

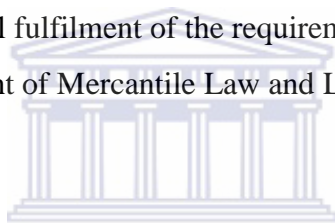


UNIVERSITY of the
WESTERN CAPE

FACULTY OF LAW

**LEGAL AND ECONOMIC UNCERTAINTIES CLOUDING DIGITAL TAXATION:
UNPACKING AND ADDRESSING THE ISSUES**

Mini-thesis submitted in partial fulfilment of the requirements for the LLM degree in the
Department of Mercantile Law and Labour Law



UNIVERSITY of the
WESTERN CAPE

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November 2015

DECLARATION

I declare that ‘Legal and Economic Uncertainties Clouding Digital Taxation: Unpacking and Addressing The Issues’ is my own work, that it has not been submitted before for any degree or examination in any other university, and that all the sources I have used or quoted have been indicated and acknowledged as complete references.

Student: Tinashe Kondo

Signature:



The logo of the University of the Western Cape, featuring a classical building with columns and a pediment, with the text 'UNIVERSITY of the WESTERN CAPE' below it.

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ABSTRACT

The digital economy has over the past years developed at a dramatic pace, generating substantial revenues for entities and individuals trading on this platform. This has fuelled vast interest and debate into whether such activity should be taxed. After the turn of the millennium, a lot of research on taxing the digital economy was done, but this was mostly in America and Europe. In South Africa, very little research has been done, most of which was conducted before the enactment of new pieces of legislation regulating digital tax.

This study analyses how the South African digital tax framework interlinks with global tax principles. More specifically, the study seeks to clarify the legal and economic uncertainties surrounding the taxation of e-trade. The pertinent issues around this area will then be analysed in depth and potential solutions furnished.

The Taxation Laws Amendment Act 21 of 2013 changed the position in South Africa in respect of the supply of electronic services. The definition of ‘enterprise’ was extended to include the supply of electronic services by a person or business outside South Africa, to a recipient in South Africa. Therefore, foreign enterprises could become liable to register as vendors in terms of s 23 of the Act, and become subject to VAT in terms of s 7 (1) (a) of the Value Added Tax Act 89 of 1991.

Amongst other implications, the new regulations effectively shift the compliance burden from the local recipient to the foreign supplier in terms of the listed electronic services while at the same time creating compliance costs for the foreign supplier.

The study builds on models adopted by other countries on the international scene. The United States and European countries have taken different paths on the matter compared to the one adopted by South Africa. The United States imposed a temporary moratorium on states levying certain taxes on Internet sales, while, on the other hand, the European Union levied different digital tax standards, which depend on whether or not the supplier is based in Europe.

The research concludes that the majority of the problems surrounding the taxation of e-trade are not of a sovereign nature but rather of a multi-jurisdictional nature. The study recommends that at a global level, there is a need for the creation of: new e-tax rules in the WTO regime; a central registration portal; a third party collection and payment mechanism, an imbedded audit system in

the portal; as well as built-in privacy mechanisms in order cure the existing shortcomings in taxing Internet transactions. For South Africa, the study suggests that the National Treasury create a timeline for the creation of a White Paper on the taxation of electronic commerce and the subsequent creation of more comprehensive Electronic Service Regulations within a reasonable period thereafter.



DEDICATION

This thesis is dedicated to my parents, Mr F & Mrs C Kondo, who contributed immensely for me to be where I am today.



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KEYWORDS

Digital taxation

Effective management

Electronic Service Regulation

E-trade

International tax principles

Model tax treaties

Moratorium

Multi-jurisdictional

Permanent establishment

Sovereign



LIST OF ABBREVIATIONS

ACEC	Advisory Committee on Electronic Commerce
BEPS	Base Erosion and Profit Shifting
E-commerce	Electronic Commerce
EEC	European Economic Cooperation
EFT	Electronic Funds Transfer
EU	European Union
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
Green Paper	South African Green Paper on Electronic Commerce 2000
ICC	International Chamber Of Commerce
INDA	Internet Non-discrimination Act
ISP	Internet Service Provider
ITFA	Internet Tax Freedom Act
ITFAA	Internet Tax Freedom Act Amendment
MNC	Multi National Company
MODEL LAW	United Nations Commission on International Trade Law Model Law on Electronic Commerce
MOSS	Mini-One-Stop-Shop
OECD	Organisation of Economic Co-Operation and Development
OEEC	Organisation for European Cooperation

PITFA	Permanent Internet Tax Freedom Act
REGULATION	Electronic Services Regulation
SARS	South African Revenue Service
UN MODEL CONVENTION	United Nations Double Tax Convention
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
US	United States of America
VAT ACT	Value-Added Tax Act 89 of 1991
VAT	Value Added Tax
VOES	Vat on Electronically Supplied Services
WTO	World Trade Organisation



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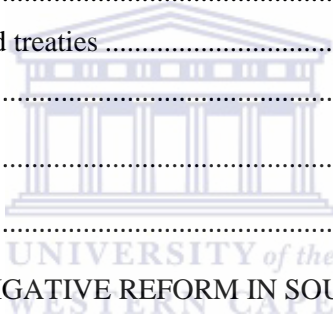
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CHAPTER 1 INTRODUCTION & BACKGROUND TO THE STUDY

1.1 BACKGROUND TO THE STUDY

Collin and Colin believe that the digital revolution is old news.¹ They argue that it has disrupted all sectors of the economy, transformed consumption patterns, production relationships, and the dynamics and shapes of both corporations and government agencies alike, with few institutions being spared the challenges it has created. Resultantly, as with the nature of all revolutions, changes will indeed need to be made. Given the scale of the changes in industry, the tax system must be attuned to the way value is now created in economies.²

Nobel laureate economist Milton Friedman stated that the Internet will make it more difficult for governments to collect taxes.³ This statement is very profound in the context of developing issues in International Taxation. Oguttu claims that electronic commerce (e-commerce) could complicate a taxpayer's ability to comply with tax laws and regulations that require knowledge of the location of the electronic transaction.⁴ The Internet's advent brought a wave of economic and legal uncertainty, with some people likening its ramifications to the extensive changes experienced during the Industrial Revolution.⁵

As the digital economy continues to grow, mainstream businesses are starting to move their transactions online, while e-commerce specialists, such as, Google, Facebook and Alibaba, continue to thrive.⁶ More than ever, this has sharpened the appetite of governments across the globe to tax e-commerce trade. Holmes views this process of collecting revenues from e-

¹ Cited Taskforce on Taxation of the Digital Economy Report 'Report to the Minister for the Economy and Finance, the Minister for Industrial Recovery, the Minister Delegate for the Budget and the Minister Delegate for Small and Medium-Sized Enterprises, Innovation and the Digital Economy' (2013) 1.

² Taskforce on Taxation of the Digital Economy Report (2013) 1.

³ Friedman A 'Commanding Heights: The Battle for the World Economy' available at <http://www.pbs.org/wgbhlcommandingheights/sharedlminitextlo/inmiltonfriedman.html> (accessed 22 December 2014).

⁴ Oguttu AW 'The Challenges that E-commerce poses to International Tax Laws: Controlled Foreign Company legislation – From a South African Perspective' (2008) 20 *SA Mercantile Law Journal* 463-4.

⁵ Levy S 'Bill and AI Get it Right' *Newsweek* July 7 1998.

⁶ Holmes D 'Solving the E-commerce tax riddle' (2003) 239 *Observer* 11.

commerce as a hard nut to crack, especially when it comes to products, such as, software and music, that can be pulled off the web from anywhere in the world.⁷

The current tax systems were designed to operate in a (more) physical environment in which most transactions are documented in writing at the place where the transaction occurs or where taxable income arises.⁸ Under this taxing system, a major consideration is whether or not the entity has a permanent establishment in the jurisdiction in question. Article 5 of the Organisation for Economic Co-operation and Development (OECD) Model Income Tax Convention defines a permanent establishment as a fixed place of business through which the business of an enterprise is wholly or partly carried on.⁹ 'Permanent establishment' is a key tax concept because, under most tax treaties, a business must be determined to have a permanent establishment presence in a country before that country can attempt to tax the profits of the business.¹⁰

The old taxing systems and principles have been rendered obsolete by the new wave of transacting in the digital biosphere. The advent of the Internet, and especially the proliferation of e-commerce, has led many commentators to question the OECD's use of 'permanent establishment' as the defining nexus by which a country may tax the business profits of a non-resident entity.¹¹ As such, the principle of permanent establishment is one of the existing tax principles of note that has been questioned in terms of its applicability in the new Internet tax regime. Forgione rightfully puts it that the prevailing system of treaty rules for the taxation of global business income is now under siege on several different fronts.¹² An analysis of how the Internet should be taxed therefore seems to call into question the applicability of existing tax principles.

Residents in South Africa are taxed on their income that forms part of their gross income according to the definition of gross income in s 1 of the Income Tax Act.¹³ Residents are then

⁷ Holmes D (2003) 11.

⁸ Lymer A 'Taxation in an Electronic World: the international debate and a role for tax research' (2000) 3 *ATAX Discussion Paper Series 2*.

⁹ The 1992 OECD Model Income Tax Convention on Income and Capital, Article 5.

¹⁰ Chan C W 'Notes on Taxation of Global E-commerce on the Internet: The underlying issues and proposed plans' (2000) 9 *Minnesota Journal of Global Trade* 244.

¹¹ Hoffart B 'Permanent Establishment in the Digital Age: Improving and Stimulation Debate Through an Access to Markets Proxy Approach' (2008) 6 *Northwestern Journal of Technology and Intellectual Property* 2.

¹² Forgione A 'Clicks and Mortar: Taxing Multinational Business Profits in the Digital Age' (2003) 26 *Seattle University Law Review* 1.

¹³ Income Tax Act 58 of 1962, Section 1.

taxed on their worldwide income while non-residents are taxed on income from a source within South Africa. Juristic persons are also not spared. As such, a company that is formed, incorporated or established or has its place of effective management in South Africa is liable for tax.¹⁴ The South African Revenue Service (SARS) Interpretation Note 6 defines ‘effective management’ as the place where the company is managed on a day to day basis by the directors or managers of the company, irrespective of where overriding control is exercised or where the board of directors meets.¹⁵ Thus it can be noted that South Africa applies the principle of permanent establishment by considering the place of effective management.

It is however trite that SARS Interpretation Notes are not law, and in certain cases it has been argued that SARS itself is not bound by its interpretation notes.¹⁶ Oguttu asserts that although South Africa is not a member of the OECD, the OECD’s interpretation of the term is relevant to South Africa since most of South Africa’s treaties follow the OECD Model Tax Convention. Thus South African courts would then have to refer to the Commentary on the OECD Model Tax Convention in interpreting the terms used in the Convention.¹⁷ This was the position taken by the Court in *SIR v Downing*.¹⁸ The position in this regard was further clarified in the case of *Oceanic Trust Co Ltd NO v CSARS* where the Court applied the interpretation of the OECD in preference to the one advanced by SARS.¹⁹ Beric *et al* note that the place of effective management can be further applied in a treaty text context as a tie breaker in cases of dual resident entities.²⁰

In the pursuit of establishing how the principle of permanent establishment is handicapped by digital transactions, we can consider the example considered by the OECD which brought about a split opinion. The issue is whether the use of computer equipment for electronic commerce constitutes permanent establishment in the country where the computer is located.²¹ One group took the standpoint that the business was carried out by the equipment while the other group disagreed, taking the view that if that were the case, electronic vendors could change locations every week.

¹⁴ SARS Interpretation Note No.6 of 26 March 2002.

¹⁵ SARS Interpretation Note No.6 of 26 March 2002.

¹⁶ Oguttu AW (2008) 356.

¹⁷ Oguttu AW (2008) 355.

¹⁸ *SIR v Downing* 1975 4 SA 518 A.

¹⁹ *Oceanic Trust Co Ltd NO v CSARS* Unreported, case no 22556/09 (WCC), 13 June 2011.

²⁰ Beric *et al Tax Law: An Introduction* (2013) 32.

²¹ Feinschreiber & Kent ‘GIIC recommends E-commerce taxation and tariff modifications’ (2001) 3 *Corporate Business Taxation* monthly 3.

