Discount vouchers, other than vouchers acquired against payment, entitle the holder to goods and services at a discounted price. At present, Council Directive 2006/112/EC provides that the value of any price reduction, discount, or rebate should be deducted from the value before VAT is levied.[886] Consequently, VAT should be levied on an amount that reflects the actual consideration received.[887] Where one person both issues and redeems the voucher, the calculation for VAT purposes is fairly uncomplicated. For example, where X grants Y Euro 5 discount on a Euro 100 garment, X only accounts for VAT on Euro 95. In practice, however, discount vouchers are often issued by the manufacturer or wholesaler and redeemed by the customer at a retailer. In addition, the vouchers are often redeemed in Member States other than the Member State of issue.

In *Elida Gibbs Ltd v Commissioner of Customs and Excise,*[888] the court ruled that where a customer presents a voucher that was issued by a person other than the seller, entitling him to a rebate or a discount on submitting proof of purchase of specific items, the value of the goods for VAT purposes shall be the value paid for

[884] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 20 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].
[885] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 5 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Cowly R (2012) "European Commission Review of VAT on Vouchers" *Irish Tax Review* vol 25 no 3 at 98.
[886] Article 79 of Council Directive 2006/112/EC in the case of the supply of goods and services, and article 87 in the case of imported goods.
[887] Bijl J (2012) "VAT: 'Money Off Vouchers' and 'Cash Back Schemes'-What are the Problems and How Can they be Solved?" *EC Tax Review* vol 21 issue 5 at 263.
[888] *Elida Gibbs Ltd v Commissioner of Customs and Excise* Case C-317/94 (1996) ECR I-05339.

the goods less as much as represents the discount. This principle was confirmed in *Commission of the European Communities v The Federal Republic of Germany*[889] where the court ruled that the value used to calculate VAT cannot be more than the consideration paid by the customer. This position is, however, inconsistent with the harmonised VAT laws.[890] The European Commission is of the view that the ECJ interpretation results in cumbersome administration and that it is difficult to follow.[891] It is further of the view that the ECJ's interpretation offers no easy solution, especially where the voucher is issued in one Member State and redeemed in another.[892] What happens where the issuer is not the source of the refund? The European Commission proposes that the voucher should not be seen as third party payment, but should be treated as part of the consideration.[893] Rather than reducing the consideration by the value of the voucher, the manufacturer or issuer thereof deducts the input VAT thereon on redemption of the voucher.[894] In other words, the purchase price is still reduced by the value of the discount voucher and VAT is paid on that value only, but instead of issuing an invoice for the full amount reflecting the payment by voucher and cash, the invoice is only issued for the reduced amount.[895]

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[889] *Commission of the European Communities v The Federal Republic of Germany* Case C - 427/98 (2002) ECR I-08315.

[890] Bijl J (2012) "VAT: 'Money Off Vouchers' and 'Cash Back Schemes'-What are the Problems and How Can they be Solved?" *EC Tax Review* vol 21 issue 5 at 266.

[891] Bijl J (2012) "VAT: 'Money Off Vouchers' and 'Cash Back Schemes'-What are the Problems and How Can they be Solved?" *EC Tax Review* vol 21 issue 5 at 270.

[892] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 9 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[893] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 9 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

[894] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 9 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012]; Bijl J (2012) "VAT: 'Money Off Vouchers' and 'Cash Back Schemes'-What are the Problems and How Can they be Solved?" *EC Tax Review* vol 21 issue 5 at 266, 269.

[895] European Commission (2012) *Draft proposal a Council Directive Amending Directive 2006/112/EC on the Common System of Value Added Tax, as Regards the Treatment of Vouchers* at 9 http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2012)206_en.pdf [accessed on 16 October 2012].

4.3.4.4 No consideration paid

In principle, VAT cannot be paid on a value greater than the consideration paid by the customer.[896] Where no consideration is paid, or where the consideration is lower than the open market value, the open market value of the supplies may be used to calculate VAT to prevent tax evasion or avoidance in respect of the supply of goods and services involving family or other close personal ties, management, ownership, membership, or financial or legal ties.[897] In contrast to the provisions in the South African VAT Act,[898] the Council Directive provides for a wider range of connected persons. Where, for example, X receives every third software update free as a result of his membership of a loyalty scheme, the discount so offered could be classified as an agreement between connected persons (members of a loyalty scheme). In this case, however, where no intention exists to avoid or evade taxation, the value of the free digital supplies should be regarded as nil for VAT purposes. It should further be noted that Member States are allowed to limit the scope of the meaning of connected persons for purposes of article 80.[899] Basu points out that, generally, where no consideration is paid, VAT is not levied.[900] As a result, no tax can be collected on free downloads, free information, or free access to the Internet.[901]

A common problem that is further exacerbated by technological advances, is the illegal sharing of files on the Internet. Various cases have hinged on the question of the taxation of illegal transactions for VAT purposes. Generally, the ECJ has applied the principle of tax neutrality to tax illegal supplies[902] except in those cases where

[896] *Commission of the European Communities v The Federal Republic of Germany* Case C - 427/98 (2002) ECR I-08315*; Staatssecretaris van Financiën v Association coopèrative "Coöperative Aardappelenbewaarplaats GA* Case C154/80 (1981) ECR I-00445.
[897] Article 80(1) of Council Directive 2006/112/EC.
[898] Act 89 of 1991.
[899] Article 80(2) of Council Directive 2006/112/EC.
[900] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].
[901] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].
[902] *Town and County Factors Ltd v Commissioners of Customs and Excise* Case C-498/99 (2002) ECR I-07173; *Karlheinz Fischer v Finanzamt Donaueschingen* Case C-283/95 (1998) ECR I-03369; *R v Goodwin & Unstead* Case C-3/97 (1998) ECR I-3257; *Staatssecretaris van Financiën v Coffeeshop "Siberië" vof* Case C-158/98 (1999) ECR I-03971.

the intrinsic nature of the illegal goods was so detrimental[903] that national laws provided for an outright ban of the goods.[904] Generally, digital supplies infringing rights of a third party, such as a copyright holder, would be an unlawful supply falling within the scope of VAT.[905] However, in these cases the illegal transactions in question involved the supply of goods and services for consideration. In the case of illegal file sharing, consideration is not paid. In limited cases users of the service pay a nominal membership fee, but the actual file downloads are available free of charge. In *Staatssecretaris Financiën v Hong Kong Trade Development Council,*[906] the ECJ ruled that a person who makes supplies of goods and services at no charge, is not a taxable person.[907] Accordingly, VAT cannot be charged on a transaction where no consideration is paid. In *RJ Tolsma v Inspecteur der Omzetbelasting Leeuwarden,*[908] the ECJ ruled that the uniform basis of taxation, provided for in article 2(1) of the Sixth Directive, does not include the consistent playing of music on the highway for which no remuneration is stipulated, even if the musician uses this means to solicit money.[909] Therefore, the illegality of the file sharing does not prohibit the "VAT-ability" thereof. However, the fact that no consideration is paid for the supply excludes it from the application of VAT. Rendahl opines that the absence of a direct link and legal relationship between the supplied services and the consideration received (or absence of consideration) excludes illegal file sharing from the VAT sphere.[910] Where the recipient is a member of a group of file sharers to which he pays a nominal membership fee, the membership fee could be subject to VAT. It could further be argued that, as a result of the membership status, the open market value of the supplies should be subject to VAT under the "connected persons" provision in article 80. Determining the open market value of illegal downloads can be problematic. It is arguable whether a reasonable purchaser is willing to pay for illegal downloads in an open market. Generally, the open market

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[903] *Vereniging Happy Family Rustenburgerstraat v Inspecteur der Omzetbelasting* Case C-289/86 (1988) ECR I-03655.

[904] Van Zyl SP (2011) "The Value Added Tax Implications of Illegal Transactions" *PELJ* vol 14 no 4 at 340 http://www.nwu.ac.za/webfm_send/4734 [accessed on 5 September 2012].

[905] Rendahl P (2011) "Imposing EU VAT on Unlawful Digital Supplies" *EC Tax Review* vol 20 issue 4 at 198.

[906] *Staatssecretaris Financiën v Hong Kong Trade Development Council* Case C-89/81 (1982) ECR I-1277.

[907] *Staatssecretaris Financiën v Hong Kong Trade Development Council* Case C-89/81 (1982) ECR I-1277 at para 13.

[908] *RJ Tolsma v Inspecteur der Omzetbelasting Leeuwarden* Case C-16/93 (1994) ECR I-0743.

[909] *RJ Tolsma v Inspecteur der Omzetbelasting Leeuwarden* Case C-16/93 (1994) ECR I-0743 at para 20.

[910] Rendahl P (2011) "Imposing EU VAT on Unlawful Digital Supplies" *EC Tax Review* vol 20 issue 4 at 202.

value of illegal downloads is zero. Caution should be applied not to tax the intrinsic value of the intellectual property of the supplies as a punitive measure where national laws fail adequately to penalise and prohibit the illegal behaviour.

4.3.4.5 Currency issues

At present different currency conversion rules apply in some Member States. This can become an obstacle for cross-border traders who must account for VAT in the currency of the country where the customer is located.[911] This can best be illustrated by way of example:

> **Example 4.3:** A foreign supplier (X) opted to register as an EU vendor in the Netherlands and accounts for VAT in the Netherlands in Euros. X supplies digital products to various customers across the European Union including Denmark, Sweden, and the Czech Republic. When rendering the supplies, X must charge VAT at the applicable rate and in the currency of the Member State where the customer is established. At the time of writing, the currencies of Denmark (Danish Krone), Sweden (Swedish Kronor), and the Czech Republic (Czechs Koruna) differed. X has to levy VAT on the value and in the currency of the country where the customer is established, but accounts for VAT on the value and in Euros in the Netherlands where it has opted to be established. Since the currency conversion rules between these countries differ, it would be impossible for X to account accurately for VAT on his total sales.

The Director-General for internal policies has suggested that, while a need for currency conversion still exists, harmonised currency conversion rules should be established.[912] In this regard it should be noted that article 366(2) of Council

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[911] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 45. http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].

[912] Directorate-General for Internal Policies (2012) *Simplifying and Modernising in the Digital Single Market* at 45.

Directive 2006/112/EC provides that the exchange rate published by the European Central Bank on the last day of the tax period shall apply. However, using this conversion method would result in different figures appearing in the tax return and the actual supplies. How the EU plans to resolve the currency conversion issues remains uncertain.

4.3.5 Is the supply made by a taxable entity?

While it is trite that the consumer (or the act of consumption) bears the ultimate burden of VAT, it is not always the final consumer that accounts for VAT to revenue authorities. The general rule defines "taxable person" as -

> ...any person who, independently, carries out in any place any economic activity, whatever the purpose or result of that activity.[913]

This definition is particularly wide and identifying the taxable person who has to account for VAT to revenue authorities cannot be accurately done. The verification of the taxable status of a person or entity is of utmost importance in cross-border trade to determine who is accountable for VAT. Council Directive 2006/112/EC does not provide clear rules by which to identify the taxable person. Identifying the taxable entity relies of the place-of-supply rules that were developed for the different types of transaction within the framework of electronically supplied services.

4.3.5.1 B2B transactions between EU vendors

In the case of intra-community transactions between VAT vendors, VAT is levied in terms of the reverse-charge self-assessment mechanism[914] on the recipient vendor

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http://www.europarl.europa.eu/document/activities/cont/201209/20120924ATT52130/20120924ATT52130EN.pdf [accessed on 15 October 2012].

[913] Article 9(1) of Council Directive 2006/112/EC.

[914] The reverse-charge mechanism in this context should be distinguished from a self-assessment mechanism in the case of B2C transactions as it is called in the EU. See Bird RM and Gendron PP (2007) *The VAT in Developing and Transitional Countries* at 139.

at the VAT rate in the country where it is established.[915] This means that the supplier vendor who is established in one Member State and who renders electronically delivered supplies to a recipient vendor in another Member State, need not account for VAT on the supplies in the country of origin. As the taxable entity, the recipient vendor must account for VAT in the Member State in which it is established. That said, Rendahl notes that where the goods acquired are not used as part of the recipient vendor's economic activity (in the making of taxable supplies) the transaction should, in principle, be treated as a supply of electronically delivered products to a non-taxable person (discussed in paragraph 4.3.5.3 below) irrespective of the recipient's vendor status.[916] The supplier vendor cannot know whether the supply will be used as part of the recipient vendor's economic activity and it is not required to investigate such use.[917] Therefore, under the reverse-charge mechanism any such private or domestic use would be subject to VAT and no input VAT deduction would be allowed. The supplier vendor merely has to establish, in the place of establishment, the VAT vendor status of the supplier to be able to disregard any further VAT obligations in the Member State of origin.[918]

4.3.5.2 B2B transactions between a foreign supplier and an EU vendor

Parrilli points out that, before the amendment of article 44 of Council Directive 2006/112/EC,[919] article 56 provided that where electronically supplied services are

[915] Article 56(1) read with article 196 of Council Directive 2006/112/EC; Ward BT, Sipior JC, Bremser W, McGinty DB (2006) "A Comparison of United States and European Union Taxation of E-commerce" ICEC '06 Proceedings of the 8th International Conference on Electronic Commerce at 346; Henriques V, Azevedo L, Bonnet J, Carvalho P, Mathan L (2001) "Extending VAT to E-commerce: an Implementation of EU Proposals" *Euroweb 2001* at 3; Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 156; Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012]; Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 91.

[916] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 74.

[917] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 74-75.

[918] Hargitai C (2001) *Value added Taxation of Electronic Supply of Services* Part II at 3 http://centers.law.nyu.edu/jeanmonnet/archive/papers/01/013301.html [accessed on 8 October 2012].

[919] As amended by Council Directive 2008/8/EC with effect from 1 January 2010.

rendered to an EU VAT vendor by a non-EU supplier, the EU VAT vendor was, under the reverse-charge mechanism, required to account for VAT in the country where it was established.[920] However, article 56 actually provided for transactions where the taxable person (recipient vendor) was "established in the Community but not in the same country as the supplier". Therefore, strictly speaking, article 56 provided for transactions between taxable persons (vendors) who were both established within the EU, albeit in different Member States. No provision was made to identify the taxable person where a foreign supplier rendered electronically delivered supplies to an EU vendor.

Article 44 as amended by Council Directive 2008/8/EC, provides that the taxable person, in the case of supplies by a non-EU vendor to an EU vendor shall be the EU vendor under the reverse-charge mechanism.[921]

4.3.5.3 B2C transactions between an EU vendor and EU non-vendor

4.3.5.3.1 The position from 1 January 2006 until 31 December 2009

Council Directive 2006/112/EC does not provide for specific place-of-supply rules in the case of electronically supplied services between an EU vendor and an EU consumer (non-vendor). The general rule, namely that the place of supply shall be the place where the supplier is established, applies.[922] From the place-of-supply rule it can be deduced that the taxable entity shall be the supplier vendor. Under the general rule, the supplier must account for VAT on the supplies in the country of establishment at the VAT rate applicable in that country.[923] Suppliers who are

[920] Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 10.
[921] Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 12.
[922] Article 43 of Council Directive 2006/112/EC.
[923] Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 13.

established in jurisdictions with a low VAT rate (such as Luxembourg), are placed at an advantage over other vendors.[924]

4.3.5.3.2 The position from 1 January 2010 until 31 December 2014

The amendments envisaged by Council Directive 2008/8/EC that applies from 1 January 2010 until 31 December 2014, also do not provide for specific place-of-supply rules for electronically supplied services between an EU vendor and an EU consumer (non-vendor). The general rule, as amended, applies. The amended version of article 45 defines the place of supply of services to non-taxable persons within the EU as the place where the supplier is established.[925] It further provides that where the supply is rendered from a fixed establishment located at a place other than the place where it has established its business, such place of fixed establishment is deemed to be the place of supply.[926] It can, therefore, be deduced that the taxable person is the supplier vendor (head office) in so far as the supplies are made from the place where it has established its business. Where the supplies are made from a fixed location (branch) other than the place where the business is established, that branch of the supplier is the taxable entity. The supplier shall account for VAT at the rate applicable in the country where it is established, or in the country where the branch from where the supplies are made has its fixed establishment, or where it resides. This amendment allows suppliers to set up establishments in low VAT jurisdictions and to distribute supplies from those branches to avoid the unfair tax advantage explained in paragraph 4.3.5.3.1 above. Nonetheless, it should be noted that smaller companies may not have the capital or resources to establish branches in various jurisdictions and are still placed at a disadvantage.

[924] In't Veld TFG (2007) "E-commerce en het Gebrek aan Fiscal Aanknopingspunten" *Weekblad Fiscale Recht* vol 136 no 6719 at 512.
[925] Article 45 of Council Directive 2008/8/EC.
[926] Article 45 of Council Directive 2008/8/EC.

4.3.5.3.3 The position after 1 January 2015

The new article 58 as envisaged by the amendments to Council Directive 2008/8/EC which will apply from 1 January 2015, provides that in the case of electronically supplied services, the place of supply to any non-taxable person shall be the place where the non-taxable recipient is established, has his permanent address, or resides. Since the reverse-charge mechanism only applies to B2B transactions, it can be deduced that the supplier of the electronically supplied services is the taxable entity. The supplier must account for VAT in the country where it is established or from where the supplies are made[927] at the VAT rate applicable in the country where the recipient is established, has a fixed address, or resides.[928] The supplier vendor is not required to register as a VAT vendor in each Member State in which it makes taxable supplies, but accounts for VAT in the preferred Member State of establishment.[929] The vendor is still required to identify the customer's Member State of residence to levy VAT at the correct applicable rate. This - as discussed in paragraph 4.3.2.2.4 - is a difficult hurdle to overcome and it is not certain to what lengths the supplier must go to verify the customer's location with absolute certainty. Should technology not be useful in coming years to resolve this problem, EU suppliers will face the same issues that non-EU suppliers have been facing since 2002.[930]

Prior to the amendment, the EU vendor was required to apply VAT at a single rate only. The amendment will require the vendor to levy VAT at 27[931] different VAT rates. Come 2015, suppliers will have to apply new accounting methods and expensive software to levy VAT at the appropriate rate and adequately reflect it in their VAT returns. This amendment will bring an end to the current discrimination

[927] Article 45 of Council Directive 2008/8/EC.
[928] Article 58 of Council Directive 2008/8/EC applicable from 1 January 2015.
[929] Article 369*a* of Council Directive 2008/8/EC applicable from 1 January 2015. Also see VAT collection mechanisms in paragraph 4.3.7 below.
[930] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].
[931] At the time of writing the EU consisted of 27 Member States.

between EU and non-EU suppliers.[932] However, Parrilli points out that instead of creating legal tools to abolish or reduce the difficulties currently faced by non-EU suppliers, the legislator has extended the application to EU vendors.[933] Parrilli is doubtful whether technology will advance to such an extent that it will be able to assist vendors in resolving the issue of locating the customer with accuracy and taxing him accordingly.[934] It could be argued that as the proposed amendments have been available since 2008, EU suppliers have been given ample time to develop appropriate software. That said, the development of software is no guarantee that the problem will be solved, especially in cases where the recipient applies software that would prevent the supplier's software from locating his place of residence.

4.3.5.4 B2C transactions between a foreign supplier and an EU non-vendor

Before the VAT reform of electronically supplied services by Council Directive 2002/38/EC, the place-of-supply rules provided that the supply was deemed to be made in the country of origin in the case of services. Accordingly, the taxable person was identified as the supplier who accounted for VAT in the country of origin if VAT or any other sales tax was to be levied on the supply. This resulted in a competitive disadvantage for EU suppliers and further caused market distortions.[935]

Article 57[936] of Council Directive 2006/122/EC provides that the place of supply, in the case of electronically supplied services where the supplier is a foreign non-EU vendor which makes supplies to a customer resident in the EU, is the location where the customer is established, has a fixed address, or resides. Since the reverse-

[932] Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 14.
[933] Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 14.
[934] Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 15.
[935] Raponi D (2000) "VAT Treatment of Electronically Delivered Services" *EC Tax Review* vol 9 issue 3 at 188-189; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 209.
[936] Article 57 applied between 2002 and 31 December 2009 when it was replaced by article 58 of Council Directive 2008/8/EC which will apply from 1 January 2010 until 31 December 2014. Article 58 will be replaced by the amended article 58 which will apply from 1 January 2015. The outcome of the provisions is the same in respect to identifying the place of supply and the taxable entity in the case of B2C transactions between a foreign non-EU vendor and an EU customer.

charge mechanism does not apply to non-taxable persons, the non-EU supplier must collect EU VAT on its supplies.[937] In contrast to the vague South African position, EU legislation is clear: A foreign supplier must levy and account for EU VAT when it makes digital supplies to customers located within the EU. Furthermore, unlike the South African position, foreign suppliers are not required to have a physical presence in the EU to register as VAT vendors.[938]

The position until 31 December 2014 places foreign suppliers at a disadvantage when compared to EU suppliers in that foreign suppliers must account for VAT at the rate applicable in the country where the customer is established, while the EU supplier levies VAT at the rate applicable in the Member State of origin. In addition, foreign suppliers are required to identify the customer's place of residence (and not the location at the time of conclusion of the contract) to levy VAT at the appropriate rate. This cannot be determined with absolute accuracy and the process places a significant administrative and technological burden on suppliers.[939] Determining the customer's place of residence often relies on the honesty and integrity of customers. Hardesty opines that only a minority of customers would apply technology to mask their identity and location.[940] Generally, this might be the case, but consumers acquiring and applying sophisticated masking technology often do so to avoid paying taxes on transactions that would, under normal circumstances, be subject to VAT amounting to substantial amounts.

Should the transaction be under- or over-taxed, the supplier could be subject to penalties and interest. Even in cases where the customer's place of residence can be located with certainty, the foreign supplier must avail itself of the national VAT legislation of the applicable country. It is not sufficient for the supplier to merely levy VAT at the rate applicable to the country in question; it must classify the type of supply correctly to enable it to levy the applicable VAT rate or to determine if the

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[937] Article 57 read with article 193 of Council Directive 2006/112/EC.

[938] Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 10; Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012]. Vendor registration options are discussed in paragraph 4.3.7.

[939] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].

[940] Hardesty D (2000) "EU Continues Efforts to Tax Digital Products" *E-commerce Tax News* 22 October http://www.mail-archive.com/members@csmfo.org/msg01582.html [accessed on 29 October 2012].

supply is taxable at all.[941] In other words, the supplier must create 27 different VAT scenarios for each of the different electronically supplied products[942] that it supplies to EU customers. Considering the fact that e-commerce transactions are automated and that minimal human intervention is required, this burden would require sophisticated and expensive software.

Parrilli points out that the best solution (until 31 December 2014) would be for foreign vendors to establish a branch in an EU jurisdiction with a low VAT rate (Luxembourg, for example) to enable them to enter the EU market at par with their EU counter-parts.[943]

Requiring non-EU established suppliers to collect EU VAT as taxable entities, has been severely criticised since the draft amendment proposals were first released. The EU legislator was especially criticised by American economists, politicians and businessmen for possibly violating international tax treaties.[944] Hardesty opines that the EU principles could set a trend that could be followed by other countries around the world.[945] Not all jurisdictions are as organised and governed by uniform and harmonised laws as are Member States of the EU. This could result in one supplier effectively being held accountable for VAT in more than 100 different jurisdictions, depending on its customer base.[946] For most suppliers this would be impossible and costly to administer, forcing them to abandon existing cross-border trade. Prospective e-tailers could be deterred from setting up businesses on a cross-border trade platform. Basu points out that many e-tailers would continue rendering cross-border supplies resulting in an industry that would be known for non-compliance.[947]

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[941] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].

[942] This presumption is based on the premise that not all digitally supplied products are taxed equally in Member States.

[943] Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 11.

[944] US Deputy Secretary Kenneth Dam as quoted in Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].

[945] Hardesty D (2000) "EU Continues Efforts to Tax Digital Products" *E-commerce Tax News* 22 October http://www.mail-archive.com/members@csmfo.org/msg01582.html [accessed on 29 October 2012].

[946] At the time of writing the UN recognised 192 independent jurisdictions. See World Atlas *How Many Countries* http://www.worldatlas.com/nations.htm [accessed on 29 October 2012].

[947] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].

It should be noted that this criticism is not aimed at the taxation of digital supplies by foreign suppliers to EU customers as such, but at the provisions that deem the foreign supplier to be the effective taxable person or entity. Since cross-border e-commerce is a global phenomenon, which is not restricted to transactions between EU customers and non-EU suppliers, a global, rather than a regional solution should be developed. Legislators and policy makers are not only faced with protecting the tax base, but should further protect local markets from competing foreign untaxed markets,[948] Further, in finding the balancing act, legislators and policy makers should take cognisance of international trade trends and agreements so as not to violate international agreements or distort international trade by overly harsh or cost ineffective rules.[949]

From a financial perspective, one could argue that the reverse-charge mechanism as applied in South Africa - in terms of which the importer of the service is deemed to be the taxable person - is the most favourable solution for international trade. This is because the supplier would not be required to register as VAT vendor in the recipient's country of establishment and further incur VAT administration costs in that country.[950] The ineffectiveness of the reverse-charge mechanism in collecting VAT from the taxable persons or entities, could, however, cause the erosion of the tax base.

A provision deeming the foreign supplier a taxable entity is beneficial in protecting the tax base, but it negatively affects international trade which could, in the long run, lead to international economic recessions. Caldwell interestingly points out that such deeming provisions cannot protect the tax base as it would be impossible to detect or audit these transactions thus nullifying arguments in favour of such provisions.[951] Due to the anonymity of e-commerce transactions, revenue authorities are dependent on the integrity and honesty of the taxable person or entity.

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[948] Hardesty D (2000) "EU Continues Efforts to Tax Digital Products" *E-commerce Tax News* 22 October http://www.mail-archive.com/members@csmfo.org/msg01582.html [accessed on 29 October 2012].
[949] Hardesty D (2000) "EU Continues Efforts to Tax Digital Products" *E-commerce Tax News* 22 October http://www.mail-archive.com/members@csmfo.org/msg01582.html [accessed on 29 October 2012].
[950] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 3.
[951] Caldwell F as quoted in Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].

Finding a solution to identify a taxable person in the case of cross-border B2C transactions that would protect the tax base and promote international trade therefore requires a global effort.

4.3.6 Is the supply made in the course and furtherance of an enterprise?

Under the EU VAT system the taxable person charges VAT on the supply of goods and services to its customers and remits VAT minus any VAT inputs or credits on his monthly or quarterly VAT return to tax authorities.[952] Conversely, VAT only generates income to the *fiscus* if the VAT charged on a transaction cannot be deducted by the purchaser.[953] Kogels opines that where transactions are concluded between businesses or VAT-liable persons, the VAT burden is zero.[954] This is not entirely correct. A VAT vendor is not always entitled to an input VAT deduction on purchases. An input VAT deduction is only allowed in respect of goods and services acquired by a vendor in the production of income, or in the furtherance of the business.[955] Where the goods or services are utilised for private consumption, input VAT cannot be deducted.[956] In the case of B2B cross-border transactions involving electronically supplied goods, in terms of the place-of-supply rules, the vendor recipient must account for VAT on the transaction in terms of the reverse-charge mechanism.[957] Depending on the VAT rules in the Member State of fixed establishment, the vendor must either account for VAT and immediately claim in input VAT deduction, or treat the transaction as non-taxable in so far as the electronically supplied services are utilised in the production of income. In other

[952] Kogels HA (1999) "VAT @ E-commerce" *EC Tax Review* vol 8 issue 2 at 118; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 388.
[953] Kogels HA (1999) "VAT @ E-commerce" *EC Tax Review* vol 8 issue 2 at 118.
[954] Kogels HA (1999) "VAT @ E-commerce" *EC Tax Review* vol 8 issue 2 at 118.
[955] Article 168 of the Sixth Council Directive 77/388/EEC of 17 May 1977; Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 117; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 388.
[956] Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 117.
[957] Doernberg RL, Hinnekens L, Hellerstein W, Li J (2001) *Electronic Commerce and Multi-jurisdictional Taxation* at 118-119; Jeanmart FX (2001) "Taxation of Electronic Commerce Part II:VAT" *Tax Planning International: European Union Focus* vol 3 no 8 at 7; Lejeune I, Korf R, Grünauer A (2003) "New E-commerce Directives: A Move Towards e-Europe?" *Journal of International Taxation* vol 14 no 4 at 20.

words, the recipient of the supply must issue a self-billed invoice in case of B2B transactions, irrespective of whether or not VAT is due on the transaction.[958] This should be contrasted with B2B transactions in South Africa where the recipient vendor is not required to account for VAT on imported services in so far as the supplies acquired are utilised and consumed in the furtherance of an enterprise and in the making of taxable supplies. Self-supply rules can supplement restrictions on input VAT deductibility.

Suppliers are generally relieved of the obligation to verify how the customer (business recipient) will actually use the services.[959] Once the customer's VAT status has been determined, the supplier is relieved of its duty to levy VAT on the supply. Since the supplier has no control over the consumption of the supplies, the customer vendor who consumes the supplies for private and domestic purposes must account for VAT on the supply in terms of the reverse-charge mechanism.[960] That said, the Implementing Regulations provide, that where, due to the nature of the supply, and where no information to the contrary exists, certain supplies are deemed to be privately consumed and must be taxed by the supplier irrespective of the business status of the customer.[961] The Regulations, however, fail to give guidelines or examples of cases where the nature of the supplies would indicate private and domestic use.

As a result of the fraud opportunities under the current fractionated system, the European Commission proposes a general application of a reverse-charge

[958] Cervino G (2007) "VAT and E-commerce" *International Tax law Review* vol 3 at 140; Jeanmart FX (2001) "Taxation of Electronic Commerce Part II:VAT" *Tax Planning International: European Union Focus* vol 3 no 8 at 7; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 393.
[959] Lejeune I, Cortvriend E, Accorsi D (2011) "Implementing Measures Relating to EU Place-of-Supply Rules: Are Business Issues Solved and is Certainty Provided?" *International VAT Monitor* vol 22 no 3 at 148; Buydens S, Holmes D, Owens J (2009) "Consumption Taxation of E-commerce: 10 Years after Ottawa" *Tax Notes International* vol 54 no 1 at 62.
[960] Jeanmart FX (2001) "Taxation of Electronic Commerce Part II:VAT" *Tax Planning International: European Union Focus* vol 3 no 8 at 7; Buydens S, Holmes D, Owens J (2009) "Consumption Taxation of E-commerce: 10 Years after Ottawa" *Tax Notes International* vol 54 no 1 at 62; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 393.
[961] Article 19 of Council Implementing Regulation (EU) 282/2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:077:0001:0022:EN:PDF [accessed on 15 October 2012].

mechanism to all B2B transactions similar to the current Dutch system.[962] Under this system, a VAT vendor must account for VAT on cross-border acquired digital goods irrespective of whether the goods will be applied in the course and furtherance of its enterprise. The vendor would, however, be entitled to an input VAT deduction in so far as the goods are applied in the making of taxable supplies. Despite the additional administrative burden, the European Commission is of the opinion that a general application of a reverse-charge mechanism should not be ruled out.[963]

4.3.7 Is the transaction taxable?

In addition to the burden of correctly classifying their supplies, suppliers of digital products must also determine if the supplies could possibly fall under one or more of the exemptions provided for in Council Directive 2006/112/EC. Member States are allowed to develop and apply provisions exempting certain transactions, activities, and entities from VAT within the framework of the harmonised exemption provisions in Council Directive 2006/112/EC.[964] It is, therefore, not sufficient for suppliers to be aware of the harmonised exemption rules alone when making supplies. This could place a tremendous administrative burden (over and above the existing task of collecting VAT in accordance with the VAT rate applicable in the customer's country of residence) on foreign suppliers who render digital supplies to EU customers. Come January 2015, this administrative burden will be extended to EU suppliers who make digital supplies to EU customers resident in a Member State other than the Member State in which the supplier is established. Effectively, e-tailers are required to become experts in the VAT legislation (or acquire the services of VAT experts) of all the Member States in which they make digital supplies. Once a supplier becomes aware of the complete compliance burden in a certain jurisdiction, it may well be discouraged from establishing a market in that jurisdiction.

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[962] European Commission (2010) *Green Paper on the Future of VAT: Towards a Simpler, more Robust and Efficient VAT System* COM(2010) 695 final at 8 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0695:FIN:EN:PDF [accessed on 21 January 2013].

[963] European Commission (2010) *Green Paper on the Future of VAT: Towards a Simpler, more Robust and Efficient VAT System* COM(2010) 695 final at 9 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0695:FIN:EN:PDF [accessed on 21 January 2013].

[964] Article 131 of Council Directive 2006/112/EC.

Conflict exists between the list of electronically supplied services in Annex II, and the exemption provisions of Council Directive 2006/112/EC. For example: In terms of item 5 of Annex II, the supply of distance teaching is deemed to be an electronically supplied service which is a taxable supply. In terms of article 132(1)(j), tuition given privately by teachers and covering school or university education is exempt. Where a teacher, in her capacity as supplier, supplies private tuition through distance teaching, or in applying digital technology through an e-learning portal, the supply can both be taxable and exempt. If, and to what extent, article 132(1)(j) will take preference above the charging provisions is not certain. Englisch states that the interpretation of exemptions is aggravated by the lack of a clear and consistently implemented rationale for the majority of the exemptions for which provision is made.[965] He further states that the ECJ has in the past implemented a "strict" interpretation approach because exemptions should be seen as an exception to the general rule.[966] As a result, where a supply, because of the exceptional circumstances, complies with the requirements of the exemption, the supply should be exempted from VAT. Multiple or combined supplies can further exacerbate the issue as can be seen from the example below.

> **Example 4.4:** A teacher, as taxable entity, develops and sells school distance teaching models to private consumers in the EU. As part of the supply, the teacher provides private tuition. The software and private tuition are sold as a single supply at a single price.

Should the supply in example 4.4 be split to exempt the private tuition and tax the distance teaching as separate supplies? If the single supply cannot be split, should the whole of the supply be taxable or exempt?

In *Everything Everywhere Ltd v Commissioners for Her Majesty's Revenue and Customs*,[967] the ECJ ruled that from an economic point of view, a single supply

[965] Englisch J (2011) "EU Perspectives on VAT Exemptions" *Oxford University Centre for Business Taxation Working Paper Series no 11/11* at 7 http://www.sbs.ox.ac.uk/centres/tax/papers/Documents/WP1111.pdf [accessed on 31 October 2012].
[966] Englisch J (2011) "EU Perspectives on VAT Exemptions" *Oxford University Centre for Business Taxation Working Paper Series no 11/11* at 7 http://www.sbs.ox.ac.uk/centres/tax/papers/Documents/WP1111.pdf [accessed on 31 October 2012].
[967] *Everything Everywhere Ltd v Commissioners for Her Majesty's Revenue and Customs* Case C-276/09 (2010) ECR I-12359.

should not be artificially split for VAT purposes.[968] This is especially the case where one or more elements of the supply constitutes the principal supply, while other elements could be construed to be ancillary supplies.[969] In these cases it has been suggested that the nature of the principal supply should be the determining factor.[970] In other words, where the principal supply is taxable and the ancillary supplies fall under one or more exemption, the whole of the supply shall be taxable, and *vice versa*.

Supplies by public postal services in so far as they do not entail passenger transport, telecommunication services, or goods incidental thereto, are exempt.[971] Where a postal service provides electronically supplied services as contemplated in Annex II, the supplies should be exempt. It is not certain whether this exemption applies to postal services in general, or only to postal services established in the EU. For example, where a public postal service in the USA supplies web services, software, and technical support to customers in the USA and Europe, can it be said that the supplies made to EU customers should be exempt? The Council Directive does not provide for the exemption of foreign supplied services if the supply would have been exempt, had it been supplied in the Community. This should be contrasted with the South African position, which provides that foreign supplied services would be exempt from South African VAT only if the supply would have been exempt from VAT had it been supplied in the Republic.[972]

It should further be noted that different revenue authorities in the various Member States can interpret the exemptions, and treat the conflict between Annexure II and the exemptions differently. What constitutes an exempt supply in one Member State could be construed to be taxable supplies by revenue authorities in another Member State. This leads to tax uncertainty and taxable entities are effectively required to

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[968] *Everything Everywhere Ltd v Commissioners for Her Majesty's Revenue and Customs* Case C-276/09 (2010) ECR I-12359 at para 22.
[969] Englisch J (2011) "EU Perspectives on VAT Exemptions" *Oxford University Centre for Business Taxation Working Paper Series no 11/11* at 11 http://www.sbs.ox.ac.uk/centres/tax/papers/Documents/WP1111.pdf [accessed on 31 October 2012].
[970] Englisch J (2011) "EU Perspectives on VAT Exemptions" *Oxford University Centre for Business Taxation Working Paper Series no 11/11* at 11-12 http://www.sbs.ox.ac.uk/centres/tax/papers/Documents/WP1111.pdf [accessed on 31 October 2012].
[971] Article 132(1)(a) of Council Directive 2006/112/EC.
[972] Section 14(5) of the VAT Act 89 of 1991.

familiarise themselves of the interpretation of exemptions in each Member State. In the UK, for example, physical books are zero-rated (effectively not subject to VAT) while e-books are subject to VAT at the standard rate since e-books are classified as electronically supplied services. Sinyor points out that the word "book" should refer to both printed and e-books as the both products meet the customer's needs in the same way.[973] That said, e-books, e-magazines, and e-newspapers can be distinguished from their tangible counterparts as the e-version offers a wider variety of services such as search capabilities and links.[974] A differentiation between the tangible and intangible versions of the same goods would not be unfair.[975] In terms of the transitional provisions applicable to the UK when it joined the EU, it is allowed to retain the zero rating and exemption provisions that were in place in 1991, but it may not extend the zero rating and exemption provisions.[976] Expanding the scope of zero rating on books to e-books would be in contravention of Council Directive 2006/112/EC. During October 2012 the EU ordered France and Luxembourg to abandon their reduced rates on e-books.[977] Should countries like France, Luxembourg, and the UK continue with reduced or zero rating of e-books, many e-book suppliers could establish their businesses in these countries to benefit from lower VAT rates until 31 December 2014 when the benefits of low VAT regimes will effectively be removed. This could cause serious market distortions and economic recession in other Member States. The damage caused by the current regime can take many years to normalise after the implementation of the amendments of 1 January 2015. The European Commission suggests that in cases of differentiated VAT rates between tangible goods and their intangible counterpart, a uniform VAT

[973] Sinyor A as quoted in Fuller C (2012) "UK: VAT Charges on E-books Could be Dropped" *Accountancy Age* http://www.accountancyage.com/aa/news/2220471/vat-charges-on-ebooks-could-be-dropped [accessed on 2 November 2012].
[974] Buydens S, Holmes D, Owens J (2009) "Consumption Taxation of E-commerce: 10 Years after Ottawa" *Tax Notes International* vol 54 no 1 at 63; García AMD and Cuello RO (2011) "Electronic Commerce and Indirect Taxation in Spain" *European Taxation* vol 51 no 4 at 145.
[975] Buydens S, Holmes D, Owens J (2009) "Consumption Taxation of E-commerce: 10 Years after Ottawa" *Tax Notes International* vol 54 no 1 at 63.
[976] Fuller C (2012) "UK: VAT Charges on E-books Could be Dropped" *Accountancy Age* http://www.accountancyage.com/aa/news/2220471/vat-charges-on-ebooks-could-be-dropped [accessed on 2 November 2012].
[977] Fuller C (2012) "UK: VAT Charges on E-books Could be Dropped" *Accountancy Age* http://www.accountancyage.com/aa/news/2220471/vat-charges-on-ebooks-could-be-dropped [accessed on 2 November 2012]; Stewart DD (2012) "EU takes on VAT treatment of E-Book sales" *Tax Notes International* vol 67 no 3 at 199.

rate should be adopted.[978] This can be achieved by either maintaining the standard rate, or adopting the reduced rate for tangible and intangible goods.[979] This should, however, be done with caution and all externalities must be considered to avoid market distortions.