Going a step further, one could also ponder the question whether an Internet website, which is a combination of software and electronic data, is capable of being assigned permanent establishment in a particular state. The OECD contends that a website does not have a location that can constitute a place of business as there is no facility, such as, premises or in certain instances, machinery or computer equipment, as far as the software and data constituting the website are concerned.²² On the other hand, however, the server on which the website is stored and through which it is accessible is a piece of equipment having a physical location and such location may constitute a fixed place of business for the enterprise in question.²³ Such is the vexatious nature of the principle when viewed in the context of digital commerce where transactions are borderless and flow seamlessly across the globe.²⁴

The principle of permanent establishment is not the only principle of tax policy that has been called into question as a result of the contagious expansion of the Internet and information communication systems. The principle of tax neutrality has also been put in the hot seat. As the name suggests, the principle denotes that any equitable tax system treat economically similar income equally. If applied in the context of Internet taxes, this will result in several disparities in its application. The principle would thus require that income earned through electronic means be taxed similarly to income earned through more conventional channels of commerce.²⁵ However, it could be argued that the application of the principle of tax neutrality to Internet transactions would otherwise place e-commerce at a competitive disadvantage relative to other modes of commerce, defeating one of the purposes of an equitable tax system.²⁶

The International Tax regime was first developed in the 1920s when the League of Nations first undertook to study ways to avoid international double taxation, and has been embodied in the model tax treaties developed by the OECD and the United Nations (UN), and in the multitude of bilateral agreements based on this model.²⁷ As a result, two jurisdiction based taxation methods were developed, namely, source based taxation and residence based taxation.

²² OECD *Model Tax Convention on Income and Capital* (2010) 110.

²³ OECD (2010) 110.

²⁴ Ward BT & Sipior JC 'To Tax or Not To Tax E-commerce: A United States Perspective' (2004) 5 *Journal of Electronic Commerce Research* 174.

²⁵ Chan CW (2000) 244.

²⁶ Chan CW (2000) 244.

²⁷ Choudhary V 'Electronic Commerce and Principle of Permanent Establishment Under International Tax Law' (2011) 4 *International Tax Journal* 35.

The source based method of taxation places different economic activities into various categories and taxes the income at the place giving rise to the activity, while, on the other hand, residence based taxation allows a sovereign to tax its residents on their worldwide income.²⁸ The concept of residency is grounded in the permanent establishment principle, and residency requirements are usually tied to some geographic or physical presence in the country.²⁹ In instances where a country fails to establish residency in a country, it may still invoke source principles to ascertain whether the income was derived within the country's geographical territorial borders. Source income principles thus generally have priority over residence rules and the country of origin usually has the right to tax income.³⁰

The difficulty of applying these two methods to e-commerce transactions is that companies solely operating on the Internet have no physical residence.³¹ Gutuza conjured up the idyllic imagery of an international business with the entrepreneur lazing in a beach chair in a low tax jurisdiction, using his laptop (or some electronic device) to access his business websites.³² By accessing these websites, the entrepreneur would be able to watch the purchases of his customers and view the profits move into an account in the same jurisdiction or a lower tax jurisdiction; however, other than a website, a server or an Internet Service Provider (ISP), he would not have no other presence in the countries of his customers.³³

The South African Income Tax Act, as in the case in many other jurisdictions, applies source as the jurisdictional link of non-residents in an attempt to bring the income of non-residents into the South African tax net, where their income has its originating cause located within the geographical confines of South Africa.³⁴ The principle finds application to both resident and non-resident individuals and companies.³⁵ The term 'source' however, is not defined in the Income Tax Act, and as such a meaning has to be derived from the common law. In *CIR v Lever Brothers and Another*, the Court said that the source of income is established by first determining

²⁸ Choudhary (2011) 35.

²⁹ Chan C W (1999) 245.

³⁰ Chan C W (1999) 245.

³¹ Ferrette CP 'E-commerce and International Political Economics: The Legal and Political Ramifications of the Internet on World Economies' (2000) 7(15) *ILSA Journal of International and Comparative Law* 4.

³² Gutuza T 'Tax & E-commerce: Where is the source' (2010) 127 *South African Law Journal* 328.

³³ Gutuza T (2010) 328.

³⁴ Gutuza T (2010) 330.

³⁵ Usa Ibp Usa (ed) South Africa Company Laws and Regulations Handbook (2009) *International Business Publications* 109.

the originating cause of the income (what the taxpayer does to produce the income), and thereafter locating the originating cause.³⁶

Buy and Cronjé advance that in the case of services rendered, it is unlikely that any vendor or person who renders services through a website or electronically will physically render services in South Africa, as he does not have any physical presence in South Africa, thus challenging the application of the existing tax precedent.³⁷ If the source of the originating cause is where the person who renders the service plies his trade (as in the case of *Millin v CIR*),³⁸ the source of income from services rendered electronically by foreigners will be outside South Africa.³⁹ Buy and Cronjé conclude that the *location of activities test* formulated in *CIR v Lever Bros & Unilever Ltd* can still be used effectively for electronic or Internet services where the originating cause is where the recipient of the service benefits from the service.⁴⁰ The approach advanced by these authors is therefore one-legged, thereby resulting in a skewed application of the test (as it only works where the recipient of the service and the originating cause are in the same location).

A question has thus arisen whether the principles of the OECD are binding on any country since the OECD is not a global governing body. Ferrette provides the solution by saying that the guidelines developed by the OECD are not binding on any country, but serve two central purposes acting as a regulatory scheme which governments may use as a model in their creation and implementation of consumer protection law regarding e-commerce; and which private companies may emulate in their development of regulatory practices.⁴¹

With the OECD lacking jurisdictional predicate to enforce its guidelines, the World Trade Organisation (WTO) asserts that electronic commerce falls within the ambit of the WTO/General Agreement on Trade and Tariffs (GATT).⁴² With the plethora of problems besetting electronic commerce, other organisations have also joined the party by providing guidelines to resolve the political and legal problems surrounding e-commerce. Examples of these

³⁶ *CIR v Lever Brothers & Another* 946 AD 441 14 SATC.

³⁷ Buy R & Cronjé (Eds) *F Cyberlaw@SA II: The Law of the Internet in South Africa* 2 ed (2004) 314.

³⁸ *Millin v CIR* 1928 AD 3 SATC 221.

³⁹ Buy R & Cronjé (2004) 315.

⁴⁰ Buy R & Cronjé (2004) 315.

⁴¹ Ferrette CP (2000) 4.

⁴² Ferrette CP (2000) 4.

organisations include the International Chamber of Commerce (ICC), and the United Nations Commission on International Trade Law (UNCITRAL).

The UNCITRAL Model Law on Electronic Commerce (Model Law) proposes ways to harmonise Internet related problems on a worldwide basis with application to any kind of information in the form of a data message used in the context of commercial activities.⁴³ William is of the opinion that although the Model Law is not designed to assign equally binding uniform rules throughout the world, it helps to harmonise legal standards with sensible supranational concepts while at the same time leaving leeway for a state to add rules specific to, or desired for, its legal system.⁴⁴

The objectives of the Model Law include the facilitation of the use of e-commerce as well as the provision of equal treatment to users of paper based documentation and users of computer based information, which are essential for the fostering of efficiency and economy in international trade.⁴⁵ The basic principles of the Model Law advocate for functional equivalence (analysing functions of paper based documentation and replicating the functions to enable the same recognition of electronic data); media and technological neutrality (equal treatment of paper based and electronic transactions: equal treatment of different technologies); and party autonomy (parties free to choose security level of transaction: primacy of party agreement on whether and how to use ecommerce techniques).⁴⁶

The Model Law has had wide influence and has adopted and has been adopted and transformed into law in several countries, namely, several non-sovereign jurisdictions, such as, Bermuda, Hong Kong and the Cayman Islands. The wide reception of the Model Law is problematic because its principles conflict with the principles and interpretation of the OECD Model Tax Treaty. Furthermore, the Model Law seems to address to a greater extent some of the shortcomings of the OECD Model Tax Treaty, such as, the ongoing uncertainty on defining 'permanent establishment' in an electronic sense, and the incompatibility of consumption tax systems.⁴⁷ Hence, one could advance the argument that the principles of the Model Law should

⁴³ William JC 'Introductory & Background Issues' Discussion paper delivered at the University of Aberdeen, School of Law, 26-7 October 2004. Unpublished paper.

⁴⁴ William JC (2004) 2.

⁴⁵ UNCITRAL Model Law on Electronic Commerce with Guide to Enactment (1996) 17.

⁴⁶ United Nations Commission on International Trade Law, Model Law on E-commerce.

⁴⁷ William JC (2004) 3.

serve as a guiding point of departure when dealing with such issues. In the interpretation of the Model Law, regard is to be given to the need to promote uniformity in its application, and the observance of good faith.⁴⁸ Furthermore, matters regulated by the Model Law but not expressly resolved in it are to be determined in terms of the general principles on which the law is based.⁴⁹ The Model Law was intended to provide essential procedures to aid modern communication mediums, since it does not fix all the rules and regulations needed to implement those techniques in an enacting State.⁵⁰

Further challenges and problems arise out of taxing the digital economy. Electronic commerce also creates opportunities and incentives for businesses to avoid tax under the current international taxation regime.⁵¹ Pastukhov advances five reasons why electronic commerce is incompatible with the current international tax regime and creates opportunities for tax evasion.⁵² These are: electronic commerce allows a business to operate without creating a permanent establishment in any country; businesses are allowed to easily relocate their taxable activities around the world at low cost and without any interruption in response to changes in legal and economic environments; it complicates the attribution of income and expenses to a particular part of the transaction; the Internet clouds the distinction between providing services and transferring property; and finally, as a result of the foregoing it complicates the administration and collection of taxes.

The digital age has further brought to the fore the problem of the use of tax havens in a bid to pay no or lower taxes. This lacuna in the law has mostly been exploited by multinational companies who see the fragmented system of international income tax as providing ample opportunity for a multinational enterprise to structure e-commerce activities in a manner that escapes tax entirely.⁵³ Thus the standard that ties tax jurisdiction to the State of incorporation is subject to manipulation, with many multinational companies not incorporating in their location

⁴⁸ UNCITRAL Guide to Enactment (1996) 4.

⁴⁹ UNCITRAL Guide to Enactment (1996) 4.

⁵⁰ UNCITRAL Guide to Enactment (1996) 4.

⁵¹ Pastukhov O 'International Taxation of Income Derived From Electronic Commerce: Current Problems and Possible Solutions' (2006) 12 *Boston University Journal of Science and Technology* 319.

⁵² Pastukhov O (2006) 319.

⁵³ Forgiione A (2003) 4.

of effective management and control. The growth of electronic commerce and the increasing use of tax havens have thus spurred pleas for international tax reforms.⁵⁴

The effect of electronic commerce on the implementation and development of international tax rules has received a lot of attention from international tax practitioners, administrators, and academics. So far, however, the response by countries has been cautious.⁵⁵

The European Union (EU) never had a problem deciding whether or not these services were taxable; the issue was where they should be taxed.⁵⁶ With the position shrouded in obscurity, the EU decided to apply standard practice and rectify the lacuna by creating provision for it in legislation. The European Council thus issued the European Union Directive on Value Added Tax (VAT) and Electronic Commerce.⁵⁷ The relatively short piece of legislation, a little over three pages generated no little interest, fuelling debate on both sides of the Atlantic.⁵⁸ The legislation came into effect on 1 July 2003. The legislation fashioned an online system for businesses based outside the European Union to pay tax on web sales to EU citizens.⁵⁹ Furthermore, non- EU firms were required to register in one EU country but pay the VAT rate applicable in each customer's country.⁶⁰ In contrast, EU firms were required to VAT at a single rate of the country in which they are located.⁶¹

With the EU being very active in e-commerce issues, it will likely have an important impact on global e-commerce policy development.⁶² Currently the EU is exploring ways to improve its existing tax framework which sometimes has shortcomings in regulating European VAT Law because of its aging nature and the manner in which the Internet has evolved.⁶³ The European Commission commissioned the high level Expert Group on Taxation of the Digital Economy which commenced work in 2013. The Group worked with increased expediency and delivered the high level report which addressed issues of both direct and indirect taxation connected to the

⁵⁴ Forgione A (2003) 4.

⁵⁵ Pastukhov O (2006) 327.

⁵⁶ Bill S & Kerrigan S 'Practical Application of European Value Added Tax to E-commerce' (2004) 38 *Georgia Law Review* 72.

⁵⁷ Council Directive 2002/38/EC of 7 May 2002.

⁵⁸ Bill S & Kerrigan S (2004) 72.

⁵⁹ Holmes D (2003) 11.

⁶⁰ CRS Report for Congress 'EU Tax on Digitally Delivered E-commerce' (2003) *Congressional Research Service: United States of America* 1.

⁶¹ CRS Report for Congress (2003) 1.

⁶² Mc Loughlin GJ 'Information policy: Electronic Commerce' (2000) 26 *The Journal of Academic Librarianship* 5.

⁶³ Bill S & Kerrigan S (2004) 71.

digital economy.⁶⁴ The report at the same time addresses broader issues on how tax policy can help maximise the opportunities the digital economy offers. As a result of these efforts, the EU on 7 October 2013 implemented Council Regulation No 1042/2013, as regards the place of supply of services. Now, electronic services delivered to a customer within the EU are now taxed at the place where the customer is located.⁶⁵

The United States (US), just like other industrial nations, generally recommends *ad hoc* modifications to existing international tax laws and norms to deal with E-commerce.⁶⁶ The first regulation by Congress delayed finding a permanent solution to the problem of taxing digital transactions. Congress in October 1998 enacted the Internet Tax Freedom Act (ITFA) which imposed a three-year moratorium on new taxes on the Internet and created the Advisory Commission on Electronic Commerce (ACEC).⁶⁷ This initial Internet tax moratorium expired on 21 October 2001, after which the Internet Tax Non-discrimination Act (INDA) was then enacted on 28 November 2001.⁶⁸ The effect of the INDA was that it effectively replaced the ITFA and extended the moratorium for another two years.

The INDA of 2003 extended the moratorium through to 1 November 2007. The Internet Tax Freedom Act Amendment Act of 2007 was then enacted, extending the moratorium for a third time through to 1 November 2014.⁶⁹ The Commission remains divided on whether e-commerce should be taxed, with one group believing that electronic commerce should be taxed and the other advocating for the continuation of the status quo (Internet tax moratorium), and perhaps its codification.⁷⁰ With the moratorium expiring on 1 November 2014, Congress was once again presented with an opportunity to lay the matter to rest. September 2014 saw Congress passing a temporary extension (later signed by President Barack Obama) of the federal moratorium to 11

⁶⁴ European Commission Taxation and Customs Union 'Expert Group on Taxing the Digital Economy' available at http://ec.europa.eu/taxation_customs/taxation/gen_info/good_governance_matters/digital_economy/index_en.htm (accessed 29 November 2014).

⁶⁵ See Taxation and Customs Union 'Explanatory Notes on the EU VAT changes to the place of supply of telecommunications, broadcasting and electronic services that enter into force in 2015' (2014) *Commission Directorate General for Taxation and Customs Union*.

⁶⁶ Forgiione A (2003) 2.

⁶⁷ Mc Lure CE 'Electronic Commerce and the State Retail Sales Tax: A Challenge to American Federalism' (1999) 6 *International Tax and Public Finance* 13.

⁶⁸ Goodlatte B 'Permanent Internet Tax Freedom Act' available at <http://www.gpo.gov/fdsys/pkg/CRPT-113hrpt510/html/CRPT-113hrpt510.htm> (accessed 20 February 2014).

⁶⁹ Goodlatte B 'Permanent Internet Tax Freedom Act' available at <http://www.gpo.gov/fdsys/pkg/CRPT-113hrpt510/html/CRPT-113hrpt510.htm> (accessed 20 February 2014).

⁷⁰ Mc Lure CE (1999) 14.

December 2014.⁷¹ The fourth extension of the moratorium was then subsequently granted and will see the moratorium subsist for another year.⁷²

The often cited reason for the tax moratorium is to prevent harm to a growing sector of the economy. The Internet is seen as boosting productivity, creating jobs, and a key driver of economic growth. Lundeen views economic growth as one of the most important considerations for good tax policy, although it is not the only consideration for the Internet tax moratorium.⁷³ It remains to be seen whether the US, by virtue of its large proportion of Internet use and e-commerce development, will try to dominate global e-commerce policy.⁷⁴

Locally, SARS continues its drive to widen the tax base, including the taxation of electronic commerce.⁷⁵ In this bid, the National Treasury published the final Electronic Services Regulation (Regulation) in terms of the definition of electronic services in s 1 of the Value-Added Tax Act 89 of 1991 (VAT ACT), on Friday 28 March 2014, with implementation effective on 1 June 2014.⁷⁶ The amendments gave effect to the VAT ACT changes, which alter the way in which certain imported electronic services will be taxed in the future.⁷⁷ Huang was correct in the remarks he made in 2004 that one of the major difficulties that the South African government must face as the electronic model grows is the question of taxation with regards to electronic transactions and of import duties when they cross international boundaries.⁷⁸

In terms of the Regulation, VAT will apply to any supplier of electronic services from an export country to any resident in the Republic, or where payment is made from a local bank.⁷⁹ The services to be taxed include educational services (distance teaching programmes; educational webcasts; Internet based courses, Internet based educational programs, and webinars), games and

⁷¹ California Office of Senate Research 'Internet Tax Moratorium Extended for the Short Term in Government Funding Measure' available at http://sor.senate.ca.gov/sites/sor.senate.ca.gov/files/Federal_Update--Internet_Tax_Freedom_Act_Update.pdf (accessed 20 February 2014).

⁷² Gross G 'Internet Tax Moratorium Extended Again' available at <http://www.pcworld.com/article/2859872/internet-tax-moratorium-extended-in-us-govt-spending-package.html> (accessed 20 February 2015).

⁷³ Lundeen WT & William TD 'Taxation and the Business of the Internet Part III: Taxation of Sales of Digitally Delivered Information' (2003) 13 *Corporate Business Taxation* monthly 1.

⁷⁴ Mc Loughlin GJ (2000) 6.

⁷⁵ Buys R & Cronjé F (2004) 316.

⁷⁶ Value Added Tax Act 89 of 1991, Regulation 221.

⁷⁷ VAT, Regulation 221.

⁷⁸ Huang W *Electronic Governance and Implementation* (2006) 339.

⁷⁹ VAT, Regulation 221.

games of chance, information system services, Internet based auction services, maintenance services, online content (e-books; films; images; music; software), and subscription services.

The Regulation may produce potential gains including additional revenue for the government, increased compliance, as well as a better competitive advantage for local businesses. On the other hand, it may push the prices of goods upwards, create onerous legislative requirements for foreign businesses, impose compliance costs on government, and lower subscriptions to international e-learning platforms. The implications of the Regulation will be explored in greater detail in this study.

Oguttu supports the recommendation of the Katz Commission that South Africa should not seek to pioneer a completely new tax regime to cope with the changes brought about by e-commerce, but that it should internationalise its laws affecting trade and investment.⁸⁰ Another South African author, Steyn, took a different approach, arguing that the government must come up with effective means of tracking, recording, and accounting for transactions to ensure that the tax base of the country is protected.⁸¹ Van Der Merwe acknowledges both views and states as that the current fiscal frameworks must be adapted successfully in order to cope with the changes in the information society, while it should be noted that e-commerce poses a threat to the consumption tax base.⁸² He further notes that e-commerce challenges the review of domestic tax principles, as the policy framework for international tax rules is important in establishing part of the detail.⁸³ These opinions beg the question whether the challenges of taxing the Internet are a local problem, calling for solutions at a governmental level? Or whether e-tax issues are a global nemesis calling for inter-governmentalism and cooperation with a fixated focus of delivering a universally applicable solution? In attempting to answer these questions, the sentiments echoed by Oguttu must be borne in mind:

‘Much as it is necessary to sit back and wait to see how e-commerce develops so as to not stifle its development, it is equally important to act fast and develop laws that can accommodate e-commerce so as to protect our country’s tax base.’⁸⁴

⁸⁰ Oguttu AW (2008) 464.

⁸¹ Steyn T ‘Vat & E-commerce: Still searching for the solution’ (2010) 22 *SA Mercantile Law Journal* 253.

⁸² Van de Merwe BA ‘Vat and E-commerce’ (2003) 15 *SA Mercantile Law Journal* 386-7.

⁸³ Van de Merwe BA (2003) 386.

⁸⁴ Oguttu AW ‘Transfer Pricing and Tax Avoidance: Is the Arm’s length Principle Still relevant in the E-commerce era?’ (2006) 18 *SA Mercantile Law Journal* 158.

Buys and Cronjé believe that despite the drive by the SARS to expand its tax base, including the taxation of e-commerce, ample tax planning opportunities exist in South Africa that assist residents and non-residents to minimise their South African income tax liability legitimately within the tax legislation.⁸⁵ They further contest that only minimum changes have been made with regards to the decreasing rate of return on tax planning to more realistic levels in respect of the global scale.⁸⁶

Electronic commerce is therefore dramatically changing the landscape of both multi-state and international taxation.⁸⁷ It has changed the very nature of many transactions, turning what would have been sales of tangible personal property into sales of intangible property, thus making obsolete the traditional methods of defining tax bases. The taxation of e-commerce is thus a complex issue which cuts across cities, countries, state borders, national borders and tax types. The continued growth of electronic commerce raises complex issues associated with the taxation of multi-jurisdictional transactions and the sourcing of the sale of, or income from, services or intangible property transactions.⁸⁸ To some, however, the question of taxation of e-commerce transactions is nation state specific.⁸⁹

With no easy solution in sight to the Internet tax dilemma, the area of tax administration continues to be a haven for uncertainty. This study proposes that, viewed from a different angle, this area can be seen as a harbour for innovation and creativity in order to address the contentious issues surrounding digital tax. The author argues that the international community adopt a next generation technology-based international system of tax administration, informed by existing tax principles but aligned to cater for the elusive and constantly changing needs of the digital economy. The author contends that this is not a process of reinventing the wheel but one of ensuring that the spirit and purport of the existing tax principles, such as, equity and fairness, are maintained, while juggling the demands of the digital revolution. The author concludes that the matter is not a sovereign one, but a multi-jurisdictional one.

⁸⁵ Buys R & Cronjé F (2004) 316.

⁸⁶ Buys R & Cronjé F (2004) 316.

⁸⁷ Lundeen WT & William TD (2003) 1.

⁸⁸ Ward BT & Sipior JC (2004) 197.

⁸⁹ Ferrette CP (2000) 4.

1.2 RESEARCH QUESTION

The main purpose of this study is to unpack and address the legal and economic uncertainties surrounding the taxation of the global digital framework, to determine the digital taxation issues and their implications for South Africa, specifically their indirect tax implications and to generate solutions to these problems by considering how individual countries are addressing these challenges.

1.3 RESEARCH OBJECTIVES

This study is guided by the following objectives:

- To give an overview of the development of digital taxation;
- To determine why the digital taxation framework was implemented in South Africa;
- To critique the existing framework and ascertain its benefits;
- To determine the implications of the South African Digital Taxation framework, more specifically, the Electronic Services Regulation;
- To determine if in comparison to other countries, the South African system needs reform;
- To determine what international policies will find application in the South African legal system;
- To ascertain the power to tax; and
- To provide solutions to the problems surrounding digital taxation

1.4 IMPORTANCE AND BENEFITS OF THE STUDY

This study is insightful and makes a considerable contribution to the taxation implications of the digital taxation framework in South Africa, by looking, amongst other legislation, at the impact of the new Electronic Service Regulation which took effect on 1 June 2014. This Regulation changes the way imported electronic services are taxed. This study is further interesting in that very little research has been done in this area, yet the Regulation seems to have far-reaching consequences in the way which Internet tax is assessed. Furthermore the study demystifies the legal and economic uncertainties surrounding global digital taxation.

Essentially, the findings may assist the SARS in identifying loopholes and lacunae in the digital taxation framework, particularly the Electronic Service Regulation and have regard to criticisms raised by tax practitioners that despite its noble intentions, the legislation remains half-baked and needs significant reform.

1.5 RESEARCH DESIGN AND METHODOLOGY

Thus this study employs a comparative approach that examines the South African framework against that of the US and countries in the EU in order to understand whether based on the premise of the global international digital taxation trends, the South African system needs reform. Cognisance is taken of the similarities and differences between other legal systems and the South African system in order to gain new knowledge which may be applied locally. Therefore, this legal methodology is critical in order to extend and validate the existing indigenous framework. A wide literature study is adopted in order to ascertain the theoretical parameters of the study. The study takes appreciable notice of Internet sources, reports and other findings of interest groups and organisations. Academic literature in the form of published journal articles, chapters in edited collections, and books are also be consulted. A division of importance will also be made between primary and secondary sources.

1.6 LIMITATIONS OF THE STUDY

It must be noted that the study is conducted within the constraints of the following limitations.

The study considers

- (1) only taxation relating to the digital economy;
- (2) only a comparison of the South African system with European and American systems;
- (3) the effect of any applicable international tax rules;
- (4) only income/revenue that is liable for tax in terms of the VAT ACT.

1.7 OVERVIEW OF CHAPTERS

The mini-thesis comprises four chapters, including this one.

Chapter II considers the relevant aspects at an international level by inspecting the power to tax, giving a summation of applicable international tax principles and policies including double tax agreements, advancing the reasons for taxing Internet sales, and explaining the roles of the various international organisations influencing tax policy.

Chapter III determines the implications of the South African digital tax framework and compares the South Africa digital tax system to the American and European digital tax models in an attempt to generate solutions for the local model.

Chapter IV furnishes a summary of the important facts, provides a conclusion and recommendation on whether the South African digital taxation framework should be reformed based on the effectiveness of the models espoused in Europe and in America, evaluates the study, and also provides solutions to problems surrounding the taxation of the digital economy.



CHAPTER 2

ISSUES SURROUNDING INTERNATIONAL DIGITAL TAXATION

‘Government’s view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving regulate it. And if it stops moving, subsidize it.’⁹⁰

Ronald Reagan

2.1 INTRODUCTION

‘The transition of the global economy from an industrial focus to one based on knowledge and information presents numerous opportunities and challenges to many countries, especially those in the developing world.’⁹¹ The Internet has played an instrumental role in this regard. There is now a new global wave of transacting on the Internet, effectuating a new regime in the way in which business is conducted. This wave has set off a new hype surrounding the ways in which goods and services are marketed and sold.