4.3.8 Collection mechanisms

The revenue potential of any VAT system depends on three factors: the rules describing rates, bases, thresholds and structural features of the tax; the scale of taxable activities; and the degree to which the rules are complied with.[980] All three factors are of equal importance and should be developed to co-exist and complement each other. In other words, well established VAT rules that can be applied to a broad base of activities are nullified if the collection mechanisms in place are inadequate to collect the taxes that are supposed to be levied on the activities.

Many countries that have a VAT system rely on voluntary compliance in terms of the self-assessment mechanism to collect VAT charged on taxable supplies.[981] Council Directive 2006/112/EC, in principle, provides for a self-assessment regime in Member States.[982] An effective self-assessment system is, *inter alia,* characterised by simple VAT registration, filing, payment, and refund procedures.[983] Council Directive 2006/112/EC provides for different registration, filing, payment, and refund procedures for the different types and classes of taxpayer. For the purposes of this study, I shall limit the discussion to these procedures applicable to the classes of taxpayer identified in paragraph 4.3.5 above.

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[978] European Commission (2010) *Green Paper on the Future of VAT: Towards a Simpler, more Robust and Efficient VAT System* COM(2010) 695 final at 15 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0695:FIN:EN:PDF [accessed on 21 January 2013].
[979] European Commission (2010) *Green Paper on the Future of VAT: Towards a Simpler, more Robust and Efficient VAT System* COM(2010) 695 final at 15 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0695:FIN:EN:PDF [accessed on 21 January 2013].
[980] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 43.
[981] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 138.
[982] Articles 193-205 of Council Directive 2006/112/EC.
[983] Ebrill L, Keen M, Bodin JP, Summers V (2001) *The Modern VAT* at 141.

4.3.8.1 Collection mechanism: EU supplier

4.3.8.1.1 Position until 31 December 2014

Generally, any taxable person who carries out any economic activity independently in any place - whatever the purpose or result of the economic activity - is required to register for VAT.[984] In other words, any supplier of electronically supplied services who is established in the EU and who renders the supplies at any place (inside or outside of the EU) is, as a general rule, obliged to register for VAT. That said, Council Directive 2006/112/EC has retained the special VAT threshold provisions applicable to the 9 Member States that formed the European Union when the Sixth VAT Directive was in place.[985,] Specific rules further apply to the 18 countries that acceded to the EU after 1 January 1978.[986,] The thresholds provided for in articles 286 and 287, set the maximum threshold that the individual Member States may apply. Each Member State is allowed to determine its own threshold up to the ceiling threshold stipulated. It should be noted, that despite the fact that a vendor might be exempted from registering for VAT as a result of the VAT threshold applicable in the Member State of establishment, it could be required to register for VAT under the Member State's small business scheme registration.[987] For example, in Austria,

[984] Article 9(1) read with Title XI of Council Directive 2006/112/EC.
[985] Annacondia F and van der Corput W (2009) "VAT Registration Thresholds in Europe" *International VAT Monitor* vol 20 no 6 at 488 http://www.adko.hu/01_files/informaciok/thresholds2009-oktober.pdf [accessed on 31 October 2012]; Annacondia F and van der Corput W (2012) " VAT Registration Thresholds in Europe" *International VAT Monitor* vol 23 no 6 at 422. In terms of article 286 the current threshold for Belgium (5580), UK (76 100), Denmark (6 700), France (32 000 in respect of services), Germany (17 500), Ireland (37 500 in respect of services), Italy (30 000), Luxembourg (10 000), and the Netherlands (1 345) is 5000 Euros.
[986] Annacondia F and van der Corput W (2009) "VAT Registration Thresholds in Europe" *International VAT Monitor* vol 20 no 6 at 488 http://www.adko.hu/01_files/informaciok/thresholds2009-oktober.pdf [accessed on 31 October 2012]; Annacondia F and van der Corput W (2012) " VAT Registration Thresholds in Europe" *International VAT Monitor* vol 23 no 6 at 422. In terms of article 287 the thresholds are as follows (the actual thresholds are in brackets): Greece (10 000 in respect of goods; 5 000 in respect of services), Spain (-), Portugal (12 500 for small businesses), Finland (8 500), Sweden (3450) and Poland (36 200): 10 000 Euros; Austria (30 000), Czech Republic (40 160), Hungary (17 875) and Slovakia (49 790): 35 000 Euros; Estonia (16 000): 16 000 Euros; Cyprus (15 600): 15 600 Euros; Latvia (50 300): 17 200 Euros; Lithuania (44 900): 29 000 Euros; Slovenia (25 000): 25 000 Euros and Malta: 37 000 Euros (35 000) if the economic activity consists mainly of the supply of goods, 24 300 Euros (24 000) if the economic activity consists mainly of the supply of services with a low value added (high inputs), and 14 600 Euros (14 000) in other cases of the supply of services with a high value added (low inputs).
[987] Annacondia F and van der Corput W (2009) "VAT Registration Thresholds in Europe" *International VAT Monitor* vol 20 no 6 488 http://www.adko.hu/01_files/informaciok/thresholds2009-oktober.pdf [accessed on

France, and Greece, small businesses with a turnover exceeding Euros 7 500 must still register for VAT despite the general VAT threshold set in Council Directive 2006/112/EC.[988] In Belgium, small businesses must register for VAT but are exempted from filing tax returns if their turnover is less than Euros 5 580 per annum.[989]

A supplier who wishes to render digitally supplied services from a Member State to customers situated in or outside of the Community, must register for VAT if the supplies will exceed the threshold in the Member State in which it intends to be established.[990] In Belgium, the supplier would be required to register irrespective of its annual turnover.

Since Council Directive 2006/112/EC (valid until 31 December 2014) does not specifically provide for place-of-supply rules in the case of electronically supplied services by an EU supplier to a non-taxable person in the EU who resides in a Member State other than the Member State in which the supplier is established, the general place-of-supply rules in terms of article 43 apply. Article 43 provides that the place of supply is deemed to be the place where the supplier is established, has his permanent address, or usually resides. Therefore, once registered in the Member State of establishment, the supplier shall account for VAT, at the rate applicable in the Member State of establishment, on all digital supplies rendered within the EU.[991] The supplier is not required to register for VAT in every Member State in which it renders digital supplies. VAT collection in these cases is fairly easy and uncomplicated. No additional burden is placed on a supplier that makes intra-Community supplies as intra-Community supplies are treated the same as domestic

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31 October 2012]; Annacondia F and van der Corput W (2012) " VAT Registration Thresholds in Europe" *International VAT Monitor* vol 23 no 6 at 422.

[988] Annacondia F and van der Corput W (2009) "VAT Registration Thresholds in Europe" *International VAT Monitor* vol 20 no 6 at 488 http://www.adko.hu/01_files/informaciok/thresholds2009-oktober.pdf [accessed on 31 October 2012]; Annacondia F and van der Corput W (2012) " VAT Registration Thresholds in Europe" *International VAT Monitor* vol 23 no 6 at 422.

[989] Boomsma A, Ermel A, Somers J, Tirard J (1989) *Ernst & Young VAT in Europe* at 25; Annacondia F and van der Corput W (2009) "VAT Registration Thresholds in Europe" *International VAT Monitor* Nov/Dec 2009 at 489 fn 2 http://www.adko.hu/01_files/informaciok/thresholds2009-oktober.pdf [accessed on 31 October 2012]; Annacondia F and van der Corput W (2012) " VAT Registration Thresholds in Europe" *International VAT Monitor* vol 23 no 6 at 422.

[990] Article 214 of Council Directive 2006/112/EC.

[991] Article 43 read with article 193 of Council Directive 2006/112/EC.

supplies. A supplier can expand its distribution territory without being subject to an additional tax compliance burden.

4.3.8.1.2 Position after 1 January 2015

The amendments to the place-of-supply rules in case of electronically supplied services that will take effect from 1 January 2015, will have a profound effect on how EU suppliers will account for VAT on intra-community supplies. In addition, VAT collection mechanisms will also alter to ensure the least burdensome compliance dispensation. From 1 January 2015, the place of supply will shift from the supplier's place of establishment to the place where the customer is established, has his fixed address, or resides.[992] This entails that suppliers must account for VAT on their supplies at the VAT rate applicable in the Member State in which the customer is established. VAT compliance can be accomplished in two ways: The vendor can register for VAT in each of the Member States in which it makes electronically supplied services and submit VAT returns in accordance with each Member State's VAT rules; or the vendor can account for VAT in terms of the "special scheme for telecommunications, broadcasting or electronic services supplied by taxable persons established within the Community but not in the Member State of consumption" as provided for in Council Directive 2008/8/EC.

i) Vendor registration in all Member States of consumption

Vendor registration in all Member States of consumption is not advised. In some Member States registration other than in terms of a special scheme, requires that the VAT vendor must have a physical presence in that country. For example, Germany requires a physical presence at the location where the supplier intends to register, while in Ireland the main place of business must be located in the area where the

[992] Article 58 of Council Directive 2008/8/EC.

supplier intends to register.[993] The supplier could, accordingly, be required to establish a physical presence in various jurisdictions which would be counterproductive in e-commerce transactions characterised by their intangible nature. In addition, supplies made in certain jurisdictions could be less than the turnover threshold, preventing vendor registration. Business expansion is further restricted due to the high cost of compliance and an increased administrative burden.

ii) Special scheme for EU suppliers of intra-community electronically delivered services

In terms of the special scheme for EU suppliers, the supplier would be required to register as a vendor in one Member State only, and file tax returns only in that Member State.[994] The VAT return shall reflect the VAT collected on behalf of revenue authorities in all the Member States in which the supplies are consumed (place where the customer resides) at the rate applicable in the respective Member States.[995]

a) Physical presence or fixed place of business required?

Compliance under the special scheme still requires that the supplier maintain a physical presence (established business) in at least one Member State.[996]

[993] Boomsma A, Ermel A, Somers J, Tirard J (1989) *Ernst & Young VAT in Europe* at 75 and 106.
[994] Article 369*d* of Council Directive 2008/8/EC; also see Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 14. Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 3; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 214.
[995] Article 369*g* of Council Directive 2008/8/EC; Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 14; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 3.
[996] Article 369*a*(1) of Council Directive 2008/8/EC.

Lamensch points out that a physical presence is not required.[997] Where the supplier has establishments in multiple Member States, it can opt to register for the special scheme in one Member State of its choice.[998] The supplier will be bound by its choice in the calendar year concerned and for two calendar years following.[999] A company supplying digital services is not reliant on the traditional infrastructure - such as physical offices, warehouses, and points of sale - typically associated with the supply of goods. Rather, it is reliant on technical standards and the availability of network connections. It is, therefore, possible for a supplier to operate its business on a portable computer, or from a small room in someone's back yard or basement. If the *dicta* in *Gunter Berkholz v Finanzamt Hamburg-Mitte-Altstadt,*[1000] are considered, an establishment must be of a certain minimum size and the human and technical resources necessary to operate it must be permanently present. The court failed to address the issue of what it regards as a "minimum size." It is trite that a server will occupy some physical space where it is located as servers are in fact tangible equipment.[1001] However, the human and or technical resources necessary for the server to operate, are not required to be permanently present for the server to operate. The benefits of cloud-computing allow the server to be remotely operated or pre-programmed to operate without human intervention.

For VAT purposes, a server would not constitute a fixed establishment, irrespective of whether or not it is physically present or fixed at a location in a Member State.[1002] Skaar notes that portable devices can never constitute a place of business as they are not fixed in one location.[1003] This would create a problem for suppliers who render digital supplies from portable devices. Article 369*a* requires only that the supplier be established in the Community and no actual fixed establishment is required. In other words, can it be said that the supplier is established in the EU if its

[997] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 3.
[998] Article 369*a* of Council Directive 2008/8/EC.
[999] Article 369*a* of Council Directive 2008/8/EC.
[1000] *Gunter Berkholz v Finanzamt Hamburg-Mitte-Altstadt* C-168/84 (1985) ECR I-02251 at para 18.
[1001] Parrilli DM (2008) "Grid and Taxation: The Server as Permanent Establishment in International Grids" in Altman J, Neumann D and Fahringer T (eds) (2008) *Grid Economics and Business Models: Lecture Notes in Computer Science* at 92.
[1002] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 77.
[1003] Skaar AA (2000) "Erosion of the Concept of Permanent Establishment: Electronic Commerce" *Intertax* vol 28 no 5 at 189.

business exists virtually? It is trite that a virtual business would be effectively managed from a fixed address, even in cases where the business is operated through portable computers. The word "established" stems for the Latin *stabilire* which means to make firm, to set up something, or to bring about something.[1004] Skaar's opinion that a portable device can never constitute a place of business is not convincing. The portable device in itself, just like a fixed server, cannot constitute a business or place of business. However, the whole of the operation, including the location of the equipment, should be considered to determine whether a business is established in a particular jurisdiction. Rendahl suggests the criteria for permanent establishment for income tax purposes, could equally apply to determine if a business is established for VAT purposes.[1005] The ECJ has, however, been reluctant to extend the permanent establishment criteria for income tax to VAT cases.[1006] It can, however, be deduced from article 1 of the Eighth Directive 79/1072/EC, that where an establishment cannot be located (because of its virtual or portable nature), the domicile or normal place of residence of the business or that of its owners can be applied to locate the place of establishment.[1007] The mere fact that the virtual business has chosen a *domicilium citandi et executandi* in the EU, can justify the conclusion that it is established in the EU for purposes of the special VAT scheme for EU suppliers. Houtzager and Tinholt state that where a foreign supplier who operates its business from a computer or server, the computer would qualify as a fixed establishment if it is located in a building in the EU, and the supplier has employed staff at that location in the EU irrespective of whether that staff operate the computer.[1008]

[1004] The Dictionary Unit for South African English (2010) *Oxford South African Concise Dictionary* 2nd edition.
[1005] Rendahl P (2007) "An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union" *Journal of Media Business Studies* vol 4 no 2 at 77.
[1006] *Mistero dell'Economia e delle Finanze, Agenze delle Etrate v FCE BANK plc* Case C-210/4 (2006) ECR I-02803 at paras 6 and 41; Anthony R (2000) "European VAT on E-commerce Services: Tax & VAT Planning of 'Place of Supply' Criteria" *Tax Planning International E-commerce* vol 2 no 5 at 19.
[1007] *Mistero dell'Economia e delle Finanze, Agenze delle Etrate v FCE BANK plc* Case C-210/4 (2006) ECR I-02803 at para 6.
[1008] Albarda ED, Derks RA, Dunaboo CA, Houtzager MLDP, Huibregtse SB, Kröger D, Tinbolt JW, Vink MR (1998) *Caught in the Web: The Tax and Legal Implications of Electronic Commerce* at 100-101.

b) Thresholds in Member State of identification applicable?

The special scheme for EU suppliers does not provide for any thresholds. It is not certain whether the thresholds applicable in the country of identification will still apply in cases where the supplier intends to register under the special scheme. If this is the case, suppliers established in Belgium would be required to register under the scheme irrespective of their turnover, while suppliers established in the Czech Republic would not be required to register if their turnover is less than Euros 37 800. This could further mean that a supplier would not be required to register for VAT in the country of establishment under national rules, but could be required to register under the special scheme because supplies rendered in the country of consumption exceed the threshold applicable in that country.

c) Duties in terms of the special scheme

The taxable person who is registered under the special scheme shall, by electronic means, communicate to the Member State of identification, when it commences or ceases the taxable activities under the special scheme, or when it no longer meets the conditions of the special scheme.[1009] VAT returns must be submitted quarterly, in electronic form, to the Revenue Authority in the Member State of identification irrespective of whether telecommunication, broadcasting, or electronically supplied services were rendered during that period.[1010] Where no such services were rendered, the VAT return, reflecting zero outputs, must still be submitted. The VAT return, bearing the VAT identification number of the supplier, must show the total amount (exclusive of VAT) of telecommunication, broadcasting, and electronically supplied services broken down per Member State of consumption.[1011] In addition, it must show the VAT collected at the applicable rate of each Member State of

[1009] Article 369*c* of Council Directive 2008/8/EC.
[1010] Article 369*f* of Council Directive 2008/8/EC
[1011] Article 369*g* of Council Directive 2008/8/EC.

consumption, as well as the total amount of VAT due for that period.[1012] Where the supplier has fixed establishments in more than one Member State, the VAT return must also indicate the total supplies, VAT, and total VAT due in respect of telecommunication, broadcasting and electronically supplied services covered under the special scheme, together with the VAT identification numbers of each of the fixed establishments.[1013] This provision creates the potential for VAT fraud.

> **Example 4.5:** ABC Ltd is located in Germany and has fixed establishments in Luxembourg, Spain, and Belgium. Each of the fixed establishments is registered for VAT in the respective Member States. ABC Ltd (Germany) registers under the special scheme in Germany.

In its VAT return under the special scheme, ABC Ltd must show the total electronically supplied services rendered by its head office as well as by the fixed establishments. The fixed establishments must, in their VAT returns in the country of establishment, also show the total supplies (including electronically supplied services). Each fixed establishment must, in its VAT return, deduct the amount of the output that constitutes supplies in terms of the special scheme.[1014] It is not certain whether the taxpayer must submit proof to the local revenue authority that the supplies were aptly taxed in terms of the special scheme. Suppliers could effectively submit a zero output VAT return in terms of the special scheme and submit a tax deduction for the actual supplies in the country of establishment. On the other hand, in the absence of proper co-operation between tax authorities, the supplier could be double taxed on the same supplies should the local revenue authorities deny the deduction allowed in terms of article 369*j.* The onus rests on the taxable person to prove that the supplies were taxed in terms of the special scheme. This could be a costly administrative task.

The VAT return must be made out in Euros.[1015] Where the country of consumption has not adopted the Euro, the supplier must still account for VAT in Euros in terms of

[1012] Article 369*g* of Council Directive 2008/8/EC.
[1013] Article 369*g* of Council Directive 2008/8/EC.
[1014] Article 369*j* of Council Directive 2008/8/EC.
[1015] Article 369*h* of Council Directive 2008/8/EC.

the exchange rate applicable on the last date of the tax period[1016] as published by the European Central Bank.[1017] This could result in different exchange rates reflected in the VAT return and the actual VAT collected when the supply was made.

Payment of VAT can be made in Euros to the bank account as designated by the Member State of identification.[1018] Member States which have not adopted the Euro may require payment in the Member State's currency.[1019]

In contrast to the strict record keeping duty in terms of the South African Tax Administration Act,[1020] suppliers under the special scheme should keep electronic records accessible to revenue authorities, at any location in the world, for a period of ten years after 31 December of the year in which the VAT returns are submitted.[1021] Electronic records must be stored in a manner that will enable the Member State of consumption to determine if the VAT return is correct.[1022]

Many authors have questioned the desirability of a one-stop-shop as a VAT collection mechanism in cross-border trade. While it is trite that the implementation of a one-stop-shop is less cumbersome for suppliers than VAT registration in each jurisdiction where it makes taxable supplies, the administrative burden of identifying and locating the customer in order to apply the correct VAT rate (and submit accurate VAT returns), as I have pointed out before, is an almost impossible task to perform accurately. The amendments of 1 January 2015 do not give guidance on the degree of accuracy that is required in locating the customer. Suppliers could be liable for hefty tax penalties and interest in the Member State of identification, and in each Member State of consumption (or Member State that claims to be the jurisdiction of consumption), for filing inaccurate VAT returns.[1023]

[1016] Article 369*h*(1) of Council Directive 2008/8/EC.
[1017] Article 369*h*(2) of Council Directive 2008/8/EC.
[1018] Article 369*i* of Council Directive 2008/8/EC.
[1019] Article 369*i* of Council Directive 2008/8/EC.
[1020] Act 28 of 2011. Also see paragraph 3.4.7.1.4 above.
[1021] Article 369*k*(2) of Council Directive 2008/8/EC.
[1022] Article 369*k*(1) of Council Directive 2008/8/EC.
[1023] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 157.

On the other hand, the one-stop-shop ensures better compliance, thus protecting the tax base from erosion. Taxpayers, under the special scheme, are known to revenue authorities and audits can be performed on a regular basis.

The success of a one-stop-shop relies on the co-operation of revenue authorities in all the Member States. This not only requires revenue authorities to assist each other in the administration of cross-border VAT collection, but they must be *ad idem* on the interpretation of the harmonised EU VAT legislation.

Creating a VAT collection mechanism that is fair, enforceable, and equitable to both suppliers and revenue authorities, is a difficult task and is perhaps still a far way off. Parrilli correctly points out that the amendments of 1 January 2015 are definitely not perfect, but they can be a useful starting point for further discussion and analysis in reaching the final harbour.[1024]

4.3.8.2 Collection mechanism: EU supplier in terms of the reverse-charge mechanism

In the case of digital cross-border supplies between EU suppliers and digital imports by EU suppliers, VAT compliance is ensured by the reverse-charge mechanism. This means the VAT vendor must account for VAT on all digital imports and intra-Community supplies in the Member State in which it is established. VAT collection is fairly uncomplicated for both the taxpayer and the revenue authority. In contrast to the South African reverse-charge mechanism, the EU supplier must account for VAT on imported electronically supplied services irrespective of whether or not the services are to be utilised in the making of taxable supplies. Where the imports or intra-community supplies are utilised in the making of taxable supplies, the taxpayer would be entitled to an input VAT deduction. In further contrast to the South African position, these provisions create better tax certainty and do not rely on the interpretation of the taxpayer of what constitutes utilisation in the making of taxable supplies, and what constitutes final consumption. Since the taxpayer is known to the

[1024] Parrilli DM (2009) "Electronically Supplied Services and Value Added Tax: The European Perspective" *Journal of Internet Banking and Commerce* vol 14 no 2 at 16.

revenue authority, and has to reflect all imports on VAT returns, audits can be done more frequently and with greater ease, ensuring better compliance.

4.3.8.3 Collection mechanism: Foreign supplier

A high probability exists that non-EU suppliers will have no exposure to the European VAT compliance obligations, even where their activities fall within the definition of electronically supplied services.[1025] This is mainly due to the fact that B2B transactions account for the majority of cross-border e-commerce transactions, and compliance is shifted to the EU vendor in terms of the reverse-charge mechanism.[1026]

Non-EU suppliers who renders electronically supplied services to EU customers who are not taxable persons (final consumers), have three options to ensure EU VAT compliance - establish in an EU Member State as an EU supplier; register in each Member State where there are taxable activities without creating an establishment; register under the special scheme for non-established suppliers.

4.3.8.3.1 Establish in a Member State

Until 31 December 2014 this may be the most attractive option for most foreign suppliers as it would mean operating on the same basis and on par with an EU-established company.[1027] The supplier can choose to register in the Member State with the lowest VAT rate (currently Luxembourg), which will place it at an advantage over other suppliers subject to higher VAT rates. Registration as an EU-supplier does, however, require that the supplier to have established a fixed business in the

[1025] Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 78.
[1026] Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 78.
[1027] Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 78; Hobbs C and Christie K (2011) "Cloud Computing and VAT" *Tax Notes International* vol 62 no 11 at 899.

Member State of registration from where supplies will be rendered.[1028] In other words, a physical presence is required. This could be costly and counterproductive in e-business characterised by the fact that a physical presence is not always required for it to operate. In addition, the benefits of establishing in a low VAT jurisdiction will be short-lived – only until the January 2015 amendments take effect. Minor, however, points out that it is possible to be liable for VAT in the Member State of establishment and in another Member State where the services are supplied, if the jurisdiction of consumption (supply) is deemed to be the jurisdiction where the supplier has a fixed establishment under that Member State's fixed establishment deeming provisions.[1029] This could lead to a risk of double taxation that could, in most cases, only be resolved by litigation in the ECJ.[1030] Given the strict interpretation of "fixed establishment" it is unlikely that double taxation can be eliminated.[1031]

4.3.8.3.2 Registration in all Member States of economic activity without creating an establishment.

In certain commercial and professional occupations (for example an architect who draws up plans for an EU city, or a singer undertaking a European tour) it has long been practice in the EU to require such suppliers to account for VAT in the Member State of economic activity through the appointment of a representative taxpayer.[1032] The current place-of-supply rules applicable to electronically supplied services widened the range of taxable persons affected by this provision.[1033] Suppliers of electronically supplied services could effectively be required to register in up to 27

[1028] Hobbs C and Christie K (2011) "Cloud Computing and VAT" *Tax Notes International* vol 62 no 11 at 899.
[1029] Minor R (2011) "A Primer on the 'One-Stop Shop' VAT Compliance Scheme for non-EU Suppliers of E-commerce Services" *Tax Notes International* vol 62 no 13 at 1046.
[1030] Minor R (2011) "A Primer on the 'One-Stop Shop' VAT Compliance Scheme for non-EU Suppliers of E-commerce Services" *Tax Notes International* vol 62 no 13 at 1046.
[1031] Minor R (2011) "A Primer on the 'One-Stop Shop' VAT Compliance Scheme for non-EU Suppliers of E-commerce Services" *Tax Notes International* vol 62 no 13 at 1046.
[1032] Article 204(1) of Council Directive 2006/112/EC; Also see Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 79.
[1033] Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 79.

Member States, and appoint a representative taxpayer in each of these. These different sets of registration, each holding its own obligations, would be a cumbersome administrative burden to overcome and is not advised. Minor opines that non-EU suppliers who fail to register under the one-stop-shop scheme are likely to be required to register in each Member State in which they have customers.[1034]

4.3.8.3.3 Special scheme for non-established suppliers

In terms of the special scheme for non-EU suppliers who make electronically supplied services available to EU customers, the supplier can choose to register under the scheme in the Member State of identification and account for VAT in that Member State. VAT should, however, be levied at the rate applicable in the Member State of consumption.[1035]

The supplier vendor must be a foreign vendor who does not have a fixed establishment or is not otherwise required to be established in the EU.[1036] No physical presence in the EU is required. Any supplier who makes electronically supplied services available to EU consumers (who are not taxable persons) qualifies as a taxable person for purposes of the special scheme. The supplier can choose the Member State of identification in which it wishes to register under the scheme, and to which it will submit its VAT returns.[1037] In the UK, registration can be completed online.[1038]

[1034] Minor R (2011) "A Primer on the 'One-Stop Shop' VAT Compliance Scheme for non-EU Suppliers of E-commerce Services" *Tax Notes International* vol 62 no 13 at 1045.
[1035] Articles 358-369 of Council Directive 2006/112/EC which applies until 31 December 2014. From 1 January 2015 the special scheme shall also apply to suppliers of broadcasting and telecommunication services.
[1036] Article 358(1) of Council Directive 2006/112/EC; article 358a(1) of Council Directive 2008/8/EC.
[1037] Article 358(3) of Council Directive 2006/112/EC; article 358a(2) of Council Directive 2008/8/EC.
[1038] Cass M and Mason C (2003) "Recent Changes to EU VAT for Services Supplied Electronically" *World Internet Law Report* vol 4 issue 11 at 14.

a) Duties in terms of the special scheme

The non-established taxpayer shall, by electronic means, notify the Member State of identification when it commences or ceases with its activities as taxable person, or when it changes its activities and no longer meets the requirements of the special scheme.[1039] The non-established taxpayer must, when it commences a taxable activity in the Community, supply the Member State of identification with its name, postal address, electronic address (including websites), national tax number in the country of establishment, and a statement that the taxpayer is not identified to be registered for VAT purposes in the EU other than in terms of the special scheme.[1040] The supplier must submit a VAT return to the Member State of identification quarterly and by electronic means, irrespective of whether or not electronically supplied services (and after 1 January 2015: telecommunication or broadcasting services) were rendered during the applicable tax period.[1041] This is a special accounting return method designed as an abridged VAT return compared to VAT returns submitted by businesses established in the EU.[1042] The VAT return must be submitted within 20 days following the last day of the tax period covered by the return.[1043] Tax periods are divided quarterly.[1044] The VAT return shall state the total value (exclusive of VAT) of the electronically supplied services (after 1 January 2015 the total value of telecommunication and broadcasting services must also be included), as well as the corresponding VAT at the rate applicable in the country of consumption, and the total VAT due for the tax period.[1045] Lamensch points out that this is quite difficult to administer.[1046] The VAT return shall be made out in Euros and payment of the VAT (in Euros) shall be made into a designated bank account

[1039] Article 360 of Council Directive 2006/112/EC; article 360 of Council Directive 2008/8/EC.
[1040] Article 361 (1) of Council Directive 2006/112/EC; article 361(1) of Council Directive 2008/8/EC.
[1041] Article 364 of Council Directive 2006/112/EC; article 364 of Council Directive 2008/8/EC.
[1042] Cass M and Mason C (2003) "Recent Changes to EU VAT for Services Supplied Electronically" *World Internet Law Report* vol 4 issue 11 at 14.
[1043] Article 364 of Council Directive 2006/112/EC; article 364 of Council Directive 2008/8/EC.
[1044] Minor R (2011) "A Primer on the 'One-Stop Shop' VAT Compliance Scheme for non-EU Suppliers of E-commerce Services" *Tax Notes International* vol 62 no 13 at 1045.
[1045] Article 365 of Council Directive 2006/112/EC; article 365 of Council Directive 2008/8/EC.
[1046] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 7.

identified by the Member State of identification.[1047] Member States who have not adopted the Euro, may require that the VAT return be made out in the national currency at the exchange rate applicable on the last day of the tax period[1048] as published by the European Central Bank.[1049] The revenue authority in the Member State of identification is required to remit taxes collected under the scheme quarterly within a short time frame.[1050]

The taxpayer (supplier) must keep electronic records of the transactions covered by the special scheme for a period of 10 years from the last day of the year during which the transaction was performed.[1051] The records must be sufficiently detailed to enable the tax authorities in the Member State of consumption to verify whether the VAT return is correct.[1052] The absence of guidelines on how suppliers must store information, in what format, and for how long the information must be retained, result in legal uncertainty.[1053]Baron opines that the administrative burden of record keeping cancels out the simplicity envisaged and brought about by the special scheme.[1054]

Since the non-established taxpayer would not be conducting a full scale enterprise in the EU, it would not be entitled to make any input VAT deduction in respect of the supplies it makes in terms of the special scheme.[1055] Should the taxpayer be of the opinion that it is entitled to a deduction for input VAT, it can apply for a refund of the input VAT paid in accordance with the Thirteenth Directive refund procedure.[1056] This means that the taxpayer must apply for a VAT refund in each of the Member States

[1047] Articles 366 (1) and 367 Of Council Directive 2006/112/EC; articles 366 (1) and 367 of Council Directive 2008/8/EC.
[1048] Article 366(1) of Council Directive 2006/112/EC; article 366(1) of Council Directive 2008/8/EC.
[1049] Article 366(2) of Council Directive 2006/112/EC.
[1050] Minor R (2011) "A Primer on the 'One-Stop Shop' VAT Compliance Scheme for non-EU Suppliers of E-commerce Services" *Tax Notes International* vol 62 no 13 at 1045.
[1051] Article 369 of Council Directive 2006/112/EC; article 369(1) of Council Directive 2008/8/EC.
[1052] Article 369(1) of Council Directive 2006/112/EC; article 369(1) of Council Directive 2008/8/EC.
[1053] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 85; Lejeune I, Cortvriend E, Accorsi D (2011) "Implementing Measures Relating to EU Place-of-Supply Rules: Are Business Issues Solved and is Certainty Provided?" *International VAT Monitor* vol 22 no 3 at 147.
[1054] Baron R (2002) "VAT on Electronic Services: The European Solution" *Tax Planning International E-commerce* vol 4 no 6 at 5.
[1055] Article 368 of Council Directive 2006/112/EC; article 368 of Council Directive 2008/8/EC; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 7.
[1056] Article 368 of Council Directive 2006/112/EC; article 368 of Council Directive 2008/8/EC.

in which input VAT was incurred.[1057] Bill and Kerrigan correctly point out that the supplier who merely supplies electronically supplied services to EU consumers, would be unlikely to incur any expenses in the EU in the making of the supplies.[1058] The rules are silent on this, but it is presumed that any input deduction to which the supplier would be entitled, would be made in the tax return in the Member State of identification.[1059] This could be a lengthy process, depending on the procedure and practice of the country from which the refund is being sought.[1060] That said, any refund within the EU would be rare.[1061]

b) Criticism

Ever since the special scheme was proposed, it has been subjected to severe criticism by non-European suppliers of electronically supplied goods, politicians, and economists. Basu points out that enforceability of the special scheme is the Achilles heel of the European VAT system.[1062] The enforceability of the special scheme causes problems owing to the difficulties in identifying the customer's VAT status and location, which lead to additional administrative costs.[1063] In addition, it is unclear if and how the EU can force a supplier from a non-EU country to register for VAT under the special scheme in a Member State.[1064] This is in particular a concern

[1057] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 7.
[1058] Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 80.
[1059] Minor R (2011) "A Primer on the 'One-Stop Shop' VAT Compliance Scheme for non-EU Suppliers of E-commerce Services" *Tax Notes International* vol 62 no 13 at 1045
[1060] Minor R (2011) "A Primer on the 'One-Stop Shop' VAT Compliance Scheme for non-EU Suppliers of E-commerce Services" *Tax Notes International* vol 62 no 13 at 1045; Cervino G (2007) "VAT and E-commerce" *International Tax law Review* vol 3 at 140-141; Fetzer T (2002) "Non-EU Businesses to Collect VAT on Electronic Services" *Tax Planning International E-commerce* vol 4 no 7 at 9; De la Feria R (2006) *The EU VAT System and the Internal Market* at 110.
[1061] Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* 38 no 1 at 80; Terra BJM and Kajus J (2012) *A Guide to the European VAT Directives* vol 1 at 1037.
[1062] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].
[1063] Cervino G (2007) "VAT and E-commerce" *International Tax law Review* vol 3 at 140; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 5-7.
[1064] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 159.

in the case of suppliers who are established in the USA. In *Quill Corp v North Dakota,*[1065] Justice Stevens ruled in the Supreme Court of the USA, that states cannot require suppliers who make interstate supplies to collect sales tax on their supplies to consumers in the state of consumption if the supplier does not have a physical presence in that state. The mere fact that a supplier communicates with a customer in a state via mail does not create a sufficient nexus between the supplier and the state to force the supplier to collect sales tax on its supplies on behalf of the state of consumption.[1066] It could be argued that the scope of this decision is not limited to inter-state sales in the USA, but that it also applies to international sales. The result is that EU Member States cannot, by virtue of the fact that a USA supplier makes electronically supplied services available to customers in the EU, compel the supplier to collect VAT on its behalf in the absence of a physical presence in the EU Member State. In addition, the Internet Tax Freedom Act of 1998 - which has been extended to apply until 1 November 2014 - protects consumers and suppliers against the imposition of new taxes on e-commerce, including the imposition of taxes on out-of-state businesses.[1067] As a result, many USA-based suppliers are unaware of their duty under EU VAT rules to collect VAT on supplies made to their customers who resides in the EU.[1068] Merrill points out that, should the EU rules be enforceable on USA businesses, the nexus argument would fall away and EU suppliers who make digital supplies to USA customers could be required to collect state taxes on behalf of USA states in the various tax jurisdictions.[1069] This could result in EU suppliers accounting for sales tax in up to 7 000 different USA tax jurisdictions.[1070] In the absence of international agreements, it is doubtful under public international law whether the EU has the extra-territorial authority to impose such a duty on foreign

[1065] *Quill Corp v North Dakota* (91-0194), 504 U.S. 298 (1992).
[1066] *Quill Corp v North Dakota* (91-0194), 504 U.S. 298 (1992); *National Bellas Hess v. Department of Revenue* - 386 U.S. 753 (1967); *America Online, Inc v Johnson* Chancery Court of Davidson County Tennessee No 97-3786-III (2001)
[1067] Gordon-Murnane L (2000) "E-commerce and Internet Taxation: Issues, Organizations and Findings" *Searcher* vol 8 issue 6 http://www.infotoday.com/searcher/jun00/gordon-murnane.htm [accessed on 15 January 2013]; Schafer CJ (2001) "Federal Legislation Regarding Taxation of Internet Sales Transactions" *Berkeley Technology Law Journal* vol 16 at 416-417; Reddick CG and Coggburn JD (2007) "E-commerce and the Future of the State Sales Tax System: Critical Issues and Policy Recommendations" *International Journal of Public Administration* vol 30 at 1027-1028; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 219.
[1068] Hobbs C and Christie K (2011) "Cloud Computing and VAT" *Tax Notes International* vol 62 no 11 at 898.
[1069] Merrill PR (2001) "The Moving Target of E-commerce" *The CPA Journal* November 2001 at 38.
[1070] Merrill PR (2001) "The Moving Target of E-commerce" *The CPA Journal* November 2001 at 38.

suppliers who do not have a fixed establishment in or sufficient nexus to the EU.[1071] However, Doernberg and Hinnekens opine that, in the case of consumption taxes, a vendor should not be required to have a fixed establishment in the state or country where it makes digital supplies for it to be liable for VAT in that state or country.[1072]

How will the EU enforce VAT compliance on businesses that exist in cyberspace? Where will the EU enforce compliance? If the vendor exists in cyberspace only, its mobility allows it to be established in various low-tax jurisdictions or tax havens that have no tax treaties with the EU.[1073] Minor notes that unilateral and multilateral inter-jurisdictional audits on non-compliant businesses, are on the rise irrespective of the presence or absence of international tax treaties.[1074] In a *Green Paper* released for consultation in December 2010, the European Commission suggests that:

i) Tax authorities must be encouraged to cooperate on VAT at International level; and
ii) New ways of collecting VAT from consumers should be investigated, for example, checking online payments.[1075]

The current system is heavily reliant on voluntary compliance.[1076] From a neutrality and competition perspective, it is questionable whether a system based on voluntary

[1071] Wasch K as quoted in Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012]; Ivanson J (2003) "Why the EU VAT and E-commerce Directive Does not Work" *International Tax Review* vol 14 issue 9 at 31. In *Trans Tirreno Express SpA v Ufficio provinciale IVA* Case C-283/84 (1986) ECR I-00231, the court ruled that a Member State is not precluded from applying its VAT legislation in respect of transport between two points in its national territory even where part of the journey is completed outside its territory, *provided* that this does not encroach on the tax jurisdiction of other states.
[1072] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 350.
[1073] Scott C, Derrick F, Sedgley N (2003) "Consumption Taxes in the Internet World" *International Advances in Economic Research* vol 9 no 4 at 310.
[1074] Minor R (2011) "A Primer on the 'One-Stop Shop' VAT Compliance Scheme for non-EU Suppliers of E-commerce Services" *Tax Notes International* vol 62 no 13 at 1045.
[1075] European Commission (2010) *Green Paper on the Future of VAT: Towards a Simpler, more Robust and Efficient VAT System* COM(2010) 695 final at 12 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0695:FIN:EN:PDF [accessed on 21 January 2013].
[1076] European Commission (2010) *Green Paper on the Future of VAT: Towards a Simpler, more Robust and Efficient VAT System* COM(2010) 695 final at 12 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0695:FIN:EN:PDF [accessed on 21 January 2013]; Fetzer T (2003) "Digital Sales and the European Union: Taxing Times Imminent" *Tax Planning International E-commerce* vol 5 no 4 at 7; Lambourne M and Llewellyn J (2002) "Does EU VAT Extension Catch You?" *Tax Planning International E-commerce* vol 4 no 11 at 5; Lejeune I, Korf R, Grünauer A (2003) "New E-commerce Directives: A Move Towards e-Europe?" *Journal of International Taxation* vol 14 no 4 at 22-23.

compliance will be acceptable in the long term.[1077] That said, the suggestions by the European Commission to address this issue are vague and based on a self-assessment mechanism which relies on voluntary compliance.[1078] In the UK failure to register may result in compulsory registration and a late registration penalty of between 5 and 15 percent of the VAT due.[1079] How this will be enforced against foreign suppliers remains an open question.

As the supplier cannot locate the customer's residence or place of consumption with absolute accuracy, the value of registering under the scheme is doubtful.[1080] The Directive is based on the premise that there will be technology that is able to locate the customer's residence. Should this technology fail to materialise, the directive will be unenforceable.[1081] In addition, the anonymity of e-commerce and the lack of a paper trail could mean that most of these transactions will be unknown in the EU. The Netherlands, the UK, Gemany, France, and Denmark have introduced software programs to perform systematic searches on the Internet for persons or companies offering products via the Internet.[1082] However, it is doubtful whether a Member State has extra-territorial jurisdiction to subject that supplier to an EU VAT audit in the country where the supplier is established. The Directive does not provide detail on how Member States will trace non-compliant businesses or enforce compliance.[1083] Hardesty notes that Member States would rely on tip-offs from compliant suppliers who are in competition with non-compliant suppliers.[1084] While this partially resolves

[1077] European Commission (2010) *Green Paper on the Future of VAT: Towards a Simpler, more Robust and Efficient VAT System* COM(2010) 695 final at 12 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0695:FIN:EN:PDF [accessed on 21 January 2013].
[1078] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 86.
[1079] Cass M and Mason C (2003) "Recent Changes to EU VAT for Services Supplied Electronically" *World Internet Law Report* vol 4 issue 11 at 14.
[1080] Bleuel J and Stewen M (2000) "Value Added Taxes on Electronic Commerce: Obstacles to the EU Commission's Approach" *Intereconomics* July/August at 159; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 8.
[1081] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].
[1082] Brandt U and Juul M (2005) "EU VAT Rules on Electronically Supplied Services" *Tax Planning International: European Union Focus* vol 7 no 10 at 15.
[1083] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].
[1084] Hardesty D (2000) "EU Continues Efforts to Tax Digital Products" *E-commerce Tax News* 22 October 2000 http://www.mail-archive.com/members@csmfo.org/msg01582.html [accessed on 29 October 2012].

the issue of detecting non-compliance, it still does not resolve the issue of how the Member State would enforce compliance or payment in the supplier's jurisdiction of establishment. Furthermore, Hardesty's opinion is based on the assumption that compliant businesses will report non-compliant businesses. It is possible that compliant businesses can follow in the footsteps of non-compliant businesses to compete on par. Bill and Kerrigan, in an unsubstantiated statement, are of the opinion that businesses will want to be compliant.[1085] Jenkins believes that because of the legal certainty created by clear and unambiguous Directives, suppliers willing to expand are more likely to comply.[1086] However, given the fact that non-compliance cannot be traced or adequately penalised, I (perhaps cynically) fail to see any reason why businesses would be compliant. Van der Merwe points out that the only remedies available to the EU are to: a) block access to websites of non-compliant businesses; b) refuse to protect the intellectual property of non-compliant businesses; c) publish the names of non-compliant companies; or d) to arrest the management of non-compliant businesses when they travel through Europe.[1087] The legitimacy of these remedies is however questionable if it is considered that their basis lies in an unenforceable inter-jurisdictional obligation.

The EU Commission argues that non-EU companies would have an interest in collecting VAT on behalf of Member States because the Member States already protect their intellectual property within the Community.[1088] The European Commission is further of the opinion that no business trading in the world's largest market, would wish to have tax debt building up against it.[1089] Basu correctly points out that a give-and-take relationship is neither legislation that can be enforced, nor is

[1085] Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* vol 38 no 1 at 81

[1086] Jenkins P (2000) "The EU Proposals for the Effective Application of VAT in the Internet Age" *Tax Planning International E-commerce* vol 2 no 12 at 7.

[1087] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 588; Fitzgerald S (2002) "U.S. Companies' Sales to EU Consumers Subject to VAT on Digital Downloads" *The Tax Adviser* June at 383-384.

[1088] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012]; Fetzer T (2003) "Digital Sales and the European Union: Taxing Times Imminent" *Tax Planning International E-commerce* vol 5 no 4 at 7; Baron R (2001) "VAT- Where Next for Europe?" *Tax Planning International E-commerce* vol 3 no 1 at 12; Ivanson J (2003) "Overstepping the Boundary-How the EU got it Wrong on E-commerce" *International Tax Report* October at 11.

[1089] Baron R (2001) "VAT- Where Next for Europe?" *Tax Planning International E-commerce* vol 3 no 1 at 12.

it an agreement enforceable in law.[1090] Since intellectual property rights are protected based on international agreements, it is not open to the EU to violate them in reaction to tax non-compliance.[1091] In essence, similar to the reverse-charge mechanism that applies to consumers under South African law, the special scheme relies on the honesty and integrity of taxpayers. Interestingly, in June 2004, just one year after the special scheme was introduced, 845 non-EU companies were registered under the special scheme, of these, eight were South African.[1092] VAT collected from these companies amounted to Euros 90 315 000 by the end of June 2004.[1093] These figures are relatively low and could be indicative of the EU's inability to enforce its VAT rules.

Compliance under the special scheme is not necessarily less burdensome or less complicated than that established in each Member State of consumption.[1094] Not only must the supplier comply with the requirements in the Member State of identification, it also must comply with any existing relevant rules applicable in the Member State of consumption.[1095] In other words, the supplier must study the national VAT rules of all the Member States of consumption. Van der Merwe points out that non-EU sellers should be allowed to follow a single set of rules for all EU sales.[1096]

In its initial proposal form, the special scheme provided for a registration threshold of Euros 100 000.[1097] Neither the present form of the scheme, nor the January 2015

[1090] Basu S (2002) "European VAT on Digital Sales" *Journal of Information, Law and Technology* issue 3 http://elj.warwick.ac.uk/jilt/02-3/basu.html [accessed on 5 October 2012].
[1091] Baron R (2001) "VAT- Where Next for Europe?" *Tax Planning International E-commerce* vol 3 no 1 at 12; Ivanson J (2003) "Overstepping the Boundary-How the EU got it Wrong on E-commerce" *International Tax Report* October at 11.
[1092] Brandt U and Juul M (2005) "EU VAT Rules on Electronically Supplied Services" *Tax Planning International: European Union Focus* vol 7 no 10 at 14.
[1093] Brandt U and Juul M (2005) "EU VAT Rules on Electronically Supplied Services" *Tax Planning International: European Union Focus* vol 7 no 10 at 15.
[1094] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 7.
[1095] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 584; García AMD and Cuello RO (2011) "Electronic Commerce and Indirect Taxation in Spain" *European Taxation* vol 51 no 4 at 142.
[1096] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 584.
[1097] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 585; Fitzgerald S (2002) "U.S. Companies' Sales to EU Consumers Subject to VAT on Digital Downloads" *The Tax Adviser* June at 382.

amendments, specifies a threshold. In the absence of a threshold, even small businesses that occasionally make digital supplies to EU customers, must register in terms of the special scheme.[1098] Fitzgerald correctly points out that it is not certain whether vendors under the special scheme are subject to the individual Member State thresholds, and if they are, whether the threshold in the Member State of identification or that of consumption should apply.[1099] Some observers are of the opinion that the proposed threshold was omitted intentionally and that it is not merely an oversight.[1100] If this view is correct, the compliance burden could either deter suppliers from rendering supplies to EU consumers, or persuade them not to comply with the special scheme.[1101] That said, a threshold would disadvantage small EU suppliers who compete against their non-EU competitors. Hardesty opines that both EU and non-EU small businesses should be exempt.[1102] However, exemption as a blanket rule is bad policy.

The time of completion of registration differs between Member States, ranging from instant online registration, to an extended process that can take weeks.[1103] In the Netherlands a registration form must be requested, completed and mailed to the *Belastingdienst.*[1104] In Germany, registration can be completed online.[1105] In Hungary, registration forms must be completed in Hungarian, and registration is subject to the appointment of a fiscal representative.[1106] Non-EU suppliers are

[1098] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 585.
[1099] Fitzgerald S (2002) "U.S. Companies' Sales to EU Consumers Subject to VAT on Digital Downloads" *The Tax Adviser* June at 382.
[1100] Brandt U and Juul M (2005) "EU VAT Rules on Electronically Supplied Services" *Tax Planning International: European Union Focus* vol 7 no 10 at 13; Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 585.
[1101] Van der Merwe B (2004) "VAT in the European Union and Electronically Supplied Services to Final Consumers" *SA Merc LJ* vol 16 no 4 at 585.
[1102] Hardesty D (2000) "EU Continues Efforts to Tax Digital Products" *E-commerce Tax News* 22 October 2000 http://www.mail-archive.com/members@csmfo.org/msg01582.html [accessed on 29 October 2012].
[1103] Brandt U and Juul M (2005) "EU VAT Rules on Electronically Supplied Services" *Tax Planning International: European Union Focus* vol 7 no 10 at 16.
[1104] Belastingdienst (2013) *Your Tax Office and Registration* http://www.belastingdienst.nl/wps/wcm/connect/bldcontenten/belastingdienst/business/vat/vat_in_the_netherlands/vat_administration/your_tax_office_and_registration [accessed on 30 April 2013].
[1105] Bundeszentralampt für Steuern (2013) *VAT on eServices* https://evat.bff-online.de/001/addNetpForm [accessed on 30 April 2013].
[1106] KPMG (2013) *Hungary: VAT Essentials* http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/vat-gst-essentials/pages/hungary.aspx#2 [accessed on 30 April 2013].

unlikely to register under the special scheme where registration cannot be completed hassle-free and within a reasonably short time.[1107]

4.4 Conclusion

The supply of digital goods is but one part in the larger phenomenon of e-commerce. The changes in technology and the impact of globalisation in general (through the economic significance of cross-border trade in intangibles) have had a major impact on international trade and could result in digital trade taking the lion's share of international commerce.[1108] *Lacunae* in existing legislation, or inadequate legislation, coupled with the rapid growth in global e-commerce could place an enormous strain on a VAT system. This could even result in an erosion of the tax base. The Member States, through the unified collaboration in the EU, are the first countries in the world to modernise the harmonised VAT system in response to this global phenomenon. The modernisation of the harmonised VAT rules, and in particular the provision for electronically supplied services, is far from perfect. However, the developments in the EU should be seen as a starting point in the right direction, and could further be used as a learning tool in the development of a unified global solution.

Despite the many problems that modernisation has brought, it is clear from the discussion above that many of the uncertainties currently faced under the South African VAT Act,[1109] can be resolved by adopting the clear and certain provisions of the EU VAT rules. These include the characterisation of digital goods as services; the adoption of clear place, time, and value of supply rules; and the adoption of a simplified vendor registration process for vendors who are not established in the jurisdiction of consumption.

The problems that the modernisation of the EU VAT rules has brought may, in the main, be attributed to rapidly evolving technology outgrowing legislation,

[1107] Brandt U and Juul M (2005) "EU VAT Rules on Electronically Supplied Services" *Tax Planning International: European Union Focus* vol 7 no10 at 16.
[1108] Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* vol 38 no 1 at 83.
[1109] Act 89 of 1991.

uncertainties resulting from imperfect legislation that is drafted in general terms, and the lack of international cooperation.

In the first instance, the definition of electronically supplied services and the list of what constitutes electronically supplied services, are rapidly outdated. The ECJ is known for its strict interpretation of directives which could result in new technological advances being excluded from the scope of electronically supplied services. In addition, the special classification of electronically supplied services results in different VAT rates applying between digital products and their tangible counterparts. This differentiation is seen as discriminatory as regards the digital trade.

Secondly, determining the customer's location for purposes of determining the place of supply, relies on technology that currently does not exist, or, where it does exist, is inadequate for this purpose. Unless technology is developed to determine the customer's residence/location with absolute accuracy, the Directive cannot be enforced.

Thirdly, the time of supply in the case of vouchers and prepaid agreements remains uncertain. However, the current EU proposals would appear to address this issue adequately.

Fourthly, in the absence of exchange rate guidelines, the determination of the value of the supply in the case of cross-border supplies in a currency other than Euro is cumbersome.

Lastly, the enforceability of the Directive on non-EU suppliers remains a contentious issue. The extra-territorial powers afforded to the EU might, strictly speaking, not be in the international public interest. In addition, how and on what basis the Directive can be enforced, is not certain. In the light of the USA Supreme Court judgment in *Quill Corp v North Dakota,*[1110] any attempt to enforce the Directive on USA established customers would be in contempt of court.

The more businesses find that cross-border trade in intangibles is an increasingly profitable component of international trade, the more they will come into contact with

[1110] *Quill Corp v North Dakota* (91-0194), 504 U.S. 298 (1992).

an increasing number of tax administrations.[1111] Excessive compliance obligations are particularly onerous for small to medium sized enterprises whose growth is important to foster in volatile economic times.[1112] In other words, the fact that a global solution to the taxation of e-commerce should be developed, cannot be over emphasised. In the next chapter I shall discuss the proposals of the OECD in the hope of their yielding a global solution.

[1111] Bill S and Kerrigan A (2003) "Practical Application of European Value Added Tax to E-commerce" *Georgia Law Review* vol 38 no 1 at 83; Ward BT, Sipior JC, Bremser W, McGinty DB (2006) "A Comparison of United States and European Union Taxation of E-commerce" ICEC '06 Proceedings of the 8th International Conference on Electronic Commerce at 348.

[1112] Cnossen S quoted in Jackson R (2011) "EU VAT: *Quo Vadis?*" *Tax Notes International* vol 62 no 13 at 999.

CHAPTER 5:

THE OECD

5.1 Introduction

In Chapter 4 it was established that the taxation of e-commerce is a global issue that cannot be resolved by adopting VAT rules with extra-territorial powers in the absence of international treaties. Furthermore, where jurisdictions modernise their VAT rules in isolation and without having regard to international trends and inter-jurisdictional relationships, the modernisation is set for failure. The Organisation for Economic Co-operation and Development (OECD) is an international body that concerns itself with the promotion of policies that will improve the social and economic well-being of people around the world. It provides a forum for governments to work together, share experiences, and seek solutions to common problems. One of its various areas of research is the taxation (more specifically consumer taxes) on cross-border electronic transactions. Despite the fact that South Africa is not a member of the OECD, the body's proposals should be considered in the process of modernising South Africa's VAT rules to bring them in line with international trends in finding a global solution for the taxation of cross-border digital trade. The OECD and South Africa do, however, have close relations through the OECD's enhanced engagement programme.

In this chapter I first discuss the history of the OECD and its involvement in research on consumer taxation of cross-border e-commerce. I then discuss the OECD proposals with the aim of identifying a solution to the compliance issues currently experienced under both the South African VAT system and the EU system.

5.2 The history of the OECD

In 1947, shortly after World War II, the Organisation for European Economic Cooperation (OEEC) was formed to implement the USA-funded Marshall Plan for the reconstruction of a continent ravaged by war.[1113] Encouraged by the successes of the OEEC and the prospect of carrying its work to the global front, Canada and the USA joined the OEEC on 30 September 1961 and formed the OECD.[1114] Various countries have since joined the OECD and the current membership stands at 34 member countries.[1115]

The OECD's work is generally based on the continued monitoring of global events and includes the medium to long-term projection of economic developments.[1116] The OECD secretariat collects and analyses data after which committees are appointed to discuss policy on the information and make recommendations to the Council.[1117] Council takes decisions which are then recommended to governments for implementation on a national level.[1118]

The OECD traditionally promotes tax reform in the international income tax arena through the implementation of and commentary on its model tax treaty.[1119] This mandate stems from article 1 of the Convention that was signed in Paris (Paris Convention) on 14 December 1960.[1120] In terms of the Paris Convention, the OECD shall promote policies-

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[1113] OECD *History* http://www.oecd.org/about/history/ [accessed on 12 November 2012].
[1114] OECD *History* http://www.oecd.org/about/history/ [accessed on 12 November 2012].
[1115] These member countries are Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States of America.
http://www.oecd.org/general/listofoecdmembercountries-ratificationoftheconventionontheoecd.htm [accessed on 3 April 2013].
[1116] OECD *History* http://www.oecd.org/about/history/ [accessed on 12 November 2012].
[1117] OECD *History* http://www.oecd.org/about/history/ [accessed on 12 November 2012].
[1118] OECD *History* http://www.oecd.org/about/history/ [accessed on 12 November 2012].
[1119] Cockfield AJ (2006) "The Rise of the OECD as Informal World Tax Organization through National Responses to E-commerce Tax Challenges" *Yale Journal of Law and Technology* vol 8 at 148.
[1120] OECD (1998) *Harmful Tax Competition:An Emerging Global issue*
http://www.oecd.org/tax/transparency/44430243.pdf [accessed on 15 April 2013].

– to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
– to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
– to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.[1121]

Generally, apart from the Canada-USA treaty, no model treaty or bilateral agreement exists that covers VAT.[1122] Since the rise of e-commerce in the late 1990s, a need for tax reform in the field of VAT has gained support among OECD members.[1123] As a result, the OECD pursued its mandate to promote reform efforts for VAT. The OECD contributes to the efficient design and operation of VAT systems through policy analysis and advice.[1124] It further develops international VAT/Sales tax guidelines as an international standard for cross-border trade to minimise the risk of double taxation or under-taxation.[1125] These guidelines are based on the principles of a "good tax" namely neutrality, efficiency, legal security, simplicity, equity, and flexibility.[1126]

5.3 The OECD proposals on consumption taxes on cross-border e-commerce

Following the Ottawa Conference on e-commerce in 1998, the OECD's Committee on Fiscal Affairs (CFA) adopted the *Guidelines on Consumption Taxation of Cross-*

[1121] OECD (1998) Harmful Tax Competition:An Emerging Global issue http://www.oecd.org/tax/transparency/44430243.pdf [accessed on 15 April 2013].
[1122] Cockfield AJ (2006) "The Rise of the OECD as Informal World Tax Organization through National Responses to E-commerce Tax Challenges" *Yale Journal of Law and Technology* vol 8 at 148.
[1123] Cockfield AJ (2006) "The Rise of the OECD as Informal World Tax Organization through National Responses to E-commerce Tax Challenges" *Yale Journal of Law and Technology* vol 8 at 148; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 213-214.
[1124] OECD *Consumption Tax* http://www.oecd.org/ctp/consumptiontax/articlesonvat.htm [accessed on 12 November 2012].
[1125] OECD *Consumption Tax* http://www.oecd.org/ctp/consumptiontax/articlesonvat.htm [accessed on 12 November 2012].
[1126] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 389.

Border Services and Intangible Property in the Context of E-commerce[1127] which was endorsed by the *Consumption Tax Guidance Series.*[1128] It has, however, become clear that the problems associated with the application of VAT on the supply of intangible goods are, in the main, rooted in the remaining differing approaches in certain jurisdictions. This has exacerbated the possibility of double taxation and under-taxation.[1129] As a result, in January 2006, the CFA adopted a set of basic principles for the development of the OECD *International VAT/GST Guidelines*.[1130] The development of the guidelines is a long-term project that aims to cover a broad spectrum of cross-border trade VAT issues.[1131]

In the discussion that follows I examine the OECD proposals on the taxation of cross-border digital sales by addressing the following issues:

a) Is there a supply of goods or services?
b) Where is the supply made?
c) When is the supply made?
d) What is the value of the supply?
e) Is it made by a taxable entity?
f) Is it made in the course or furtherance of an enterprise?
g) Is the supply taxable?
h) How is VAT on the transaction collected?

[1127] OECD (2001) *Guidelines on Consumption Taxation of Cross-Border Services and Intangible Property in the Context of E-commerce* http://www.oecd.org/tax/consumptiontax/5594831.pdf [accessed on 12 November 2012]; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 212-213.
[1128] OECD (2010) *What are the OECD International VAT/GST Guidelines?* at 3 http://www.oecd.org/tax/consumptiontax/48077011.pdf [accessed on 12 November 2012]; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 212-213.
[1129] OECD (2010) *What are the OECD International VAT/GST Guidelines?* at 3 http://www.oecd.org/tax/consumptiontax/48077011.pdf [accessed on 12 November 2012].
[1130] OECD (2010) *What are the OECD International VAT/GST Guidelines?* at 3 http://www.oecd.org/tax/consumptiontax/48077011.pdf [accessed on 12 November 2012].
[1131] OECD (2010) *What are the OECD International VAT/GST Guidelines?* at 4 http://www.oecd.org/tax/consumptiontax/48077011.pdf [accessed on 12 November 2012].

5.3.1 Is there a supply of goods or services?

As digitised products cannot be "handled" in the traditional sense, they are not subject to the same customs controls as their tangible counterparts.[1132] Although the customer may create a tangible product from the digitised product, the product is intangible when it is initially received.[1133] In 1998, the OECD Ministers welcomed the proposal that the supply of intangible products, for consumption tax purposes, should not be treated as goods[1134] – a principle that is endorsed in its *International VAT/GST Guidelines.*[1135] This proposal is rather vague and does not provide for specific guidelines as to whether the sale of intangible goods should be treated as services, royalties, or a separate category in its own right. In January 1999, the CFA appointed the Technical Advisory Group (TAG) with a general mandate "to examine the characterisation of various types of electronic commerce payments under tax conventions with a view to providing the necessary clarifications in the Commentary."[1136] In its analysis, the TAG identified 28 different categories of e-commerce transaction, each posing its own characterisation and classification problems.

5.3.1.1 Electronic processing of tangible products

These transactions involve the electronic ordering of tangible goods that are physically delivered to the customer through traditional means. The TAG does not see that these types of transaction would pose any classification issues as the

[1132] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 379.
[1133] Van der Merwe B (2003) "VAT and E-commerce" *SA Merc LJ* vol 15 no 3 at 379.
[1134] OECD (2001) *Guidelines on Consumption Taxation of Cross-Border Services and Intangible Property in the Context of E-commerce* at 1 http://www.oecd.org/tax/consumptiontax/5594831.pdf [accessed on 12 November 2012].
[1135] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1136] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 3 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

products can clearly be identified as "goods".[1137] Existing VAT rules on cross-border trade continue to apply. In exceptional cases, where the parties expressly agree to this effect, the payment may be treated as royalties and the goods as intellectual property.[1138]

5.3.1.2 Electronic ordering and downloading of digital products

These transactions involve the online ordering of digital products which are electronically delivered and stored on the customer's hard drive or other non-temporary storage device.[1139] These transactions are often the main contributors to the confusion as to whether the sale involves the sale of services, or whether the payment constitutes royalties for the use and enjoyment of copyright. The TAG proposes that where the transaction permits the customer to download digitised products (such as music, video, images, text, or software) electronically for his own use and enjoyment, the payment is made to acquire data in the form of an electronic transmission.[1140] The copying of the data onto the customer's hard drive or non-temporary storage device, is incidental to the transaction and does not amount to the transfer of the right to use and enjoy copyright for which royalties are payable.[1141]

[1137] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 20 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 10.
[1138] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 20 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1139] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 20 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 10.
[1140] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 20-21 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1141] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 21 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 4.

The copying is not indicative of the transfer of copyright. This classification is fully consistent with the OECD principles of tax neutrality.[1142]

5.3.1.3 Electronic ordering and downloading of digital products for purposes of commercial exploitation of copyright

Digital products can be treated as the sale of intellectual property where the parties have expressly agreed that the transaction includes the transfer of the right to use, enjoy, and exploit the copyright in the data.[1143] This would typically be the case where the data is sold to enable the purchaser to make a profit or commercial gain from exploiting the intellectual property - for example, where music is transferred to a movie producer who will use it in a film that is to be produced.

5.3.1.4 Updates and add-ons

In these cases, the provider of software or digital products agrees to provide the customer with updates or add-ons to the digital products. These updates or add-ons are not customer specific. In so far as the updates or add-ons are delivered to the customer in a tangible form, the TAG proposes that the update or add-on should be treated as goods.[1144] Consequently, where the updates or add-ons are delivered electronically, as envisaged in paragraph 5.3.1.2 above, they are treated as services.[1145]

[1142] Andrus JL and Merril PR (2000) "Treaty Characterisation of E-commerce Payments-Comments on the TAG Draft" *Tax Planning International E-commerce* vol 2 no 6 at 10.
[1143] Yu R (2001) *Characterisation of E-commerce Transactions: A Review of TAG Final Report on Tax Treaty Characterisation* at 10 http://raymondyu.net/pub/papers/eChar.pdf [accessed on 14 November 2012]; OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 21 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1144] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 21 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1145] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 22 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

5.3.1.5 Limited duration software and digital information licenses

In these cases, the customer receives the right to use the software or other digital products for a limited period that is less than the expected useful lifetime of the product.[1146] The product, and any copies thereof, are automatically deleted or become useless at the end of the licence period.[1147] Where the software is delivered to the customer by electronic means, the products should be treated as the supply of services.[1148]

5.3.1.6 Single-use software

In these cases, the customer receives the right to use software or any other digital product only once.[1149] The data may be downloaded or accessed remotely. The customer does not receive the right to make copies.[1150] This would typically be the case of pay-per-view downloads or where a one-time password is sent to a customer by which he may access a document or other digital product of some sort. The TAG proposes that these products should be treated as services.[1151] Commercial exploitation is the key feature leading to royalty classification.[1152] It therefore follows that where a right to use software without the right to exploit it commercially, is

[1146] Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 10.
[1147] Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 10.
[1148] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 22 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1149] Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 11.
[1150] Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 11.
[1151] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 22 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1152] Andrus JL and Merril PR (2000) "Treaty Characterisation of E-commerce Payments-Comments on the TAG Draft" *Tax Planning International E-commerce* vol 2 no 6 at 10.

transferred, the proceeds of the transaction should be treated as business income.[1153]

5.3.1.7 Application hosting-separate licence

Application hosting involves the granting of a perpetual licence in terms of which a host entity loads the software copy on a server operated by the host and provides technical support against failure.[1154] The customer can access, execute, or operate the application remotely, or after it has been downloaded into RAM.[1155] These applications are typically used for financial management (Payroll), human resources management (Oracle), or any other resource management. The TAG proposes that the digital goods and subsequent services (technical support) so supplied should be treated as the supply of services, and not rental activities, since the supply would mainly be the supply of data warehousing services.[1156] The TAG further proposes that, in cases where a treaty provides for the taxation of technical support at source, the supply of application hosting should be treated as services and not technical support in so far as the application hosting primarily provides for data warehousing and does not require any special technical skill or knowledge.[1157]

5.3.1.8 Application hosting-bundled contract

This involves an agreement, at a single or bundled fee, in terms of which a provider, who is also the copyright holder, allows access to one or more software application,

[1153] Andrus JL and Merril PR (2000) "Treaty Characterisation of E-commerce Payments-Comments on the TAG Draft" *Tax Planning International E-commerce* vol 2 no 6 at 10.
[1154] Jansen C *Hosted Application* http://www.techopedia.com/definition/26633/hosted-application [accessed on 14 November 2012]; OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 23 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1155] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 23 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1156] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 23 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1157] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 23 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

and hosts the application of the software on a server he owns and operates and provides technical support for the software and hardware.[1158] The customer can access, execute or operate the application remotely or after it has been downloaded into RAM, and the contract is renewable upon payment of an annual fee.[1159] This type of supply should generally be treated as a supply of services.[1160] In exceptional circumstances, where a bilateral agreement provides for the taxation of technical support at source, that part of the supply that constitutes technical support should be treated differently (as technical support) from the remainder of the supply.[1161]

5.3.1.9 Application service provider

These transactions involve the granting of a licence to use a software application in the provider's business of operating as an application service provider.[1162] The customer gains access to a software application hosted on computer servers owned and operated by the provider.[1163] The software automates a particular back-office business function for the customer, for example, the automation of sourcing, ordering, payment, and delivery.[1164] The provider does not supply the goods and

[1158] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 23 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 11.
[1159] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 23 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1160] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 24 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1161] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 24 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1162] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 24 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 12.
[1163] Mitchell B *Application Service Provider* http://compnetworking.about.com/od/internetaccessproviders/g/providers_asp.htm [accessed on 14 November 2012]; OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 24 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 12.
[1164] Mitchell B *Application Service Provider* http://compnetworking.about.com/od/internetaccessproviders/g/providers_asp.htm [accessed on 14 November 2012]; OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 24

services, but merely provides an automation and management system for the supply of goods and services.[1165] The customer has no control over or possession of a software copy, and is not permitted to copy the software.[1166] This amounts to the supply of services.[1167] Where the provider's customers will have access to copyrighted material that is hosted on the server, the TAG is of the opinion that the use of copyright would be minimal and should be negated for purposes of classifying the overall supply.[1168]

5.3.1.10 Website hosting

Website hosting entails the offering of space on the provider's server to host a website.[1169] The customer is allowed to post and remove copyrighted material on the website, and ownership and control of the copyright vests entirely with the customer.[1170] The supply should be treated as the supply of services irrespective of whether or not a bilateral agreement or treaty provides for the taxation of technical fees at source.[1171]

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http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 12.

[1165] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 24 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1166] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 24 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1167] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 24 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1168] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 25 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1169] http://www.macmillandictionary.com/dictionary/american/web-hosting [accessed on 14 November 2012]; OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 25 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 12.

[1170] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 25 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 12.

[1171] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 25 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

5.3.1.11 Software maintenance

These transactions involve the bundling of updates and technical support at a single annual fee.[1172] In many of these agreements the principal supply involves the updating of software, and technical support is regarded as an incidental service. These transactions should generally, as a whole, be treated as the supply of services.[1173] In cases where a treaty provides for the taxation of technical fees or technical support at source, that part of the supply that constitutes technical support should be treated separately as such.[1174] It should, however, be noted that in many cases the supply is paid for upfront as an additional fee when the software is purchased. It will be impossible for the supplier (and to an even greater extent for the recipient) to determine what part of the supply constitutes updates and what part constitutes technical support when the agreement is entered into. Unless the value of the technical support is determined upfront, or if it is billed afterwards, the supply could be incorrectly classified and incorrectly taxed.

5.3.1.12 Data warehousing

Data warehousing involves the storing of computer data on a remote server that is owned and operated by the provider.[1175] The customer can access and manipulate the data remotely and no licence fee is payable for the service.[1176] Typical

[1172] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 25 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 12.
[1173] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 25 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1174] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 25 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1175] Hoffer JA, Prescott MB, Mcfadden FR (2005) *Modern Data Based Management* 7th edition at 2 http://www.itu.dk/people/pagh/DBS05/OLAP-MDM-2s.pdf [accessed on 14 November 2012]; OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 26 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 13.
[1176] Hoffer JA, Prescott MB, Mcfadden FR (2005) *Modern Data Based Management* 7th edition at 2 http://www.itu.dk/people/pagh/DBS05/OLAP-MDM-2s.pdf [accessed on 14 November 2012]; OECD (2001)

application can be found in retail stores where an employee from one branch can access the stock level data of another branch to enable the employee to divert stock to his branch.

Since the fees generally payable for data warehousing do not include the payment for the use of intellectual property or for the supply of technical support, the TAG advises that the supply be treated as services.[1177]

5.3.1.13 Customer support over a computer network

The provision of online customer support in the form of online technical information, or a trouble shooting database in the form of FAQ's, or human assistance via email, or VOP, can create serious characterisation problems.[1178] The TAG considered whether such support or advice could be classified as "know-how", but concluded that it should generally be treated as a service.[1179] Generally, "know-how" includes the transfer of certain secret or classified information pertaining to a specific trade that can be commercially exploited. The provision of customer support involves the divulging of information to a customer to assist him to install, operate, or fix a product purchased from the provider. The customer cannot further exploit the information commercially and is limited to apply it in installing, operating, or fixing the product. "Know-how" is necessary for the reproduction of a product or process.[1180]

On the question of whether the support amounts to technical support for purposes of conventions that provide for the source taxation of technical support, the TAG

Tax Treaty Characterisation Issues Arising from E-commerce at 26 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 13.

[1177] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 26 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1178] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 26 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 13.

[1179] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 26 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1180] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 26 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

suggests that the mere access to technical documentation does not involve technical skill or knowledge.[1181] The provision of online technical assistance from a technician or specifically trained person, requires the application of technical skill and knowledge and could be treated as the supply of technical support.[1182]

5.3.1.14 Data retrieval

In this case, the provider makes a repository of information available to customers to search and retrieve.[1183] The customer can retrieve specific information from a vast collection of data.[1184] The customer pays for the service which enables it to search for specific data that it requires, satisfying the conclusion that the supply should be treated as a service.[1185]

5.3.1.15 The delivery of exclusive or high value data

Just as with the data retrieval service in paragraph 5.1.3.14 above, a repository of information is made available to customers. Only, in this case, the provider adds additional value to the data (not customer specific) such as the analysis of statistics or comparison of reports, et cetera.[1186] Such reports can be electronically supplied to

[1181] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 27 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1182] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 27 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1183] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 27 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 13.
[1184] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 27 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 13.
[1185] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 27 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1186] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 28 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 14.

the customer or ordered and downloaded from an online catalogue.[1187] The TAG is of the opinion that the supply does not require the application of special technical skill or knowledge and should be treated as services.[1188]

5.3.1.16 Advertising

The supply of web hosted advertisements in the form of banners, pop-ups, or simulated scenes in online games, which allows the web user to access the advertiser's website by clicking on the advertisement, results in the supply of services irrespective of whether or not the advertisement contains certain copyrighted material.[1189]

5.3.1.17 Electronic access to professional advice

Where a customer is granted electronic access to professional advice through e-mail, video conferencing, instant messaging, or any remote means of communication, the supply is that of services.[1190] It should, however, be noted that where the service goes beyond the mere supply of consultancy services (for example, the transfer of know-how or the provision of technical support) it should not be treated as the supply of services where a convention or treaty provides for special taxation measures of specific types of service.[1191]

[1187] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 28 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1188] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 28 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1189] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 28 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 14.
[1190] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 28-29 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 14.
[1191] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 29 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

5.3.1.18 Technical information

Where the customer is provided with undivulged technical information concerning a product or process that is akin to a narrative description or diagrams of a confidential or secret manufacturing process, the supply should be treated as the supply of intellectual property and the payment therefore constitutes royalties.[1192]

5.3.1.19 Information delivery

Where the provider periodically provides the customer with information electronically in accordance with the customer's needs, the supply is the supply of services.[1193] This service typically includes custom-packaged information that will suit the customer's specific needs - for example, sales statistics for the customer's products in certain areas.

5.3.1.20 Access to an interactive website

In terms of these transactions customers are granted access, against the payment of a subscription fee, to an interactive website that allows the user to view video, pictures, or listen to audio files.[1194] The customer interacts with the website while online, as opposed to downloading products from the website.[1195] The supply of the

[1192] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 29 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 14.
[1193] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 29 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 14.
[1194] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 30 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 14.
[1195] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 30 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000)

interactive content to the customer is the supply of services, while the supply of any copyrighted material to the provider is the supply of intellectual property.[1196]

5.3.1.21 Online shopping portal

In terms of an online shopping portal service, the website owner hosts catalogues of various suppliers of tangible and intangible products which the customer may use to place orders for specific goods.[1197] No contractual relationship exists between the customer and the website owner in respect of the goods and services ordered.[1198] The website owner merely provides an agency service for which a commission is payable.[1199] The supply constitutes a service.[1200]

5.3.1.22 Online auctions

Many items are displayed on the website and the customer concludes a contract of sale directly with the supplier of the goods and not the website owner.[1201] The

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"OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 14.

[1196] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 30 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1197] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 30 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.

[1198] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 30 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.

[1199] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 30 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.

[1200] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 30 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1201] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 30 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.

website owner is remunerated for its auction facilities by the vendor.[1202] The supply or facility should be treated as the supply of a service.[1203]

5.3.1.23 Sales referral programs

The website operator lists certain of the products of a provider of digital products as a hyperlink on its website on which the customer can click to be linked to the provider's website and ultimately purchase items (for example, Groupon and LivingSocial).[1204] The provider can trace the source of the link and pays the website operator a commission as a percentage for every successful sale.[1205] The supply constitutes the supply of services.[1206]

5.3.1.24 Content acquisition transactions

In these cases, the website operator acquires news, stories, or other content against payment from various providers to attract users to its website.[1207] Alternatively, the website operator pays a provider to provide his website with new content.[1208] Two

[1202] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 30 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1203] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1204] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.
[1205] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.
[1206] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1207] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.
[1208] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.

scenarios should be distinguished. Where the operator pays the provider for material in which copyright either vests in the provider or in another person or entity, the supply is treated as the supply of intellectual property for which royalties are paid.[1209] Where the operator appoints a provider to create content, and as a result of the underlying contractual agreement, copyright in the content vests in the operator, the supply should be treated as the supply of services.[1210] This proposal could be in contravention of local copyright laws that do not provide for the transfer of future works. For example, in Germany future works can only be transferred in so far as the future exploitation methods are known at the time of conclusion of the agreement.[1211]

The OECD proposal makes provision for the inverse of this transaction, namely, where the content provider pays the website owner to display stories, news, and data on the website.[1212] It is suggested that the supply of such content is the supply of commercial services and should be treated as business income under article 7 of the Model Treaty.[1213]

5.3.1.25 Streamed (real-time) web-based broadcasting

Consumers can access a website from which they can view real time video or listen to real-time audio broadcasting of copyrighted material.[1214] The broadcaster either

[1209] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1210] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].
[1211] Article 40(1) of the German *Urheberrechtsgesetz* of 9 September 1965.
[1212] Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 3; Andrus JL and Merril PR (2000) "Treaty Characterisation of E-commerce Payments-Comments on the TAG Draft" *Tax Planning International E-commerce* vol 2 no 6 at 9.
[1213] Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 3; Andrus JL and Merril PR (2000) "Treaty Characterisation of E-commerce Payments-Comments on the TAG Draft" *Tax Planning International E-commerce* vol 2 no 6 at 9.
[1214] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.

receives a subscription fee from consumers, or generates income from advertising.[1215] The supply constitutes the supply of services.[1216]

5.3.1.26 Carriage fees

Where a content provider pays a website or network operator to have its content displayed by the website or network operator, the copyright remains with the content provider and is exclusively exploited for gain by the content provider.[1217] The supply therefore constitutes a supply of services.[1218]

5.3.1.27 Website subscription allowing the download of digital products

Against the payment of a subscription fee, the provider allows the customer to download copyrighted material such as video or audio files from the provider's website.[1219] The difference between this supply and the supply in paragraph 5.3.1.20 is that the customer is allowed to download the copyrighted material on a hard disk or other storage device. In this instance the consumer downloads the copyrighted material for his own use and enjoyment satisfying the conclusion that the supply should be treated as the supply of services.[1220]

[1215] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.

[1216] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 31 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1217] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 32 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012]; Owens J (2000) "OECD TAG-Treaty Characterisation of E-commerce Payments" *Tax Planning International E-commerce* vol 2 no 9 at 15.

[1218] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 32 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1219] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 32 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

[1220] OECD (2001) *Tax Treaty Characterisation Issues Arising from E-commerce* at 32 http://www.oecd.org/ctp/consumptiontax/1923396.pdf [accessed on 12 November 2012].