The term ‘e-commerce’ was coined to describe the assortment of commercial undertakings that facilitate trade without the limitation of geographical confines.⁹² E-commerce has had phenomenal growth, creating a world-wide network of virtual economies and trading systems.⁹³ Steyn, conducting an analysis on this information driven era, gave a very solid and nuanced view by stating that ‘in an information-driven era, taxpayers conducting business electronically realise that they face not only the risk of multiple taxation but also the serious risk of new or increased taxes’⁹⁴. According to Feinschreiber and Kent, increased or multiple taxes will contribute more than any other factor in inhibiting electronic commerce.⁹⁵ Feinschreiber and Kent note that ‘electronic commerce should not subject to higher or lower tax rates or to greater compliance

⁹⁰ BBC News ‘Ronald Reagan: In his own words’ available at <http://news.bbc.co.uk/2/hi/americas/3780871.stm> (accessed 31 May 2015).

⁹¹ Department of Communications Green Paper on Electronic Commerce (2000) 15.

⁹² Oguttu AW (2008) 348.

⁹³ Oguttu AW (2008) 348.

⁹⁴ Steyn T (2010) 210.

⁹⁵ Feinschreiber & Kent (2001) 5.

burdens'.⁹⁶ They note some of the principles to consider when effecting a tax such as non-discrimination, avoidance of excessive compliance obligations, simplicity, uniform classifications and consistency of rules.⁹⁷

Ward and Sipior state that over time technological innovations have been integrated into commercial undertakings, 'changing the products and services themselves, their delivery, and how processes underlying the completion of a transaction are performed'.⁹⁸ Ward and Sipior aver that a wide variety of products and services are bought and sold over digital platforms, thus raising complex tax issues.⁹⁹ They summed up the increasing complexity of global e-commerce taxation by highlighting new trends of borderless commerce, digital convergence, virtual organisations, automated transactions, and new business models that are characterised by multiple tax types and multiple government regulations.¹⁰⁰ Ward and Sipior are correct in their observations. The speed of e-commerce transactions, its efficiency, considerably lucrative revenues, a borderless environment, coupled with a lack of tax regulation in many jurisdictions make it lucrative for many merchants to trade online in more than one jurisdiction, thus raising the complexity of electronic commerce, not only at a national level but at a global level.¹⁰¹ Therefore, one can argue that taxing the Internet opens the proverbial can of worms.

Despite e-commerce taxation being a relatively new unit of analysis, it lends itself to distinctive issues as depicted above.¹⁰² This chapter thus analyses the pertinent issues surrounding the taxation of e-commerce, from a global perspective. This is done by considering why electronic commerce should or should not be taxed; exploring the power tax; discussing the overarching principles of tax policy that have in the past guided the development of tax systems; and analysing the role and development of tax organisations, bodies, treaties and conventions at an international level. Finally, it provides a conclusion on the current global e-commerce taxation landscape.

⁹⁶ Feinschreiber & Kent (2001) 5.

⁹⁷ Feinschreiber & Kent (2001) 5.

⁹⁸ Ward BT & Sipior JC (2004) 175.

⁹⁹ Ward BT & Sipior JC (2004) 175.

¹⁰⁰ Ward BT & Sipior JC (2004) 175.

¹⁰¹ Ferrette CP (2000) 1.

¹⁰² Ferrette CP (2000) 1.

2.2 WHY TAX THE INTERNET AT ALL?

Inevitably, when one considers the issues around the taxation of e-commerce, one will be confronted by the question: why tax the e-commerce at all? The answer to this question is neither simple, nor is it one to be made based on emotional considerations. An enquiry into the question can be approached by arguing both sides of the divide and thereafter taking the side that based on the evidence adduced, is noteworthy and holds more merit. According to Wiseman, the current debate on Internet taxation has placed an onus on scholars to establish why electronic commerce should or should not be taxed.¹⁰³ In this case, Wiseman believes that the Internet has a ubiquitous presence that cannot be ignored; its taxation therefore calls for increased attention on the subject matter.¹⁰⁴

Jones and Basu considered the question on whether e-commerce should be taxed in depth. They were of the opinion that a very simple answer to the question could be that until someone comes up with a better idea, taxation is the only practical means of raising the revenue to finance government spending on the goods and services that most of us demand.¹⁰⁵ However, the authors acknowledged that establishing an efficient and fair system is far from simple.¹⁰⁶ They raise a valid point in that at the heart of this issue lies the fact that governments want to tax electronic commerce to raise revenue to sustain government expenditure especially in the face of shrinking traditional tax bases.

Former Governor of California in the US, James Gilmore, argued the case that there should be a tax free zone on all electronic transactions.¹⁰⁷ He believed that the Internet was driving America's boom and that it was beyond dispute that the Internet is creating new jobs and business opportunities, as well as contributing to the steep stock market growth. It is against this backdrop that the Governor concluded in his proposal to the ACEC that because of the increased stimulus of economic activity, increased productivity which created new wealth, hence enhancing tax collection by governments, there was a need for governments to engage in a

¹⁰³ Wiseman AE *The Internet Economy: Access, Taxes, and Market Structure* 2ed (2010) 92.

¹⁰⁴ Morris IJ 'Creating an Online Internet Tax: A Complex Construction?' (2004) 2 *Northwestern Journal of Technology and Intellectual Property* 8.

¹⁰⁵ Jones R & Basu S 'Taxation of Electronic Commerce: A Developing problem' (2002) 16 *International Review of Law Computers* 35. This argument is also applicable to taxation in general.

¹⁰⁶ Jones & Basu (2002) 35.

¹⁰⁷ Gilmore JS 'No Internet Tax: A Proposal Submitted to the Policies & Options Paper of the Advisory Commission on Electronic Commerce' (1999) 5.

paradigm shift and not tax the Internet in validation of the maxim, the Internet changes everything.¹⁰⁸

Besides the views of scholars and legislators, the EU Commission in 1998, expressly stated that the EU VAT system should provide the legal certainty, simplicity and neutrality required for the full development of electronic commerce, for the provision of a competitive playing field for all traders in the developing global market place, and for the avoidance of market distortions.¹⁰⁹ Neutrality in this context entails that the consequence of taxation should be the same for transactions in goods and services, regardless of the mode of electronic commerce used or whether delivery is effected on-line or off-line.¹¹⁰

From the above brief observation, it can be noted that there is already a divergence of interesting opinions on whether or not e-commerce transactions should be taxed. This study shall now consider the arguments for taxing e-commerce, and those against taxing e-commerce.

2.2.1 A case for taxing Internet trade

There is no closed list of the advantages of taxing the Internet, but for the purposes of this study only two will be considered. These are: increasing online tax revenue, and the prevention of base erosion and profit shifting (BEPS). The reason for the choice of the two, for the purpose of this study, is their nexus to the need for governments to maintain and increase their tax bases, which has had growing importance in economies across the globe over the years.

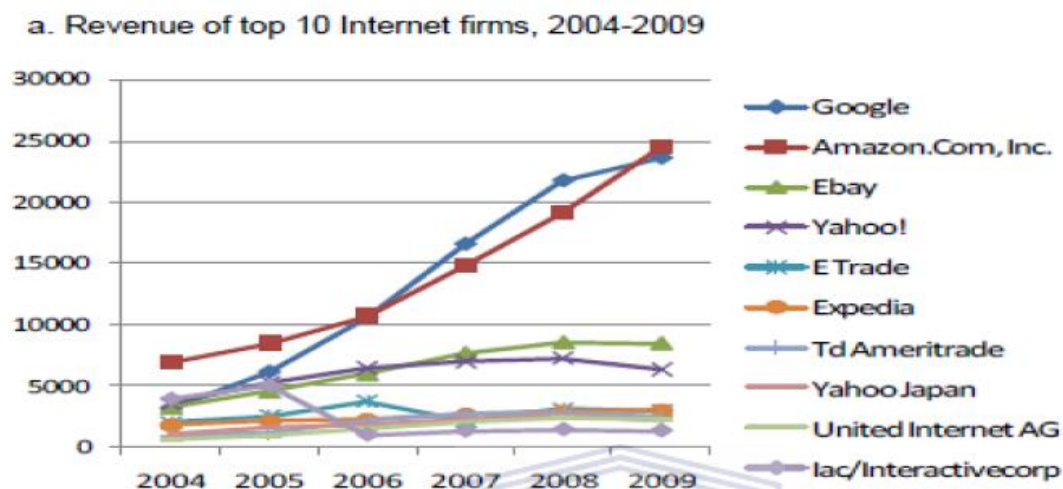
¹⁰⁸ Gilmore JS (1999) 5.

¹⁰⁹ Mc Lure 'The Nuttiness of State and Local Taxes and the Nuttiness of Responses Thereto' (2002) 25 *State Tax Notes* 841.

¹¹⁰ Mc Lure (2002) 841.

2.2.1.1 Increasing Online Tax Revenue

FIGURE 1: INTERNET FIRM REVENUES - IN US \$ MILLION



Source: OECD Information Technology Outlook Database

TABLE 1: INTERNET FIRM REVENUES - IN US \$ MILLION

b. Revenue of top 30 Internet firms, 2009

Amazon (US)	24,509	GMO internet (JP)	402
Google (US)	23,644	Stream Co. (JP)	306
Ebay (US)	8,475	Asos (UK)	303
Yahoo! (US)	6,304	Blue Nile (US)	265
Expedia (US)	3,011	Liquidity Services (US)	235
E Trade (US)	2,978	The9 Limited (CN)	209
Td Ameritrade (US)	2,423	Adlink Internet Media (DE)	193
United Internet AG (DE)	2,320	U.S. Auto Parts network (US)	174
Yahoo Japan (JP)	2,154	Dmail Group Spa (IT)	161
Netflix (US)	1,634	Shutterfly (US)	154
Iac/Interactivecorp (US)	1,345	Start Today (JP)	103
Findel (UK)	1,131	Internet Brands (US)	96
Manutan (FR)	735	Dreamnex (FR)	92
Valueclick (US)	527	Buch.De Internetstores (DE)	91
Rue Du Commerce (FR)	468	Internet Group (PL)	69

Source: OECD Information Technology Outlook Database

Since the beginning of e-commerce, the revenues of companies that trade on the Internet have surged dramatically, with the top Internet enterprises' net worth climbing to the (US\$) billions as a result of these high revenues. Consequently, these companies are now dominating global business markets, surpassing the revenues and net worth's of long established and prominent brick and mortar enterprises.¹¹¹

The growth of these Internet firms is clearly depicted in Figure 1. Amazon.com grew from just under US \$8 billion in 2004 to US \$24, 509 billion in 2009. This symbolises a growth in revenue of a shade over 400%. Google follows just a bit behind Amazon with an estimated revenue of around US \$4 billion in 2004 and US \$23, 644 billion in 2009. Google's growth over the period amounted to just over 550%. The growth of the other top Internet companies was not as substantial as that of Google and Amazon.com. Third placed Ebay grew from an estimated revenue of US \$4 billion to US \$8, 475 billion, which translates to a growth of just over a 100%. To date, Internet firms' revenues continue to increase significantly.¹¹² In 2014, the research done by Kutcher et al observed that 'it's no secret that growth matters for any company and that software and online-services companies grow faster than those in other sectors'.¹¹³ Statistical evidence provides decisive proof of the growth of this infant industry (Internet firms). By 2014, there were 612 Internet companies valued between US\$ 100 million – 200 million each, and 73 companies valued between US\$ 1 billion – US \$1.5 billion each.¹¹⁴

In the face of increased e-commerce revenues, governments are then faced with a decision on whether to tax these revenues against the opportunity costs of not taxing them and stimulating an infant industry, thus setting it on an increasing growth trajectory. Therefore, a strong case can then be made to tax e-commerce to finance government expenditure on key matters such, as government capital expenditure on infrastructure development.