5.3.1.28 Discussion and criticism

From the outset, it should be noted that the OECD classification is primarily aimed at the distinction between business income and royalties for income tax purposes. That said, the classification can also be applied as a guideline or general classification measure for electronically supplied products for VAT purposes. From the discussion above it is clear that the OECD proposes that electronically supplied goods should, generally, be treated as services except in those cases where the supply constitutes the supply of intellectual property or technical support where, as a result of a convention, treaty, or bilateral agreement, intellectual property or technical support is taxed differently. The OECD does not propose that legislation should provide for electronically supplied products as a specific type of service. On the one hand, the general classification of digital supplies as services could eliminate the risk of item-specific definitions in legislation becoming outdated. It further removes any fences around which avoidance and tax planning can occur. Li points out that the current characterisation simplifies classification issues and creates a sense of tax certainty.[1221] Tadmore, however, opines that the approach does not ensure tax certainty, but rather opens the door to tax-planning opportunities and inconsistent results.[1222] It is not hard to imagine transactions, the status of which remain undecided in terms of the criteria.[1223]

On the other hand, since jurisdictions apply different tax rules and rates to different categories of services, a general classification of this kind could act as a barrier to achieving harmonised tax rules that are e-commerce specific. The classification of a supply has a direct impact on the place of supply, value, and timing of the supply, as well as on VAT collection methods.[1224] A general classification of digital products as services could, accordingly, have an adverse effect on these issues. Put simply, the same product can be treated differently in different tax jurisdictions creating an

[1221] Li J (2003) *International Taxation in the Age of Electronic Commerce: A Comparative Study* at 444.
[1222] Tadmore N (2004) "Further Discussion on Income Characterization" *Canadian Tax Journal* vol 52 no 1 at 128 http://staging.ctf.ca/ctfweb/Documents/PDF/2004ctj/04ctj1-tadmore.pdf [accessed on 15 November 2012].
[1223] Baron R (2001) "Income Characterisation" *Tax Planning International E-commerce* vol 3 no 4 at 17.
[1224] Evans K (2003) "Cross-border E-commerce and GST/HST: Towards International Consensus or Divergence" *Canadian Journal of Law and Technology* at 3 http://cjlt.dal.ca/vol2_no1/pdfarticles/evans.pdf [accessed on 15 November 2012].

additional burden for taxpayers. It could further encourage "favourable tax regime shopping".[1225] Moreover, the disparity between the tax treatment of tangible goods and their intangible counterpart, leads to tax inequality that could adversely affect developing markets.[1226] This notwithstanding, Li predicts that the OECD guidelines will provide a useful point of reference to national tax authorities in applying treaty and domestic rules.[1227]

The proposed characterisation test involves questions that are to be determined by the transaction itself. This raises the question of subjectivity and subsequent ambiguities and uncertainties.[1228] Charlet and Holmes opine that the contract itself reveals much about the characterisation of the supply.[1229] However, complex and mixed transactions will make the classification more cumbersome, and the possibility of determining the essence of the payment with absolute certainty would further be undermined.[1230]

In avoiding complexities, the TAG guidelines narrow the test down to a distinction between private use and commercial exploitation. Where the customer is a private consumer, the products would likely be purchased for private use and enjoyment, thus constituting the supply of services. A commercial purchaser is more likely to exploit the copyright for commercial gain. This approach deviates from the OECD definition of royalties[1231] which draws no distinction between use and enjoyment and

[1225] Pedwell K (2002) "Taxation of Electronic Commerce: An Assessment of the Opportunities and Challenges Facing Taxpayers and Tax Authorities" *Journal of E-Business* vol 1 issue 2 at 5 http://egov.ufsc.br/portal/sites/default/files/anexos/20479-20480-1-PB.pdf [accessed on 15 November 2012].
[1226] Pedwell K (2002) "Taxation of Electronic Commerce: An Assessment of the Opportunities and Challenges Facing Taxpayers and Tax Authorities" *Journal of E-Business* vol 1 issue 2 at 5 http://egov.ufsc.br/portal/sites/default/files/anexos/20479-20480-1-PB.pdf [accessed on 15 November 2012].
[1227] Li J (2003) *International Taxation in the Age of Electronic Commerce: A Comparative Study* at 444.
[1228] Tadmore N (2004) "Further Discussion on Income Characterization" *Canadian Tax Journal* vol 52 no 1 at 127 http://staging.ctf.ca/ctfweb/Documents/PDF/2004ctj/04ctj1-tadmore.pdf [accessed on 15 November 2012].
[1229] Charlet A and Holmes D (2010) "Determining the Place of Taxation of Transactions under VAT/GST: Can Transfer Pricing Principles Help?" *International VAT Monitor* November/December 2010 at 436 http://www.wtsfrance.fr/fr/img/Determining_the_place_of_taxation_of_transactions_under_VAT-GST_-_IVM_-_IBFD.pdf [accessed on 28 November 2012].
[1230] Tadmore N (2004) "Further Discussion on Income Characterization" *Canadian Tax Journal* vol 52 no 1 at 128 http://staging.ctf.ca/ctfweb/Documents/PDF/2004ctj/04ctj1-tadmore.pdf [accessed on 15 November 2012].
[1231] Article 12 of the OECD Model Tax Convention defines "royalties" to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or

commercial exploitation.[1232] In the context of electronic commerce, this could result in many negative and unintended implications.[1233] For example, where the supplier is deemed to be the taxable entity, it will have to indentify the tax or commercial status of the customer to determine if the supply should be treated as a supply of services or of intellectual property. The mere fact that a customer can be identified as a business, does not justify the conclusion that the supply is of intellectual property. A possibility exists that the customer acquired the products for its own use and enjoyment. In the absence of an express agreement as to the nature of the supply, the supplier would require insight into the ultimate use of the product by the customer to correctly classify the supply. Tadmore notes that the OECD guidelines do not provide sufficient guidance to resolve the practical e-commerce classification issues, and cannot be relied upon.[1234] Baron suggests that simpler classification would lead to greater compliance.[1235] Businesses are likely to ignore complicated classification systems if they would result in a greater administrative burden.[1236]

The TAG guidelines are further based on contemporary practices and technologies which could soon become obsolete as technology advances and practices change.[1237] In the context of e-commerce, the distinction between royalties and business income (the supply of services) is an extension of an historical dispensation that has no reason to exist and is not supported.[1238] This is clear by the fact that

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scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

[1232] Tadmore N (2004) "Further Discussion on Income Characterization" *Canadian Tax Journal* vol 52 no 1 at 129 http://staging.ctf.ca/ctfweb/Documents/PDF/2004ctj/04ctj1-tadmore.pdf [accessed on 15 November 2012].

[1233] Tadmore N (2004) "Further Discussion on Income Characterization" *Canadian Tax Journal* vol 52 no 1 at 139 http://staging.ctf.ca/ctfweb/Documents/PDF/2004ctj/04ctj1-tadmore.pdf [accessed on 15 November 2012].

[1234] Tadmore N (2004) "Further Discussion on Income Characterization" *Canadian Tax Journal* vol 52 no 1 at 139 http://staging.ctf.ca/ctfweb/Documents/PDF/2004ctj/04ctj1-tadmore.pdf [accessed on 15 November 2012].

[1235] Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 5.

[1236] Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 5.

[1237] Tadmore N (2004) *The Interaction between E-commerce and Tax Treaties re-Examined* DJur Thesis, Deakin University at 121 http://dro.deakin.edu.au/eserv/DU:30023183/tadmore-interactionbetween-2003.pdf [accessed on 15 November 2012].

[1238] Tadmore N (2004) *The Interaction between E-commerce and Tax Treaties re-Examined* DJur Thesis, Deakin University at 123 http://dro.deakin.edu.au/eserv/DU:30023183/tadmore-interactionbetween-2003.pdf [accessed on 15 November 2012].

OECD member countries like Canada, some Member States in the EU,[1239] and Australia have all deviated from the characterisation guidelines.

The absence of definitions of services and intangibles for VAT purposes, and the subsequent reliance on the current classification for income tax purposes, leaves room for conflicting interpretations between jurisdictions.[1240] In addition, the *VAT/GST Guidelines* do not propose to introduce a dispute resolution mechanism, which, given the multi-jurisdictional nature of e-commerce, is indispensible.[1241]

5.3.2 Where is the supply made?

At the 1998 OECD Ministerial Conference in Ottawa, the OECD ministers endorsed the proposal that VAT, being a consumption tax, should be levied in the jurisdiction of consumption.[1242] Taxation at the place of consumption ensures tax neutrality and eliminates double taxation and unintended non-taxation of consumption.[1243] As a result, the ministers proposed that, in the case of cross-border electronic commerce, VAT should be levied in the jurisdiction of consumption.[1244] They further proposed that consensus should be sought on circumstances under which supplies are to be held to be consumed in a jurisdiction.[1245]

It was soon realised that these broad criteria would be impossible to implement as each jurisdiction of consumption would have to be identified.[1246] In most cases the

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[1239] See para 5.2 above.
[1240] Lamensch M (2010) "OECD Draft Guidelines on VAT/GST on Cross-Border Services" *International VAT Monitor* vol 21 no 4 at 274.
[1241] Lamensch M (2010) "OECD Draft Guidelines on VAT/GST on Cross-Border Services" *International VAT Monitor* vol 21 no 4 at 274.
[1242] OECD (1998) *Electronic Commerce: Taxation Framework Conditions* at 5 http://www.oecd.org/tax/consumptiontax/1923256.pdf [accessed on 19 November 2012].
[1243] Hellerstein W (2003) "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective" *Georgia Law Review* vol 38 fn 54 at 16; Horner FM and Hardy M (1998) " The OECD Work on Taxation and E-commerce" *Tax Planning International E-commerce* Introductory issue at 27.
[1244] OECD (1998) *Electronic Commerce: Taxation Framework Conditions* at 5 http://www.oecd.org/tax/consumptiontax/1923256.pdf [accessed on 19 November 2012].
[1245] OECD (1998) *Electronic Commerce: Taxation Framework Conditions* at 5 http://www.oecd.org/tax/consumptiontax/1923256.pdf [accessed on 19 November 2012]; Scheer ETH (1999) "Electronic Commerce and VAT: The European View" *Journal of International Taxation* vol 10 no 3 at 17.
[1246] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* Annexe II at 4 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 28 August 2012]; Lamensch M

place of consumption cannot be determined with absolute accuracy at the time of conclusion of the agreement, and the supplier would require insight into the consumer's ultimate use of the product to establish the place of consumption.[1247] The TAG team proposes a less accurate, but more workable, test to establish the place of consumption for each transaction.[1248] In its proposal, it distinguishes between B2B and B2C transactions. It should be noted that the guidelines do not apply to services that cannot be delivered directly from a remote location (for example, vehicle rental or hotel accommodation), or services for which the place of consumption can be easily determined by the fact that the supplier and consumer are physically present at the same location when the services are rendered (for example hairdressing), or where the services are applied to fixed property.[1249]

5.3.2.1 B2B transactions

The place of consumption (place of supply) for the cross-border supplies of services and intangibles capable of direct delivery from a remote location to a non-resident business recipient, should be the jurisdiction in which the recipient has located its business.[1250] The non-resident business recipient is identified as the taxable person in the jurisdiction of consumption, or the person or entity that is required to register for VAT under national laws, or is otherwise identified as a taxable person or

(2010) "OECD Draft Guidelines on VAT/GST on Cross-Border Services" *International VAT Monitor* vol 21 no 4 at 272; Grandcolas C (2007) "VAT on the Cross-Border Trade in Services and Intangibles" *Asia-Pacific Tax Bulletin* vol 13 no 1 at 40.

[1247] Hellerstein W (2003) "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective" *Georgia Law Review* vol 38 at 16; Lamensch M (2010) "OECD Draft Guidelines on VAT/GST on Cross-Border Services" *International VAT Monitor* vol 21 no 4 at 272.

[1248] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* Annexe II at 4 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 28 August 2012].

[1249] OECD *Commentary on Place of Consumption for Business-to-Business Supplies (Business Presence)* at 2-3 http://www.oecd.org/tax/consumptiontax/5592717.pdf [accessed on 19 November 2012].

[1250] OECD (2001) *Consumption Taxation of Cross Border Services and Intangible Property in the Context of E-commerce* at 1 http://www.oecd.org/tax/consumptiontax/5594831.pdf [accessed on 24 August 2012]; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 213.

entity.[1251] The business presence is the establishment (headquarters, registered office, or branch) of the recipient to which the supply is made.[1252]

Determining the business customer's business presence or place of establishment in the absence of an established relationship between the supplier and the recipient, could prove difficult.[1253] The TAG team proposes that existing contracts and normal commercial practices should be applied to locate the place of establishment.[1254] In other words, the contract information or information gathering mechanisms applied in normal business practices, should be used to locate the customer's place of establishment. This method relies on the honesty and the integrity of the customer to provide the correct information. Unlike the European system, the OECD proposal does not require the supplier to verify the VAT/GST registration status of the customer. Since the preferred method of collection in the case of B2B transactions is the reverse-charge or self assessment mechanism, the verification of the customer's VAT/GST status is crucial to prevent tax avoidance.

In the case of high value transactions, the supplier is likely to have an established relationship with the customer and the VAT/GST registration status and location of the customer would be known to the supplier.[1255] No additional verification of status or location should be required in these cases. Should the customer route the supplies to a location other than the location known to the supplier, the supplier should not be required to trace the supply to the actual place of consumption. In these cases the existing business agreement would be relied on to identify and

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[1251] OECD (2001) *Consumption Taxation of Cross Border Services and Intangible Property in the Context of E-commerce* at 1 http://www.oecd.org/tax/consumptiontax/5594831.pdf [accessed on 24 August 2012].
[1252] OECD (2001) *Consumption Taxation of Cross Border Services and Intangible Property in the Context of E-commerce* at 1 http://www.oecd.org/tax/consumptiontax/5594831.pdf [accessed on 24 August 2012].
[1253] Hellerstein W (2004) "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective" *Georgia Law Review* vol 38 fn 163 at 51; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 10.
[1254] OECD *Commentary on Place of Consumption for Business-to-Business Supplies (Business Presence)* at 3 http://www.oecd.org/tax/consumptiontax/5592717.pdf [accessed on 19 November 2012]; Lamensch M (2010) "OECD Draft Guidelines on VAT/GST on Cross-Border Services" *International VAT Monitor* vol 21 no 4 at 273.
[1255] OECD *Verification of Customer Status and Jurisdiction* at 2 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012]; Buydens S, Holmes D, Owens J (2009) "Consumption Taxation of E-commerce: 10 Years after Ottawa" *Tax Notes International* vol 54 no 1 at 62.

locate the customer.[1256] A business agreement is not restricted to a written legal contract between the parties, but includes general correspondence, service delivery agreements, invoices, purchase orders, payment instruments, and delivery notes.[1257] It is therefore not desirable for jurisdictions to draw up a restrictive list of what should be included in a business agreement to safely rely on the information obtained there as an identification and location tool.[1258] Business agreements cannot be interpreted in isolation, and surrounding agreements, documents, or circumstances can also be consulted.[1259]

Where no prior relationship exists, private customers (final consumers) may have a financial incentive if they declare that they are registered vendors or businesses.[1260] In these cases customer declarations are not reliable. The proposal does not provide for any guidance in the absence of any business agreement.[1261] However, the Centre for Tax Policy and Administration (CTPA)[1262] proposes three methods of verifying the customer's declaration.

5.3.2.1.1 Verification of registration numbers

i) Online verification

In jurisdictions where the vendor registration database is available online and accessible to any member of the public - like the VIES system in Europe - the

[1256] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 8-9 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].
[1257] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 9 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].
[1258] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 9 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].
[1259] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 9-10 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].
[1260] OECD *Verification of Customer Status and Jurisdiction* at 3 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1261] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 11.
[1262] The Centre for Tax Policy and Administration is a subcommittee within the OECD that is mandated to research and develop tax policy documents.

customer's VAT status can easily be verified.[1263] Online verification is, however, not commonly available in all jurisdictions. In many cases the customer's VAT registration status is subject to privacy legislation, and tax authorities are reluctant to divulge any information to suppliers. The disclosure of a taxpayer's tax or personal information is strictly prohibited in South Africa.[1264]

To apply online verification tools requires a global approach in which all jurisdictions make the country's VAT/GST registration database publicly available.[1265] In addition, an online validation system should allow for automated integration with the supplier's systems to ensure a continuous and automated e-commerce platform.[1266] In the absence of an online validation system, or in cases where these systems are off-line, an alternative verification method should be applied.[1267]

ii) Computation system

A computation system allows the supplier to verify the validity of a customer's VAT/GST number by applying a specified check digit technique.[1268] For example, should the numbers in sequence be added and divided by the last digit, the result will always yield the first digit. A computation system requires that registration numbers should be issued in applying a specific algorithm. In addition, it should consist of numerals only. A computation system can only be successfully applied if the same digit check technique is applied in all jurisdictions. Unless the customer's location is known to the supplier, the supplier will be unable to apply the correct check digit technique to verify the VAT status.

[1263] OECD *Verification of Customer Status and Jurisdiction* at 4 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1264] Section 6 of the VAT Act 89 of 1991 and sections 67 and 68 of the Tax Administration Act 28 of 2011.
[1265] OECD *Verification of Customer Status and Jurisdiction* at 4 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1266] OECD *Verification of Customer Status and Jurisdiction* at 4 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1267] OECD *Verification of Customer Status and Jurisdiction* at 4 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1268] OECD *Verification of Customer Status and Jurisdiction* at 4 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].

A computation system is further limited in that the supplier can only validate the existence of the VAT/GST registration number, and the actual registration status of the supplier remains unknown.[1269] As with the online validation system, the computation system cannot verify whether the customer is who he says he is.[1270] Private consumers can easily obtain the VAT/GST numbers of businesses and give that registration number to the supplier to gain the tax incentive. Computation systems should further guard against reverse-engineering.[1271] As a result of the limitations of online verification systems and computation systems, additional verification methods should be applied.

5.3.2.1.2 Indicia

Certain *indicia* inherent in the agreement could satisfy the conclusion that the customer is a registered vendor or taxable person.

i) Payment system data

At present, it is unlikely that the tax status of the customer can be determined by its credit card details.[1272] In order to combat credit card fraud, suppliers obtain little to no information from credit card companies about the status and location of the

[1269] OECD *Verification of Customer Status and Jurisdiction* at 4 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012]; Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 7.
[1270] OECD *Verification of Customer Status and Jurisdiction* at 4 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012]; Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 7.
[1271] OECD *Verification of Customer Status and Jurisdiction* at 4 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012]; Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 7.
[1272] OECD *Verification of Customer Status and Jurisdiction* at 5 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012]; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 10.

customer.[1273] That said, the CTPA proposes that, in collaboration with credit card companies, certain vital information - such as the location of the customer and its tax status - could be made available to suppliers.[1274] In cases of electronic transfers where larger amounts are involved, more information is often divulged to suppliers and this can be used as a complementary verification method.[1275]

ii) Nature of supply

The nature and quantity of the supply can be indicative of the customer's tax status. For example, where music, movies, or pictures are ordered without the embedded intellectual property rights, this could be an indication that the customer is not a business and/or is not likely to use the supplies to make further taxable supplies.[1276] Similarly, an order for business accounting software suggests that the customer might be a business entity.[1277]

This notwithstanding, the reasonable assumptions that may be made from the nature of the contract have their limitations. Where anti-virus software is purchased, the customer can be a private customer or a small to medium business.[1278] In this case the nature of the supply would not be indicative of the customer's tax status.

[1273] OECD *Verification of Customer Status and Jurisdiction* at 5 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1274] OECD *Verification of Customer Status and Jurisdiction* at 5 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1275] OECD *Verification of Customer Status and Jurisdiction* at 5 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1276] OECD *Verification of Customer Status and Jurisdiction* at 5 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1277] OECD *Verification of Customer Status and Jurisdiction* at 5 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1278] OECD *Verification of Customer Status and Jurisdiction* at 5 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].

5.3.2.1.3 Digital certificates

Many jurisdictions issue digital tax certificates to vendors as a prerequisite for obtaining government tenders.[1279] The integrity of the certificates can be secured by applying secure encryption software. If these certificates were issued to all VAT/GST vendors in the country of registration, suppliers could use software to verify the authenticity of the certificate and determine both the tax status of the customer and its location.[1280] Verification can be done in real time with greater reliability.[1281]

5.3.2.1.4 Mismatch between self-declarations and other *indicia*

In cases where the information supplied by the customer in the self-declaration contradicts the results of other *indicia* stemming from the agreement or other factors, the local revenue authorities should provide domestic guidance on how to tax the transaction.[1282] It should be noted that this proposal goes out from the premise that the supplier can, with reasonable accuracy, determine the customer's location (place of establishment) so as to apply the special guidance applicable in that jurisdiction. Where the customer's location (place of establishment) cannot be determined as a result of mismatches between the self-declaration and the *indicia*, the supplier would be unable to apply the guidance applicable to the transaction in respect of the relevant jurisdiction correctly.

Certain obvious *indicia* should allow the supplier to make presumptions in respect of the customer's tax status that are likely to reflect the true nature of events. For example, where the customer proclaims to be a vendor in the self-declaration, but

[1279] OECD *Verification of Customer Status and Jurisdiction* at 5 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1280] OECD *Verification of Customer Status and Jurisdiction* at 6 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1281] OECD *Verification of Customer Status and Jurisdiction* at 6 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1282] OECD *Verification of Customer Status and Jurisdiction* at 6 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].

fails to produce a VAT/GST registration number, the supplier can assume that the customer is not a business/vendor.

5.3.2.1.5 Alternative place-of-supply rules

In cases where this main criterion (the customer's place of establishment) would cause distortion, competition, or avoidance, countries may apply a different criterion to determine the place of consumption to reflect the actual place of consumption.[1283] This would be the case where supplies are routed to a branch of the recipient that is located in a tax-free or low-tax jurisdiction, and where the supplies are further distributed to the branch of consumption as an intra-group supply. It should, however, be noted that place-of-supply rules are not a mechanism to undo tax competition. That will be driven by broader forces and be open to a broader set of policies, some of which are tax policies and some non-tax policies.

5.3.2.1.6 Intra-group supplies or subsequent supplies

i) Intra-group supplies

It is common practice among multi-national businesses, to centralise procurement in a low-tax jurisdiction from where internationally acquired goods, services, and intangibles are redistributed to the associated businesses within the group which are established in different jurisdictions. The supplies between the procurement business and the associated businesses are governed by its own business agreements, and the transaction should be taxed under the reverse-charge mechanism in the jurisdiction where the associated business is established.[1284] This intra-group supply does not concern or affect the tax treatment of the transaction between the initial

[1283] OECD (2001) *Consumption Taxation of Cross Border Services and Intangible Property in the Context of E-commerce* at 1 http://www.oecd.org/tax/consumptiontax/5594831.pdf [accessed on 24 August 2012].
[1284] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 13 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].

supplier and the procurement business, irrespective of whether the associated business is situated in the same jurisdiction as the initial supplier or not.[1285]

ii) Subsequent supplies to third parties

Where the customer, in terms of a *bona fide* agreement, renders the services or intangibles acquired from the supplier to a third party, the customer remains the customer as identified in the principal business agreement, and it is this customer's location that determines the place of taxation.[1286] The subsequent business agreement will determine the place of taxation for the transaction between the customer and the third party.

iii) Supplier paid by third party

Businesses are often structured in such a way that different departments are situated in different jurisdictions. It can, therefore, happen that a transaction between the supplier and the customer is paid by a third party.

> **Example 5.1:** A concludes an agreement with B in terms of which B will supply intangibles to A in India where the intangibles will be applied in a manufacturing process. Payment is effected by C who acts as A's paymaster in terms of the company structure. C and B are both established in Canada.

[1285] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 13 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].
[1286] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 13 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].

Payment flows in themselves do not create additional supplies, nor do they alter the supplies. They can also not reliably identify the customer or its location.[1287] The supplier makes the supplies to the customer as identified in the business agreement irrespective of who makes the payment.[1288] In example 5.1, the transaction will be taxed in the jurisdiction where A is established (India), irrespective of the fact that C, who made the payment, is located in the same jurisdiction as the supplier.

5.3.2.2 B2C transactions

In the case of a non-taxable person, or a person who is not liable to register for VAT/GST, the place of supply is deemed to be the jurisdiction in which the customer has his/her usual residence.[1289] The OECD recognises that this proposal negates the consumption principle, since the place of residence and place of consumption do not always coincide.[1290] Taxing the transaction at the location of consumption would place a significant compliance burden on suppliers.[1291] As a result of the mobility of communications, identifying the actual place of consumption would, in most cases and in the absence of practical evidence, be impossible.

In contrast to locating a business customer, a non-taxable person does not have a VAT/GST registration number that can be verified and used to locate its place of residence. The CTPA recommends that tax authorities develop national guidelines to assist suppliers in locating the customer's place of residence.[1292]

[1287] [1287] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 14 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].

[1288] [1288] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 14 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].

[1289] OECD (2001) *Consumption Taxation of Cross Border Services and Intangible Property in the Context of E-commerce* at 2 http://www.oecd.org/tax/consumptiontax/5594831.pdf [accessed on 24 August 2012].

[1290] OECD (2001) *Consumption Taxation of Cross Border Services and Intangible Property in the Context of E-commerce* at 1 http://www.oecd.org/tax/consumptiontax/5594831.pdf [accessed on 24 August 2012].

[1291] OECD (2001) *Consumption Taxation of Cross Border Services and Intangible Property in the Context of E-commerce* at 1 http://www.oecd.org/tax/consumptiontax/5594831.pdf [accessed on 24 August 2012].

[1292] OECD *Verification of Customer Status and Jurisdiction* at 6 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].

5.3.2.2.1 Self-declaration

As it was indicated above, reliance on the customer's self-declaration as a single method of locating the customer's place of residence, is not effective and should not be recommended. Customers can manipulate information to achieve the outcome they desire in cases where it is not possible to verify the information independently.[1293] In jurisdictions where the submission of false information in a self-declaration is penalised, substantial penalties could act as a deterrent to such behaviour.[1294] Should the supplier's website contain an explicit warning of possible penalties, customers would likely be deterred from submitting false information.[1295] The OECD does not explicitly recommend that jurisdictions impose penalties on the submission of false information in self-declaration, but the notion is endorsed. Not all customers would manipulate information to achieve a certain outcome. The self-declaration could, accordingly, in most cases, provide accurate and detailed information about the customer. That said, the risk factor requires that other methods of locating the customer's place of residence be used in conjunction with the self-declaration to verify the information so obtained.

5.3.2.2.2 Payment information/Billing information

Given considerations of security, payment systems will, as I have indicated previously, in future assist little in establishing the customer's location. Banks and credit card companies no longer provide suppliers with the customer's details save for proof of payment. The card numbering system used by credit card companies does not identify the card holder's jurisdiction of residence.[1296] Financial institutions

[1293] OECD *Verification of Customer Status and Jurisdiction* at 6 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012]; Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 6.
[1294] OECD *Verification of Customer Status and Jurisdiction* at 6 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1295] OECD *Verification of Customer Status and Jurisdiction* at 6 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1296] OECD (2000) *Report by the Technology Technical Advisory Group* at 45 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012]; Baron R (2001)

would be in breach of their privacy code of conduct were the customer's details to be disclosed to suppliers.[1297] Furthermore, credit card holders are not necessarily resident in the jurisdiction where the card is issued, nor can it be guaranteed that consumption will take place in the country of issue of the card.[1298] It is common for consumers who, for business purposes, temporarily reside in a different jurisdiction, to retain credit cards issued in the country of their former residence.[1299] In border regions, customers often acquire cross-border cards in jurisdictions where lower card fees or better deals are available.[1300]

In cases where a billing address is required, a correlation between the customer's jurisdiction of residence and billing is likely to exist.[1301] The billing address supplied for payment purposes could thus be used to verify the information supplied in the self-declaration. Where a mismatch between the billing address and the self declaration exists, additional verification measures should be applied. The supplier could alert the customer that a mismatch exists and that he is required to review and correct the information. Where the addresses differ, but are both in the same jurisdiction, it would lead to the same tax result and the mismatch can be negated. Suppliers could, in cases where the addresses are located in different jurisdictions, cancel the transaction in cases where the customer fails to review and correct the information or fails to submit adequate reasons for the mismatch.

"The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 6; Arthur S (2000) "International Perspectives on E-commerce Taxation" *Tax Planning International E-commerce* vol 2 no 12 at 18; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 10.

[1297] OECD (2000) *Report by the Technology Technical Advisory Group* at 44-45 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

[1298] OECD (2000) *Report by the Technology Technical Advisory Group* at 46 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012]; Arthur S (2000) "International Perspectives on E-commerce Taxation" *Tax Planning International E-commerce* vol 2 no 12 at 18.

[1299] OECD (2000) *Report by the Technology Technical Advisory Group* at 46 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

[1300] OECD (2000) *Report by the Technology Technical Advisory Group* at 46 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

[1301] OECD *Verification of Customer Status and Jurisdiction* at 7 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].

5.3.2.2.3 Tracking/Geo-location software

Various information resources can be applied to identify the customer's location through its IP address by utilising geo-location software.[1302] When a customer types an IP address (URL) in the browser's URL bar, the browser sends a connection request to the IP address which in turn sends a location request to the geo-location provider.[1303] The geo-location provider sends the customer's location information, based on the IP address on its database, to the supplier's or requested website's server.[1304] Svantesson refers to the location identification by the geo-location provider as an educated guess.[1305] The accuracy of geo-location technology is difficult to assess.[1306] A disparity exists between the accuracy levels proclaimed by software developers, and the testimony by expert witnesses in court. Geo-location provider, Digital Element, claims that it has 99,9 per cent accuracy in respect of country location, and 95 per cent accuracy in respect of city location.[1307] In *La Ligue Contre Racisme et L'Antisemitisme v Yahoo Inc*,[1308] the panel of experts testified that around 70 per cent of IP addresses assigned to French Internet users can be accurately matched to persons resident in France.[1309] The finding was based on numerous exceptions, for example, where Internet users subscribe to international or

[1302] OECD *Verification of Customer Status and Jurisdiction* at 7 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1303] Svantesson DJB (2008) "How Does the Accuracy of Geo-location Technologies Affect the Law?" *Masaryk University Journal of Law and Technology* vol 2 issue 1 at 12 http://mujlt.law.muni.cz/storage/1234798550_sb_02_svantesson.pdf [accessed on 26 November 2012].
[1304] Svantesson DJB (2008) "How Does the Accuracy of Geo-location Technologies Affect the Law?" *Masaryk University Journal of Law and Technology* vol 2 issue 1 at 12 http://mujlt.law.muni.cz/storage/1234798550_sb_02_svantesson.pdf [accessed on 26 November 2012].
[1305] Svantesson DJB (2008) "How Does the Accuracy of Geo-location Technologies Affect the Law?" *Masaryk University Journal of Law and Technology* vol 2 issue 1 at 12 http://mujlt.law.muni.cz/storage/1234798550_sb_02_svantesson.pdf [accessed on 26 November 2012].
[1306] Svantesson DJB (2008) "How Does the Accuracy of Geo-location Technologies Affect the Law?" *Masaryk University Journal of Law and Technology* vol 2 issue 1 at 13 http://mujlt.law.muni.cz/storage/1234798550_sb_02_svantesson.pdf [accessed on 26 November 2012]; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 10.
[1307] http://www.digitalelement.com/our_technology/our_technology.html [accessed on 26 November 2012].
[1308] *La Ligue Contre Racisme et L'Antisemitisme v Yahoo, Inc* Tribunal de Grande Instance de Paris No RG 00/05308 (November 20,2000).
[1309] Akdenis Y (2001) "Case Analysis of *League Against Racism and Antisemitism (LICRA), French Union of Jewish Students v Yahoo Inc (USA), Yahoo France* Tribunal de Grande Instance de Paris (The County Court of Paris), Interim Court Order, 20 November, 2000" *Electronic Business Law Reports* vol 1 issue 3 at 111 http://www.cyber-rights.org/documents/yahoo_ya.pdf [accessed on 26 November 2012].

private service providers.[1310] In *Nitke v Ashcroft*,[1311] expert witness Ben Laurie testified that geo-location software has a maximum of 70 per cent accuracy on state level.[1312] In most cases, the geo-location software can accurately identify the location of customer's Internet Service Provider, but the actual location of the machine/device used by the customer cannot be established accurately.[1313] In addition, geo-location software is dependent on information already available in its data-base.[1314] Consequently, geo-location software operates as a verification process in terms of which the IP address submitted by the customer's device or service provider, are compared to information that was submitted by or to the customer's service provider when the customer's IP address was issued or assigned. Where the information submitted during this initial phase is false or incorrect, geo-location software would be unable to verify its authenticity.

Circumvention software can be applied to hide the customer's IP address from geo-location software or submit another machine/device's IP address to the geo-location provider.[1315] It is trite that sophisticated circumvention technology is expensive and not readily available to the general public.[1316] That said, anonymising technology, although less advanced than most circumvention software, is inexpensive and commonly used to hide or obscure the customer's IP address from geo-location

[1310] Akdenis Y (2001) "Case Analysis of *League Against Racism and Antisemitism (LICRA), French Union of Jewish Students v Yahoo Inc (USA), Yahoo France* Tribunal de Grande Instance de Paris (The County Court of Paris), Interim Court Order, 20 November, 2000" *Electronic Business Law Reports* vol 1 issue 3 at 111 http://www.cyber-rights.org/documents/yahoo_ya.pdf [accessed on 26 November 2012].
[1311] *Nitke v Ashcroft* 253 F.Supp.2d 587 (S.D.N.Y. Mar 24, 2003) (NO. 01 CIV. 11476 (RMB).
[1312] Laurie B (2005) *Nitke v Ashcroft: Geolocation of Web Users* at 10 http://www.apache-ssl.org/nitke.pdf [accessed on 26 November 2012].
[1313] Laurie B (2005) *Nitke v Ashcroft: Geolocation of Web Users* at 6-10 http://www.apache-ssl.org/nitke.pdf [accessed on 26 November 2012].
[1314] Svantesson DJB (2008) "How Does the Accuracy of Geo-location Technologies Affect the Law?" *Masaryk University Journal of Law and Technology* vol 2 issue 1 at 14 http://mujlt.law.muni.cz/storage/1234798550_sb_02_svantesson.pdf [accessed on 26 November 2012]; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 11.
[1315] Svantesson DJB (2008) "How Does the Accuracy of Geo-location Technologies Affect the Law?" *Masaryk University Journal of Law and Technology* vol 2 issue 1 at 16 http://mujlt.law.muni.cz/storage/1234798550_sb_02_svantesson.pdf [accessed on 26 November 2012]; Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 7.
[1316] Svantesson DJB (2008) "How Does the Accuracy of Geo-location Technologies Affect the Law?" *Masaryk University Journal of Law and Technology* vol 2 issue 1 at 16 http://mujlt.law.muni.cz/storage/1234798550_sb_02_svantesson.pdf [accessed on 26 November 2012].

software.[1317] Anonymising software can assign an IP address located in a jurisdiction best suited to the customer's needs.[1318] Yet, anonymising software is limited, and the number of countries that can be used as a smoke screen location is further limited.[1319] These limitations do not prevent customers from choosing a location in a low-tax jurisdiction to reap the benefits of a lower tax rate or to avoid consumption tax altogether. The Technological TAG team, however, opines that it is unlikely that attempts to avoid consumption taxes would attract significant numbers of customers to anonymisers.[1320]

Svantesson states that where the IP address and port number of a proxy server located in a jurisdiction best suited to the customer's needs are known to the customer, the customer's location can be hidden or obscured by changing the proxy server information on the customer's web browser.[1321]

Geo-location software cannot be used in isolation to determine the customer's location. The OECD proposes that geo-location software should be used to verify the information submitted in the customer's self-declaration.[1322] While geo-location software cannot guarantee accuracy in itself, where it is used as a secondary tool to verify the information in the self-declaration, suppliers can achieve greater accuracy. The CTPA suggests that jurisdictions should develop an acceptable protocol in cases where a mismatch exists between the geo-location results and the self-

[1317] Akdenis Y (2001) "Case Analysis of *League Against Racism and Antisemitism (LICRA), French Union of Jewish Students v Yahoo Inc (USA), Yahoo France* Tribunal de Grande Instance de Paris (The County Court of Paris), Interim Court Order, 20 November, 2000" *Electronic Business Law Reports* vol 1 issue 3 at 111 http://www.cyber-rights.org/documents/yahoo_ya.pdf [accessed on 26 November 2012].
[1318] Svantesson DJB (2008) "How Does the Accuracy of Geo-location Technologies Affect the Law?" *Masaryk University Journal of Law and Technology* vol 2 issue 1 at 17 http://mujlt.law.muni.cz/storage/1234798550_sb_02_svantesson.pdf [accessed on 26 November 2012].
[1319] Svantesson DJB (2008) "How Does the Accuracy of Geo-location Technologies Affect the Law?" *Masaryk University Journal of Law and Technology* vol 2 issue 1 at 17 http://mujlt.law.muni.cz/storage/1234798550_sb_02_svantesson.pdf [accessed on 26 November 2012].
[1320] OECD (2000) *Report by the Technology Technical Advisory Group* at 30 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1321] Svantesson DJB (2008) "How Does the Accuracy of Geo-location Technologies Affect the Law?" *Masaryk University Journal of Law and Technology* vol 2 issue 1 at 17 http://mujlt.law.muni.cz/storage/1234798550_sb_02_svantesson.pdf [accessed on 26 November 2012].
[1322] OECD *Verification of Customer Status and Jurisdiction* at 7 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].

declaration.[1323] The CTPA, however, fails to indicate or suggest an acceptable protocol.

5.3.2.2.4 Nature of supply

In some cases the nature of supply can be applied as an indicator of the customer's location. This includes a combination of factors such as language, content, and the currency in which the transaction is completed.[1324] It should be noted that these factors are only indicative and should not be applied as the predominant test to avoid incorrect assessments.[1325] For example, where a resident of Spain orders a popular novel in Dutch (in order to improve his language skills), the language and currency could indicate that the customer is located in the Netherlands while he, in fact, resides in Spain.

5.3.2.2.5 Digital certificates

It is trite that digital certificates offer the most accurate solution to identifying and locating the customer. However, digital certificates are not often issued by revenue authorities.[1326] In addition, the use of digital certificates is less common among individuals.[1327]

[1323] OECD *Verification of Customer Status and Jurisdiction* at 7 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1324] OECD *Verification of Customer Status and Jurisdiction* at 7 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1325] Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 8.
[1326] OECD *Verification of Customer Status and Jurisdiction* at 7 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012]; Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 6.
[1327] OECD *Verification of Customer Status and Jurisdiction* at 7 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012]; Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 6.

5.3.2.2.6 Constant evaluation required

As technology advances far more rapidly than legislation or policy can, the CTPA suggests that the verification methods prescribed by jurisdictions should be regularly re-evaluated and revised to keep pace with technological advances.[1328] One such technological development is the use of a Universal User Profile system whereby a user's password and other identity information is stored on the Personal User Agent's database to allow the user easy access to multiple websites and resources.[1329] Information such as the user's location, language preference, file format preference, and currency preference, can be stored on the Personal User Agent's database.[1330] When the user accesses a website, the Universal User Profile system can, based on the information on its database, *inter alia,* display the text in the preferred language, file format, and currency.[1331] Uncertainty still exists as to how a Universal User Profile system can be applied to assist suppliers in identifying and locating the customer.[1332] As with identification through payment systems, security and privacy issues might prevent the Personal User Agent from disclosing the user's stored information to suppliers. Nonetheless, the CTPA is of the opinion

[1328] OECD *Verification of Customer Status and Jurisdiction* at 8 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012]; Hellerstein W (2004) "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective" *Georgia Law Review* vol 38 fn 119 at 37.

[1329] Kovacikova T, Petersen P, Pluke M, Bartolomeo G (2012) "User Profile Management-Integration with the Universal Communications Identifier Concept" *Proceedings of the 13th WSEAS International Conference on Communications* at 118 http://www.wseas.us/e-library/conferences/2009/rodos/COMMUNICATIONS/COMMUNICATIONS18.pdf?3e3ea140 [accessed on 27 November 2012].

[1330] Kovacikova T, Petersen P, Pluke M, Bartolomeo G (2012) "User Profile Management-Integration with the Universal Communications Identifier Concept" *Proceedings of the 13th WSEAS International Conference on Communications* at 118 http://www.wseas.us/e-library/conferences/2009/rodos/COMMUNICATIONS/COMMUNICATIONS18.pdf?3e3ea140 [accessed on 27 November 2012].

[1331] Kovacikova T, Petersen P, Pluke M, Bartolomeo G (2012) "User Profile Management-Integration with the Universal Communications Identifier Concept" *Proceedings of the 13th WSEAS International Conference on Communications* at 118-119 http://www.wseas.us/e-library/conferences/2009/rodos/COMMUNICATIONS/COMMUNICATIONS18.pdf?3e3ea140 [accessed on 27 November 2012].