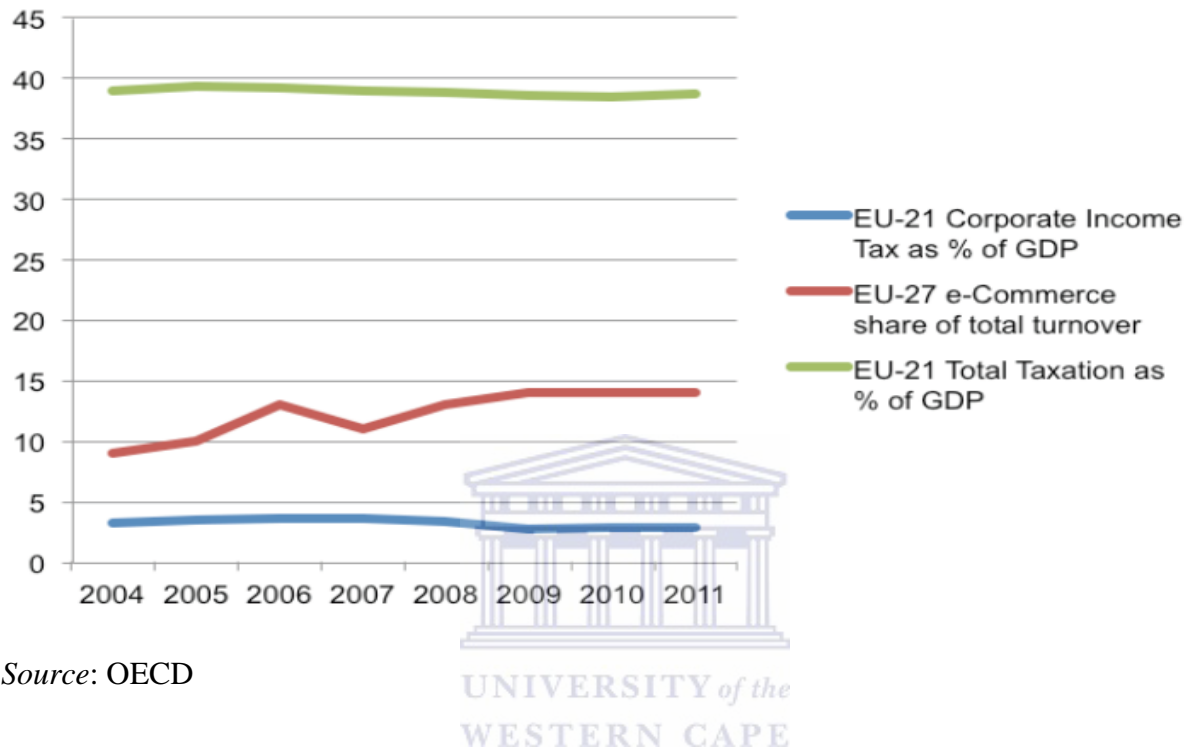
¹¹¹ Zook M *The Geography of the Internet Industry* 2 ed (2008) 6.

¹¹² Geron T 'America's Fastest Growing Tech Companies 2013' available at <http://www.forbes.com/sites/tomiogeron/2013/06/05/americas-fastest-growing-tech-companies-2013/> (accessed 29 May 2015). See also Kutcher et al 'Grow fast or die slow' available at http://www.mckinsey.com/insights/high_tech_telecoms_internet/grow_fast_or_die_slow (accessed 29 May 2015).

¹¹³ Kutcher et al 'Grow fast or die slow' available at http://www.mckinsey.com/insights/high_tech_telecoms_internet/grow_fast_or_die_slow (accessed 29 May 2015).

¹¹⁴ Kutcher et al 'Grow fast or die slow' available at http://www.mckinsey.com/insights/high_tech_telecoms_internet/grow_fast_or_die_slow (accessed 29 May 2015).

FIGURE 2: E-COMMERCE SALES SHARE OF TOTAL TURNOVER VS CORPORATE INCOME TAX AS A % OF GDP



Source: OECD

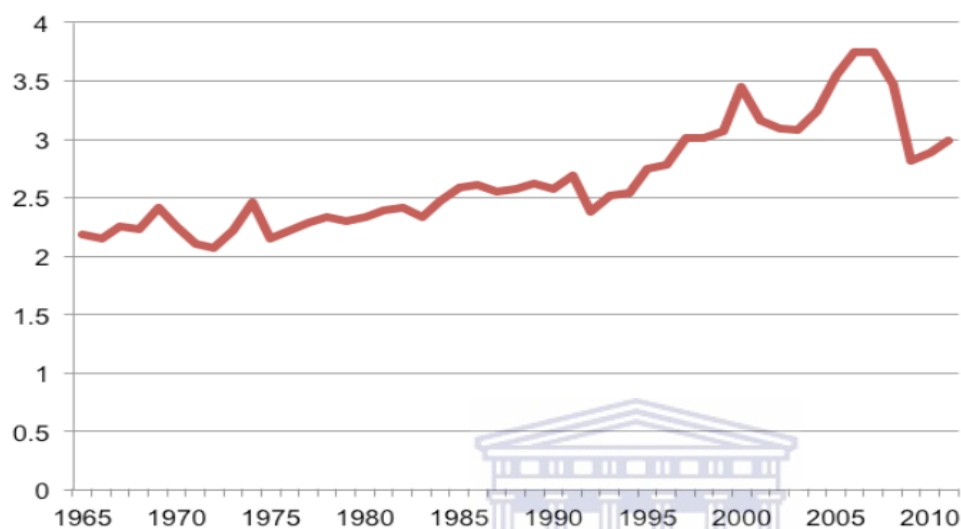
An analysis of whether or not to tax e-commerce revenues cannot simply be reduced to a consideration of Internet firms only as ordinary brick and mortar institutions have also moved some of their business online. These corporates have also enjoyed some of the benefits of conducting business online and have received income from trading online.

Narrowing the focus of the analysis to just the OECD countries, we turn to Figure 2 above. Figure 2 shows that e-commerce revenue has made marginal increases in the period 2004 – 2011 when considered as a percentage of corporate income. The e-commerce share of corporate income increased from around 9% in 2004 to around 14% in 2011. This reinforces the position that the Internet is now a trading platform where firms can earn considerable revenues.

Having regard to Figure 3 below, we realise that from 1965, corporate tax revenues are increasingly occupying an increasing share of the Gross Domestic Product (GDP) of the OECD countries. This gives an indication that in the future, Internet revenues will continue to be a

lucrative area for the extension of the taxman's arm in jurisdictions where it's already not taxed or when there has been less than adequate enforcement of its taxation.

FIGURE 3: CORPORATE INCOME TAX REVENUES AS % OF GDP (OECD COUNTRIES, 1965 - 2011)



Source: OECD, 2013



2.2.1.2 Preventing Base Erosion and Profit Shifting (BEPS)

For a protracted period of time there have been concerns that global computer-based communications cut across territorial borders, creating a realm of human activity that undermines the feasibility and legitimacy of laws based on geographic boundaries.¹¹⁵ The OECD then conceived the term 'BEPS' in a bid to implement an action plan at the behest of the G20.¹¹⁶ Profit shifting refers to the practices of multinational companies, who play off national taxation rules against each other and shift profits (and costs) between jurisdictions to ultimately achieve

¹¹⁵ Davis Tax Committee Interim Report 2014 – Addressing Base Erosion and Profit Shifting in South Africa (2014) 1.

¹¹⁶ See OECD 'About Base Erosion and Profit Shifting (BEPS)' available at <http://www.oecd.org/ctp/beps-about.htm> (accessed 16 March 2016). The G20 is an informal group of 19 countries and the EU, with representatives of the International Monetary Fund and the World Bank.

non-taxation of their income.¹¹⁷ Base erosion on the other hand refers to the resulting erosive effect on tax bases.¹¹⁸

Revenue lost through the digital economy is a growing concern for governments internationally that lose substantial corporate tax revenue because of arrangements implemented by multinational enterprises which shift profits to low tax jurisdictions, thus eroding the taxable base.¹¹⁹ An example of such harmful practices is the case of Internet based companies such as Google, which can collect data in one country and sell it to another, with such revenues being syphoned to low tax jurisdictions.¹²⁰

The G20 leaders in sanctioning the BEPS Action Plan noted:

‘In a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes is more than ever a priority. Tax avoidance, harmful practices and aggressive tax planning have to be tackled. The growth of the digital economy also poses challenges for international taxation.’¹²¹

Therefore, a case can be made that taxing the Internet efficiently will ensure that the sanctity of national tax bases is maintained and prevent the shift of profits within a tightening global economy. The next section will consider the demerits of taxing the Internet.

2.2.2 Is taxing the e-commerce crossing the Rubicon? A case for not taxing the Internet

While some advocates in America claim that tax-free Internet commerce amounts to mass tax evasion, others believe that there are benefits and reasons to not tax the Internet.¹²² Margaret Mitchell stated that ‘death, taxes and childbirth! There is never any convenient time for them’.¹²³ Kobrin and Wagner share similar but more radical sentiments than Mitchell, postulating that the

¹¹⁷ Makiyama & Vershelde ‘OECD BEPS: Reconciling Global Trade, Taxation Principles and The Digital Economy’ (2014) 4 *Ecipe Occasional Paper* 2.

¹¹⁸ Makiyama & Vershelde (2014) 2.

¹¹⁹ Davis Tax Committee Interim Report (2014) 1.

¹²⁰ Davis Tax Committee Interim Report (2014) 5.

¹²¹ Davis Tax Committee Interim Report (2014) 5.

¹²² Isidro IM ‘Internet Taxation: Which side are you on?’ available at <http://www.powerhomebiz.com/vol4/internet-taxation.htm> (accessed 28 February 2015).

¹²³ Cited Morris IJ (2004) 1.

mantra of those who partake in e-commerce seems to be that ‘if you tax us, you will kill us’.¹²⁴ In the face of these arguments, the three main reasons from a tax law perspective why the Internet should not be taxed will be explored.

2.2.2.1 Consumers need a tax break

The global economic crunch that began in 2008 left many deep holes in the pockets of consumers.¹²⁵ With many losing their jobs, others becoming contract workers, and some suffering wage cuts,¹²⁶ the effects of the crisis are still fresh in the minds of many. On top of having to deal with slowly responding economies, consumers have had to deal with numerous taxes ranging from VAT to personal gains taxes. Consumers simply have had enough taxes and need relief from paying taxes. The protests in Hungary over a proposed tax on Internet data traffic were a clear indication that consumers have had it up with taxes.¹²⁷ Consumers simply do not want further financial encumbrance through Internet taxes.¹²⁸

Governments across the globe continue to hike existing tax rates to cater for increased government expenditure.¹²⁹ In South Africa, this was evidenced by the recent increase in income tax.¹³⁰ Finance Minister Nhlanhla Nene told Parliament in a budget speech that taxpayers would cough up an extra percentage point on Personal Income Tax in a bid to enable the government to raise R12 billion in 2015, and another R15 billion in 2016.¹³¹ According to the International Labour Organisation, the projected unemployment rate in South Africa was at a record high of 25.7% in 2015. In this light, one can only acknowledge that there are tough times ahead for

¹²⁴ Kobrin SJ & Wagner E ‘Taxing Internet Transactions’ (2000) 21 *University of Pennsylvania Journal of International Economic Law* 666.

¹²⁵ Gokay B ‘The 2008 World Economic Crisis: Global shifts and faultlines’ available at <http://www.globalresearch.ca/the-2008-world-economic-crisis-global-shifts-and-faultlines/12283> (accessed 31 May 2015).

¹²⁶ ‘Worst cuts in wages for UK workers in the deepest recession since WWII, IFS shows’ available at <http://rt.com/news/workers-cut-wages-recession-570/> (accessed 31 March 2015).

¹²⁷ BBC News ‘Hungary Internet Tax Cancelled After Mass Protests’ available at <http://www.bbc.com/news/world-europe-29846285> (accessed 29 May 2015).

¹²⁸ BBC News ‘Hungary Internet Tax Cancelled After Mass Protests’ available at <http://www.bbc.com/news/world-europe-29846285> (accessed 29 May 2015).

¹²⁹ IMF ‘Budget Processes and Commitment to Fiscal Discipline’ (1996) *IMF Working Paper WP/96/78* i.

¹³⁰ SouthAfrica.info ‘Budget 2015: South Africa raises income tax’ available at http://www.southafrica.info/news/budget-260215.htm#.VPI2x_mUf7o (accessed 28 February 2015).

¹³¹ Cited in SouthAfrica.info ‘Budget 2015: South Africa raises income tax’ available at http://www.southafrica.info/news/budget-260215.htm#.VPI2x_mUf7o (accessed 28 February 2015).

consumers.¹³² A break from taxing the Internet would surely bring consumers a much needed break in taxes. Besides giving consumers a break from taxes, there might be something worthy in the protection of this growing industry.

2.2.2.2 Protection of a growing industry

‘The internet is changing the way we work, socialise, create and share information, and organise the flow of people, ideas, and things around the globe.’¹³³ According to Manyika and Roxburgh, by 2011, the Internet accounted for 21% of the GDP growth of mature economies for the previous five years.¹³⁴ These authors however contend that, despite the considerable growth of the Internet, ‘we are still in the early stages of the transformations the Internet will unleash and the opportunities it will foster.’¹³⁵ It is against this backdrop that the primary argument of the opponents of e-commerce taxation is that a ban on such taxation is necessary to encourage the dispersal of this beneficial technology.¹³⁶ These proponents of a tax free Internet claim that the Internet is so important a technology that States should not discourage its growth through taxation.¹³⁷ Manyika and Roxburgh believe the argument for protecting the Internet from tax as a growing industry by saying that, ‘governments policy makers, and businesses must recognize and embrace the enormous opportunities the Internet can create,’¹³⁸ especially when left untaxed and encouraged to grow. Other than protecting a growing industry and giving consumers a tax break, there are also efficiency considerations at play.