[1332] OECD *Verification of Customer Status and Jurisdiction* at 8 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].

that Universal User Profile technology should be explored as an identification and location tool.[1333]

The OECD further suggests that jurisdictions should develop identification and location policies that are clear, but not onerous for suppliers, and are consistent with the natural process of collecting information in business or other practices.[1334] When policy changes are considered, revenue authorities should strive to implement policies that ensure 100 per cent accuracy without an onerous effect on suppliers.[1335]

5.3.2.2.7 Discussion and criticism

It is trite that it would generally be onerous, if not impossible, to determine the actual place of consumption for tax purposes in the absence of a close relationship between the supplier and the non-taxable customer. The proposal to deem the place of consumption to be the customer's normal place of residence (in the case of individuals), or place of establishment (in the case of businesses), could have an adverse effect on the destination principle. This is even more so in the case of individuals who are more mobile than businesses. Individuals often consume supplies in a jurisdiction different from the place of residence. That said, the impracticality of a pure consumption test warrants the proposal that the place of residence or establishment is deemed to be the place of consumption. Greve points out that even this rough proxy becomes difficult to apply in cases where the customer principally exists in cyberspace.[1336] A constant review of identification and location proxies is required to keep pace with technology.[1337] Lamensch opines that the OECD guidelines are outdated and that the current inefficiencies have been

[1333] OECD *Verification of Customer Status and Jurisdiction* at 8 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1334] OECD *Verification of Customer Status and Jurisdiction* at 8 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1335] OECD *Verification of Customer Status and Jurisdiction* at 8 http://www.oecd.org/ctp/consumptiontax/5574687.pdf [accessed on 19 November 2012].
[1336] Greve MS (2003) *Sell Globally, Tax Locally: Sales Tax Reform for the New Economy* at 8-9.
[1337] Greve MS (2003) *Sell Globally, Tax Locally: Sales Tax Reform for the New Economy* at 9.

ignored by the OECD.[1338] Baron proposes that businesses should only be required to make limited efforts to establish a customer's location.[1339] Once two or three tests have been laid down, any business which applies them should be treated as having fulfilled its obligations in locating the customer.[1340] It should further be noted that the tests should not irritate customers, or significantly slow down the transaction process.[1341]

Ligthart opines that substantial international cooperation would be required to prevent countries from adopting and implementing mutually inconsistent tax policies that would lead to double taxation or unintended under or non-taxation.[1342] Consequently, the destination principle should be adopted globally in respect of electronically supplied services or intangibles. The OECD guidelines are considered soft-law and can merely serve as persuasive guidelines to jurisdictions in reforming national VAT/GST legislation.[1343] Enforcing international cooperation, and moreover enforcing the OECD's place-of-supply proposals, would be impossible in the absence of sanctions or penalties against defaulting countries.

5.3.3 When is the supply made?

At the time of writing, Chapter IV (Time of supply and Attribution rules) had not been finalised. At the First OECD Global Forum on VAT held on 7-8 November 2012 in Paris, it was concluded that an ambitious work programme should be followed to publish the final VAT/GST Guidelines by 2014.[1344] Nevertheless, the Technological

[1338] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 86.
[1339] Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 8.
[1340] Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 8.
[1341] Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 8.
[1342] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 12 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012].
[1343] Charlet A (2010) "VAT Focus: Draft OECD VAT/GST Guidelines" *Tax Journal* March at 22 http://www.oecd.org/tax/consumptiontax/45274124.pdf [accessed on 29 November 2012].
[1344] OECD (2012) *Conclusions of the First OECD Global Forum on VAT* http://www.oecd.org/ctp/consumptiontax/conclusionsglobalforumvat.htm [accessed on 29 November 2012].

TAG team investigated the viability of the application of time stamping technology that could assist revenue authorities and suppliers in determining the exact time of supply.[1345] It was, however, established that no real commercial purpose for such software exists, and that the cost were prohibitive for the majority of online transactions.[1346]

5.3.4 What is the value of the supply?

At the time of writing, Chapter V (Value of Supply) of the OECD International VAT/GST Guidelines, too, had not been finalised. General inconsistency currently exists on the treatment of vouchers in respect of the value and timing of the supply for VAT purposes.[1347] It has been suggested that the OECD develop guidelines that are in line with the current EU alignment on the treatment of vouchers.[1348]

5.3.5 Is it made by a taxable entity?

VAT is primarily designed to tax consumption at household level.[1349] As a result of the impracticality and the burden associated with the application of the reverse-charge mechanism to individuals, businesses are required to collect the tax on behalf of revenue authorities.[1350] In the case of cross-border supplies of services or

[1345] OECD (2000) *Report by the Technology Technical Advisory Group* at 91-93 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1346] OECD (2000) *Report by the Technology Technical Advisory Group* at 10 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1347] Taxand (2012) *Taxand Responds to OECD Discussion Draft on International VAT Neutrality Guidelines* http://www.taxand.com/files/u12/rality_Guidelines_-_26-9-2012_VMWT-1498-3309.pdf [accessed on 4 December 2012].
[1348] Taxand (2012) *Taxand Responds to OECD Discussion Draft on International VAT Neutrality Guidelines* http://www.taxand.com/files/u12/rality_Guidelines_-_26-9-2012_VMWT-1498-3309.pdf [accessed on 4 December 2012].
[1349] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 2 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].
[1350] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 2 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].

intangibles, the place-of-supply rules in the case of B2B and B2C transactions respectively should be relied on to identify the taxable entity.

5.3.5.1 B2B transactions

In terms of the OECD's principal rule, once the supplier has identified the customer as a business entity and has located the place of the customer's establishment in a foreign jurisdiction, the supplier is relieved from the VAT burden on the transaction.[1351] The transaction will be taxed in the customer's country of jurisdiction in terms of the reverse-charge mechanism.[1352] Put simply, the tax burden is shifted to the business customer who is deemed to be the taxable entity.[1353]

The OECD recommends that the burden of VAT should not lie on taxable businesses unless specifically provided for in legislation.[1354] In other words, the business, as taxable entity, should be able to recover the taxes from its customers when it makes subsequent supplies for final home consumption. In the case of B2B cross-border transactions the principal rule (above) cannot be applied in the light of tax treaties which govern the type of supply. The result is that the business carries the VAT burden in that it cannot recover the VAT paid as an input deduction. Alternative measures are required to ensure tax neutrality.[1355] The OECD, however, does not provide any guidelines on these alternative measures.

Circumstances under which legislation can specifically provide for the burden to be placed on the business include, but are not limited to:

[1351] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1352] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1353] OECD (2010) *OECD International VAT/GST Guidelines: International Trade in Service and Intangibles: Public Consultation for on Draft Guidelines for Consumer Location* at 8 http://www.oecd.org/ctp/consumptiontax/44559751.pdf [accessed on 28 November 2012].
[1354] OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 4 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012].
[1355] OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 4 and 7 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012].

- Where the transactions concluded by the business are exempt because the tax base of the outputs is difficult to assess (in the case of financial services), or for policy reasons (in the case of health care and education or domestic passenger transport).[1356] For example, where a supplier of financial services acquires computer software, it has to account for output VAT on the import in terms of the main rule, but would not be entitled to claim an input VAT deduction because the supply is not acquired to make taxable supplies.[1357] The business would, furthermore, not be able to collect VAT from its customers as it makes exempt supplies. In other words, the business carries the VAT burden.
- Where the full input deduction is not allowed because of the nature of related transactions.[1358] This would be the case where the related transactions fall outside the scope of VAT (no consideration paid), or where the supplies are not wholly applied in the furtherance of the taxable business activities.[1359]
- Where input blocks are provided to balance the application of a lower VAT rate where goods can either be embedded in a product or bought separately at different rates.[1360]
- Where input deductions are disallowed because explicit administrative requirements were not adhered to.[1361] For example, where insufficient evidence is submitted to support the tax deduction.[1362]

[1356] OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 8 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012].

[1357] In terms of the definition of "imported services" in section 1 of the South African VAT Act 89 of 1991, the tax burden, in the case of imported services, lies with the importer (business or individual) in so far as the imported services are not utilised and consumed in the furtherance of an enterprise and in the making of taxable supplies.

[1358] OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 8 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012].

[1359] OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 8 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012].

[1360] OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 8 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012].

[1361] OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 8 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012].

It should be noted that the VAT burden not only relates to the financial burden of carrying the cost of VAT, but the cost of recovering foreign VAT creates an additional burden on businesses.[1363] It is recommended that the OECD develop further guidelines to minimise the additional burden on businesses.[1364]

In cases where the supplier is required to register as a VAT vendor in the country in which it makes cross-border supplies to another business, the reverse-charge mechanism shall not apply and the supplier shall be the taxable entity.[1365] In other words, the supply shall be treated as a domestic supply.

5.3.5.2 B2C transactions

The OECD does not provide for specific guidelines to determine the taxable entity in the case of cross-border B2C transactions. It recognises the problems associated with the collection of VAT on cross-border B2C transactions and the subsequent identification of the tax collecting entity.[1366] In so far as jurisdictions require non-resident suppliers of cross-border supplies to register as VAT vendors in the jurisdiction of supply, the non-resident supplier shall be deemed to be the taxable entity.[1367]

Where registration is not required, the customer is the taxable person under the reverse-charge mechanism.[1368] As a result of the difficulty of enforcing compliance

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[1362] OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 8 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012].
[1363] Taxand (2012) *Taxand Responds to OECD Discussion Draft on International VAT Neutrality Guidelines* http://www.taxand.com/files/u12/rality_Guidelines_-_26-9-2012_VMWT-1498-3309.pdf [accessed on 4 December 2012].
[1364] Taxand (2012) *Taxand Responds to OECD Discussion Draft on International VAT Neutrality Guidelines* http://www.taxand.com/files/u12/rality_Guidelines_-_26-9-2012_VMWT-1498-3309.pdf [accessed on 4 December 2012].
[1365] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1366] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1367] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1368] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].

by non-registered taxable persons, the OECD is of the opinion that the reverse-charge mechanism should not be applied in cross-border B2C transactions.[1369]

The OECD is aware of the global nature of B2C transactions and the possible eroding effect they have on the tax base if the taxable entity cannot be identified with certainty, and if compliance cannot be enforced on that taxable entity.[1370] Member countries should therefore strive to enhance greater international administrative cooperation when appropriate control and enforcement measures are developed.[1371]

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

Where the business customer would be entitled to recover output VAT for which it must account on imports in terms of the reverse-charge mechanism, the OECD recommends that jurisdictions should consider dispensing with the self-assessment method.[1372] Simply put, where the business customer applies the imported intangibles in the course and furtherance of an enterprise (in the making of taxable supplies), it should not be required to account for output VAT upon import, and simultaneously recover VAT as inputs. The supplier will only account for output VAT when it makes further taxable supplies to consumers (from whom VAT will be collected) or where the supplies acquired are not applied to make further taxable supplies. The South African position is in line with the OECD proposal. It should, however, be noted that while this method reduces the risk of businesses carrying the burden of VAT, the reliance on the taxpayer's interpretation of what constitutes "in the furtherance of an enterprise" could increase the risk of VAT fraud or under-taxation. The self-assessment mechanism further relies on the integrity of the taxable entity to account for output VAT on the import of intangibles in so far as they are acquired to make exempt supplies or for final consumption. It would generally be

[1369] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1370] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1371] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1372] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].

difficult for revenue authorities to verify the accuracy of the taxpayer's self-assessed tax return in the absence of practical evidence reflecting the actual use of the intangibles.

In contrast, where the supplier accounts for VAT on every import and simultaneously claims an input VAT deduction, revenue authorities have better control and the risk of VAT fraud or under taxation is reduced. This can be detected if the amount of input VAT deductions significantly or continuously exceed the amount of output VAT on sales.[1373]

However, in cases where the supplier for some or other reason cannot claim an input VAT deduction or cannot recoup the VAT from its customers, it will carry the burden of VAT and tax neutrality is distorted.

5.3.7 Is the supply taxable?

The identified taxable entity in cross-border trade is required to levy VAT on the transaction at the appropriate rate. Under the OECD Model Law, jurisdictions are allowed to exempt or zero rate certain categories of supplies in accordance with the OECD principles on tax neutrality.[1374, 1375]

The OECD does not provide specific guidelines in respect of what categories of supplies of goods or services should be exempt or zero-rated in member countries.

[1373] Alfredo J (2012) "Applying VAT to International Trade-The Challenge of Economic Globalisation: The Challenge for Tax Administrations" *First Meeting of the OECD Global Forum on VAT* at 54 http://www.oecd.org/ctp/consumptiontax/PptpresentationsessionmaterialGFonVAT.pdf [accessed on 5 December 2012].

[1374] OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 3 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012].

[1375] The OECD guidelines on tax neutrality *inter alia* entail that:

i) Businesses should not carry the burden of VAT except where specifically provided for in legislation;
ii) Businesses in similar situations making similar supplies should be subject to similar tax treatment;
iii) VAT rules should be framed in such a way that it does not influence business decisions;
iv) Foreign business should not be advantaged or disadvantaged compared to domestic businesses where the tax is due and payable;
v) Foreign businesses should not incur irrecoverable VAT;
vi) Where administrative requirements for foreign businesses are deemed necessary, compliance should not create a disproportionate on inappropriate burden.

In the case of cross-border trade, the main principle of tax neutrality dictates that the supply must be taxed in the jurisdiction of consumption.[1376] This implies that supplies are zero-rated in the country of origin and taxed in the country of destination.

In cases where non-resident vendors are required to register for VAT in the country where they make supplies, the vendor would be required to determine if the supply is taxable in that jurisdiction, and if so, he has further to determine the applicable rate. This effectively requires the foreign supplier to be familiar with local VAT/GST rules as well as foreign VAT/GST rules in every jurisdiction where it is required to register. It could be argued that compliance under these circumstances creates a disproportionate or inappropriate burden on the supplier resulting in a distortion of tax neutrality. That said, resident vendors would be required to make the same assessment in the case of local supplies. Subjecting foreign and local suppliers to the same tax rules is in accordance with the OECD guidelines on tax neutrality.

5.3.8 Collection mechanisms

Inadequate and inappropriate VAT collection mechanisms in cross-border trade are the main contributors to VAT fraud and the erosion of the tax base.[1377] The OECD recognises four essential VAT collection mechanisms: registration; collection through a reverse-charge mechanism; taxing at source and remittance; and collection by collecting agents.[1378] Since registration and the reverse-charge mechanism are commonly applied in most jurisdictions, the OECD suggests that, as an interim approach, it should be adapted (where required) and applied as the collection

[1376] OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 3 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012].
[1377] Alfredo J (2012) "Applying VAT to International Trade-The Challenge of Economic Globalisation: The Challenge for Tax Administrations" *First Meeting of the OECD Global Forum on VAT* at 54 http://www.oecd.org/ctp/consumptiontax/PptpresentationsessionmaterialGFonVAT.pdf [accessed on 5 December 2012].
[1378] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012]; OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 5 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].

mechanism of choice in the case of cross-border trade in intangibles.[1379] Despite the rise of modern technology that can be applied to develop collection mechanisms, member countries are of the opinion that the traditional collection mechanisms remain the most effective.[1380]

5.3.8.1 Registration

Under the registration mechanism, the non-resident supplier is required to register as a VAT vendor in the foreign jurisdiction where it makes supplies which are taxable under the VAT rules of that jurisdiction.[1381] Depending on the tax dispensation, the non-resident supplier either pays VAT on the transaction to revenue authorities, or collects VAT from consumers and remits it to the tax authority.[1382] The OECD recommends that registration should, generally, not be required in the case of B2B transactions. In the case of B2B transactions, the business customer would, under domestic laws, be required to register for VAT in the country of establishment, and VAT collection on imported intangibles or services can be effected through the reverse-charge mechanism. Requiring the non-resident supplier of B2B supplies of intangibles or services to register in the foreign jurisdiction of supply creates an unnecessary compliance burden for the supplier while alternative, as effective but less burdensome, collection mechanisms can be applied.

Where jurisdictions face major market distortions or the potential risk of significant revenue losses when dealing with B2B transactions, a registration system consistent with the national consumption tax system of that jurisdiction should be considered.[1383] The administrative and cost burden to suppliers could be

[1379] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012]; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 217.
[1380] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1381] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1382] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1383] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].

significant.[1384] In many cases, the cost of compliance in the case of nominal value supplies, would outweigh the benefit of international establishment.[1385] Where registration of non-resident vendors is required, the burden on these vendors should be minimised.[1386] Discrimination created by specific rules applicable to foreign vendors should therefore not be disguised as compliance with these specific rules.[1387] This can be achieved by developing a simplified registration regime for foreign vendors which includes electronic registration and declaration procedures.[1388] Registration in organised regions can be simplified by allowing registration in one jurisdiction only, as applies in the EU.[1389] To reduce the risk of VAT fraud, the recovery of VAT as input VAT deductions can, under the simplified registration dispensation, be limited or prohibited.[1390]

The effectiveness of a registration system is greatly affected by the design and application of a threshold system.[1391] To further minimise the burden on small and micro businesses, thresholds that apply to resident vendors should be applied equally to non-resident suppliers.[1392] In other words, the simplified registration dispensation should not create alternative registration thresholds for non-resident suppliers.

[1384] OECD (2000) *Report by the Technology Technical Advisory Group* at 56 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012]; Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 10.
[1385] OECD (2000) *Report by the Technology Technical Advisory Group* at 56 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1386] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1387] Charlet A and Buydens S (2011) "The OECD's Draft Guidelines on Neutrality for Value Added Taxes" *Tax Notes International* vol 61 no 6 at 447.
[1388] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012]; OECD (2012) *OECD International VAT/GST Guidelines: Draft Commentary on the International VAT Neutrality Guidelines* at 17 http://www.oecd.org/ctp/consumptiontax/50667035_ENG.pdf [accessed on 29 November 2012]; Grandcolas C (2007) "VAT on the Cross-Border Trade in Services and Intangibles" *Asia-Pacific Tax Bulletin* vol 13 no 1 at 41.
[1389] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 18 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1390] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].
[1391] Oka N (2012) "Specific Challenges for Tax Administrations in Applying VAT in International Trade" *First Meeting of the OECD Global Forum on VAT* at 81 http://www.oecd.org/ctp/consumptiontax/PptpresentationsessionmaterialGFonVAT.pdf [accessed on 5 December 2012].
[1392] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012].

When registration is considered, jurisdictions should take cognisance of the need for greater international cooperation.[1393] Existing tax, trade, and development treaties should be considered to develop an enforceable registration regime that would not lead to market distortions.

5.3.8.1.1 Simplified registration process

Generally, a requirement for registration is that the supplier must have a physical presence or fixed establishment in the jurisdiction where it makes taxable supplies. In the case of cross-border supplies of intangibles, the nature of the supply allows the supplier to make cross-border supplies without having a physical presence or fixed establishment in the jurisdiction where it makes the supplies. As a result, suppliers would increasingly find themselves with VAT/GST liabilities in countries in which they have no physical presence or fixed establishment.[1394] Where these suppliers are required to register in the countries where they make taxable supplies, to require a physical presence or fixed establishment would be counterproductive to the virtual nature of e-commerce establishments. The OECD, therefore, recommends that the simplified registration regime for the cross-border supply of intangibles should not require the supplier to have a physical presence or fixed establishment in the country of supply.[1395]

Applicants should be allowed to complete an online registration application form that is accessible from the revenue authority's home page.[1396] The application form should further be available in the official language of the applicable country's major

[1393] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012]; Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 10; Schenk A and Oldman O (2007) *Value Added Tax: A Comparative Approach* at 218.
[1394] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].
[1395] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].
[1396] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].

trading partners.[1397] In addition, the form should be standardised and the information requested should be limited to:

i) the registered name of the business and trading name;

ii) name and contact details of the person responsible for tax administration;

iii) postal/registered address of the business and name of contact person;

iv) telephone number of contact person;

v) electronic address of contact person;

vi) website URL of business;

vii) the national tax number in the jurisdiction of establishment.[1398]

Confirmation of receipt of the application, and the final registration number should be communicated to the supplier by electronic means.[1399]

The South African VAT registration system does not provide for a simplified registration process for suppliers of cross-border intangibles. Vendors must, amongst other requirements, have a fixed establishment with a physical presence in the Republic.[1400] The current vendor registration regime is inconsistent with the simplified registration proposal. It is trite that the strict VAT registration regime in South Africa serves as a tax administration tool to combat VAT fraud and false VAT registrations. Charlet and Buydens suggest that member countries should take advantage of information exchange treaties as mutual assistance and debt recovery tools, as opposed to implementing stricter registration requirements.[1401] This way business can be relieved from burdensome compliance procedures.[1402]

[1397] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 12 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].
[1398] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].
[1399] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].
[1400] See paragraph 3.4.5.2 above.
[1401] Charlet A and Buydens S (2011) "The OECD's Draft Guidelines on Neutrality for Value Added Taxes" *Tax Notes International* vol 61 no 6 at 447.
[1402] Charlet A and Buydens S (2011) "The OECD's Draft Guidelines on Neutrality for Value Added Taxes" *Tax Notes International* vol 61 no 6 at 447.

5.3.8.1.2 Assessment under simplified registration regime

In addition to a simplified registration process, a simplified electronic self-assessment procedure should be available to non-resident suppliers of cross-border intangibles.[1403] VAT declarations in the various jurisdictions vary in format, filing periods, and filing methods. This could adversely affect business. The OECD recommends that a standardised international declaration form and process should be developed for vendors who are registered under the simplified registration regime.[1404] The VAT/GST declaration form should strike a balance between the need for simplicity, and the need for tax authorities to verify whether the tax obligations have been fulfilled.[1405] The OECD suggests that further guidance should be given on the frequency of tax returns.[1406]

5.3.8.1.3 Record keeping under a simplified registration regime

Registered vendors are generally required to keep records of transactions to enable tax authorities to review the data to ensure that VAT/GST has been correctly levied and paid to the relevant tax authority. Jurisdictions are free to prescribe the method of record keeping required by vendors. That said, the different record keeping requirements in the different jurisdictions, of which some prohibit the electronic storage of documents, could have an adverse effect on business. The OECD proposes that an international standard for record keeping in the case of cross-border traders should be developed.[1407] In developing record keeping guidelines that can ensure reliable and verifiable records that can be trusted to contain a full and

[1403] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].
[1404] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].
[1405] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].
[1406] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 13 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].
[1407] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 14 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012].

accurate account of the electronic transaction concerned, cognisance should be taken of existing acceptable business practices.[1408]

It could be argued that the strict requirements for electronic record keeping in terms of section 29 of the South African Tax Administration Act,[1409] place an additional administrative burden on non-resident suppliers which is not in line with the OECD guidelines.[1410] In terms of the OECD guidelines, record keeping in jurisdictions other than the jurisdiction in which the documents are created, should not pose an adverse risk to tax authorities if a standardised record keeping format (as is required in the jurisdiction of establishment) is maintained and can be guaranteed.[1411] Record keeping in a place other than the Republic of South Africa is, generally, prohibited unless strict requirements are adhered to.[1412] In contrast, the EU Directive allows for record keeping in the cloud, provided that online access can be guaranteed. Record keeping under the EU model is less restrictive than under the South African model.

5.3.8.1.4 Enforceability of compliance / administrative burden

Enforceability of registration remains the chief challenge. In the absence of definitive rules and international cooperation, tax collection from non compliant offshore suppliers would be difficult to enforce.[1413] In addition, transparency in cases where registration can be enforced, would be difficult to achieve.[1414] For example, would

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[1408] OECD (2003) *Consumption Tax Guidance Series: Simplified Registration Guidance* at 14 http://www.oecd.org/ctp/consumptiontax/17851117.pdf [accessed on 6 December 2012]; OECD *Record Keeping Guidance* at 17 http://www.oecd.org/tax/taxadministration/31663114.pdf [accessed on 6 December 2012].

[1409] Act 28 of 2011.

[1410] See paragraph 3.4.7.1.4 above.

[1411] OECD *Record Keeping Guidance* at 14 http://www.oecd.org/tax/taxadministration/31663114.pdf [accessed on 6 December 2012].

[1412] See paragraph 3.4.7.1.4 above.

[1413] Oka N (2012) "Specific Challenges for Tax Administrations in Applying VAT in International Trade" *First Meeting of the OECD Global Forum on VAT* at 81 http://www.oecd.org/ctp/consumptiontax/PptpresentationsessionmaterialGFonVAT.pdf [accessed on 5 December 2012].

[1414] Oka N (2012) "Specific Challenges for Tax Administrations in Applying VAT in International Trade" *First Meeting of the OECD Global Forum on VAT* at 81 http://www.oecd.org/ctp/consumptiontax/PptpresentationsessionmaterialGFonVAT.pdf [accessed on 5 December 2012].

revenue authorities have extra-territorial powers to conduct audits on non-resident suppliers to ensure the accuracy of tax returns? Furthermore, would revenue authorities be able to enforce penalties, interest, or other punitive measures against non-compliance in foreign jurisdictions? Ecker opines that arbitration or similar forms of alternative dispute resolution, should be considered to enforce extra-territorial compliance.[1415] The negotiation of multilateral treaties, as opposed to bilateral treaties, must be undertaken to ensure greater international and regional cooperation.[1416]

From an economic perspective, compliance under a registration dispensation would create an additional burden on business. The administrative burden is, in most cases, costly and could deter foreign vendors from making supplies in a particular jurisdiction. To advance international trade, registration thresholds could be applied in the case of small to medium cross-border enterprises. However, striking a balance between a reduced administrative burden and the protection of the tax base would be difficult to accomplish.[1417]

5.3.8.1.5 Tax representative

Many countries, including South Africa, allow a non-resident supplier to register as a VAT vendor in the country where the non-resident vendor has appointed a representative taxpayer with a fixed establishment in the jurisdiction of registration. From a business perspective, the appointment of a representative taxpayer does not make economic sense.[1418] The representative taxpayer bears the liability towards

[1415] Ecker T (2012) "Considering the Future: A VAT Model Tax Treaty?" *First Meeting of the OECD Global Forum on VAT* at 119 http://www.oecd.org/ctp/consumptiontax/PptpresentationsessionmaterialGFonVAT.pdf [accessed on 5 December 2012].
[1416] Ecker T (2012) "Considering the Future: A VAT Model Tax Treaty?" *First Meeting of the OECD Global Forum on VAT* at 120 http://www.oecd.org/ctp/consumptiontax/PptpresentationsessionmaterialGFonVAT.pdf [accessed on 5 December 2012].
[1417] Oka N (2012) "Specific Challenges for Tax Administrations in Applying VAT in International Trade" *First Meeting of the OECD Global Forum on VAT* at 83 http://www.oecd.org/ctp/consumptiontax/PptpresentationsessionmaterialGFonVAT.pdf [accessed on 5 December 2012].
[1418] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 24 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].

the tax authority for non-compliance by the non-resident supplier and receives payment for this service.[1419] The additional cost of appointing a representative taxpayer, benefits only the revenue authority, while both the supplier and the representative taxpayer are burdened with additional administration and liability risks.[1420] As a result of the high risk to the representative taxpayer, the increased cost to the supplier, and the overall complexities associated with a representative taxpayer system, the OECD recommends that it should be avoided in a simplified registration regime.[1421]

5.3.8.1.6 Tax processing body/trusted third party model

Rather than registering in each jurisdiction where supplies are made, the TAG team proposes that tax authorities appoint a tax processing body with which suppliers can register and remit taxes due.[1422] In terms of this model, the customer provides his credit card information to the supplier, which transmits it to the online tax processing body.[1423] The online tax processing body, based on the credit card and product information provided by the supplier, locates and identifies the taxpayer, determines if the product is taxable or exempt in the customer's country of residence, and taxes the transaction accordingly.[1424] The tax calculation is transmitted back to the supplier who informs the customer that tax will be levied before the order is submitted.[1425] Upon shipment, the customer's credit card is debited for the full sale amount

[1419] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 24 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1420] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 24 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1421] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 24 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1422] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 25 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1423] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 25 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1424] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 25 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1425] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 25 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].

including tax.[1426] The supplier's account is credited with the sale amount and the online tax processing body's account is credited with the amount of tax.[1427] The online tax processing body remits the taxes due to the relevant tax authority and prepares a tax report for the supplier.[1428]

While this model provides greater tax certainty and reliability for suppliers (in particular small to medium size enterprises) in that the liability is shifted from the supplier to the online tax processing body, the OECD has identified a number of problems inherent in this model:

i) The majority of tax systems are based on an invoice system that is not compatible with e-commerce. It is suggested that an invoice should be replaced by a transaction number as issued by the online tax processing body, which can be used as reference.[1429]

ii) If the model is limited to B2C transactions for intangibles, its viability is questionable, given the high cost of establishing and maintaining an online tax processing body.[1430]

iii) The administrative cost of the online tax processing body should be reasonable enough to eliminate the risk of non-compliance.[1431] Consequently, where the administrative cost is recovered from the supplier, the cost should be low enough to encourage compliance. The OECD recommends that tax authorities should fund the administrative cost for small and medium enterprises.[1432] It is, however, questionable whether the revenue will outweigh the overall administrative cost where alternative tax collection options are applied. It is further likely that an online tax processing

[1426] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 25 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1427] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 25 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1428] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 25 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1429] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 25 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1430] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 26 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1431] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 26 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1432] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 25 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].

body would not be established by government despite the fact that tax collection can be done more cheaply by government.[1433] Where the private sector is involved in the task of tax collection, it would be driven by profit, resulting in higher costs.[1434]

iv) If the model is also applied in the case of cross-border transactions of tangible goods, the revenue gain would outweigh the administrative cost.[1435] Tangible goods can be taxed upon shipment, and pre-cleared for customs purposes.[1436] If this model is applied as the main tax collection method for both tangible and intangible cross-border transactions, bottlenecks at customs can be eliminated and small parcel exemptions can be abandoned.[1437]

v) VAT/GST systems are generally complicated, especially in jurisdictions where multiple VAT rates apply. For this model to be effective, VAT/GST rules will have to be significantly simplified.[1438] This model requires sophisticated software in the case of complicated VAT/GST rules. Where software is not available or fails, human intervention would be required which makes this model impractical.[1439]

vi) The model relies on the supposition that the online tax processing body is able to identify and locate the customer based on the information received by the supplier.[1440] The customer's location cannot be established through credit card details alone. It is not clear whether the supplier or tax processing body would be burdened with the duty of locating the customer. Since the agreement is essentially entered into between the customer and the supplier, the supplier would be in a better position to identify and locate the customer by applying a combination of

[1433] OECD (2000) *Report by the Technology Technical Advisory Group* at 62 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1434] OECD (2000) *Report by the Technology Technical Advisory Group* at 62 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1435] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 26 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1436] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 26 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1437] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 26 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1438] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 26 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1439] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 26 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1440] OECD (2000) *Report by the Technology Technical Advisory Group* at 63 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

identification and location tools. As a result, the supplier's software system should be integrated with that of the tax processing body to enable the processing body to calculate the tax due rapidly. This process raises privacy issues when the customer's information is transmitted to a third party. I suggest that suppliers should, as part of the standard terms and conditions of the transaction, inform customers that information supplied will be revealed to a trusted third party to establish and calculate the tax consequence of the transaction. The customer should be offered the choice of cancelling the agreement before such information is transmitted.

A variation on the stream-line registration and trusted third party model through the implementation of a one-stop-shop, is successfully applied in the EU and, through the Streamlined Sales and Use Tax Agreement, in the USA.[1441] In the case of the EU's one-stop-shop regime, tax collection is effected by revenue authorities, while in the USA, trusted third parties are appointed to collect taxes.[1442]

It remains uncertain whether the registration model (or variations thereof) serves its purpose of raising revenue and establishing competitive neutrality between resident and non-resident suppliers of intangibles.[1443]

5.3.8.2 The reverse-charge mechanism

In the case of B2B transactions where the supplying vendor is not registered or required to register, in the jurisdiction of supply, the OECD recommends that the self-assessment or reverse-charge mechanism should apply to the recipient

[1441] Ainsworth RT (2005) "Digital VAT and Development: D-VAT and D-Development" *Boston University School of Law Working Paper no 06-21: Tax Notes International* August at 633 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=923119 [accessed on 14 December 2012].
[1442] Ainsworth RT (2005) "Digital VAT and Development: D-VAT and D-Development" *Boston University School of Law Working Paper no 06-21: Tax Notes International* August at 633 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=923119 [accessed on 14 December 2012].
[1443] Alexiou C and Morrison D (2004) "The Cross-border Electronic Supply EU VAT Rules: Lessons for Australian GST" *Revenue Law Journal* vol 14 issue 1 at 148 http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1151&context=rlj&sei-redir=1&referer=http%3A%2F%2Fscholar.google.co.za%2Fscholar%3Fstart%3D30%26q%3DVAT%2Bcollection%2Bmechanisms%26hl%3Den%26as_sdt%3D1%2C5#search=%22VAT%20collection%20mechanisms%22 [accessed on 14 December 2012].

business.[1444] Generally, in the case of B2B supplies, the recipient business is a registered VAT vendor in the country of consumption. In these cases the reverse-charge mechanism is more effective because authorities can verify and enforce compliance without difficulty.[1445] That said, where the recipient business is not a registered vendor in the country of consumption, the reverse-charge mechanism relies on the integrity of the recipient to declare and pay VAT which could result in reduced effectiveness. Similarly, where the recipient business is a tax exempt entity (exempted from levying output VAT on the making of supplies), the reverse-charge mechanism is an ineffective tax collection model since it would mainly rely on the honesty and integrity of the tax exempt entity to complete tax returns. The tax exempt entity would still be required to account for VAT on the consumption of imported services and intangibles.

In applying the reverse-charge mechanism to B2B transactions, the possible compliance burden on foreign suppliers is effectively reduced to encourage cross-border trade.[1446] In addition, the likelihood that tax is collected from the person who ultimately bears the burden of VAT is increased.[1447]

The OECD TAG team is of the opinion that the reverse-charge mechanism is not an optimal tax collection mechanism in the case of B2C transactions.[1448] This can mainly be attributed to the fact that compliance relies on the integrity and honesty of

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[1444] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012]; Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 7; Grandcolas C (2007) "VAT on the Cross-Border Trade in Services and Intangibles" *Asia-Pacific Tax Bulletin* vol 13 no 1 at 40.

[1445] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012]; OECD (2008) *Applying VAT/GST to Cross-border Trade in Services and Intangibles: Emerging Concepts for Defining Place of Consumption* at 7 http://www.oecd.org/tax/consumptiontax/39874228.pdf [accessed on 5 December 2012].

[1446] OECD (2006) *International VAT/GST Guidelines* http://www.oecd.org/ctp/36177871.pdf [accessed on 24 August 2012]; OECD (2008) *Applying VAT/GST to Cross-border Trade in Services and Intangibles: Emerging Concepts for Defining Place of Consumption* at 7 http://www.oecd.org/tax/consumptiontax/39874228.pdf [accessed on 5 December 2012]; Grandcolas C (2007) "VAT on the Cross-Border Trade in Services and Intangibles" *Asia-Pacific Tax Bulletin* vol 13 no 1 at 40.

[1447] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 16 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012]; Grandcolas C (2007) "VAT on the Cross-Border Trade in Services and Intangibles" *Asia-Pacific Tax Bulletin* vol 13 no 1 at 40.

[1448] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 5 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012]; OECD (2000) *Report by the Technology Technical Advisory Group* at 8 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

customers to report transactions and account for VAT thereon. Where customers have become accustomed to a system where prices include VAT, they would generally be unaware that they are in fact responsible for VAT on imported intangibles in terms of a reverse-charge mechanism. Consumers are generally unaware of what goods are zero or standard rated or exempt.[1449] In addition, the cost of prosecuting defaulting individuals would in most cases outweigh the actual revenue due. It would not take long for individuals to realise that revenue authorities do not have the capacity to prosecute defaulting individuals.[1450] Yet, the TAG team opines that technological changes driven by privacy issues, fraud and piracy prevention, could transform the self-assessment mechanism into an effective tax collection tool in B2C transactions.[1451] Smartcard technology can be applied as an identification tool to alert the customer to the tax consequences of a transaction.[1452]

> **Example 5.2:** Country A issues every resident with an identification card in the form of a smartcard. The smartcard contains the individual's personal information, tax number and tax status, as well as any outstanding taxes or traffic penalties, warrants of arrest or similar information. When the individual purchases intangibles from a foreign supplier, he would be required to submit the identification number to the supplier's system which would automatically calculate the amount of tax, inform the customer of his duty to account for VAT, and record the amount of outstanding VAT on the identity card. Non-compliance can easily be detected when the customer uses the card at any government institution or bank as identification. This would enable the institution of appropriate measures against the taxpayer.

The use of smartcards raises some privacy issues. In the first instance, information transmitted to the supplier should be limited to the essential information to identify and locate the customer to enable the supplier to apply the correct VAT rate, and or

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[1449] OECD (2000) *Report by the Technology Technical Advisory Group* at 52 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1450] Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 10.
[1451] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 5 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1452] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 17 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].

transmit records of the transaction to the relevant revenue authority.[1453] Secondly, only information relating the total value of the supply and the type of supply (and not the full details of the transaction) should be transmitted to the revenue authority to enable them to verify that VAT was accurately calculated and to identify the taxpayer.[1454]

While a smartcard system under the reverse-charge mechanism places the burden of accounting and paying VAT solely on the customer, the liability for under-taxation would revert to the supplier who chooses to continue with a transaction where an outdated smartcard is used, or where the smartcard does not contain the correct tax number.[1455] In the case of under-taxation where the smartcard was properly used, the shortfall will be collected directly from the customer.[1456]

The use of smartcard technology would, in the main, rely on greater international cooperation between revenue authorities, governments and businesses. It is unlikely that smartcards will be widely available in the near future. In addition, the use of smartcards would require an extensive technological network of card readers, software, servers, and human resources, the development and application of which could take decades to roll out.

Until such time as smartcard technology is widely applied, the self-assessment mechanism would be costly and ineffective to apply in B2C transactions.[1457] The Technical TAG team further advises that transactional reporting, as opposed to annual reporting, would create a greater burden on both consumers and tax authorities.

Baron points out that registration of customers as individual taxpayers, could offer an alternative in cases where an individual concludes more than a set minimum number

[1453] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 17 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1454] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 17 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1455] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 17 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1456] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 17 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].
[1457] OECD (2000) *Report by the Technology Technical Advisory Group* at 53 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

of cross-border transactions.[1458] He further opines that the registration should be linked to the existing personal tax registration of the individual to ensure the practicality of the proposal.[1459]

Some countries, such as South Africa and Canada, apply the reverse-charge mechanism in both B2B and B2C transactions. In terms of the South African model, reporting is required on a transactional basis, the application of which is ineffective and not in line with the OECD proposals.[1460] Also, during the proposal stage in the amendment of the Japanese consumption tax laws to provide for the taxation of cross-border digital transactions, many observers pointed out that the inherent difficulties of implementing and enforcing a reverse-charge mechanism on B2C and B2B transactions where the business customer is a tax exempt entity, results in the reverse-charge mechanism being an ineffective tax collection model.[1461] Nevertheless, the application of the reverse-charge mechanism in B2C transactions cannot be summarily dismissed as an inappropriate and ineffective tax collection tool. The effectiveness thereof should continuously be assessed in the light of available and developing technology.

5.3.8.3 Tax collection at source and remittance

In terms of this model, the supplier levies VAT/GST on the transaction in terms of the VAT/GST rules applicable in the jurisdiction where the supply is made, and remits tax to the revenue authority in the jurisdiction where the supplier is established. The tax authority in the jurisdiction of source will pay the appropriate taxes to the revenue authority in the jurisdiction of consumption. The assumption that this model would

[1458] Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 5.
[1459] Baron R (2001) "The OECD and Consumption Taxes Part 1" *Tax Planning International E-commerce* vol 3 no 9 at 5.
[1460] See paragraph 3.4.8.2 for a full discussion of the reverse-charge mechanism in South Africa.
[1461] Uneki T (2013) 'Proposed VAT Amendments Affecting Software Downloads" *International Law Office* 1 February 2013 http://www.internationallawoffice.com/Newsletters/Detail.aspx?g=e76d15bd-6c45-4e8d-a87b-5949e82687f8&utm_source=ILO+Newsletter&utm_medium=email&utm_campaign=Corporate+Tax+Newsletter&utm_content=Newsletter+2013-02-15 [accessed on 18 February 2013].

overly burden tax authorities may be overstated.[1462] For example, it is also possible for suppliers to remit taxes directly to the revenue authority in the jurisdiction of consumption and provide proof of payment to the local revenue authority in the country of establishment.[1463] Suppliers would, however, prefer to remit taxes to their local tax authorities.[1464] Revenue authorities would be reluctant to remit taxes to other jurisdictions where the administration costs cannot be recovered.[1465] The OECD recommends that a percentage of taxes so remitted could be withheld to cover the administration costs incurred.[1466]

Despite the fact that this model requires greater international cooperation than the registration model, it would be premature to conclude that it holds little potential.[1467] The TAG team opines that this model, in conjunction with the online tax processing body model, could limit the reliance on international cooperation, to cooperation on the certification of online tax processing bodies.[1468] This could be achieved by bilateral agreements between major trading countries. [1469] As was mentioned above, the administrative costs of an online tax processing body could be significantly higher than the revenue collected. Where revenue authorities would be required to fund the online tax processing body, greater international cooperation would be required, and the costs should be distributed as a pro rata contribution in respect of the country's total revenue collected through this model. Where the cost is recovered from business, profit margins will be increased to offset the cost, resulting in higher prices which could oust small to medium enterprises from the market.

[1462] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 26 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012]; Hinnekens L (2002) "An Updated Overview of the European VAT Rules Concerning Electronic Commerce" *EC Tax Review* vol 11 issue 2 at 71.

[1463] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 26 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].

[1464] OECD (2000) *Report by the Technology Technical Advisory Group* at 59 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

[1465] Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 10.

[1466] OECD (2000) *Report by the Technology Technical Advisory Group* at 60 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

[1467] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 26-27 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].

[1468] OECD (2000) *Report by the Consumption Tax Technical Advisory Group* at 27 http://www.oecd.org/tax/consumptiontax/1923240.pdf [accessed on 24 August 2012].

[1469] OECD (2000) *Report by the Technology Technical Advisory Group* at 61 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

This model, like the registration model, relies on the supplier's ability to locate the customer's jurisdiction.[1470] In addition, the supplier would be required to be familiar with the VAT/GST rules in the customer's jurisdiction so as to apply VAT/GST at the appropriate rate and remit this to the relevant tax authority.[1471] As I have pointed out above, none of the identification and location tools is 100 per cent accurate resulting in a risk of unintentional over or under-taxation. It is not clear whether suppliers would be subject to penalties for incorrect taxation or remittance under this model. Furthermore, in cases where the supplies are made in multiple jurisdictions, sophisticated taxation software would be required to apply the correct tax rate applicable to the transaction type and jurisdiction of supply.

5.3.8.4 Collection agent

Generally, payment in e-commerce transactions is effected by credit card or EFT payments. Since the financial transaction between the customer and supplier is already facilitated by the financial institution, the Technological TAG team has suggested that financial institutions could be enlisted to assist revenue authorities in tax collection on cross-border e-commerce transactions.[1472] In terms of this model the liability to charge and collect VAT is shifted to the financial institution which facilitates the payment.[1473] The model can be summarised as follows:

i) The taxpayer enters his credit card details on the supplier's payment system when the order is placed.

ii) The supplier transmits the credit card details to the financial institution to effect payment.

[1470] OECD (2000) *Report by the Technology Technical Advisory Group* at 59 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1471] OECD (2000) *Report by the Technology Technical Advisory Group* at 59 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1472] OECD (2000) *Report by the Technology Technical Advisory Group* at 18 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1473] OECD (2000) *Report by the Technology Technical Advisory Group* at 18-19 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

iii) The financial institution identifies and locates the customer through its database, calculates the appropriate tax on the transaction, and transmits the information to the supplier.

iv) The customer receives the "tax quote" and final price and submits the final order.

v) The customer's credit card is debited with the purchase price and VAT. The supplier's account is credited with the purchase price and the financial institution remits the tax to the relevant revenue authority.

A number of credit card companies have already indicated to the Technological TAG team that they do not collect the necessary data to perform the tax collection task.[1474] Since they are not involved in the business of selling goods and services online, financial institutions believe they are not adequately equipped to collect taxes on these transactions.[1475] A further misconception exists among financial institutions, that suppliers are more likely to establish the customer's location with greater accuracy through the application of the self-declaration method.[1476] As I have pointed out above, the self-declaration method must be applied in conjunction with other identification and location tools to verify the information supplied. Absolute accuracy cannot be ensured even where a combination of self-declaration and other identification and location tools are applied.

While it is trite that suppliers have access to a greater flexibility of identification and location tools, financial institutions have direct access to their client's personal details.[1477] In contrast to suppliers who must obtain customer details through a combination of identification and location tools, financial institutions can obtain and verify a customer's details instantly by accessing its own database. That said, the Technological TAG team opines that a significant change in the financial institution's

[1474] OECD (2000) *Report by the Technology Technical Advisory Group* at 18 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012]; ; Arthur S (2000) "International Perspectives on E-commerce Taxation" *Tax Planning International E-commerce* vol 2 no 12 at 18.
[1475] OECD (2000) *Report by the Technology Technical Advisory Group* at 18 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1476] OECD (2000) *Report by the Technology Technical Advisory Group* at 18 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1477] OECD (2000) *Report by the Technology Technical Advisory Group* at 18 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

infrastructure would be required if it is to act as tax collection agent.[1478] In addition, the software systems of both the supplier and the financial institution should be integrated to allow for smooth communication and instant transmission.[1479] As a result of the identity verification and location liability on financial institutions, transmission of information would be slowed down and business efficacy would be affected.[1480] Financial institutions are further concerned that, due to the fact that they are not able to ascertain the type of supply, they would be unable to levy VAT at the appropriate rate.[1481] This is of special concern in jurisdictions where multiple rates apply. It would not be sufficient for suppliers merely to provide a description of the supplies to financial institutions. This would require financial institutions to correctly classify the type of supplies in terms of the local VAT/GST rules. Sharing of customer's information with suppliers and revenue authorities further raises privacy concerns.[1482]

As a result of the significant burden that this model places on financial institutions, coupled with the fact that a complete infrastructure change would be required, the OECD concludes that this model is not an appropriate tax collection model.[1483]

5.3.8.5 Bit tax

As an alternative to imposing consumption taxes on cross-border digital transactions, the radical and revolutionary bit taxing model does not tax the value of the digitised products internationally sourced, but it taxes the number of bits or bytes that are

[1478] OECD (2000) *Report by the Technology Technical Advisory Group* at 18 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1479] OECD (2000) *Report by the Technology Technical Advisory Group* at 18 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1480] OECD (2000) *Report by the Technology Technical Advisory Group* at 42 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1481] OECD (2000) *Report by the Technology Technical Advisory Group* at 18 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1482] OECD (2000) *Report by the Technology Technical Advisory Group* at 18-19 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].
[1483] OECD (2000) *Report by the Technology Technical Advisory Group* at 18 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

transmitted over the Internet and received by the user.[1484] The task of tax collection rests on the ISP that has access to information in respect of the user, his location, and the number of bits transferred to the user's device.

Bit tax has no regard for economic value as its primary objective is the taxation of data flow, as opposed to the content of the data.[1485] This results in an unfair tax regime. For example, a movie or music downloaded in digital form would be taxed in the same manner as unsolicited e-mails or pop-ups. For this reason bit tax has been rejected by most official organisations and most international tax experts because it is not in line with the basic principles of international taxation.[1486] In terms of the Ottawa Framework, the OECD rejects the introduction of new taxes that are designed to tax the Internet.[1487] As a result, the bit-rate tax model should not be considered as a possible taxing solution for cross-border trade in intangibles.

5.4 Conclusion

The OECD has established itself as an international organisation with the principal aim of establishing tax guidelines to assist in the developing of clear tax rules, business certainty, reducing the risk of tax avoidance and tax evasion, but also ensuring flexibility so as to keep pace with technological advances and new business developments. In this chapter I discussed the OECD proposals on the international issues associated with digital cross-border trade. The purpose of the discussion was to establish if the OECD proposals could be applied as a global solution to the identified issues, and whether these proposals pose a workable solution for the current South African position. Despite the fact that the OECD guidelines have no

[1484] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 360; Young C and Tsang R (1998) "Taxing Business on the Internet" *Tax Planning International E-commerce* Introductory issue at 10.
[1485] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 360.
[1486] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 361.
[1487] Kogels HA (1999) "VAT @ E-commerce" *EC Tax Review* vol 8 issue 2 at 117; Arthur S (2000) "International Perspectives on E-commerce Taxation" *Tax Planning International E-commerce* vol 2 no 12 at 18; Fairpo CA (1999) "VAT in the European Union-Where are we now" *Tax Planning International E-commerce* vol 1 no 9 at 18; Young C and Tsang R (1998) "Taxing Business on the Internet" *Tax Planning International E-commerce* Introductory issue at 10; Hinnekens L (2002) "An Updated Overview of the European VAT Rules Concerning Electronic Commerce" *EC Tax Review* vol 11 issue 2 at 71.

legal force, they include principles that can be followed by member countries.[1488] In addition, these principles can be used as persuasive evidence in a court of law or other adjudicating body.

It has been established that the basic principles as laid down in the Ottawa Framework are the key steps to building VAT/GST systems based on neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. These key principles include that: in cross-border trade, VAT/GST should be levied at the jurisdiction of consumption; digital goods should not be treated as goods; and that the reverse-charge mechanism should be applied in the case of B2B transactions. While it has been established that these key principles offer a significant solution in respect of South Africa's lack of place-of-supply rules and the current confusion in respect of the classification of supplies, additional issues were identified and discussed:

i) The OECD, in proposing that intangible digital supplies should not be treated as goods, advocates an artificial distinction between the supply of services and royalties. This distinction further complicates the classification of digital supplies in countries where multiple VAT rates apply. The guidelines do not provide sufficient guidance to resolve the practical e-commerce classification issues, and cannot be relied upon.

ii) Difficulties arise when attempting to determine the actual place of consumption, and the OECD consequently proposes that the customer's place of residence or establishment should be accepted as a deemed place of consumption. It can be argued that the deemed place of supply rules would eliminate most of the current problems associated with the interpretation of "utilised and consumed in the Republic" in terms of the South African VAT Act.[1489] Where the obligation of identifying and locating the customer lies with the supplier, the application of the OECD proposal that a combination of identification and locating tools be used, could overburden the supplier and negatively impact on business efficacy. In addition, the

[1488] Charlet A and Buydens S (2011) "The OECD's Draft Guidelines on Neutrality for Value Added Taxes" *Tax Notes International* vol 61 no 6 at 447.
[1489] Act 89 of 1991.

possibility of penalties and interest for unintended over or under-taxation would deter many international suppliers from making cross-border digital supplies.

iii) The OECD has not yet developed guidelines in respect of the value of supplies. Given the fact that many cross-border digital transactions include the provision of multiple supplies for which the determination of the value of the supply is often complicated, definitive guidelines are required.

iv) The OECD has not developed guidelines for the timing of the supply. Many e-commerce transactions are effected by vouchers, prepaid agreements, and third-party payment structures which have a direct effect on the timing of the supply. It is, therefore, essential that guidelines should be issued on the determination of the time of supply where the timing is affected by the nature of the payment or other conditional issues in the agreement.

v) The proposal to simplify VAT/GST systems for cross-border digital trade, and in particular the notion of applying a uniform flat tax rate for these types of transaction, would require international cooperation between not only OECD member countries, but every jurisdiction on earth. Since membership to the OECD is voluntary, the OECD acts as a toothless watchdog over the economic and social development of nations. In other words, no sanction can be imposed on member countries (and still less on non-members) for not implementing OECD proposals. International cooperation of the kind required to realise this proposal would, therefore, be an impossible goal to achieve given the current composition and powers of the OECD.

vi) Tax collection models should ideally ensure the most efficient tax collection through the elimination of tax evasion and avoidance, and unintended over and under-taxation without over burdening the taxable entity, and at the lowest administrative cost to the revenue authority. The interim solution proposed by the OECD, namely registration for B2C transactions, and self-assessment for B2B transactions, favours revenue authorities in that it places the burden of tax collection and the burden of administrative costs on the taxable entity. In addition, efficiency cannot be guaranteed as it is not clear to what extent revenue authorities will be granted extra-territorial powers to enforce cross-border VAT collection.

Taxing at source and remittance, whether by revenue authorities or by a trusted third party, require international cooperation on a grand scale. Despite the fact that the OECD recommends that cooperation can be achieved through the implementation of bilateral agreements, it should be noted that businesses often trade with countries other than those with which bilateral agreements have been concluded. In addition, the cost of remittance could in most cases outweigh the revenue collected. It is unlikely that tax authorities would fund the operational costs of an online tax collection body. Should the operational costs be funded by business, small to medium enterprises could be negatively affected if the costs cannot be recovered from customers.

The conclusion that tax collection by financial institutions is not a viable option, is based on resistance and objections received from financial institutions, and the international perception and interpretation of privacy rights in respect of banker-customer relationships at the time when the proposal was investigated. Current business trends, and a shift in tax collection mechanisms at local level, justify the conclusion that tax collection by financial institutions in the case of cross-border digital trade should be re-investigated.

CHAPTER 6:

VAT COLLECTION BY BANKS

6.1 Introduction

The viability of VAT as an effective source of revenue relies chiefly on the ability to enforce VAT rules and to collect VAT effectively on affected transactions. An ideal tax collection model ensures the elimination of tax fraud, tax avoidance, tax evasion, and over or under taxation at the least cost to the *fiscus* and without placing an additional cost or administrative burden on the taxable entity. This might be an illusionary ideal. Nevertheless, the registration and reverse-charge mechanisms as VAT collection models for cross-border digital trade are not sustainable in an online environment.

Existing VAT collection mechanisms are in dire need of modernisation, in that they are inefficient and increasingly burdensome on revenue authorities and suppliers. Some observers have proposed the use of financial institutions as VAT collectors and using technology to facilitate their task. In the Chapter 5, it was established that the OECD conclusion that VAT collection by financial institutions is not a viable option, is based on resistance and objections from financial institutions coupled with the general international perception of the banker-customer relationship in respect of customer privacy prevailing when the proposal was considered. Doernberg and Hinnekens opine that withholding taxes by financial institutions should be a method of last resort if the registration of non-resident vendors turns out to be an ineffective VAT accountability and collection tool.[1490] I believe that this view (as with the concerns raised by financial institutions) was formulated on the basis of outdated perceptions and the state of technology when it was considered. Despite the fact that the registration mechanism has not yet given rise to serious cross-country

[1490] Doernberg R and Hinnekens L (1999) *Electronic Commerce and International Taxation* at 352.

coordination efforts, I believe it to be an ineffective cross-border collection mechanism in the absence of international cooperation.

Recent technological advances, and a shift in VAT collection trends at local level, warrant further research on the viability of VAT collection by financial institutions in the case of cross-border digital trade.

In this Chapter I discuss VAT collection by financial institutions[1491] as a viable tax collection model for cross-border digital trade. This will be achieved by first discussing the operation of this model, followed by a discussion of the benefits it offers as a VAT collection mechanism on a local level with international consequences. The main objections, concerns, and possible difficulties in implementing the model will also be considered.

6.2 VAT collection by financial institutions: How does it work?

The basis of this model is to collect VAT on each transaction at the point at which it is traded through an electronic payment system – for example, a credit card system - based on the location of the customer and the VAT rules applicable in that jurisdiction.[1492] In other words, the customer is immediately assessed when the transaction is entered into, and the VAT payable is transferred to the relevant revenue authority without delay. This is typically achieved when the supplier submits the customer's credit card or other payment details to the customer's bank or credit card company, which then identifies and locates the customer's place of residence or establishment. Details of the transaction, i.e. the purchase price and type of supply, are transmitted to the financial institution to enable it to correctly assess the transaction based on the VAT rules applicable in the customer's jurisdiction where he resides, is established, or has a permanent address. The amount payable by the

[1491] For the purpose of this thesis "financial institution" will be interpreted in the narrow sense to denote banks, credit card companies, building societies or similar institutions which, as part of their ordinary duties, make payments from a customer's account to third parties on instruction of the customer.

[1492] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 14 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012]; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 14-15.

customer is the final amount inclusive of VAT. A split-payment system separates the payment in two: the purchase price is transferred into the supplier's bank account; while VAT is transferred to the relevant revenue authority. This can be seen in the schematic explanation below.

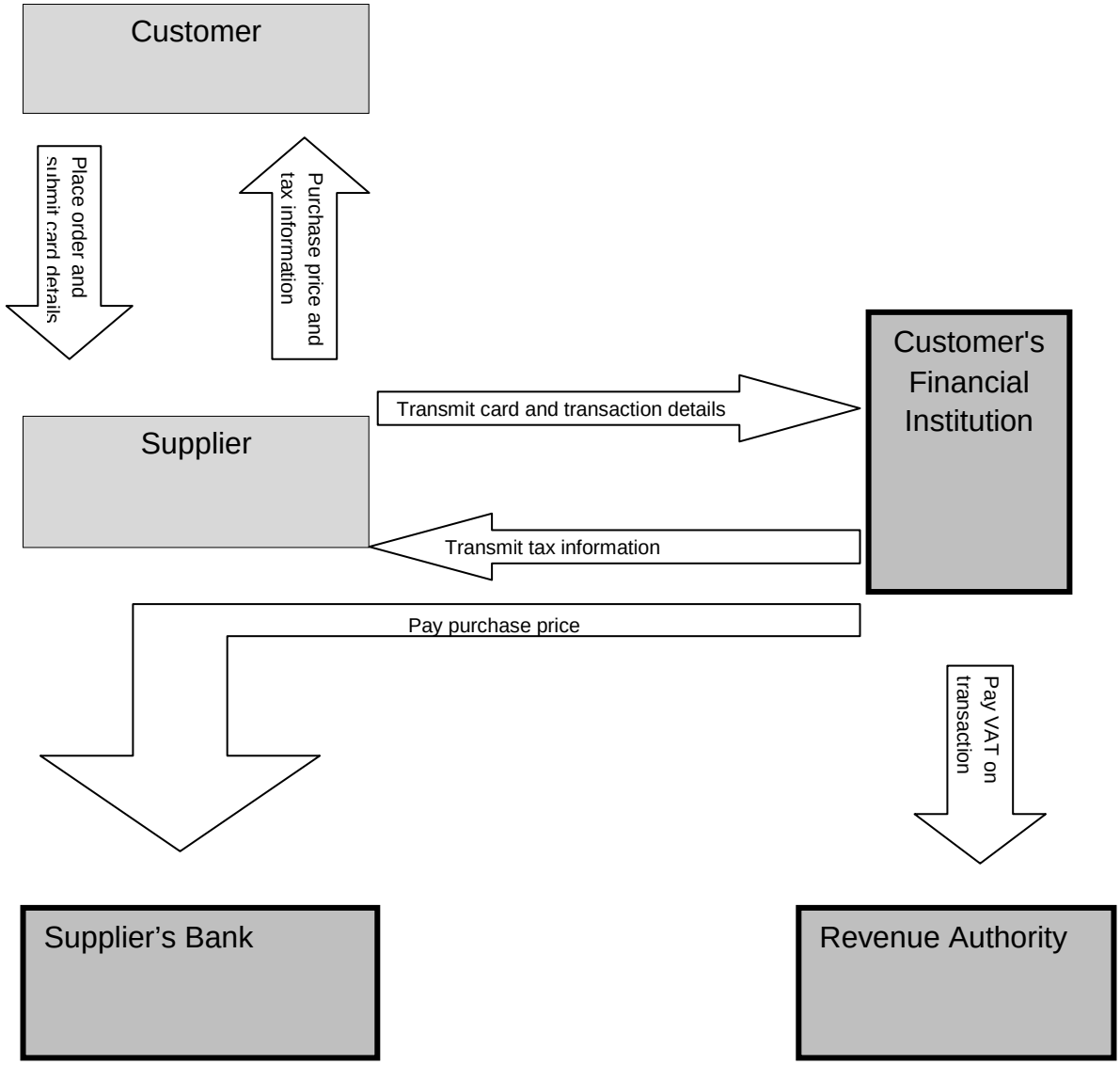

Fig 6.1

Neither the supplier nor the customer is required to register with the relevant revenue authority. Involving financial institutions in the VAT collection process is an attempt to move VAT closer to a return-free system through the increased use of electronic

payment instruments.[1493] Currently, two models exist. A Blocked VAT Account system and a Real-time VAT system.

6.2.1 Blocked VAT Account system

The Blocked VAT Account system was developed by PricewaterhouseCoopers.[1494] A Blocked VAT Account system is essentially a split payment system in terms of which the financial institution that executes the payment, levies VAT on the transaction, and then pays it into a blocked VAT account.[1495] The blocked VAT account can be used for no purpose other than incoming and outgoing VAT payments, and for VAT settlements at the end of a VAT reporting period.[1496] The financial institution merely acts as an intermediary burdened with the task of splitting the payment.[1497] Since the VAT collected from the customer is not deposited into the supplier's private bank account, the risk of disappearing vendors is eliminated.[1498] The supplier is still burdened with filing tax returns at the end of a VAT reporting period.[1499] However, the supplier will receive a partially completed assessment form

[1493] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 9 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].
[1494] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 8 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].
[1495] PricewaterhouseCoopers (2010) *Study on the Feasibility of Alternative Methods for Improving and Simplifying the Collection of VAT Through the Means of Modern Technologies and/or Financial Intermediaries* at 11 http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/future_vat/vat-study_en.pdf [accessed on 19 December 2012].
[1496] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 8 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].
[1497] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 9 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].
[1498] PricewaterhouseCoopers (2010) *Study on the Feasibility of Alternative Methods for Improving and Simplifying the Collection of VAT Through the Means of Modern Technologies and/or Financial Intermediaries* at 11 http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/future_vat/vat-study_en.pdf [accessed on 19 December 2012].
[1499] PricewaterhouseCoopers (2010) *Study on the Feasibility of Alternative Methods for Improving and Simplifying the Collection of VAT Through the Means of Modern Technologies and/or Financial Intermediaries* at 11 http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/future_vat/vat-study_en.pdf [accessed on 19 December 2012].

from the financial institution reflecting all the transactions effected by it for which VAT was paid into the blocked account.[1500] Consequently, the more transactions are executed through the blocked account, the less the supplier's burden in completing VAT returns.[1501] VAT payments and refunds will be effected from and to the blocked account.[1502] Despite the fact that VAT is collected in real-time, settlement with tax authorities is delayed until the supplier submits an assessment at the end of a reporting period.[1503] This system remains to be tested. Until then, I do not wish to express a firm view in favour or against implementing this system.

6.2.2 Real-time VAT

Real-time VAT (RT-VAT) collection is most consistent with the tax collection model by financial institutions outlined in figure 6.1 above. RT-VAT was put forward by Chris Williams, chairman of the RTpay® executive committee, a non-profit organisation the main aim of which is to promote RT-VAT as an alternative assessment method to the current registration and reverse-charge mechanisms.[1504] RT-VAT is a real-time VAT collection system that operates on the existing card and payment platforms.[1505] Once the supplier has submitted the customer's card details,

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[1500] PricewaterhouseCoopers (2010) *Study on the Feasibility of Alternative Methods for Improving and Simplifying the Collection of VAT Through the Means of Modern Technologies and/or Financial Intermediaries* at 11 http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/future_vat/vat-study_en.pdf [accessed on 19 December 2012]; Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 9 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

[1501] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 9 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

[1502] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 9 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

[1503] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 8 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

[1504] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 17 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012]; Jennings C (2010) "The EU VAT System-Time for a New Approach?" *International VAT Monitor* vol 21 no 4 at 257.

[1505] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 17-18 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012]; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 394; Ainsworth RT

purchase price, and transaction details to the financial institution, the financial institution will identify and locate the customer from its database and levy VAT on the transaction based on the VAT rate applicable in the customer's jurisdiction of residence.[1506] Payment is made directly from the customer's bank account and split into two separate payments. The purchase price is paid into the supplier's bank account, and VAT is paid to the relevant revenue authority.[1507] Payment of VAT is effected once every 24 hours, as opposed to the delayed payment system under the post-transaction assessment model.[1508] A dedicated server system (Tax Authority Settlement System (TASS)) tracks every transaction to ensure that allowable input VAT claims in the case of B2B transactions are paid automatically.[1509] Lamensch opines that it is hardly possible to keep track of each and every transaction concluded on the Internet.[1510] It remains uncertain how TASS would ensure secure and adequate tracking. The RT-VAT system remains to be tested. Until then, I do not wish to express a firm view in favour or against implementing this system.

6.3 Benefits of VAT collection by financial institutions

6.3.1 Identification and location of customer

In the case of cross-border digital trade where the supplier is required to levy VAT on the transaction based on the VAT rules applicable where the intangibles are consumed or where the customer resides or is established, the supplier is required to identify and locate the customer and or locate the place of consumption. Verifying

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(2011) "Technology Can Solve MTIC Fraud-VLN, RTvat, D-VAT Certification" *International VAT Monitor* vol 22 no 3 at 157; Jennings C (2010) "The EU VAT System-Time for a New Approach?" *International VAT Monitor* vol 21 no 4 at 257.

[1506] Williams C (2012) *RTvat: A Real-time Solution for Improving Collection of VAT* http://www.rtpay.org.php5-20.dfw1-2.websitetestlink.com/wp-content/uploads/2012/02/rtvathandoutv1.pdf [accessed on 18 December 2012]; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 394.

[1507] Williams C (2012) *RTvat: A Real-time Solution for Improving Collection of VAT* http://www.rtpay.org.php5-20.dfw1-2.websitetestlink.com/wp-content/uploads/2012/02/rtvathandoutv1.pdf [accessed on 18 December 2012].

[1508] Williams C (2012) *RTvat: A Real-time Solution for Improving Collection of VAT* http://www.rtpay.org.php5-20.dfw1-2.websitetestlink.com/wp-content/uploads/2012/02/rtvathandoutv1.pdf [accessed on 18 December 2012].

[1509] Williams C (2012) *RTvat: A Real-time Solution for Improving Collection of VAT* http://www.rtpay.org.php5-20.dfw1-2.websitetestlink.com/wp-content/uploads/2012/02/rtvathandoutv1.pdf [accessed on 18 December 2012].

[1510] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 12.

the customer's identity and location is a difficult task. Even in cases where a combination of identification and location tools is applied, 100 per cent accuracy cannot be attained. It is trite that payment and credit card details, in the hands of the supplier, do not reveal much about the customer. However, the financial institution that executes the payment, is able to access the customer's details from its database. In terms of the "know-your-customer" principle, financial institutions are required to keep records of their customer's identification and place of residence.[1511] Internationally, financial institutions are prohibited from keeping anonymous accounts or accounts in fictitious names.[1512] In South Africa, there is no specific legislation prohibiting such a practice. However, because of the duty of record keeping,[1513] and the reporting duties[1514] of accountable institutions[1515] in terms of

[1511] Financial Action Task Force (2012) *International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation:The FATF Recommendations* at 14 http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%20(approved%20February%202012)%20reprint%20May%202012%20web%20version.pdf [accessed on 20 December 2012]; Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 89; Baron R (2002) "VAT on Electronic Services: The European Solution" *Tax Planning International E-commerce* vol 4 no 6 at 4; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 13-14.

[1512] Financial Action Task Force (2012) *International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation:The FATF Recommendations* at 14 http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%20(approved%20February%202012)%20reprint%20May%202012%20web%20version.pdf [accessed on 20 December 2012].

[1513] Sections 21 and 22 of the Financial Intelligence Centre Act 38 of 2001 in terms of which accountable institutions are prohibited from establishing a business relationship or entering into a single transaction with a person or entity unless the financial institution has verified the identity and place of residence or establishment of such person or entity.

[1514] Sections 27 to 41 of the Financial Intelligence Centre Act 38 of 2001.

[1515] An "accountable institution" means an attorney as defined in the Attorneys Act 53 of 1979; a board of executors; a trust company; or any other person who invests, keeps in safe custody, controls or administers trust property within the meaning of the Trust Property Control Act 57 of 1988; an estate agent as defined in the Estate Agents Act 112 of 1976; a financial instrument trader as defined in the Financial Markets Control Act 55 of 1989; a management company registered in terms of the Unit Trusts Control Act 54 of 1981; a person who carries on the "business of a bank" as defined in the Banks Act 94 of 1990; a mutual bank as defined in the Mutual Banks Act 124 of 1993; a person who carries on a "long-term insurance business" as defined in the Long-Term Insurance Act 52 of 1998, including an insurance broker and an agent of an insurer; a person who carries on a business in respect of which a gambling licence is required to be issued by a provincial licensing authority; a person who carries on the business of dealing in foreign exchange; a person who carries on the business of lending money against the security of securities; a person who carries on the business of rendering investment advice or investment broking services, including a public accountant as defined in the Public Accountants and Auditors Act 80 of 1991, who carries on such a business; a person who issues, sells or redeems travellers' cheques, money orders or similar instruments; the Postbank referred to in section 51 of the Postal Services Act 124 of 1998; a member of a stock exchange licenced under the Stock Exchanges Control Act 1 of 1985; the Ithala Development Finance Corporation Limited; a person who has been approved or who falls within a category of persons approved by the Registrar of Stock Exchanges in terms of section 4(1)(a) of the Stock Exchanges

the Financial Intelligence Centre Act,[1516] it is neither possible nor legally tenable for South African banks to keep anonymous accounts. Consequently, financial institutions in South Africa are required to maintain a database of information pertaining to their customers' identity and location. Where payment in the case of a cross-border digital transaction is executed by a South African financial institution, by mere fact that the customer's credit card or payment method was issued/executed by a South African financial institution, the financial institution would be in the position to identify the customer as a South African resident or entity established in South Africa. In addition, in many jurisdictions, including South Africa, financial institutions are already required to monitor and report the transfer of funds in terms of exchange control legislation.[1517] It can, therefore, be concluded that financial institutions, as payment facilitators in the cross-border digital trade chain, are best equipped to verify the customer's identification and location. Ligthart points out that the customer's identification cannot be ascertained if the credit card was issued by a bank in a country with bank secrecy laws.[1518] She is not entirely correct. While it is trite that, in these countries, the information in respect of the customer's identification and location cannot be divulged to third parties, the financial institution would still be able to ascertain the customer's identification and location despite secrecy provisions. Further, if the bank is authorised (or rather, under compulsion of legislation) to disclose the personal details of its customers, this will override the common law duty of confidentiality which a bank owes its customers. Lamensch suggests that customers should not be required to disclose their card or payment details to the supplier who will in turn disclose the information to the financial institution to identify and verify the customer's location and tax status.[1519] Privacy, according to Lamensch, can be ensured by applying secure payment systems.[1520] In

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Control Act 1 of 1985; a person who has been approved or who falls within a category of persons approved by the Registrar of Financial Markets in terms of section 5(1)(a) of the Financial Markets Control Act 55 of 1989; and a person who carries on the business of a money remitter.

[1516] Act 38 of 2001.

[1517] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 24.

[1518] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 14 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012].

[1519] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 89.

[1520] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 89.

terms of these systems, the customer is directed to a secure payment platform operated by the financial institution. The customer identifies himself by submitting his card details, and the financial institution can immediately recognise the customer based on the information stored on its database.[1521] The financial institution only requires the value and nature of the supply from the supplier to levy the correct amount of VAT.

fig 6.2[1522]

6.3.2 Destination and origin principle

VAT collection by financial institutions as a viable collection method is not restricted to cross-border transactions concluded under the destination principle.[1523] Under the origin principle, the customer's bank would be required to identify the country of

[1521] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 89.
[1522] Steiner P (1993) *The New Yorker* vol 69 no 20 at 61 http://www.unc.edu/depts/jomc/academics/dri/idog.html [accessed on 4 January 2013].
[1523] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 18 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012]; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 394.

origin based on the information submitted by the supplier, levy VAT on the transaction in accordance with the rules applicable in the country of origin, and pay VAT to the relevant revenue authority.[1524] Under the origin principle, greater cooperation between financial institutions and various revenue authorities in different jurisdictions is required. It should, however, be noted that the origin of the supply (place where the supplier is established) cannot be determined with absolute certainty. The financial institution would rely on information submitted by the supplier who can choose to accept payment in a low VAT jurisdiction while the actual supplies were delivered from another location or in the cloud.

Under the destination principle, the financial institution is only required to cooperate with the revenue authority in the country where the customer is located. Consequently, VAT is collected based on a single set of VAT rules and paid to a single revenue authority. This is based on the premise that the customer and financial institution are located in the same jurisdiction. In the case of a federal system, greater cooperation might be required which could overburden financial institutions. Ligthart opines that a national clearing house could be set up under a federal system to assist financial institutions in transferring VAT payments to the relevant revenue authority.[1525] While this proposal was in line with the requirements for a clearinghouse under the now abandoned 'definitive regime', a clearinghouse has never been set up. Basu points out that there is a greater likelihood of a legal nexus existing between the financial institution and the state for which taxes are being collected in a federal system, than would be the case where these taxes are collected by a supplier.[1526] In other words, the system is compliant with both the Internet Tax Freedom Act[1527] of the USA and the *Quil* judgment.[1528] Basu further points out that existing debt and credit collection mechanisms, as applied by the

[1524] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 18 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

[1525] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 15 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012].

[1526] Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 11 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013].

[1527] The Internet Tax Freedom Act, Amendment Act of 2007.

[1528] *Quill Corp v North Dakota* (91-0194), 504 U.S. 298 (1992); Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 25.

financial institution in the state of incorporation - including court procedures - can be applied to collect taxes due on a transaction.[1529] Such measures would, however, not be required. Under both the RT-VAT and Blocked-VAT systems, VAT is immediately levied on the transaction and recovered from the customer's bank account, leaving no opportunity for unpaid taxes that must be recovered by a debt collection process or court procedure. Where the bank has extended credit to a customer who has insufficient funds to cover both the purchase price and VAT, any subsequent action to recover such money would be a claim for outstanding and unpaid debt and not for outstanding and unpaid VAT.

6.3.3 Simplified VAT collection

In non-federal systems where the destination principle applies, financial institutions tasked with VAT collection, are only required to account for VAT in the jurisdiction where they are established. Simply put, VAT collection is simplified to the extent that the financial institution applies a single set of VAT rules. This should be contrasted against the registration method where suppliers, as VAT collectors, are required to register in multiple jurisdictions and are further required to apply multiple VAT rules. It should, however, be noted that it is possible for a customer to have a bank account at a financial institution not established in the jurisdiction in which he resides.[1530] In these cases, the financial institution would be required to apply a set of VAT rules that applies in the foreign country where the customer resides. This could place an additional administrative burden on the financial institution which must then cooperate with multiple tax authorities. This, according to Lamensch should not pose any difficulty to these financial institutions.[1531]

As VAT payments are automatically transferred to revenue authorities, financial institutions are not burdened with completing difficult VAT returns and manual

[1529] Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 11 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013].

[1530] De Campos Amorim J (2009) "Electronic Commerce Taxation in the European Union" *Tax Notes International* vol 55 no 9 at 779; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 15.

[1531] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 15-16.

payment systems.[1532] The automated payment system under the RT-VAT system simplifies the collection and remittance process, creating a VAT collection mechanism that places the least administrative burden on the financial institution.

6.3.4 No delays in VAT remittance

Under the RT-VAT system, VAT remittance is automated at 24 hour intervals.[1533] The transaction, VAT collection, and remittance, can effectively be completed on the same day. However, this is not the case under the blocked VAT account model in terms of which VAT is immediately collected but remitted to revenue authorities at the end of a reporting period.[1534] This is similar to the registration and reverse-charge models. Delays in VAT remittance negatively impact on the cashflow of revenue authorities, and increase opportunities for VAT fraud. From the vendor's perspective, however, delays in VAT remittance may temporarily aid cash flow; at the same time this poses a risk to the vendor that when VAT has to be remitted there may not be cash on hand.

6.3.5 VAT fraud and unintended under-taxation eliminated

Generally, VAT fraud is associated with schemes that involve - i) the collection of VAT on taxable transactions and the failure of suppliers to remit VAT to revenue authorities; and ii) artificially inflated input VAT deductions that exceed outputs.[1535] Since VAT is automatically collected on transactions and automatically remitted to

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[1532] Williams C (2012) *RTvat: A Real-time Solution for Improving Collection of VAT* http://www.rtpay.org.php5-20.dfw1-2.websitetestlink.com/wp-content/uploads/2012/02/rtvathandoutv1.pdf [accessed on 18 December 2012]; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 15-16.

[1533] Williams C (2012) *RTvat: A Real-time Solution for Improving Collection of VAT* http://www.rtpay.org.php5-20.dfw1-2.websitetestlink.com/wp-content/uploads/2012/02/rtvathandoutv1.pdf [accessed on 18 December 2012]; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 394; Ainsworth RT (2011) "Technology Can Solve MTIC Fraud-VLN, RTvat,D-VAT Certification" *International VAT Monitor* vol 22 no 3 at 156; Jennings C (2010) "The EU VAT System-Time for a New Approach?" *International VAT Monitor* vol 21 no 4 at 257.

[1534] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 8 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

[1535] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 2,7 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

revenue authorities within a 24 hour cycle under the RT-VAT system, VAT fraud opportunities are virtually eliminated.[1536] Similarly, in the case of a Blocked-VAT account, VAT is not paid into private bank accounts eliminating the chance of VAT fraud and simultaneously reducing the number of audits required.[1537]

Under reporting of output VAT is often associated with the failure to issue invoices or the lack of proper record keeping by suppliers. In the case of VAT collection by financial institutions, records of transactions are kept by third parties (financial institutions) which ensures that a sound audit trail is established, resulting in the elimination of VAT fraud opportunities.[1538]

Reliability, respectability, and creditworthiness are essential elements in a successful third party VAT collection system.[1539] This cannot be guaranteed by a reverse-charge or registration system. The principle of a fractionated VAT system operated by a reverse-charge mechanism, poses tremendous risks of non-payment in the case of insolvency.[1540] VAT collection by financial institutions removes the risk of lost VAT in the case of businesses going bankrupt.[1541] In jurisdictions that provide for

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[1536] Williams C (2012) *RTvat: A Real-time Solution for Improving Collection of VAT* http://www.rtpay.org.php5-20.dfw1-2.websitetestlink.com/wp-content/uploads/2012/02/rtvathandoutv1.pdf [accessed on 18 December 2012]; Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 14 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012]; Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 90; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 395; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 16.

[1537] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 8-9 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

[1538] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 9 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012]; Kleven HJ, Kudsen MB, Kreiner CT, Pedersen S, Saez E (2010) "Unwilling or Unable to Cheat? Evidence from a Randomized Tax Audit Experiment in Denmark" *NBER Working Paper Series no 15769* at 20 http://www.nber.org/papers/w15769.pdf [accessed on 21 December 2012]; Williams C (2011) "Technology Can Solve MTIC Fraud-2" *International VAT Monitor* vol 22 no 4 at 231; Ainsworth RT (2011) "Technology Can Solve MTIC Fraud-VLN, RTvat,D-VAT Certification" *International VAT Monitor* vol 22 no 3 at 157.

[1539] Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 11 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013].

[1540] Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 388.

[1541] Williams C (2012) *RTvat: A Real-time Solution for Improving Collection of VAT* http://www.rtpay.org.php5-20.dfw1-2.websitetestlink.com/wp-content/uploads/2012/02/rtvathandoutv1.pdf [accessed on 18 December

special treatment of the *fiscus* as a statutory preferential creditor against the estate of the insolvent taxpayer, complete recovery of outstanding taxes cannot be guaranteed. Under the RT-VAT system, as VAT is collected by a third party and immediately remitted to the relevant tax authority, the possibility that the money can be embezzled by the supplier is eliminated. Furthermore, the trustee of the insolvent supplier cannot argue that the money falls into the insolvent estate, and that the revenue authority should submit a claim against the insolvent estate as a concurrent or statutory preferrent creditor. This is because the revenue authority's entitlement to the money vests as soon as the transaction has been concluded, and the money is collected on behalf of the revenue authority by the financial institution.