2.2.2.3 Efficiency considerations

When considering whether to tax or not to tax e-commerce, it is paramount to consider a number of efficiency questions that have not yet received significant attention either in academic

¹³² Cited Fin24.com ‘SA among top 10 with highest unemployment’ available at <http://www.fin24.com/Economy/SA-among-top-10-with-highest-unemployment-20150120> (accessed 1 March 2015).

¹³³ Manyika R & Roxburgh R ‘The great transformer: The impact of the Internet on economic growth and prosperity’ (2011) *McKinsey Global Institute* 1.

¹³⁴ Manyika R & Roxburgh R (2011) 1.

¹³⁵ Basu S *Global Perspectives on E-commerce Taxation Law* 2 ed (2013) 203.

¹³⁶ Schafer CJ ‘Federal Legislation Regarding Taxation Of Internet Sales Transactions’ (2001) 16 *Berkely Technology Law Journal* 18.

¹³⁷ Schafer CJ (2001) 8.

¹³⁸ Manyika R & Roxburgh R (2011) 1.

literature or the popular press.¹³⁹ A view that has been maintained amongst economists postulates that a good tax minimises distortions in consumer behaviour.¹⁴⁰ The tax of Internet transactions will likely amplify the efficiency losses from altered consumer behaviour.¹⁴¹

It is important to note that taxing the Internet will result in compliance costs for taxpayers. An example is when a seller in Canada sells electronic services to a consumer in South Africa. The seller will thus have to register as a VAT vendor in South Africa.¹⁴² This compliance burden can further be viewed from the perspective of a borderless environment. This is essentially problematic in the case of information or software downloaded over the Internet, with the Internet as the sole medium of delivery.¹⁴³ The implications of this are that businesses would then be required to track various tax rates for their sales as well as the taxability of various items in different jurisdictions.¹⁴⁴

Furthermore, large scale use of virtual business arrangements enhances the possibilities of self-employment or multiple employers, either of which would make it challenging to achieve efficient tax collection.¹⁴⁵ Economists have for the last half a century been preoccupied by the question of how to design a minimally efficiency-distorting tax system.¹⁴⁶ Globalisation and trade liberalisation, despite their successes, have thus put a constraint on the policy space for domestic regulators.¹⁴⁷

Up to this point, this chapter has given an introduction to the issues surrounding taxing the Internet on a global scale, posed the question why it is necessary to tax the Internet, and furnished the arguments for and against taxing the Internet. The next question therefore to be answered by this paper is: Where does the power to tax come from?

¹³⁹ Bruce D, Fox W & Murray M 'To Tax Or Not To Tax? The Case Of Electronic Commerce' (2003) 21 *Contemporary Economic Policy* 32-3.

¹⁴⁰ Maguire S *State of Internet Transactions* (2011) 14.

¹⁴¹ Maguire (2011) 14.

¹⁴² If the business is earning more than R 1 million per year, then they must register as a VAT vendor. Voluntary registration is also possible if the business had a revenue of not less than R20 000 in the past year. Nonetheless, the VAT vendor, voluntary or compulsory, must collect VAT for SARS. Such business must declare to SARS how much revenue has been made.

¹⁴³ Redpath IJ, Redpath EM & Ryan K 'Sales and Use Tax in E-commerce: Where are we and what needs to be done' (2007) 24 *Information Systems Management* 243.

¹⁴⁴ Redpath *et al* (2007) 24.

¹⁴⁵ Lymer A (2000) 5.

¹⁴⁶ Makiyama H & Vershelde B (2014) 10.

¹⁴⁷ Makiyama H & Vershelde B (2014) 10.

2.3 THE POWER TO TAX

The power to tax, sometimes referred as the jurisdiction to tax, is a concept that is central to the issue of taxation. The power to tax can best be explained by following its historical footprint and development.

The idea of taxation developed closely together with the idea of an orderly society and the institution of a government with authority.¹⁴⁸ Around 3000 BCE- 2800 BCE, the first tax system could be found in Ancient Egypt, where the Pharaoh conducted a biennial tour of the kingdom collecting tax, which was at some point calculated by measuring the rise and fall of the Nile River.¹⁴⁹ From this point onwards, traces of taxing were found in several different other societies, including the Roman and Greek empires, with the first extensive tax being imposed in the Roman empire on Roman citizens based on heads (*capita*) and land (*iuga*), to provide funding for the increased expenditure of the Republic.¹⁵⁰

From these early stages taxation continued to develop up to the Middle Ages where taxation was idealised as an inherent and indispensable power of the government to coerce its subjects to surrender their property without their consent.¹⁵¹ Tax on household property was developed, which led to further developments in the notion of tax on expenditure, which later transposed into taxation of net profits, or income in today's modern tax systems.

In the modern era, governments still impose taxes. Unlike in Roman times when tax was imposed on Roman citizens only, 21st century taxing systems do not simply assign tax liability to citizens of a particular country, but also impose on foreign nationals and businesses whose income has an originating cause in that country. The surfacing of e-commerce has simplified the process for consumers to obtain goods and services from outside their jurisdiction.¹⁵²

An example could be that a person in South Africa could easily buy an Apple computer by importing it from America. The question then arises in such a global environment: Does the government of the seller have a right to allocate tax to the transaction or, alternatively, does the

¹⁴⁸ Oguttu & Miller (2013) 2.

¹⁴⁹ Oguttu & Miller (2013) 2.

¹⁵⁰ Oguttu & Miller (2013) 2.

¹⁵¹ Oguttu & Miller (2013) 2.

¹⁵² Steyn (2010) 231.

government of the purchaser have a right to levy a tax on the transaction? Answers to this question can then be supplied by assessing the nature and extent of the tax/power to tax.

A country only has the power to tax the income from a particular transaction if it can establish a connection, or a tax nexus, between itself and the income.¹⁵³ When establishing a nexus, there are currently two schools of thought. The first school of thought proposes that the source of the transaction is the connecting factor; and thus persons are taxed on income that originates from their territorial or geographic confines.¹⁵⁴ The second school of thought looks at residence. In terms of the residence principle a State to tax its citizens on their world-wide income.¹⁵⁵ To date, there is no general consensus on which of the schools of thought should take precedence. This section has identified the source of a government's power to tax; the next section discusses the applicable tax principles.

2.4 APPLICABLE TAX PRINCIPLES

There are principles of international taxation, some of which 'are basic principles of tax theory and policy, although they have a specific meaning in the international taxation context, and in particular within the taxation of e-commerce'.¹⁵⁶ These tax principles can generally be categorised in one of two ways, namely, those dealing with efficiency¹⁵⁷ and those dealing with fairness. Application of the two categories is usually in pursuit of the protection of heterogeneous interests; and therefore no tax system can be efficient while at the same time being completely fair. Despite tax principles having only an advisory character, they have been instrumental in the development of local regulatory frameworks. According to Basu, there is a general consensus in the area of public finance that a tax system should be designed according to the principles of neutrality, efficiency, certainty, simplicity, effectiveness, fairness and flexibility.¹⁵⁸ These principles presented by Basu will now be briefly discussed. Several

¹⁵³ Oguttu AW & Van der Merwe B (2005) 305.

¹⁵⁴ Oguttu AW & Van der Merwe B (2005) 306.

¹⁵⁵ See Chapter 1.1 of this paper.

¹⁵⁶ Choudhary V (2011) 36.

¹⁵⁷ Tax efficiency minimises the cost of complying with the tax code by reducing its administrative burden and by minimising the distortions in the economy caused by the tax. See 'Taxation: efficiency and equity' available at <http://thismatter.com/economics/taxation.htm> (accessed 31 May 2015).

¹⁵⁸ Basu S *Global Perspectives on E-commerce Taxation Law* 1 ed (2007) 82.

principles have been discussed together in the same sections for the reasons of practical necessity. The principle of efficiency will be discussed first.

2.4.1 Efficiency

‘Taxation is not only a pure transfer of resources from the private sector to the state, but it also affects the behaviour of the tax payer. The efficiency principle encompasses notions of both fiscal efficiency and economic efficiency.’¹⁵⁹ Fiscal efficiency looks at any system that can be administered as a low and cost-free process, while economic efficiency considers the maximisation of economic output given the resources at the disposal of the community.¹⁶⁰ Efficiency is therefore heavily connected to compliance costs. An efficient tax system must therefore ensure that compliance costs for the taxpayer and administrative costs for the tax authorities are minimised as far as possible.¹⁶¹ Looked at through this prism of cost minimisation, a tax should be able to leave economic behaviour unaffected.¹⁶² From a practical standpoint, if governments were to avoid distortion in economic behaviour and not tax the Internet, governments in the future would be unable to realise substantial revenues to fund socially useful expenditure without generating considerable inequity.¹⁶³ Despite being efficient, a tax must also be neutral. The principle of tax neutrality is now considered.

2.4.2 Principle of tax neutrality

In principle, tax neutrality requires that taxation rules should not affect economic choices.¹⁶⁴ Business decisions should be motivated by economic rather than tax considerations.¹⁶⁵ The principle of tax neutrality therefore belongs to the efficiency category.¹⁶⁶ In essence, the same taxation principles that apply to income from conventional ways of conducting business should also apply to income from e-commerce transactions.¹⁶⁷ Chan believes that if conventional

¹⁵⁹ Basu S (2007) 82.

¹⁶⁰ Basu S (2007) 82.

¹⁶¹ Silifais K ‘Taxation of E-commerce a task for jugglers’ (2007) 1 *Masaryk Journal of Law and Technology* 148.

¹⁶² Basu S (2007) 82.

¹⁶³ Basu S (2007) 82.

¹⁶⁴ Basu S (2001) 10.

¹⁶⁵ Silifais K (2007) 148.

¹⁶⁶ Choudhary V (2011) 36.

¹⁶⁷ Basu S (2001) 10.

taxation principles are applied to e-commerce transactions, this would place e-commerce at a competitive disadvantage relative to other modes of commerce, defeating one of the purposes of an equitable tax system.¹⁶⁸ Chan argues that the ‘practical application of the principle of tax neutrality, then, would be a position that no “new” taxes should be placed on e-commerce transactions’.¹⁶⁹

Chan’s averments are debatable, as counter-arguments can be raised against them. To begin with, the current non-taxation of electronic commerce could be viewed as a violation of the principle of tax neutrality, as for example, a specific good or service sold in a brick and mortar institution is subject to tax while the same product or service sold online is not subject to tax. This distortion tilts the scales in favour of a particular economic choice, namely purchasing a product or service online.¹⁷⁰ Another argument could also be that ‘the same principles of taxation should apply to all forms of business, while addressing specific features that may otherwise undermine an equal and neutral application of those principles’.¹⁷¹ Therefore, for the principle of neutrality to be given effect on the e-commerce landscape, electronic commerce must be taxed, not by new tax or additional taxes, but by adapting existing tax rules and principles to treat the income earned from income earned through electronic transaction similarly to from existing channels of commerce.¹⁷² This must however be done bearing in mind any issues that may affect the neutrality of such a tax.¹⁷³ Gutuza concedes that in reality, it is clear that a tax system is unlikely to be completely neutral.¹⁷⁴ The principles of certainty, simplicity, flexibility, and effectiveness will now be considered.¹⁷⁵

¹⁶⁸ Chan CW (1999) 244.

¹⁶⁹ Chan CW (1999) 244.

¹⁷⁰ OECD ‘Addressing the Challenges of the Digital Economy’ (2014) *OECD Publishing* 30.

¹⁷¹ OECD (2014) 30.

¹⁷² Dunahoo C ‘Electronic Commerce and Tax Neutrality: Current Vat Issues’ available at <http://www.ilpf.org/events/jurisdiction/presentations/dunahoopr.htm> accessed 29 June 2015.

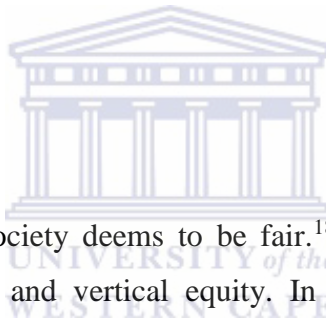
¹⁷³ Brox J & Fader C ‘Forecasting Tax Implications of B2C E-commerce’ (1999) 3. Unpublished paper.

¹⁷⁴ Gutuza T *An Analysis of the Methods Used in the South African Domestic Legislation and in Double Taxation Treaties Entered into by South Africa for the elimination of International Double Taxation* (unpublished DPhil thesis, University of Cape Town, 2013) 37.

¹⁷⁵ These principles were grouped together because they all fall under the category of efficiency principle.

2.4.3 Certainty, simplicity, flexibility and effectiveness

Taxation should be as simple as possible.¹⁷⁶ Taxpayers want a degree of certainty when they conclude their transactions. Tax rules should be clear and simple in order to facilitate this degree of certainty, particularly with regard to tax consequences.¹⁷⁷ This therefore includes the knowledge of how, when and where a transaction would be taken into account. Furthermore, costs of compliance and administration ought to be practical. Where the costs of enforcing a particular policy are not practical, then there will be a need to reengineer the policy.¹⁷⁸ The systems for taxation should be flexible and dynamic in order to guarantee that they remain at par with the developments in commerce and technology.¹⁷⁹ A tax should also be effective. Taxation should produce the right amount of tax at the right time.¹⁸⁰ The potential for evasion and avoidance should be minimised and counteracting measures should be proportionate to the risks involved.¹⁸¹ Despite being efficient, taxes must also be fair. The next section debates the principles of equity and fairness.



2.4.4 Equity and fairness

Equity in simple terms is what society deems to be fair.¹⁸² There are two types of taxpayer equity, namely, horizontal equity and vertical equity. In simple terms, horizontal equity is satisfied when people with an equitae ability to pay a tax end up paying the same tax.¹⁸³ Conversely, vertical equity is fulfilled when people with a 'greater ability to pay end up paying the appropriate amount more than people with a lesser ability to pay'.¹⁸⁴ There is a general consensus that taxes should not be regressive in manner and form in that they draw a larger portion of the income of those with lower incomes.¹⁸⁵ From an e-commerce perspective, the

¹⁷⁶ Mc Lure CE (2000) 2.

¹⁷⁷ SA Green Paper on Electronic Commerce (2000) 31.

¹⁷⁸ Mc Lure CE 'Should We Fix Sales Tax or Discard It' (2000) 77 *Brigham Young University Law Review* 79.

¹⁷⁹ SA Green Paper on Electronic Commerce (2000) 31.

¹⁸⁰ SA Green Paper on Electronic Commerce (2000) 31.

¹⁸¹ SA Green Paper on Electronic Commerce (2000) 31.

¹⁸² Mc Lure CE (2000) 79.

¹⁸³ Basu S (2007) 86.

¹⁸⁴ Basu S (2007) 82.

¹⁸⁵ Cited Mc Lure CE (2000) 79.

application of taxpayer equity would imply that transactions conducted online should therefore be treated as equally as transactions that were effected in a brick and mortar institution.¹⁸⁶

‘The principle of equity is often viewed as a fairness principle.’¹⁸⁷ A tax should inherently be perceived as fair, despite the subjectivity associated with the word ‘fairness’. Basu notes that there is ‘a widespread agreement that high-income individuals should pay their share of taxes and low income individuals should not be burdened with excessive taxation’.¹⁸⁸ The author draws from the literature that there is however less agreement on ‘exactly what a high-income individual’s share of taxes is and to what degree low-income individuals should be able to avoid taxation on equity grounds’.¹⁸⁹ From a taxing the Internet perspective, could it be possible that consumers can be taxed based on their income? Or should consumers be taxed according to the volumes of their transactions? Maybe there is a need for future research on how the principles of fairness and equity find application in regulating the taxability of the online realm? Considering the above arguments, maybe the arguments adduced by Basu should be accepted with caution. Another principle which is closely related to equity is inter-nation equity.

2.4.5 Inter-nation equity

There is a very close nexus between the principle of equity and inter-nation equity. Inter-nation equity means that there is an equitable division of tax revenue between sovereign nations.¹⁹⁰ The principle assumes that the source country and the residence country both make a contribution to the creation of value in cross-border transactions.¹⁹¹ This process is however heavily reliant on the allocation of taxable activities between the source country and the residence country, as well as the tax rate in the source country.¹⁹² In order to ensure the distribution of tax revenue amongst various countries, mutual co-operation through double tax agreements or an international tax body is required.¹⁹³

¹⁸⁶ Cited Choudhary V (2011) 36.

¹⁸⁷ Basu S (2007) 82.

¹⁸⁸ Basu S (2007) 82.

¹⁸⁹ Basu S (2007) 82.

¹⁹⁰ Cited Lexner KD ‘Selected Issues in the Denmark-US Tax Treaty’ (2011) 61 *Tax Notes International* 611.

¹⁹¹ Choudhary (2011) 36.

¹⁹² Lexner KD (2011) 611.

¹⁹³ Gutuza T (2013) 37.

The purpose of double tax agreements between two nations is to enable the administrations to eliminate double taxation.¹⁹⁴ These agreements play an important role because ‘if a resident in one country earns income from a source in another country, double taxation is likely to result because one country will tax that income on a source basis and the other country on a residence basis’.¹⁹⁵ Most of these treaties are of bilateral nature and then serve as an exception to the internationally accepted regime that the source country has the prior right to tax and the residence country is in charge of unburdening the double taxation.¹⁹⁶

The growth of cyber-transacting and e-commerce have reduced the certainty of the application of the principle of inter-nation equity. This is so because e-commerce has blurred the line between a source¹⁹⁷ and a residence country,¹⁹⁸ as it becomes increasingly difficult to identify the source country.¹⁹⁹

In practice, it becomes difficult to concurrently apply all the principles discussed above, as there are trade-offs’ existing amongst them.²⁰⁰ For the purposes of this paper, it is not necessary to delve into the economics behind the trade-off of the principles, but just to note that some of the principles may be contradictory.²⁰¹ With the multiplicity of these international tax principles, it becomes important to consider whether there are any international bodies or conventions dealing with the application of these principles. The next part considers the development of these organisations, as well as their roles and the conventions that apply to them.

¹⁹⁴ SARS ‘Double Taxation Agreements (DTAS) & Protocols’ available at <http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/default.aspx> (accessed 29 June 2015).

¹⁹⁵ Thuronyi V *Tax Law Design and Drafting* Vol 2 (1998) 722.

¹⁹⁶ Thuronyi V (1998) 722.

¹⁹⁷ A source-based method of taxation places different economic activities into various categories and taxes the income at the place giving rise to the activity. See Chapter 1.1 for detailed discussion on source rules.

¹⁹⁸ A residence based taxation allows a sovereign to tax its residents on their worldwide income. See Chapter 1.1 for detail discussion on residence rules.

¹⁹⁹ Choudhary V (2011) 36.

²⁰⁰ Basu S (2007) 82.

²⁰¹ Basu S (2007) 82.

2.5 THE ROLE AND DEVELOPMENT OF INTERNATIONAL TAX ORGANISATIONS, BODIES AND CONVENTIONS

More often than not, tax treaties are drafted using the guidelines of tax conventions.²⁰² The two main models are the OECD Model and the United Nations Model. The discussion of these organisations and conventions is by no means exhaustive, but rather seeks to give an overview from a taxing perspective. This section will look at: the origin of the OECD, explore the origin of its Model Tax Convention, consider the role of the OECD and its model law, look at the response of the OECD to digital tax concerns, examine the role of the OECD Convention on Mutual Administrative Assistance on Tax Matters; and consider the UN Double Taxation Convention. There will be a strong focus on the OECD and its conventions because of their wide application, and because the OECD Model Convention served as the basis of the original draft of the United Nations Model Convention.²⁰³ We turn to the origin of the OECD.

2.5.1 The OECD

2.5.1.1 Origin

The OECD was founded on 30 September 1961.²⁰⁴ However, its history can be traced back to the First World War.²⁰⁵ After the ravaging effects of the war, the Organisation for European Economic Cooperation (OEEC) was established in 1948 to spearhead the US-funded Marshall Plan, with an aim of reconstructing war-torn Europe.²⁰⁶ The OEEC encouraged its Member State governments to recognise and acknowledge the importance of the interconnectedness of their economies, thus charting a new era of cooperation that would in future change the face of Europe.²⁰⁷ In view of the success of the OEEC, and future prospects in a global arena, the US

²⁰² Gautrin C 'Basic Introduction to Tax Treaties' (2009) 17 *Willamette Journal of International Law and Dispute Resolution* 158.

²⁰³ Sung-Soo H 'The Harmonisation of Tax Treaties and Domestic Law' (2011) 7 *Brigham Young University International Law & Management Review* 29.

²⁰⁴ Love P 'The OECD's origins in the trenches' available at <http://oecdinsights.org/2014/11/11/the-oecd-origins-in-the-trenches/> (accessed 29 March 2015).

²⁰⁵ Love P 'The OECD's origins in the trenches' available at <http://oecdinsights.org/2014/11/11/the-oecd-origins-in-the-trenches/> (accessed 29 March 2015).

²⁰⁶ OECD 'History' available at <http://www.oecd.org/about/history/> (accessed 29 March 2015).

²⁰⁷ OECD 'History' available at <http://www.oecd.org/about/history/> (accessed 29 March 2015).

and Canada joined the OEEC Member States in signing the OECD Convention on 14 December 1960.²⁰⁸

Since then, the membership of the OECD has grown and today 34 nations work hand in hand to identify critical challenges facing our times, and generate policies to help address these problems.²⁰⁹ The OECD since its inception has taken active strides to address the problems of its Members, with significant progress being made in this regard. The US has, since joining the OECD, tripled its GDP per capita wealth, with similar progress being made by other Member States.²¹⁰ With the partnership forged with some of the emerging economies such as Brazil, India, Indonesia, China and South Africa, the OECD brings to the table about 40 countries that account for up to 80% of world trade.²¹¹ Now that the origin of the OECD has been established, the next part reviews the origin of the OECD Model Tax Convention.

2.5.1.2 Origin of the OECD Model Tax Convention

The tax treaty system has advanced since the efforts made by the League of Nations.²¹² In order for international trade and investment to bloom, there must be legal certainty.²¹³ This legal certainty requires a highly standardised network of bilateral tax treaties.²¹⁴ In this light, the OEEC, the OECD, and the UN's Economic and Social Council have constructed, laid out and published model tax treaties coupled with commentaries.²¹⁵ The OEEC adopted the first recommendation with regard to double taxation on 25 February 1955.²¹⁶ At this stage, only 70 bilateral general conventions had been signed between countries that now form part of the OECD.²¹⁷ The problem with this Convention was that it was not binding on its signatories. It was these shortcomings that led the Fiscal Committee to undertake in 1956 to work toward a

²⁰⁸ OECD 'History' available at <http://www.oecd.org/about/history/> (accessed 29 March 2015).

²⁰⁹ OECD 'History' available at <http://www.oecd.org/about/history/> (accessed 29 March 2015).

²¹⁰ OECD 'History' available at <http://www.oecd.org/about/history/> (accessed 29 March 2015).

²¹¹ OECD 'History' available at <http://www.oecd.org/about/history/> (accessed 29 March 2015).

²¹² Kobetsky M *International Taxation of Permanent Establishments: Principles and Policy* (2011) ch 5.

²¹³ Douma S and Engelen FA *The Legal Status of OECD Commentaries* Vol 1 (2008) 255.

²¹⁴ Douma S and Engelen FA (2008) 255.

²¹⁵ Douma S and Engelen FA (2008) 255.

²¹⁶ OECD Model Tax Convention on Income Tax and Capital Condensed Version, 2014 (2014) OECD Publishing 7.

²¹⁷ Model Tax Convention Condensed Version (2014) 7.

draft convention that would effectively resolve the double taxation problems between OECD countries, and that would be acceptable to all Member States.²¹⁸

A draft convention was completed in 1963 with the final product being completed in 1977, forging towards a new era of Model Tax conventions and commentaries.²¹⁹ From this stage, the OECD model continued to grow. Currently, the OECD Model takes centre stage in the tax treaty system of OECD countries.²²⁰ This represents a paradigm shift in the way countries view their jurisdiction to tax, and their sovereignty.²²¹ Kobetsky notes that the implementation of the OECD Model and Commentary in the tax treaties of both OECD and non- OECD countries is a considerable achievement.²²² By 2008, there were over 3000 tax treaties across the globe which are based on the OECD model.²²³ With the OECD Model Tax Convention taking centre-stage in the global forum, its role will be discussed next.

2.5.1.3 Role of the OECD & Its Model Tax Convention

The OECD Model Tax Convention aims to champion, ‘clarify, standardise, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial or any other activities in other countries through the application of identical solutions’.²²⁴ Generally, the Model Tax Convention of the OECD attempts to provide a common set of rules that national jurisdictions can follow to escape the possibility of double taxation of income and capital, and stimulate cross-border investment and trade.²²⁵

Owens and Bennet argue that, simply put, the OECD Model has set itself as the mode of resolving common difficulties that arise in the field of tax administration.²²⁶ They contend that this is achieved by facilitating a measure of harmonisation of double tax treaties, as well as

²¹⁸ Model Tax Convention Condensed Version (2014) 7.

²¹⁹ Model Tax Convention Condensed Version (2014) 7.

²²⁰ Kobetsky M (2011) 152.

²²¹ Kobetsky M (2011) 152.

²²² Kobetsky M (2011) 152.

²²³ Owens J & Bennett M ‘OECD Model Tax Convention’ available at

http://www.oecdobserver.org/news/archivestory.php/aid/2756/OECD_Model_Tax_Convention.html (accessed 23 April 2015).