In the case of B2C cross-border digital trade where the reverse-charge mechanism applies, many transactions escape the VAT net purely because taxpayers are unaware of their statutory duty to report the transaction and remit VAT to the revenue authority.[1542] A deferred payment system requires effective and regular internal audits and a higher degree of compliance by taxpayers to ensure constant VAT collection.[1543] Under the RT-VAT and Blocked-VAT account systems, B2C cross-border transactions can be detected and taxed effectively. As this happens during the transaction phase, the parties cannot escape VAT through a failure to report the transaction.

Nevertheless, it should be noted that the RT-VAT and Blocked-VAT systems cannot eliminate every form of VAT fraud.[1544] Spending all resources to eliminate every form

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2012]; Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 11 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013]; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 395.

[1542] OECD (2000) *Report by the Technology Technical Advisory Group* at 52 http://www.oecd.org/tax/consumptiontax/1923248.pdf [accessed on 11 December 2012].

[1543] Cnossen S (1998) "Global Trends and Issues in Value Added Tax" *International Tax and Public Finance* vol 5 issue 3 at 413 http://link.springer.com/article/10.1023%2FA%3A1008694529567?LI=true# [accessed on 4 January 2013].

[1544] Goolsbee A and Zittrain J (1999) "Evaluating the Costs and Benefits of Taxing Internet Commerce" *The Berkman Center for Internet and Society Research Publication no* 1999-03 5/1999 at 18 http://cyber.law.harvard.edu/sites/cyber.law.harvard.edu/files/1999-03.pdf [accessed on 3 January 2013]; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 16.

of VAT fraud is an unrealistic approach.[1545] Goolsbee and Zittrain opine that VAT collection by financial institutions should primarily be developed to simplify VAT compliance and to make VAT fraud and evasion difficult to the extent that the problem can be limited.[1546]

6.3.6 Can be applied to tangible and intangible transactions

Both the RT-VAT and Blocked-VAT account systems are not restricted to the application of cross-border trade in intangibles, but can be applied to any transaction where funds are transferred electronically.[1547] Should these systems be applied to cross-border trade in tangibles, possible bottlenecks during peak import times can be avoided. Since import VAT on tangibles is generally levied on the value of the goods, the purchase price, which must be disclosed to the financial institution, can be used to calculate and levy VAT. This will further eliminate valuation problems by customs where imported goods are not accompanied by invoices reflecting the purchase price or insured value. The cost of training custom officials, and further retaining expert and diligent officials in the system, could outweigh the revenue collected from small parcels. Should the RT-VAT system be applied to both tangible and intangible cross-border supplies, fewer custom officials would be required, and expert or experienced officials could be deployed in fields where their expertise can better be applied. Kogels points out that the popularity of mail-order and online shopping portals will increase the flow of small parcels that cannot be checked adequately by customs, which could lead to distortions in competition for suppliers in local markets.[1548] This can be avoided if an RT-VAT system is applied to both tangible and intangible cross-border supplies.

Records of the transaction and VAT collected thereon will be transmitted by the financial institution to the supplier as proof that VAT was levied and duly paid. In the

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[1545] Goolsbee A and Zittrain J (1999) "Evaluating the Costs and Benefits of Taxing Internet Commerce" *The Berkman Center for Internet and Society Research Publication no* 1999-03 5/1999 at 18 http://cyber.law.harvard.edu/sites/cyber.law.harvard.edu/files/1999-03.pdf [accessed on 3 January 2013].

[1546] Goolsbee A and Zittrain J (1999) "Evaluating the Costs and Benefits of Taxing Internet Commerce" *The Berkman Center for Internet and Society Research Publication no* 1999-03 5/1999 at 18 http://cyber.law.harvard.edu/sites/cyber.law.harvard.edu/files/1999-03.pdf [accessed on 3 January 2013].

[1547] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 19.

[1548] Kogels HA (1999) "VAT @ E-commerce" *EC Tax Review* vol 8 issue 2 at 122.

case of cross-border tangible sales, a print-out of the VAT record must be included in the package to prevent unintended double taxation at border posts.

It is recommended that an RT-VAT collection model must be applied to both cross-border tangible and intangible trade to offset the cost of implementation and to ensure its constant viability through periods where tangible trade is preferred to intangible trade and vice versa.

6.4 Objections and concerns

6.4.1 No data to process transaction

While it has been established above that financial institutions are better equipped (than suppliers) to identify and locate their customers when they facilitate payment in the case of cross-border transactions, financial institutions are not equipped to tax the transaction in accordance with the local tax rules applicable to the transaction.[1549] That said, because of technological advances, the gathering of information in order to tax a transaction is no longer limited to the supplier of the goods or services.[1550] In jurisdictions where multiple VAT rates apply, the financial institution would require data reflecting the value of the supply, the type of supply, and the recipient's VAT status.[1551]

[1549] Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 12 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013]; Hinnekens L (2002) "An Updated Overview of the European VAT Rules Concerning Electronic Commerce" *EC Tax Review* vol 11 issue 2 at 71.

[1550] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 87.

[1551] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 15 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012]; Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 12 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013]; Jenkins P (1999) "VAT and Electronic Commerce: The Challenges and Opportunities" *International VAT Monitor* vol 10 no 1 at 5.

6.4.1.1 Value of the supply

Determining the value of the supply would depend on the data received from the supplier. In the absence of a tax evasion scheme between connected persons, the purchase price would, generally, constitute the value of the supply. Since payment to the supplier is limited to the purchase price submitted to the financial institution, suppliers are likely to submit the actual amount they require to make the supply. The purchase price can be substantiated by means of an invoice.

6.4.1.2 Type of supply

In order to apply the correct VAT rate, a taxable entity is required to classify the type of supply correctly. As I have pointed out, this is an onerous task, especially in the absence of clear definitions. Save for facilitating payment, financial institutions are not involved in the supply chain. Burdening financial institutions with the task to classify the type of supply would require industry-specific data and expert knowledge of the VAT system applicable to the supply. In a highly competitive market, suppliers could submit false product descriptions to best suit the customer's needs as regards VAT rates. Neither financial institutions, nor revenue authorities, has the capacity to verify that the final supply and its description match. Such an investigation would require an extensive extra-territorial audit. Even in the absence of an underlying tax evasion scheme, financial institutions would find it difficult to classify the type of supply based purely on the product description submitted by the supplier. Furthermore, the financial institution cannot rely on the classification by the supplier, as the classification in the country of supply and the country of consumption could differ dramatically. Furthermore, financial institutions may, for other reasons such as conflict of laws, be reluctant or unable to act against suppliers who fail to provide the necessary classification. Financial institutions could refuse to do further business with these suppliers - but that is not an ideal outcome for the either the bank or the supplier.

Basu suggests that an international uniform product classification should be developed.[1552] But who would develop this uniform product classification data bases, and would it be enforceable in all jurisdictions? Basu further suggests that the uniform product classification system should operate on a standardised coding formula.[1553] Under this system all stakeholders in the supply chain, including revenue authorities, will apply a uniform standardised code assigned to products according to their classification.[1554] Should this system be applied, financial institutions would not be burdened with the task of classifying supplies.

> **Example 6.1:** X (a South African resident) orders an e-book from Y (an American supplier) and submits his credit card details to Y. Y submits the price and internationally unified code for electronic books to the credit card company to facilitate payment. The credit card company identifies X as a South African resident from the available information in their database. The system further, based on the unified code submitted to it, links the supply to the applicable VAT rate and duly debits X's account with the purchase price and South African VAT.

In jurisdictions that apply multiple VAT rates, Basu's suggestion creates an opportunity for suppliers and customers to engage in tax evasion schemes. For example, where an e-book is taxed at 0% in the customer's country of residence and computer software is taxed at 20%, a supplier and customer can collude to submit the unified code for e-books when, in fact, computer software is being supplied. As with the self-assessment mechanism, the classification of goods by suppliers relies on the suppliers' good faith - although to a much lesser extent.[1555] It should further be noted that the problem of tax evasion schemes similar to the one in this example,

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[1552] Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 4,8-9 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013].

[1553] Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 4,8-9 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013].

[1554] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 18.

[1555] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 90.

is not restricted to online transactions. There are no economic arguments that supports nonsensical rate differentiation.

Moreover, the suggestion of a unified coding system requires greater international cooperation and sophisticated software or changes in the suppliers' and financial institutions' systems.[1556] In cases where an international code has not been assigned to a particular product or service, but where the VAT rules in the country of consumption provide for the taxation of the transaction in question, additional changes to the payment system would be required to facilitate the transaction. This can be done by a dropdown list of classifications to which a country specific code has been assigned.[1557] However, this system would constantly need to be adapted and amended to provide for new technologies, new services, and new categories of supply. This could negatively impact on its application.

Lamensch suggests that the financial institution should not be burdened with the task of classifying and taxing the transaction.[1558] While this view should be supported, it should also be noted that revenue authorities would be far keener to burden banks (and not suppliers) with this duty. The main reason is that there are fewer banks which are easier to monitor, than millions of suppliers worldwide.[1559] Lamensch further suggests that the supplier must submit both the value and the amount of tax to the financial institution.[1560] The financial institution would, therefore, merely act as a tax collection agency. However, this suggestion raises certain issues. In order for the supplier to submit the value and the tax to the financial institution, it must be able to locate the supplier to calculate VAT at the rate applicable in the jurisdiction of consumption. To establish the location with accuracy, the supplier would have to rely on the customer's location information as established by the financial institution. Disclosure of the customer's location to the supplier raises serious privacy issues in

[1556] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 90.
[1557] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 19.
[1558] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 89.
[1559] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 16.
[1560] Lamensch M (2012) "Unsuitable EU VAT Place of Supply Rules for Electronic Services-Proposal for an Alternative Approach" *World Tax Journal* vol 4 issue 1 at 89.

the hands of the financial institution, resulting in the suggestion being largely un-implementable.

Further issues that need to be resolved include whether the financial institution would be liable for penalties for incorrect taxation based on incorrect product classification,[1561] whether a customer would have a right of recourse against the financial institution for incorrectly collecting VAT on the transaction,[1562] and whether a customer would be entitled to a VAT refund on transactions incorrectly taxed.[1563]

6.4.1.3 Recipient's VAT status

Based on the findings in the previous chapters, it can be concluded that the majority of observers are of the view that cross-border B2B digital transactions should be exempted from VAT. This conforms to the international practice that VAT should be levied at consumption. However, this practice would require financial institutions (as VAT collectors) to determine the customer's VAT registration status to enable them to levy VAT at the correct rate. It could be argued that financial institutions can rely on the VAT status information supplied to them by the customer, or base their conclusion on the information available in their customer database. I have pointed out that consumers can manipulate transactions to comply with their taxing needs by submitting false VAT registration numbers (or using the VAT number of a registered VAT vendor) resulting in the avoidance of VAT. Even in cases where the VAT number can be verified by means of an integrated system linked to the revenue

[1561] In terms of section 59(1)(*g*) of the VAT Act 89 of 1991, a person who knowingly issues any tax invoice, credit note, or debit note under the Act which is in any material respect erroneous or incomplete, commits an offence. Where the bank acts *bona fide* no penalties can be raised. It should, however, be noted that the different countries are free to provide for penalties in domestic VAT legislation.

[1562] Where a customer institutes the claim against the bank, the customer would likely succeed where the claim is based on delict or breach of contract, provided that the requirements for these claims are present and can be proved. See for example *Nedbank v Pestana* (142/08) [2008] ZASCA 140 (27 November 2008). The non-customer would base his or her claim on delict. In limited cases, provided that the requirements of the respective enrichment claims are present and can be proved, the non-customer would likely succeed in a claim for enrichment. To avoid unnecessary litigation, I suggest that a customer's right of recourse against the bank be limited or excluded.

[1563] Section 44(2)(*a*) of the VAT Act 89 of 1991 provides any person who has paid any amount of tax, additional tax, penalty, or interest in excess of the amount of tax, additional tax, penalty, or interest that should have been charged, may apply for a refund. Where the bank has charged VAT on the transaction incorrectly, either because of an incorrect product classification or any other reason, the recipient of the imported services may apply for a refund of the VAT incorrectly levied and collected. Also see Stiglingh M (ed), Koekemoer AD, Van Schalkwyk L, Wilcocks JS, De Swardt RD (2013) *Silke: South African Income Tax* at 1012.

authority's taxpayer database, it would in some cases be difficult to verify if the vendor is who he claims to be. It could be argued, that where the customer's personal information stored in a financial institution's database, and the personal information stored in a revenue authority's database differ, it can be assumed that the customer is not a registered VAT vendor. This would, however, not always be the case as the vendor could trade under one name for VAT purposes, but effect international payment under another name or from another account not linked to its business account.

Such an integrated system would require sophisticated software and a change in both systems. In addition, as I have pointed out, privacy issues would prevent revenue authorities from divulging the taxpayer's personal information to financial institutions. Therefore, even in cases where the systems are fully integrated, the financial institution would, at best, be able to verify the existence of the VAT number supplied.

Under a credit system, financial institutions would not be required to verify the taxpayer's status. All transactions are taxed in real-time when payment is facilitated, irrespective of the customer's tax status. Where, because of the customer's tax status, the transaction qualifies for exempted or zero rating, the customer can claim VAT levied and paid in real-time as input credits. Under a credit system, VAT collection by financial institutions can be simplified, VAT fraud issues eliminated, and the taxpayer's privacy can be ensured.

6.4.2 Sophisticated software / change in systems required

A dominant concern associated with real-time tax collection by financial institutions, is that it would require sophisticated software and a change in banking systems that must be integrated or linked to other systems.[1564] Developing and regularly updating

[1564] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 15 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012]; Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 3-4 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013].

the required software is costly.[1565] Ainsworth points out that major technological advances in trade, spur the need for technology-orientated reforms of VAT systems that are efficient and have revenue maximising potential.[1566] A natural concomitant of technology-orientated tax collection systems is the development of sophisticated software. Consequently, a change in systems and the development of sophisticated software is an unavoidable requirement for the development of an efficient VAT collection mechanism for cross-border digital trade.

RTPay®, a non-profit organisation, constantly develops real-time VAT collection software for governments.[1567] These systems are designed to offer the most efficient, cost effective, and fraud-proof methods of tax collection.[1568] The system is swift and simple to implement, and requires minimal upfront capitalisation from revenue authorities.[1569]

In the light of the availability of real-time VAT software systems, the argument that VAT collection by financial institutions would require the costly development of sophisticated software does not stand up to close scrutiny.

6.4.3 Additional costs involved

Under the registration and reverse-charge models, the taxable entity (the entity tasked to collect VAT) generally carries the administrative cost of collecting VAT on behalf of revenue authorities.[1570] Where the taxable entity develops systems to

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[1565] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 15 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012]; Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 3-4 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013].

[1566] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 22 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

[1567] http://www.rtpay.org/sample-page/ [accessed on 9 January 2013].

[1568] Williams C (2012) *RTvat: A Real-time Solution for Improving Collection of VAT* http://www.rtpay.org.php5-20.dfw1-2.websitetestlink.com/wp-content/uploads/2012/02/rtvathandoutv1.pdf [accessed on 18 December 2012].

[1569] Williams C (2012) *RTvat: A Real-time Solution for Improving Collection of VAT* http://www.rtpay.org.php5-20.dfw1-2.websitetestlink.com/wp-content/uploads/2012/02/rtvathandoutv1.pdf [accessed on 18 December 2012].

[1570] Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 7.

simplify the VAT collection and remittance burden, the taxable entity bears the cost of the development and implementation of such systems.[1571]

Some observers have proposed that this general practice cannot be applied in the case of VAT collection by financial institutions.[1572] It is suggested that the cost of developing and implementing an integrated real-time collection system should be borne by revenue authorities as it is the *fiscus* that will ultimately benefit from the implementation.[1573]

The collection of VAT necessarily involves additional administrative costs for financial institutions for which they would expect to be compensated.[1574] Some observers suggest that financial institutions should be compensated for their services.[1575] The proposed compensation rates should be negotiated and paid for on a "per transaction" basis in the form of a transactional fee.[1576] This could lead to a

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[1571] Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 7.

[1572] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 14 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012]; Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 18 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013]; Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 7; Harley G (1999) "VAT and the Digital Economy: How Can VAT Evolve to Meet the Challenges of E-commerce" *Tax Planning International E-commerce* vol 1 no 10 at 11.

[1573] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 14 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012]; Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 18 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013]; Baron R (2001) "The OECD and Consumption Taxes: Part 2" *Tax Planning International E-commerce* vol 3 no 10 at 7; Harley G (1999) "VAT and the Digital Economy: How Can VAT Evolve to Meet the Challenges of E-commerce" *Tax Planning International E-commerce* vol 1 no 10 at 11.

[1574] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 16.

[1575] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 14 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012]; Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 18 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-commerce%20Tax%20Policy.pdf [accessed on 4 January 2013]; Jennings C (2010) "The EU VAT System-Time for a New Approach?" *International VAT Monitor* vol 21 no 4 at 258.

[1576] Basu S (2003) "Implementing E-commerce Tax Policy" *18th BILETA Conference: Controlling Information in an Online Environment* at 18 http://bileta.nsdesign7.net/content/files/conference%20papers/2003/Implementing%20E-

differentiation between taxable entities under a real-time VAT system, and taxable entities under the current registration and reverse-charge systems. Lighart points out that a real-time VAT system will not be viable if financial institutions are not compensated for their services.[1577] I would not be surprised if the legislator simply burdens banks with the duty, without compensating them for the additional administrative burden. The banks, in turn, will undoubtedly, recoup their costs from their customers by way of increased transaction fees and other bank charges.

It is trite that banks would be reluctant to assume a VAT collection duty voluntarily if there is no prospect of profit or compensation for their services. That said, the viability of a real-time VAT collection system is not dependant on the compensation and voluntary cooperation of financial institutions. Therefore, the absence of a compensation prospect negatively affects the attractiveness of real-time VAT collection from the financial institutions' perspective. The cost of VAT collection under the registration and reverse-charge models is generally recovered from consumers by increasing profit margins, or the implementation of an administration or convenience fee. In my opinion the viability or "attractiveness" of a real-time VAT collection model lies not in the compensation for collection services as such, but in the right to recover collection and administrative costs. To avoid a differentiation between tax collectors under a real-time VAT collection model and the registration and reverse-charge models, I suggest that financial institutions should be allowed to charge customers a transaction or convenience fee for facilitating an international payment and processing, collection, and remittance of taxes due on the transaction. This would be in line with the current SARS practice of charging a valuation and transaction fee on imported goods. To avoid exorbitant fees, revenue authorities should develop a rate structure based on transaction values and frequencies. This rate structure should be legislated and reviewed annually.

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commerce%20Tax%20Policy.pdf [accessed on 4 January 2013]; Jennings C (2010) "The EU VAT System-Time for a New Approach?" *International VAT Monitor* vol 21 no 4 at 259.

[1577] Ligthart JE (2004) "Consumption Taxation in a Digital World: A Primer" *CentER Discussion Paper no 2004-102* at 14 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625044 [accessed on 28 November 2012].

6.4.4 Debt collection risk

The South African VAT Act[1578] provides that where a VAT vendor has made a supply on credit on which VAT has been duly collected and remitted, and where the debt has subsequently become irrecoverable, the vendor may claim an input VAT deduction of that proportion of the irrecoverable amount which constitutes VAT.[1579] In order to claim an input VAT deduction, three requirements must be met:

i) the vendor must have made a taxable supply for which payment in money is deferred to a future date payable either as a once off future payment or in instalments;
ii) VAT must have been levied on the supply and the vendor must have furnished a VAT return in respect of the tax period for which output VAT on the supply was payable, and have properly accounted for VAT on the supply;[1580]
iii) the vendor must have written off the amount of the outstanding debt that has become irrecoverable.[1581]

In the case of VAT collection by financial institutions, where the financial institution has extended credit (for example, overdraft facilities) to the customer in facilitating the payment, the financial institution can in principle finance the VAT that it is required to levy on the value of the supply. Where the credit so extended has become irrecoverable, the financial institution would not be able to make an input VAT deduction under section 21 of the VAT Act[1582] for that part of the irrecoverable debt that constitutes VAT. This is chiefly because the financial institution did not make a supply in the ordinary course of business for which payment is deferred to a future date. The granting of credit to facilitate payment, even if the payment constitutes the payment of taxes, constitutes a financial service which is exempted

[1578] Act 89 of 1991.
[1579] Section 21(1) of the VAT Act 89 of 1991.
[1580] Section 21(1)(*b*) of the VAT Act 89 of 1991.
[1581] Section 21(1)(*c*) of the VAT Act 89 of 1991.
[1582] Act 89 of 1991.

from VAT.[1583] The question arises whether the provision in section 21 should be extended to financial institutions that act as statutory VAT collection agents under a real-time VAT collection model?

Where a bank extends credit to a customer to enable the customer to pay personal taxes and the customer fails to repay the bank, the bank can only recover the amount outstanding from the customer (debtor) or its sureties. It is well established in common law that the outstanding debt cannot be recovered from the third party to whom the initial payment was made by the customer. The question is whether this should be distinguished from the position where the bank has collected taxes on behalf of the *fiscus* by extending credit to the customer and the customer has failed to repay such credit. Where credit is granted to enable the customer to pay personal taxes, the customer voluntarily wishes to use the loan/credit to settle outstanding taxes. This is no different from the case where the customer applies the loan to make payments to any other third party. In the case where credit is granted to facilitate an international payment of services for which the bank is obliged to collect VAT on the value of the supply, the customer does not voluntarily apply the funds to pay taxes. Yet, the customer can, after he has become aware of the fact that the bank will levy VAT on the transaction, decide to continue or abandon the transaction. The bank can, as where the customer voluntarily applies for credit to pay personal taxes, approve or reject the customer's application for credit. The bank, therefore, grants credit entirely at its own risk. In most cases the granting of credit to facilitate the payment of VAT will be clear from the transaction itself; but not invariably so. The system must, therefore, provide for an alert function to inform the financial institution when the overdraft or credit facility is being used to pay VAT on a transaction. The granting of credit to facilitate VAT payment under a real-time VAT model remains a financial service which is exempted from VAT. Despite a statutory duty (as proposed by the RT-VAT model) to collect VAT on the transaction, the financial institutions may refuse to facilitate the payment of the supply in the case of insufficient funds to cover both the value of the supply and taxes. The argument that the risk of irrecoverable debt is shifted from the *fiscus* to the financial institution under a real-time VAT collection model, therefore, is without basis. A financial institution which

[1583] Section 12(*a*) read with the deeming provision in section 2(1)(*f*) of the VAT Act 89 of 1991.

extends credit to a customer to facilitate VAT payment under a real-time VAT collection model, should, in principle, not be entitled to recover VAT so collected as an input VAT credit where the debt has become irrecoverable.

6.4.5 Privacy

Global legislative trends show that the protection of personal data has become a basic human right which may only be infringed upon under exceptional circumstances. People generally place a high premium on their personal information and privacy, and therefore require third parties and professionals who deal with their personal information do so in confidence.[1584]
The right to privacy is furthermore enshrined in the Constitution of the Republic of South Africa, 1996, which provides that:

> Everyone has the right to privacy, which includes the right not to have
>
> a. their person or home searched;
> b. their property searched;
> c. their possessions seized; or
> d. the privacy of their communications infringed.[1585]

6.4.5.1 Banker-customer confidentiality

Banking services originated in temples during the Ancient Period and it were mainly executed by priests of gods.[1586] This bestowed a holy and mystical character on banking services.[1587] It has become customary that one of the most important aspects of being a banker is to keep a customer's affairs confidential.[1588]

[1584] Faul W (1991) *Grondslae van die Beskerming van die Bankgeheim* LLD Thesis, RAU at 1.
[1585] Section 14 of the Constitution of South Africa.
[1586] Faul W (1991) *Grondslae van die Beskerming van die Bankgeheim* LLD Thesis, RAU at 4; Faul W (1986) *Bankgeheimnis: 'n Regsvergelykende Studie met die Oog op die Hervorming van die Suid-Afrikaanse Reg* at 6; Willis N (1981) *Banking in South African Law* at 5.
[1587] Faul W (1991) *Grondslae van die Beskerming van die Bankgeheim* LLD Thesis, RAU at 4; Faul W (1986) *Bankgeheimnis: 'n Regsvergelykende Studie met die Oog op die Hervorming van die Suid-Afrikaanse Reg* at 6; also see the rise of the goldsmiths in Willis N (1981) *Banking in South African Law* at 8-9.
[1588] Faul W (1991) *Grondslae van die Beskerming van die Bankgeheim* LLD Thesis, RAU at 4; *Stevens and Others v Investec Bank Ltd and Others* (2012/32900) [2012] ZAGPJHC 226 (25 October 2012) at para [10].

In South Africa, banking secrecy was first recognised in *Abrahams v Burns,*[1589] and is traditionally protected by the contractual relationship between the banker and its customer.[1590] In the case of breach of the banker-customer confidentiality relationship, the customer can find recourse through delictual or contractual remedies.[1591] As is the case in the United Kingdom, in South Africa the banker's duty to maintain secrecy is not a statutory duty but a customary duty that has found its way in the contract of mandate.[1592] This duty of confidentiality forms part of the tacit *naturalia* of the contract between bank and customer.[1593] The customer's right to have his personal affairs kept confidential, is, accordingly, not an absolute right.[1594] Various incidences exist where a bank is required by statute to (under certain circumstances) furnish third parties with information relating to the transactions or other personal data of its customers.[1595] In *Tournier v National Provincial & Union Bank of England,*[1596] the court ruled that a number of exceptions exist in terms of which the banker's duty of secrecy cannot be relied upon. In these cases, the banker is relieved of its duty of secrecy and either has a duty, or is permitted, to disclose information about the affairs of its customer.[1597] These exceptions can broadly be classified as:

[1589] *Abrahams v Burns* 1914 CPD 452 at 456.

[1590] Faul W (1991) *Grondslae van die Beskerming van die Bankgeheim* LLD Thesis, RAU at 321; Faul W (1986) *Bankgeheimnis: 'n Regsvergelykende Studie met die Oog op die Hervorming van die Suid-Afrikaanse Reg* at 314; Van Jaarsveld IL (2001) "The End of Bank Secrecy? Some Thoughts on the Financial Intelligence Centre Bill" *SA Merc LJ* vol 13 no 4 at 587; Schulze WG (2007) "Confidentiality and Secrecy in the Bank-client Relationship" *Juta's Business Law* vol 15 part 3 at 122; Willis N (1981) *Banking in South African Law* at 24,39-41.

[1591] Faul W (1991) *Grondslae van die Beskerming van die Bankgeheim* LLD Thesis, RAU at 321; Faul W (1986) *Bankgeheimnis: 'n Regsvergelykende Studie met die Oog op die Hervorming van die Suid-Afrikaanse Reg* at 314; Willis N (1981) *Banking in South African Law* at 40.

[1592] Faul W (1991) *Grondslae van die Beskerming van die Bankgeheim* LLD Thesis, RAU at 321; Faul W (1986) *Bankgeheimnis: 'n Regsvergelykende Studie met die Oog op die Hervorming van die Suid-Afrikaanse Reg* at 314; Van Jaarsveld IL (2001) "The End of Bank Secrecy? Some Thoughts on the Financial Intelligence Centre Bill" *SA Merc LJ* vol 13 no 4 at 587.

[1593] Schulze WG (2001) "Big Sister is Watching You: Banking Confidentiality and Secrecy under Siege" *SA Merc LJ* vol 13 no 4 at 602; *George Consultants and Investments (Pty) Ltd and Others v Datasys Ltd* 1988 (3) SA 726 (W) at 736; *Densam (Pty) Ltd v Cywilnat (Pty) Ltd* 1991 (1) SA 100 (A) at 109.

[1594] *Abrahams v Burns* 1914 CPD 452 at 456; *Stevens and Others v Investec Bank Ltd and Others* (2012/32900) [2012] ZAGPJHC 226 (25 October 2012) at para [11]; Van Jaarsveld IL (2001) "The End of Bank Secrecy? Some Thoughts on the Financial Intelligence Centre Bill" *SA Merc LJ* vol 13 no 4 at 587; Willis N (1981) *Banking in South African Law* at 40-41.

[1595] *Stevens and Others v Investec Bank Ltd and Others* (2012/32900) [2012] ZAGPJHC 226 (25 October 2012) at para [11].

[1596] *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461.

[1597] Schulze WG (2001) "Big Sister is Watching You: Banking Confidentiality and Secrecy under Siege" *SA Merc LJ* vol 13 no 4 at 602.

i) where the disclosure is required by law;
ii) where disclosure is in the public interest;[1598]
iii) where the disclosure is in the interest of the bank;[1599] and
iv) where the disclosure is made with the customer's express or implied consent.[1600]

In *First Rand Bank Ltd v Chaucer Publications (Pty) Ltd and Others,*[1601] it was held that for considerations of public policy, the relationship between a bank and its customer must be confidential.[1602] Equally, for considerations of public policy, this duty is subject to a greater public interest.[1603] Traverso DJP, made the important ruling that where information, which merely confirms the existence of a customer's bank account at a certain bank, was obtained from a third party and not from the bank, there is no violation of the banker's duty to secrecy.[1604] The mere publication of the fact that a person is a customer of a specific bank cannot infringe the right of privacy of either the bank or the customer, as envisaged in section 14 of the Constitution.[1605] Schulze, however, points out that the banker-customer relationship, being an agreement of mandate, necessarily entails that the mandatory may well have a duty to protect the confidentiality of the affairs of the mandator.[1606] On this basis, a bank would have legal standing to prevent third parties from publishing the fact that a certain person banks or deals with a certain bank.[1607]

In recent years the legislature has passed various pieces of legislation that would potentially infringe on the banker's duty of confidentiality towards the customer. This

[1598] This would be the case where danger to the state or the public at large supersedes the duty of an agent to his principle. See *Stevens and Others v Investec Bank Ltd and Others* (2012/32900) [2012] ZAGPJHC 226 (25 October 2012).
[1599] This would be the case where the bank has instituted a legal claim against a defaulting customer and the disclosure relates to the outstanding debt. See *Densam (Pty) Ltd v Cywilnat (Pty) Ltd* 1991 (1) SA 100 (A) at 110-111; *George Consultants and Investments v Datasys Ltd* 1988 (3) SA 726 (W) at 737.
[1600] For example, in cases where a customer applies for credit at another institution and authorises the bank to disclose the information that is required in respect of the credit application.
[1601] *First Rand Bank Ltd v Chaucer Publications (Pty) Ltd* 2008 (2) SA 592 (C).
[1602] *First Rand Bank Ltd v Chaucer Publications (Pty) Ltd* 2008 (2) SA 592 (C) at para [20].
[1603] *First Rand Bank Ltd v Chaucer Publications (Pty) Ltd* 2008 (2) SA 592 (C) at para [20].
[1604] *First Rand Bank Ltd v Chaucer Publications (Pty) Ltd* 2008 (2) SA 592 (C) at para [20].
[1605] *First Rand Bank Ltd v Chaucer Publications (Pty) Ltd* 2008 (2) SA 592 (C) at para [24].
[1606] Schulze WG (2007) "Confidentiality and Secrecy in the Bank-client Relationship" *Juta's Business Law* vol 15 part 3 at 125.
[1607] Schulze WG (2007) "Confidentiality and Secrecy in the Bank-client Relationship" *Juta's Business Law* vol 15 part 3 at 125.

is especially evident in respect of the collection of taxes. For purposes of this study, the discussion will be limited to cases where disclosure is required by law for VAT purposes.

6.4.5.1.1 Statutory duty to disclose information

The Commissioner, or any officer of SARS, may for the purposes of administering the VAT Act[1608] in relation to any vendor, require such vendor or any other person to furnish such information, documents, or things as the Commissioner or officer may require.[1609] Section 57A does not indicate who the "any other person" is for purposes of the section, or whether such person must have a business or other relationship with the taxpayer. Therefore, given its ordinary meaning, a bank would qualify as "any other person" for purposes of section 57A. The Commissioner can, as a result, require a bank to furnish him or her with any information which the bank might hold in respect of its customer that the Commissioner may find will assist him in administering the VAT Act.[1610] Section 57A has been repealed and replaced by section 46(1) of the Tax Administration Act[1611] with effect from 1 October 2012. In terms of section 46(1), SARS may require any person to furnish it with information relating to a taxpayer which it may require in respect of the identified or objectively identifiable taxpayer.[1612]

[1608] Act 89 of 1991.
[1609] Section 57A of the VAT Act 89 of 1991.
[1610] Act 89 of 1991.
[1611] Act 28 of 2011.
[1612] Section 46 further provides that:
"(2)A senior SARS official may require relevant material in terms of subsection (1) in respect of taxpayers in an objectively identifiable class of taxpayers.
(3) A request by SARS for relevant material from a person other than the taxpayer is limited to the records maintained or that should reasonably be maintained by the person in relation to the taxpayer.
(4) A person receiving from SARS a request for relevant material under this section must submit the relevant material to SARS at the place and within the time specified in the request.
(5) SARS may extend the period within which the relevant material must be submitted on good cause shown.
(6) Relevant material required by SARS under this section must be referred to in the request with reasonable specificity.
(7)A senior SARS official may direct that relevant material be provided under oath or solemn declaration.
(8) A senior SARS official may request relevant material that a person has available for purposes of revenue estimation".

Croome opines that a citizen who embarks upon a business venture assumes certain obligations, one of which is to comply with the tax laws of the country.[1613] The Commissioner has the responsibility of gathering taxes so that the government can function properly and finance social and welfare programmes.[1614] Should the bank furnish the Commissioner with information in terms of section 57A of the VAT Act[1615] or section 46 of the Tax Administration Act,[1616] relating to transactions entered into by its customers, or in respect of any other personal information of the customer, the bank would not be in breach of its duty of secrecy.[1617] It would merely be in compliance with national tax laws, the same laws to which the citizen, who started the business venture, is subject. Governments the world over take defensive steps to protect their revenue, resulting in the erosion of the tax base.[1618] This is simply another price we have to pay for living in a complex society.

6.4.5.1.2 Statutory collection agent

Before the promulgation of the Tax Administration Act,[1619] the so-called agency appointment provision in section 47 of the VAT Act[1620] provided that:

> The Commissioner may, if he thinks necessary, declare any person to be the agent of any other person, and the person so declared an agent shall for the purposes of this Act be the agent of such other person in respect of the payment of any amount of tax, additional tax, penalty or interest payable by such other person under this Act and may be required to make payment of such amount

[1613] Croome B (2010) *Taxpayer's Rights in South Africa* at 129.
[1614] Croome B (2010) *Taxpayer's Rights in South Africa* at 129.
[1615] Act 89 of 1991.
[1616] Act 28 of 2011.
[1617] Interestingly, Schulze notes that section 74A of the Income Tax Act (now repealed), cannot be applied to banks to compel them to disclose their customer's information upon request of the Commissioner. His statement is based on the fact that section 74A neither creates an express duty on banks to comply, nor does it require any objective basis of reasonable suspicion in order for the Commissioner to invoke section 74A. In essence, section 74A can easily be abused as a "fishing expedition" into the affairs of the taxpayer. Similar objections can be raised against section 57A of the VAT Act and section 46 of the Tax Administration Act. It should, however, be noted that for the Commissioner to require information to compile an estimate assessment of the taxpayer's earnings, no evidence or basis of suspicion is required. See Schulze WG (2001) "Big Sister is Watching You: Banking Confidentiality and Secrecy under Siege" *SA Merc LJ* vol 13 no 4 at 611.
[1618] Cockfield AJ (2002) "Designing Tax Policy for the Digital Biosphere: How the Internet is Changing Tax Laws" *Connecticut Law Review* vol 34 no 2 p333.
[1619] Act 28 of 2011.
[1620] Act 89 of 1991.

> from any moneys which may be held by him for or due by him to the person whose agent he has been declared to be: Provided that a person so declared an agent who, is unable to comply with the requirement of the notice of appointment as agent, must advise the Commissioner in writing of the reasons for not complying with that notice within the period specified in the notice.[1621]

The collection of taxes by an appointed agent in terms of section 47 can only be done in respect of taxes, penalties or interest due to SARS that exist at the time of appointment of the agent. Put simply, the taxpayer and the amounts due must be known to SARS before an agent can be appointed to collect such amounts. In addition, the agent must be appointed by way of written notice. A financial institution cannot be appointed to collect future taxes (on a per transaction basis similar to a real-time tax collection model) from its customer.

Section 47 has been repealed and replaced by section 179 of the Tax Administration Act[1622] with effect from 1 October 2012. Section 179(1) provides that:

> A senior SARS official may by notice to a person who holds or owes or will hold or owe any money, including a pension, salary, wage or other remuneration, for or to a taxpayer, require the person to pay the money to SARS in satisfaction of the taxpayer's tax debt.

In contrast to the notice in terms of section 47 of the VAT Act,[1623] the notice in terms of section 179(1) of the Tax Administration Act[1624] may be delivered to the collection agent in electronic format accompanied by a statement reflecting the taxpayer's personal information, taxes due, and the amount required to be paid to SARS.[1625]

Where the agent so appointed cannot collect the money in terms of the notice, it must inform the senior SARS official of its inability (and reasons therefor) to comply

[1621] Section 99 of the Income Tax Act 58 of 1962 provides for similar provisions in respect of taxes, interest, and penalties owed to SARS in terms of the Income Tax Act.
[1622] Tax Administration Act 28 of 2011.
[1623] Act 89 of 1991.
[1624] Act 28 of 2011.
[1625] Le Roux D and Van der Walt J (2013) "Third Party Appointments by SARS under the Tax Administration Act" *Tax Talk* issue 38 at 16.

with the notice within the period specified in the notice.[1626] The person (agent) who fails to pay the money in terms of the notice, will be held personally liable.[1627] The collection of monies in terms of section 179(1) relates only to existing taxes, penalties, and interest owed to SARS. In contrast to the notice in terms of section 47 of the VAT Act,[1628] the notice in terms of section 179(1) of the Tax Administration Act[1629] is not limited to the taxpayer's funds which the agent holds or to which he has access at the time of the issuing of the notice, but extends to future funds until the debt in terms of the notice has been settled.

Under both section 47 of the VAT Act[1630] and section 179 of the Tax Administration Act,[1631] the appointed agent is prevented from informing the taxpayer of the agent's obligation in terms of the notice to prevent the taxpayer from moving funds.[1632] This secret withdrawal of funds and subsequent remittance thereof to SARS, would not be in breach of the bank's duty of secrecy, provided that it is carried out in terms of the financial institution's statutory obligation by way of the written notice. This was confirmed in *Hindry v Nedcor Ltd & Another*[1633] where Wunsch J compared the application of section 99 of the Income Tax Act,[1634] to a garnishee order, and further ruled that a bank is in the same position as any other of the taxpayer's debtors.[1635] Section 99 serves as a civil judgment against the taxpayer, and the bank, as is the case with any other debtor, is obliged to pay the monies demanded in terms of the order.[1636] This is a duty that cannot be altered by the bank's duty of secrecy towards its customer.[1637]

[1626] Section 179(2) of the Tax Administration Act 28 of 2011.
[1627] Section 179(3) of the Tax Administration Act 28 of 2011.
[1628] Act 89 of 1991.
[1629] Act 28 of 2011.
[1630] Act 89 of 1991.
[1631] Act 28 of 2011.
[1632] Le Roux D and Van der Walt J (2013) "Third Party Appointments by SARS under the Tax Administration Act" *Tax Talk* issue 38 at 16.
[1633] *Hindry v Nedcor Ltd and Another* 1999 (2) SA 757 (W).
[1634] Act 58 of 1962.
[1635] *Hindry v Nedcor Ltd and Another* 1999 (2) SA 757 (W) at 773.
[1636] *Hindry v Nedcor Ltd and Another* 1999 (2) SA 757 (W) at 770; *Nedbank Limited v Pestana* (142/08) [2008] ZASCA 140; 2009 (2) SA 189 (SCA) at para [11].
[1637] Van Jaarsveld IL (2001) "The End of Bank Secrecy? Some Thoughts on the Financial Intelligence Centre Bill" *SA Merc LJ* vol 13 no 4 at 592; Schulze WG (2007) "Electronic Fund Transfers and the Bank's Right to Reverse a Credit Transfer: One Small Step for Banking Law, One Huge Leap for Banks" *SA Merc LJ* vol 19 no 3 at 385.

In *Nedbank v Pestana,*[1638] the court was called upon to decide whether a bank may legally (or has a duty to) reverse a previous transaction for the transfer of funds from a customer's bank account where a notice in terms of section 99 of the Income Tax Act[1639] was issued on the bank. *In casu,* the customer instructed a branch of the main bank to transfer funds from his account. A few minutes earlier, a notice in terms of section 99 of the Income Tax Act,[1640] in respect of the customer, had been issued on bank at its head office. Nedbank contended that the instruction from the customer to transfer the funds was either given with the intention to defraud SARS or the bank. On this basis, Nedbank argued, it was legally entitled to reverse the transfer. The court held that the branch which had been instructed to make the transfer and which had no knowledge of the notice at the time, may not, and is not legally obliged to, reverse the previous transaction to fulfil its duties in terms of the section 99 notice.[1641] Consequently, an instruction from a customer to transfer funds may only be reversed where the mandate to the bank has a decidedly suspicious ring to it,[1642] or where it was given in the furtherance of the commission of a crime.[1643] A mere speculation on facts is not sufficient.[1644] Schulze, however, opines that this does not mean that any other competent court may rule that in certain circumstances, a credit transfer can be reversed, and that a credit transfer is not generally an unconditional and final juristic act - especially in the case where there was fraud on the part of either the transferor or the transferee.[1645]

[1638] *Nedbank v Pestana* (142/08) [2008] ZASCA 140 (27 November 2008).
[1639] Act 58 of 1962.
[1640] Act 58 of 1962.
[1641] *Nedbank v Pestana* (142/08) [2008] ZASCA 140 (27 November 2008) at para [15].
[1642] Schulze is of the opinion that the available facts from the *Pestana* case have a decidedly suspicious ring to them, to whit that Mr Pestana instructed the transfer of the money from his account with the intention of defrauding SARS or Nedbank. See Schulze WG (2008) "Electronic Fund Transfers and the Bank's Right to Reverse a Credit Transfer: One Big Step (backwards) for Banking Law, One Huge Leap (forward) for Potential Fraud: *Pestana v Nedbank* (Act one, Scene Two)" *SA Merc LJ* vol 20 no 3 at 296; Schulze WG (2009) "A Final Curtain Call, but Perhaps not the Last Word on the Reversal of Credit Transfers : *Nedbank Ltd v Pestana*" *SA Merc LJ* vol 21 no 3 at 400.
[1643] *Nedbank v Pestana* (142/08) [2008] ZASCA 140 (27 November 2008) at para [10].
[1644] *Nedbank v Pestana* (142/08) [2008] ZASCA 140 (27 November 2008) at para [10].
[1645] Schulze WG (2009) "A Final Curtain Call, but Perhaps not the Last Word on the Reversal of Credit Transfers: *Nedbank Ltd v Pestana*" *SA Merc LJ* vol 21 no 3 at 401.

6.4.5.2 Invasion of privacy by the financial institution

Financial institutions are concerned that a statutory duty to collect taxes on transactions entered into by their customers may result in an invasion of the customer's right to privacy. According to Ainsworth and Madzharova, it is unlikely that a real-time VAT collection model would comply with international privacy laws.[1646] This is in part because the bank would be required to obtain information in respect of the transaction which the customer could consider private. However, the financial institution would generally be unaware of the exact particulars of the underlying transaction.[1647] The bank would only have access to the limited information to enable it to identify the general type of transaction from the transaction code or description, the parties to the transaction, and the relevant revenue authority to which the payments are due.[1648] Consequently, the intricacies of the transaction, or the relationship between the customer and the supplier, would remain private information. This is no different from any other transaction for which the financial institution facilitates payment on behalf of the customer. This can be illustrated by way of example.

> **Example 6.2**: Where the customer uses a bank card as payment instrument at a supplier (both conventional or over the Internet), the supplier and the customer's identity, as well as a general description of the goods purchased or services rendered, would be revealed to the financial institution to enable it to execute the customer's order to make the payment effectively. The general product or service description is revealed to the financial institution for record keeping purposes. Without this information the financial institution would not be able to execute the customer's order to pay.

[1646] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 22 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

[1647] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 19; Ainsworth RT (2011) "Technology Can Solve MTIC Fraud-3 and Final" *International VAT Monitor* vol 22 no 4 at 232.

[1648] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 19.

A real-time VAT collection model raises privacy concerns in respect of section 14(d) of the Constitution in so far as the customer's communication with the supplier is disclosed to the financial institution. Nevertheless, the information transmitted between the supplier and the financial institution, constitutes the necessary sharing of information in the ordinary course of businesses to enable the financial institution to make the payment as it was instructed to do by its customer. The transmission of information would be in line with what the customer consented to when it instructed the financial institution to make the payment – as in example 6.2 above.

In *Bernstein and Others v Bester and Others NNO*,[1649] Ackermann J explained the meaning of "privacy" as:

> ...an individual condition in life characterised by seclusion from public and publicity. This implies an absence of acquaintance with the individual or his personal affairs and this state. [ ] The unlawfulness of a (factual) infringement of privacy is adjudged "in the light of contemporary *boni mores* and the general sense of justice of the community as perceived by the Court.[1650]

Ackermann J further explained that:

> Privacy is acknowledged in the truly personal realm, but as a person moves into communal relations and activities such as business and social interaction, the scope of personal space shrinks accordingly.[1651]

Where a person opens a bank account with a financial institution, and subsequently enters into a business transaction which requires the bank to make certain payments on his behalf, that person's right to privacy is limited in the interests of business efficacy. Similarly, where the financial institution transmits information pertaining to the transaction to SARS in terms of a statutory duty, the customer's right to privacy will not be infringed upon. This is chiefly because the customer, when he entered into the transaction, subjected himself, through the operation of law (although in many cases involuntarily), to the country's tax laws and thus, in effect, consented through his conduct.

[1649] *Bernstein and Others v Bester and Others NNO* 1996 (2) SA 751 (CC).
[1650] *Bernstein and Others v Bester and Others NNO* 1996 (2) SA 751 (CC) at para [68].
[1651] *Bernstein and Others v Bester and Others NNO* 1996 (2) SA 751 (CC) at para [67].

6.4.6 Multiple payment systems

Despite the popularity of credit cards as a payment method, various forms of digital cash or electronic money are increasingly being used as payment methods. Since these payment methods are not executed through the financial institution with which the customer banks, they cannot be tracked and traced by the financial institution burdened with tax collection. However, at least some of these new methods do require a formal affiliation or relationship with a bank-for example, credit and debit transfers (including EFTs), and even electronic money in the form of an electronic wallet, can be traced to the original possessor of the wallet because these can at present (at least in South Africa) only be obtained through a bank. Further, one must have a bank account with a particular bank before it will issue an electronic wallet. Money-laundering considerations will prevent a bank from issuing electronic wallets on the payment of a cash sum by the applicant. In some jurisdictions it is possible to buy an electronic wallet from entities other than banks. This is not, at the time of writing, possible in South Africa. Thus, at present, all electronic wallets issued in South Africa are issued through the intervention of banks, which will inevitably involve the positive identification of the applicant for the card, as well as his address, details, et cetera. Subsequent payments made by that card can, therefore, be linked to the original applicant. Electronic wallets are, of course, freely transferable from the original applicant for the card to subsequent possessors of the card. This increases the potential for tax avoidance or jurisdiction shopping.[1652] Two possibilities exist to overcome this issue. The electronic cash system could be linked to the RT-VAT system allowing it to identify and locate the customer, calculate the applicable VAT, and deduct it from the customer's electronic cash balance.[1653] Alternatively, electronic cash can be taxed *ex ante* – as is done in the case of single-purpose vouchers in terms of the EU proposal as discussed in paragraph 4.3.2.2 above.[1654] To avoid double taxation, the tax status of the payment voucher should be revealed to the supplier. The issuer of the voucher or e-cash would be required to account for

[1652] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 20.
[1653] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 20.
[1654] Soete L and Ter Weel B (1998) *Globalization, Tax Erosion and the Internet* at 24 http://arno.unimaas.nl/show.cgi?fid=331 [accessed on 19 February 2013].

VAT in the jurisdiction where the customer resides. It should, however, be noted that the RT-VAT system is designed to cope with multi-purpose vouchers and e-cash, and it is likely to be more effective than the current (EU) system.[1655]

Bentley suggests a third option. The electronic cash system could act as a mere notification tool that informs the customer's financial institution of the date, value, and type of transaction.[1656] This would enable the financial institution to collect the applicable taxes from the customer's account *ex post facto*.[1657] This would not be possible where the electronic wallet (to mention but one example) has been transferred from one person to another. The model further requires closer cooperation between the e-cash provider and the financial institution. The fraud potential, privacy issues, and cooperation requirements render this model infeasible. In addition, the financial institution could effectively be required to extend credit to the customer in the case of insufficient funds to collect and remit VAT.

Some form of electronic payment or payment method that leaves a transaction record is required for the RT-VAT system to be effective. Cash transactions would not be detected and taxed by the RT-VAT system.[1658] Escaping the VAT net by means of cash payments and the failure to keep records of the transaction is not restricted to e-commerce transactions.[1659] The parties can also enter into a barter

[1655] Jennings C (2010) "The EU VAT System-Time for a New Approach?" *International VAT Monitor* vol 21 no 4 at 258.

[1656] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 20.

[1657] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 20.

[1658] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 25; Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 22 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012]; Wohlfahrt B (2011) "The Future of the European VAT System" *International VAT Monitor* vol 22 no 6 at 394; Jennings C (2010) "The EU VAT System-Time for a New Approach?" *International VAT Monitor* vol 21 no 4 at 258; Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 15.

[1659] Williams C (2011) "Technology Can Solve MTIC Fraud-2" *International VAT Monitor* vol 22 no 4 at 231; Ainsworth RT (2011) "Technology Can Solve MTIC Fraud-3 and Final" *International VAT Monitor* vol 22 no 4 at 232.

agreement to escape the application of the RT-VAT system.[1660] However, barter transactions and cash payments are rare in cross-border e-commerce.[1661]

In South Africa, the use of credit cards and electronic fund transfers (EFTs)[1662] is increasingly popular as payment methods to replace traditional cheque and cash payments.[1663] Yet, the volume of credit card payments is relatively small compared to that of EFT transactions.[1664] This could probably be attributed to strict credit extension regulations and a general perception that credit card transactions are unsafe and expensive.

6.4.7 Greater international cooperation required

The implementation of an international classification code system as discussed in paragraph 6.1.4.2 above, requires significant international consensus. In addition, international standards and licensing of financial institutions burdened with collecting VAT under a RT-VAT system must be established. Uniform software - such as the existing RT-VAT system - must be applied by all participating revenue authorities, financial institutions, and suppliers to ensure smooth and continuous operation. Bentley opines that it would only require a few large and influential countries to adopt an RT-VAT system that would set the standards and requirements for developing countries to follow.[1665] That said, jurisdictions that fail to apply the uniform international standard would not be excluded from the market. The inefficiencies of traditional tax collection mechanisms and an increasing loss in revenue, could convince the majority of tax authorities to adopt a uniform standard under a RT-VAT system.

[1660] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 25.
[1661] Lamensch M (2012) "Are 'reverse-charging' and the 'one-stop-scheme' efficient ways to collect VAT on digital supplies?" *World Journal of VAT/GST Law* vol 1 issue 1 at 15.
[1662] The term includes the payment by electronic bank card, electronic transfers settled among banks but excludes credit card transactions and intrabank transactions.
[1663] South African Reserve Bank (2012) *Quarterly Bulletin* Sept no 265 at S-13.
[1664] South African Reserve Bank (2012) *Quarterly Bulletin* Sept no 265 at S-13.
[1665] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 24.

In some cases, additional bilateral or multilateral agreements between jurisdictions will have to be negotiated to avoid double taxation or unintended under taxation.[1666] This would be the case where one jurisdiction applies the origin base taxation model, and the other jurisdiction applies the destination base taxation model. In most cases, these bilateral and multilateral agreements already exist between major trading jurisdictions in respect of tangible goods. The application of the agreements can merely be extended to include intangible goods. In practice, almost all the jurisdictions apply the destination principle for cross-border transactions.[1667]

Unlike other tax collection models that require a regional or international clearing house, or confer extra-territorial powers on tax authorities, the RT-VAT system allows each jurisdiction to recover VAT within its borders and in accordance with domestic VAT rules.[1668] Save for standardised international classification codes and licensing standards, the operation of the RT-VAT system requires minimal cooperation between revenue authorities in different jurisdictions.

6.5 Conclusion

International trends show that tax collection by third party intermediaries is increasingly being introduced in countries where cross-border trade and employment are on the rise.[1669] This is particularly evident in Latin American countries which increasingly apply withholding tax mechanisms as a VAT collection tool.[1670] The implementation of withholding tax mechanisms in terms of which a third party (financial institution) is burdened with the withholding duty, is a common modern taxing trend among developing countries. Similar trends have recently been

[1666] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 23.
[1667] Lamensch M (2010) "OECD Draft Guidelines on VAT/GST on Cross-Border Services" *International VAT Monitor* vol 21 no 4 at 272.
[1668] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 25.
[1669] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 11 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].
[1670] Ainsworth RT and Madzharova B (2012) "Real-Time Collection of Value Added Tax: Some Business and Legal Implications" *Boston Univ School of Law Working Paper no 12-51* at 11 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166316 [accessed on 18 December 2012].

introduced in South Africa.[1671] However, collection by third party intermediaries will inevitably result in costs to banks. Banks will pass these on to their customers. In a country such as South Africa where there is a high percentage of "unbanked" citizens, and where bank costs are already amongst the highest in the world, the affordability of burdening low income bank customers with even higher bank costs, must be questioned.

VAT collection under an RT-VAT system complies with the OECD's principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. It affects only existing collection and reporting rules that already apply to all forms of commerce.[1672]

The development of technology and software by RTpay®, eliminates most of the objections that were raised against VAT collection by financial institutions. The issue of privacy, and the banker's duty of secrecy remain the chief objections to an RT-VAT system. This obstacle can be overcome by the development and implementation of a statutory duty on financial institutions to collect VAT on behalf of SARS through a withholding tax mechanism implemented by an RT-VAT system. However, since RTpay® remain to be tested, the successful integration of the software with that of financial instutions and revenue authorities is speculative.

Cross-border digital trade is a fully fledged electronic trading, and often automated, phenomenon. The execution of these transactions requires no or minimal human intervention. It therefore follows that the taxation of cross-border digital transactions should preferably be done electronically and with minimal human intervention. A withholding tax mechanism by financial institutions through the implementation of an RT-VAT system, offers this possibility. The implementation of the RT-VAT system should be considered as a matter of urgency in cases where the registration and reverse-charge mechanisms are found to be ineffective tax collection models.[1673]

[1671] In terms of section 37I of the Income Tax Act 58 of 1962 any person who pays interest to or for the benefit of a foreign person must withhold the tax from that payment except in circumstances where the interest or the foreign person is exempted from tax. Section 37I will come into operation on 1 July 2013. Similarly, in terms of section 49E, any person making payment of any royalty to or for the benefit of a foreign person must withhold 15% tax from that payment. Section 49E will come into operation on 1 July 2013.

[1672] Bentley D (1999) "A Model for Electronic Tax Collection" *Tax Planning International E-commerce* vol 1 no 11 at 25.

[1673] See further para 7.8.4.

CHAPTER 7:

RECOMMENDATIONS AND CONCLUSION

7.1 Introduction

Technological advances, the availability of Internet networks, and the rise in consumer confidence in technologically advanced communication and entertainment tools, have contributed to a rise in e-commerce transactions in South Africa. These transactions are not confined to the borders of South Africa. Consumers are increasingly engaging in cross-border e-commerce transactions. Moreover, automated machine-initiated cross-border digital downloads are becoming a common phenomenon as advanced technological equipment such as smart phones, on-board computers in vehicles, tablets, and other devices demand regular software updates.

VAT systems around the world date from a period when e-commerce - in particular cross-border digital trade - was the future brainchild of computer technicians and futuristic dreamers. Throughout this study it has been shown that VAT systems, as originally designed, can, in the main, not cope with the effective taxation of cross-border digital transactions. The South African VAT Act[1674] is riddled with uncertainty which hinders the effective taxation of cross-border digital trade.

In identifying the problems associated with the taxation of cross-border digital trade, the discussion in this study has centred around the following issues:

- Is there a supply of goods or services?
- Where is the supply made?
- When is the supply made?
- What is the value of the supply?
- Is it made by a taxable entity?

[1674] Act 89 of 1991.

- Is it made in the course or furtherance of an enterprise?
- Is the supply taxable?
- How is VAT on the transaction collected?

Throughout the study it has emerged clearly that the South African VAT Act[1675] requires amendments that are in line with international trends if it is effectively to tax cross-border digital trade and further avoid the erosion of the tax base. However, it requires more than mere legislative redrafting to achieve a durable solution. Recources will have to be devoted to reform tax policies, and tax administrators must be equipped with the tools (such as increased powers, and information technology) to execute their duties.

In this chapter I present my recommendations on the basis of the questions above. This will be achieved by extrapolating a brief summary of my findings and the shortcomings in the VAT Act[1676] identified as requiring amendment. This is followed by my recommendations based on developments in EU VAT laws and the OECD guidelines on consumption taxes.

7.2 Is there a supply of goods or services?

The VAT Act[1677] contains no definition of electronically supplied goods. As a result uncertainties have arisen as to whether digital supplies should be treated as the supply of goods or of services. Despite indications that SARS is likely to treat electronically supplied goods as services, no official policy has been forthcoming. In line with the OECD guidelines and the amendments envisaged by Council Directive 2008/8/EC of the harmonised EU VAT laws, digital products should generally be treated as a supply of services. However, a blanket classification of electronically supplied goods as services cannot be recommended where differing VAT rates apply.

In a modern commercial environment, which is characterised by constant technological changes and advances, many technology-driven supplies could

[1675] Act 89 of 1991.
[1676] Act 89 of 1991.
[1677] Act 89 of 1991.

escape the VAT net as they do not fall within the definition of either goods or services. A definition of electronically supplied goods is, therefore, essential in any VAT system.

As technology is constantly advancing and evolving, restrictive or technology-specific definitions could be outdated before they are promulgated. This was identified as the Achilles heel in the definition of "electronically supplied services" under the harmonised EU VAT rules. The ECJ's history of strict interpretation of legislation means that many modern electronically supplied services fall outside the scope of the EU definition, and ultimately escape the VAT net.

To remedy so restrictive an application, a general definition of electronically supplied services is required to serve as a catchall for most digital supplies. In addition, an annual list of the types of supply that qualify as "electronically supplied services" must be issued to circumvent avoidance. This list must be incorporated into the VAT Act[1678] as an annexure, and must be updated in collaboration with technology experts to ensure its relevance. It is important that this list not be published in the form of regulations or Interpretation Notes, as these are of persuasive value only.

I therefore recommend the following amendments to the VAT Act:[1679]

- The term "electronically supplied services" must be included after the word "services" in section 7(1)(*a*), The provision will then read:

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

- In addition, provision must be made for imported electronically supplied services by the insertion of section 7(1)(*d*) that reads:

[1678] Act 89 of 1991.
[1679] Act 89 of 1991.

on the import of any electronically supplied services by any person on or after the commencement date.

- A definition of "electronically supplied services" must be incorporated in section 1 which will read as follows:

> **"electronically supplied services"** means anything with commercial value that is capable of being delivered over the Internet or any other electronic network, the nature of which requires no or minimum human intervention to render the supply thereof.

As a result of the technology-bound nature of an indicative list of what constitutes electronically supplied services, I do not attempt to compile a list in this thesis.

7.3 Where is the supply made?

The main reason for the ineffectiveness of the VAT Act[1680] to adequately tax cross-border digital trade, lies in the absence of definitive place-of-supply rules. The reliance on the "utilised and consumed in the Republic" principle adds to confusion in determining the place of supply or consumption. This is particularly evident where intangible products or services have been physically delivered (downloaded) outside of the Republic, but where the benefit of the service or product is experienced in the Republic. Unless the electronically supplied product emits signals which enable the supplier or revenue authority to locate the actual place of consumption, or if the place of consumption can be determined by an after sales relationship between the supplier and the customer, the actual place where the products are utilised and consumed cannot be located.

Article 59a of Council Directive 2008/8/EC - which will come into operation on 1 January 2015 - provides that the use and enjoyment principle may be applied in cases where the special place-of-supply rules (applicable to electronically supplied services) lead to double or non-taxation, or market distortions. In other words, the

[1680] Act 89 of 1991.

use and enjoyment principle should only be applied in exceptional circumstances. This is in line with the OECD guidelines.

To avoid the difficulty of determining the place of consumption under the use-and-enjoyment principle, the OECD recommends that proxies, or deemed place-of-supply rules, should be implemented. The OECD recommends the following proxies:

- In the case of B2C transactions where the customer and supplier are situated in different jurisdictions, the place of supply is the jurisdiction where the customer resides.
- In the case of B2B transactions where the supplier and customer business are situated in different jurisdictions, the place of supply is the jurisdiction where the customer's business is established.

Until 31 December 2014, EU intra-community B2C transactions will be taxed in the member state of supply (origin), while supplies from non-EU suppliers will be taxed in the member state where the customer resides (in the case of B2C transactions), or where the customer's business is established (in the case of B2B transactions). These differentiating place-of-supply rules put EU suppliers at an economic advantage over non-EU suppliers. This could lead to market distortions. The amendments that will take effect from 1 January 2015, are in line with the OECD proposals which provide that in the case of cross-border electronically supplied services, the place of supply is the place where the customer resides (in the case of B2C transactions), or where the customer's business is established (in the case of B2B transactions).

It has been established that the use-and-enjoyment principle cannot stand, and that the VAT Act[1681] must be amended to include definitive place-of-supply rules. This can be achieved by the insertion of section 7A:

Place of supply rules

(1) The place of supply of electronically supplied services to a person or entity other than a registered vendor shall, for purposes of this Act, be the place where such person or entity usually resides or has his fixed address, where:

[1681] Act 89 of 1991.

(a) such place of residence or fixed address shall be determined in terms of paragraph (*a*) of the meaning of 'resident' in terms of section 1 of the Income Tax Act (Act 58 of 1962).

(2) The place of supply of electronically supplied services to a registered vendor or other taxable entity, shall be the place where such vendor or taxable entity is established, has his fixed address, or usually resides where:

(a) such place of establishment, fixed address, or usual residence, shall be determined in terms of paragraph (*b*) of the meaning of 'resident' under section 1 of the Income Tax Act (Act 58 of 1962).

It has further been established that even where definitive place-of-supply rules exist, the identification and location of customers cannot be accurately established. Various identification and location tools exist, none of which can guarantee 100 per cent accurate results. Generally, suppliers burdened with the duty to collect VAT on cross-border transactions, would be subject to penalties where VAT was incorrectly levied as a result of inaccurate customer identification and location. Guidelines should be developed to indicate the extent to which suppliers are required to apply identification and location tools. In addition, provision should be made for exemption from penalties where it can be established that a supplier has complied with the guidelines. See further recommendations in this regard in paragraph 7.8.4 below.

Determining a customer's VAT or tax status is difficult where VAT or tax registration numbers cannot be verified. Electronic verification databases such as the EU VIES system offer little assistance to e-commerce suppliers who are reliant on fast, automated electronic transaction tools. Guidelines should be developed to indicate the extent to which suppliers must verify the authenticity of the customer's declaration of its tax status. See further recommendations in this regard in paragraph 7.8.3 below.

In order to circumvent high VAT rates, business customers often route digital supplies to branches of the main business which are established in low VAT regimes. These supplies are then re-routed to the main business as an intra-group supply. Suppliers of electronically supplied services should not be burdened with any subsequent supplies which the customer might make. Any such supply to an

independent branch established in the Republic, must be treated as an imported supply in terms of section 14(4) of the VAT Act.[1682]

7.4 When is the supply made?

VAT is generally levied on the date of issue of an invoice or on payment, whichever is earlier. In the case of customer initiated transactions, the existing time-of-supply rules under the VAT Act[1683] can be applied to determine the time of supply. However, in the case of automated transactions, such as software updates, determining the time of supply is complicated by the lack of invoices and/or definitive payment records. While these transactions generally stem from prior or existing agreements, the actual time of supply cannot be determined by the customer unless he is informed of the payment by the financial institution effecting the payment, or if an invoice is issued. Customers that are required to account for VAT on imported services under the reverse-charge mechanism in terms of section 14(1), could potentially be faced with additional penalties and interest for late compliance.
Where automated transactions are governed by prepaid agreements, two conflicting interpretations exist:

a) The time of supply is determined by the date of payment of future services irrespective of the date on which actual services begins.
b) Payment in a prepaid agreement constitutes a conditional payment rendering the agreement a conditional agreement. Neither the agreement, nor payment constitutes an invoice or payment for purposes of determining the time of supply in terms of section 9(1). The time of supply can be determined when the condition has been fulfilled and the supplier becomes entitled to the payment.

These conflicting interpretations can be remedied by the introduction of deemed time-of-supply rules in section 9(2) which reads as follows:

> A supply of goods or services [or electronically supplied services] shall be deemed to take place:

[1682] Act 89 of 1991.
[1683] Act 89 of 1991.

(*f*) where the supply is for consideration in money received by the supplier as an advance payment for the supply of goods, services, or electronically supplied services at a future date under a prepaid agreement, at the time when such payment is made in respect of the prepaid agreement.

In terms of this proposed amendment, where the customer terminates the agreement before the expiry date, the balance of the prepaid amounts and VAT must be returned to the customer upon cancellation. The supplier would be entitled to an input VAT deduction on the payment returned and VAT. Where the reverse-charge mechanism in terms of section 14(1) applies, the taxpayer should, in principle, be entitled to claim a VAT refund directly from SARS.

Determining the time of supply is further complicated by the increased use of vouchers and the multiple uses to which vouchers can be put. The VAT Act[1684] does not provide adequate rules to determine the time of supply where multi-purpose vouchers are used in exchange for a variety of goods and services. Similar *lacunae* exist in the EU's harmonised VAT rules. However, the European Commission has put forward draft proposals in respect of the treatment of vouchers. In the absence of OECD guidelines, I recommend that the EU draft proposals should be adopted to amend the VAT Act[1685] to provide for the treatment of vouchers. The following amendments should be considered:

- Definitions of single-purpose vouchers and multi-purpose vouchers should be included in section 1 that read -

  "single-purpose voucher" means a voucher that carries the right to receive the supply of goods or services where the supplier's identity, place of supply, and the VAT rate applicable to the supply of goods or services is known at the time of issue of the voucher.

  "multi-purpose voucher" means any voucher, other than a discount or rebate voucher, which does not constitute a single-purpose voucher.

[1684] Act 89 of 1991.
[1685] Act 89 of 1991.

- In order to determine the time of supply in the case of single- and multi-purpose vouchers, deemed time-of-supply rules should be included in section 9(2) which read as follows:

    (*g*) where a single-purpose voucher is issued against the payment of consideration, at the time when the voucher is issued and paid for.

    (*h*) where a multi-purpose voucher is issued, at the time when the voucher is partially or fully redeemed.

7.4 What is the value of the supply?

VAT is levied on the consideration paid for the supplies, or on the open market value of the supplies where consideration other than money was used, or in the case of supplies between connected persons.
In determining the value of supplies, the VAT Act[1686] differentiates between imported goods and imported services by imposing a higher value on imported goods. In addition, the taxation of imported goods is subject to a valuation and customs transaction charge. This differentiation could result in market distortions where the digital version of the tangible goods can be imported at a lower cost. Tangible goods and their intangible equivalent should be taxed at the same value.

Unlike the EU VAT rules, the VAT Act[1687] provides for value-of-supply rules when a single-purpose voucher is issued against the payment of consideration. VAT is levied on the value of the consideration paid for the voucher. The value of the goods and services supplied upon redemption of the voucher, is nil. The European Commission's draft amendment proposals on the determination of the value of supplies in the case of single-purpose vouchers, provide for similar deemed value-of-supply rules.

In the case of multi-purpose vouchers, the VAT Act[1688] provides that the value of the goods so redeemed must be accepted as the value for VAT purposes. In terms of

[1686] Act 89 of 1991.
[1687] Act 89 of 1991.
[1688] Act 89 of 1991.

the European Commission's draft amendment proposals, the deemed value in the case of multi-purpose vouchers should be the nominal value at the time when the voucher was issued. Since the value of the goods or services supplied cannot always be determined with certainty, especially in the case of automated transactions, I suggest that the EU proposal of a nominal value should be adopted.

Where no consideration is paid in terms of a *bona fide* loyalty or similar reward scheme, the value of the supplies should be nil. In the case of illegal file sharing, the open market value of the supplies should apply. However, it should be cautioned that VAT should not be applied as a substitute to penalise criminal action where national legislation fails to penalise or fails to prohibit illegal behaviour.

7.5 Was the supply made by a taxable entity?

The provisions in the VAT Act[1689] governing the determination of the taxable entity are unproblematic. However, it remains uncertain whether a foreign supplier who makes digital supplies in excess of the R1 million threshold, is required to register as a VAT vendor and levy and collect VAT on its supplies. The strict statutory registration requirements and the additional strict registration process, prevent foreign suppliers from registering as South African VAT vendors, despite the fact that they are required to register based on the threshold requirements in section 23(1). This is not in line with the OECD proposal to allow for a slim-line registration mechanism for foreign non-established suppliers of services, where such suppliers are, in principle, required to register as the identified taxable entity. When and how the proposed vendor registration model for foreign suppliers who supply e-books, music, and other digital goods will be implemented, is uncertain.

Issues concerning the identification of the taxable entity are further discussed in the proposed VAT collection mechanisms in paragraph 7.8 below.

[1689] Act 89 of 1991.

7.6 Is the supply made in the course and furtherance of an enterprise?

In terms of the OECD proposals, businesses should not carry the burden of VAT where they are required to collect VAT on behalf of revenue authorities either under a registration model, or under a reverse-charge mechanism.

The VAT Act[1690] provides that vendors can, subject to exceptions and exclusions, claim an input VAT deduction on supplies acquired in the course and furtherance of their enterprise. In the case of imported services in terms of the use-and-consumption principle, the recipient vendor of imported services has to account only for VAT on the imported services that are not applied by it in the course and furtherance of an enterprise. The use-and-consumption principle relies on the vendor's *bona fide* interpretation of what constitutes "in the course and furtherance of an enterprise." Non-disclosure of imported services that are not applied in the course and furtherance of an enterprise, cannot be detected and ultimately escape the VAT net.

To eliminate VAT fraud, the European Commission proposed that in the case of cross-border trade, the reverse-charge mechanism as currently applied in the Netherlands, should find general application. Under this system, the recipient vendor of imported services must account for VAT on the supplies, irrespective of whether or not the supplies are applied in the furtherance of the enterprise. The supplier will immediately be entitled to an input VAT deduction. Despite the additional administrative burden, VAT fraud and unintended mistakes can easily be detected.

I therefore recommend that the reverse-charge mechanism as applied in the Netherlands should be implemented in the case of B2B cross-border trade. This can be achieved by amending the VAT 201 form to make provision for:

a) The disclosure of the value of imported services, irrespective of their application in the course and furtherance of an enterprise.

b) An input VAT deduction in respect of imported services that were applied in the course and furtherance of an enterprise.

[1690] Act 89 of 1991.

7.7 Is the supply taxable?

The provisions in the VAT Act[1691] that provide for standard rated, zero-rated, and exempt supplies are fairly clear and simple to apply, and no amendments are required.

Where provision is made for specific types of supply such as electronically supplied services, legislators should caution against conflicts arising between the list of taxable electronically supplied services, and the lists of zero-rated or exempt services. As a result of conflicts under the harmonised EU VAT rules, confusion exists as to whether a supply is taxable or exempt.

To avoid market distortions, legislators should further avoid differentiated VAT rates between tangible and the intangible versions of products.

7.8 How is VAT on the transaction collected?

Inadequate and inappropriate VAT collection mechanisms in cross-border trade are the main contributors to VAT fraud and the erosion of the tax base. Tax collection models should ideally ensure the most efficient tax collection through the elimination of: i) tax evasion and avoidance; and ii) unintended over and under-taxation, without over burdening the taxable entity. This must be achieved at the lowest administrative cost to the revenue authority.

7.8.1 Reverse-charge mechanism

The reverse-charge mechanism is an ineffective tax collection model in so far as it relies on the taxpayer's honesty and integrity. In the Netherlands, the reverse-charge mechanism has been relatively successfully applied in the case of B2B transactions where suppliers are required to disclose every cross-border transaction. As a result of the use-and-consumption principle applied in South Africa, many transactions escape the VAT net because of non-compliance or under-reporting. The anonymity of e-commerce and the absence of physical evidence of supplies can further assist taxpayers to abuse the self-assessment procedure. I accordingly recommend that

[1691] Act 89 of 1991.

the reverse-charge mechanism (as it is currently applied in South Africa) should not be applied in the case of imported electronically supplied services.

7.8.2 Registration

As an interim solution, the OECD proposes registration for B2C transactions, and a general reverse-charge mechanism for B2B transaction. The registration of foreign suppliers mainly benefits the revenue authorities. The additional compliance and administrative burden on suppliers is costly and it often outweighs the benefit of establishing in foreign markets. Moreover, it could result in one supplier registering in more than a 1000 jurisdictions worldwide.[1692] To limit the number of registrations, provision should be made for one-stop-shop registrations in major trading regions. This would require significant global cooperation between nations.
In the EU, where a simplified registration procedure and a one-stop-shop have been implemented, compliance cannot be guaranteed. It remains uncertain whether EU Member States will have extra-territorial powers to enforce compliance on non-EU suppliers.

Under the current registration requirements in terms of the VAT Act,[1693] foreign suppliers must, among other strict requirements, have a fixed establishment in the Republic. This is in contrast to the slim-line registration model proposed by the OECD. Developing a slim-line registration process for foreign suppliers of electronically supplied goods requires extensive amendments to the VAT Act[1694] and the current registration procedure. This would jeopardise the measures taken by SARS to eliminate false VAT registrations and VAT fraud. In addition, it would create an adverse differentiation between vendors established in the Republic and foreign vendors which is not in line with the principle of tax neutrality.

Furthermore, enforcement measures and penalties for non-compliance granting SARS extra-territorial powers, would have to be developed. These powers will not be enforceable unless tax treaties are in place between South Africa and the country in

[1692] Registration is sometimes not only required at a national level, but also at a state and/or local level.
[1693] Act 89 of 1991.
[1694] Act 89 of 1991.

which the enforcement measures are to be imposed. Additional bilateral and multilateral treaties would, therefore, have to be negotiated.

If the current foreign supplier registration data are indicative of supplier compliance trends, the cost of establishing and enforcing a workable registration mechanism for South Africa would outweigh the annual revenue. In this light, I recommend that registration should be considered as a last resort.

7.8.3 OECD proposals

Alternative collection mechanisms proposed by the OECD include: i) collection at source and remittance to the revenue authority in the jurisdiction of consumption; ii) Bit-rate taxation; and iii) VAT collection by financial institutions.
Collection at source and remittance would require global cooperation between revenue authorities. The OECD recommends that this can be achieved through the negotiation of treaties between major trading jurisdictions. It should, however, be noted that suppliers often trade in jurisdictions other than those with which bilateral agreements have been concluded. It is further unlikely that revenue authorities would fund the cost of establishing and maintaining an international online tax collection body. It is likely that suppliers would be required to fund this model. This would exclude many small to medium size enterprises from the market. Furthermore, this model does not remove the supplier's duty to locate and identify the customer.

Bit-rate taxation has no regard for economic value since tax is levied on the amount of data flow. This means that worthless data, such as e-mail correspondence, would effectively be taxed. Since the OECD does not recommend the introduction of new taxes in e-commerce, Bit-rate tax should be rejected.

7.8.4 Collection by financial institutions

The OECD's rejection of VAT collection by financial institutions is based on resistance and objections by financial institutions, and the general international perception of the banker-customer relationship in respect of customer privacy at the time when the proposal was considered. Globally, revenue authorities increasingly

introduce legislation imposing the collection of taxes by financial institutions or intermediaries in the cases where cross-border trade and employment are on the rise.

The development of the RTpay® system eliminates the main concerns in respect of product classification and taxation, software requirements, and integration with revenue systems. Where the destination principle applies, global cooperation is generally not required. Suppliers are not required to identify and locate customers, further removing the need for guidelines as proposed in paragraph 7.3 above. Since both B2B and B2C transactions are taxed, the need to establish the customer's tax status is eliminated. Business customers can claim an input VAT deduction.

The main objections to VAT collection by financial institutions are the possible infringement of the customer's right to privacy, and the possible breach of the banker's duty of confidentiality. Neither the customer's right to privacy, nor the right to banker-customer confidentiality is absolute and can be limited by statute. Moreover, when entering into business ventures/transactions, one voluntarily subject oneself to laws and regulations that could infringe one's rights. The infringement of the customer's right to privacy is a necessary concomitant of effective trade.

The proposed benefits of VAT collection by financial institution through the RTpay® system outweigh the cost of implementation and the administrative burden placed on financial institutions. As the RTpay® system was developed to integrate with existing international banking software systems, it can be applied in South Africa without extensive adjustments to the existing South African banking system. Moreover, integration with existing software applications used by SARS could result in a fully automated VAT system for all imports (goods, services, and electronically supplied services). However, the RTpay® system remains to be tested.

To impose the burden of VAT collection on financial institutions, the following amendment to section 7(2) is required:

> Except as otherwise provided in this Act, the tax payable in terms of paragraph (*a*) of subsection (1) shall be paid by the vendor referred to in that paragraph, the tax payable in terms of paragraph (*b*) of that subsection shall be paid by the person referred to in that paragraph[,] ~~and~~ the tax payable in

terms of paragraph (*c*) of that subsection shall be paid by the recipient of the imported services [and the tax payable in terms of paragraph (*d*) of that subsection shall be paid by the financial institution which is authorised or instructed to make payment on the transaction.]

7.9 Conclusion

Whatever the solution adopted, the taxation of e-commerce should not artificially advantage or disadvantage e-commerce over comparable traditional commerce, or unnecessarily hinder the development of e-commerce.[1695] Finding a global solution requires global cooperation on a massive scale. It is impossible for such a solution to satisfy both suppliers and revenue authorities around the world. Some measure of autonomy should be allowed to countries to develop their own or regional policies to the extent that these do not adversely affect the rights of other jurisdictions, or put a damper on business efficacy and development. The highly criticised EU model potentially infringes on the international rights of traders in the USA, and could severely impact on the development of e-commerce between these two major trading partners. Should countries like South Africa follow suit, e-commerce and international trade could forever be relegated to the history books.
The RT-VAT payment system discussed in Chapter 6 allows for greater autonomy amongst jurisdictions to develop VAT rules with international reach which can be implemented at local level without infringing on the rights of foreign jurisdictions.

Cross-border digital trade is a fully fledged electronic trading and often automated phenomenon. The execution of these transactions requires little or no human intervention. It is, therefore, imperative that VAT collection should be effected by an electronic automated system that requires minimal human intervention.

I believe that my proposals to amend the VAT Act[1696] will not only remove the current inadequacies in levying VAT on digital imports, but that they would, in conjunction

[1695] OECD (1998) *Dismantling the Barriers to Global Electronic Commerce* at 39 http://www.oecd.org/sti/2751237.pdf [accessed on 1 February 2013].
[1696] Act 89 of 1991.

with the implementation of an RTpay® system, lead to a VAT policy that provides for the levying and collection of VAT on all cross-border transactions.

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