²²⁴ Cited Kobetsky M (2011) 153.

²²⁵ Jackson JK *OECD Initiative on Tax Havens* (2010) ch 1.

²²⁶ Owens J & Bennett M ‘OECD Model Tax Convention’ available at

http://www.oecdobserver.org/news/archivestory.php/aid/2756/OECD_Model_Tax_Convention.html (accessed 23 April 2015).

providing a framework within which bilateral negotiations can be conducted, whilst also assisting in the uniform settlement of disputes.²²⁷

Jones argues that the OECD has taken its place as, and is becoming the world, body overseeing tax treaties.²²⁸ Cockfield agrees with Jones and asserts that the OECD is slowly developing into an informal 'World Tax Organisation' through its national responses to e-commerce tax challenges.²²⁹ The then OECD Secretary-General in 2008 noted that the success of the OECD Model could be attributed to the capacity to adapt international tax rules to the changing business environment, the enhanced participation of the business community and the progressive participation of non-member countries.²³⁰ The averments by Jones that the OECD is becoming the global body overseeing tax treaties urges us to consider the response of the OECD to digital tax concerns.

2.5.1.4 Response of the OECD to digital taxation concerns

The OECD Model Tax Convention since its first publication in 1963 has been updated numerous times.²³¹ The OECD updates the text of the OECD Model Treaty constantly in order to reflect new and increasingly complicated global economic developments in tax administration.²³² Furthermore, the updates are made so that at any particular point in time, the Model and Commentaries reflect the views of the OECD countries.²³³

Since the proliferation of e-commerce, many governments have failed to respond to the challenges that this platform creates by means of promulgating laws to regulate the taxation of e-commerce.²³⁴ The OECD Model Convention then came to the fore by taking decisive action in establishing the guiding principles and tax rules regarding the governance and administration of

²²⁷ Owens J & Bennett M 'OECD Model Tax Convention' available at http://www.oecdobserver.org/news/archivestory.php/aid/2756/OECD_Model_Tax_Convention.html (accessed 23 April 2015).

²²⁸ Johns JFA 'Are Tax Treaties Necessary' (1999) 53 *Tax Law Review* 53.

²²⁹ Cockfield AJ 'The Rise of the OECD as an Informal World Tax Organisation Through Responses to E-commerce Challenges' (2006) 8 *Yale Journal of Law and Technology* 138.

²³⁰ Ault H 'Reflections on the Role of the OECD in Developing International Tax Norms' (2009) 34 *Brooklyn Journal of International Law* 757.

²³¹ Mangels C 'Review of International Commercial Tax' (2014) 32 *Berkely Journal of International Law* 472.

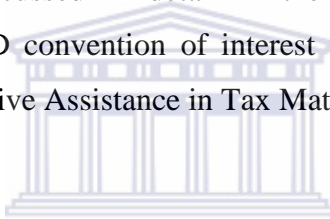
²³² Kirsch MS 'The Limits of Administrative Guidance in Interpretation of Tax Treaties' (2009) 87 *Texas Law Review* 1065.

²³³ It is important to note that OECD decision makers are government administrators of the OECD Member States.

²³⁴ Cockfield AJ (2006) 138.

tax principles.²³⁵ The OECD, in conjunction with its Member States has also succeeded in successfully launching the global debate on realising an internationally acclaimed and standardised way of treating VAT in electronic transactions.²³⁶

Although most countries impose taxes on income (direct taxes) and consumption (indirect taxes), which come in a variety of forms, ‘the OECD has identified the e-commerce issues concerning consumption (VAT) taxes as being of more immediacy than the issues affecting direct taxes’.²³⁷ Consumption taxes are found when a transaction involves the exchange of goods and services ‘for consideration either at the last point of sale to the final end user (retail sales tax and VA), or on intermediate transactions between business (VAT), [or through] levies on particular goods or services such as excise taxes, customs and import duties’.²³⁸ The position taken by the OECD of focusing on indirect taxation of electronic commerce is similar to the position to one taken by South Africa, which will be discussed in detail in the next chapter. The OECD Model Convention is not the only OECD convention of interest for the purposes of this study: the Convention on Mutual Administrative Assistance in Tax Matters will now be dissected.



2.5.1.5 Convention on Mutual Administrative Assistance in Tax Matters

The Convention on Mutual Administrative Assistance in Tax Matters is an agreement that is crafted to facilitate international co-operation between tax authorities in a number of countries so as to improve their ability to tackle tax evasion and avoidance.²³⁹ ‘The convention was developed jointly by the OECD and the Council of Europe in 1988 and amended by Protocol in 2010.’²⁴⁰ The Convention was amended in order to ensure that countries derive benefit from a more transparent tax environment.²⁴¹ The crafting of the Convention respects the fundamental

²³⁵ Cockfield AJ (2006) 138.

²³⁶ Steyn (2010) 231.

²³⁷ Irish Tax & Customs ‘Electronic Commerce and the Irish Tax System’ available at <http://www.revenue.ie/en/about/publications/ecommerce-report-irish-tax-system.html> (accessed 29 June 2015).

²³⁸ OECD (2014) 32.

²³⁹ ‘OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters’ available at <http://www.offtax.com/resources/article.php?id=99> (accessed 24 April 2015)

²⁴⁰ OECD ‘Convention of Mutual Administrative Assistance in Tax Matters’ available at <http://www.oecd.org/ctp/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm> (accessed 24 April 2015).

²⁴¹ OECD ‘Convention of Mutual Administrative Assistance in Tax Matters’ available at <http://www.oecd.org/ctp/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm> (accessed 24 April 2015).

rights of tax payers.²⁴² It could be argued that this Treaty is the most comprehensive of its kind.²⁴³ To date the Multilateral Convention has over 60 signatories and has been extended to over ten jurisdictions.²⁴⁴

This myriad of countries is representative of all G20 countries, all BRICS countries, major financial centres and an increasing number of developing countries.²⁴⁵ Article 1 of the Convention considers the object of the Convention and the persons covered.²⁴⁶ It states that subject to the provisions of Chapter IV, the Members shall provide administrative assistance to each other on tax matters.²⁴⁷ Pursuant to Art 2, the Convention applies to, inter alia, taxes on income or profits, taxes on capital gains which are imposed separately from the tax on income or profits, and taxes on net wealth.²⁴⁸ The Convention is slowly achieving increasing importance, with the amended Convention advancing better co-operation between national tax laws on an international scale.²⁴⁹

Central to treaty negotiations is ‘whether and to what extent, in respect of particular profits or gains, the source country (the host country of investment) will relinquish its taxing rights’.²⁵⁰ This discussion becomes important in the context of the differences between the OECD Model Tax Convention discussed above and the UN Model Double Tax Convention (UN Model Convention), which will now be discussed.²⁵¹

²⁴² ‘OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters’ available at <http://www.offtax.com/resources/article.php?id=99> (accessed 24 April 2015)

²⁴³ ‘Multilateral Treaty’ available at <http://www.gov.je/TaxesMoney/InternationalTaxAgreements/MultilateralConventionInternationalTaxC/Pages/ConventionMutualAdministrativeAssistance.aspx> (accessed 24 April 2015).

²⁴⁴ ‘Multilateral Treaty’ available at <http://www.gov.je/TaxesMoney/InternationalTaxAgreements/MultilateralConventionInternationalTaxC/Pages/ConventionMutualAdministrativeAssistance.aspx> (accessed 24 April 2015).

²⁴⁵ OECD ‘History’ available at <http://www.oecd.org/about/history/> (accessed 29 March 2015).

²⁴⁶ Convention on Mutual Administrative Assistance in Tax Matters, 1988 (1988), Art 1.

²⁴⁷ Convention on Mutual Administrative Assistance in Tax Matters, Art 1.

²⁴⁸ Convention on Mutual Administrative Assistance in Tax Matters, Art 2.

²⁴⁹ OECD ‘History’ available at <http://www.oecd.org/about/history/> (accessed 29 March 2015).

²⁵⁰ Lennard M ‘The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments’ (2009) *Asia-Pacific Tax Bulletin* 4.

²⁵¹ Lennard M (2009) 4.

2.5.2 UN Model Double Taxation Convention

The UN Model Convention between developed and developing countries is ‘used by countries as a basis for negotiation of their bilateral treaties’.²⁵² The UN Convention favours the retention of the taxing rights of the “source country” country, rather than the application of the taxing rights of the “residence country” of the investor.²⁵³ The UN Convention acknowledges the need for stimulating investment by respecting investment taxing rights, but views the need to award the source country taxing rights as being more pressing, especially in the context of developing countries.²⁵⁴ In essence the UN Model Convention gives more weight to the source principle than is accorded under the OECD Model Convention.²⁵⁵ In the application of the UN Model Convention, it must be understood that it is not prescriptive; but rather, intended to facilitate negotiation, interpretation, and practical application of bilateral treaties based upon its provisions.²⁵⁶

The role played by the UN Model Convention has been depicted as not being that important by some authors and commentators.²⁵⁷ Mangels suggests that the UN Model Convention was proposed as a counterweight by developing countries and remains less influential than its counterpart the OECD Model Convention.²⁵⁸

Bryne in a logical analysis advances that the OECD Model is more technical than the UN Model.²⁵⁹ He continues by stating that developing countries are increasingly entering into sustained competition for capital from developing countries; hence the revision of the UN Model. He argues that the question now becomes whether the UN Model should lean toward the OECD Model. He adds that, if there should be a UN Model that is very similar to the OECD, why have it at all then? He concedes that even if other avenues of development of the UN Model are followed, developing countries with their need to quench their investment thirst would still

²⁵² United Nations ‘United Nations Double Tax Convention between Developed and Developing Countries’ available at <http://www.un.org/en/development/desa/publications/double-taxation-convention.html> (accessed 31 March 2015).

²⁵³ United Nations Double Tax Convention between Developed and Developing Countries, 2011 (2011) vi.

²⁵⁴ United Nations Double Tax Convention between Developed and Developing Countries (2011) vi – viii.

²⁵⁵ United Nations Double Tax Convention between Developed and Developing Countries (2011) vii.

²⁵⁶ United Nations Double Tax Convention between Developed and Developing Countries (2011) ix.

²⁵⁷ See Mangels C (2014) 472.

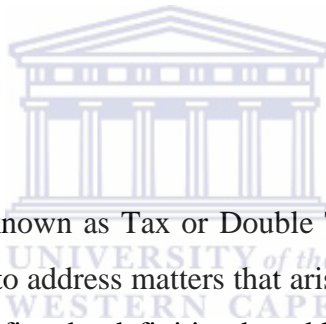
²⁵⁸ Mangels C (2014) 472.

²⁵⁹ Cited Mangels C (2014) 472.

adopt the OECD Model Convention anyway? Byrne is on point in his analysis. The UN Model Convention, in the view of this paper, is at the risk of gradually becoming obsolete.²⁶⁰

Lang *et al* beg to differ with Mangels.²⁶¹ They believe that the economic growth being experienced in many developing countries has led to the realisation that tax treaties play an important role.²⁶² As such they believe that this growth has effectuated a need to develop a treaty network. Resultantly, according to Lang *et al* there would therefore be an increased need for the UN Model Convention.²⁶³

Lang *et al* advance that despite the fact the UN Model Convention follows the same structure and applies the same terminology employed by the OECD Model, it still contains some noble and notable particularities that assimilate the needs of developing countries.²⁶⁴ They contend that in particular the UN Model Convention allocates more taxing rights to a source state as opposed to the OECD Model Convention.



2.5.3 Tax Treaties

Gautrin defines tax treaties (also known as Tax or Double Tax Conventions) as instruments of Public International Law that seek to address matters that arise when two countries attempt to tax the same income.²⁶⁵ Gautrin simplifies the definition by adding that they are simply agreements between two sovereign states to limit or modify the application of their tax legislation in order to escape the possibility of double taxation.²⁶⁶ Kirsch views tax treaties through the prism that they are simply bilateral treaties that are negotiated directly between two countries.²⁶⁷ Double taxation is a serious concern for the OECD because it has the ability to burden Member States and cripple global expansion.²⁶⁸ Sung So believes that these tax treaties are not simply bilateral but they can also be multilateral.²⁶⁹ Kirsch makes a noteworthy deduction by stating that tax treaties are not

²⁶⁰ Mangels C (2014) 472.

²⁶¹ Lang et al (Eds) *The OECD-Model-Convention and its Update 2014* (2015) 209.

²⁶² Lang et al (2015) 209.

²⁶³ Lang et al (2015) 209.

²⁶⁴ Lang et al (2015) 209.

²⁶⁵ Gautrin C (2009) 158.

²⁶⁶ Gautrin C (2009) 158.

²⁶⁷ Kirsch MS (2009) 1065.

²⁶⁸ Caster B 'Note and Comment: How Courts Should Handle OECD Commentary in Double Taxation Treaty Interpretations' (2011) 105 *Northwestern University Law Review* 1325.

²⁶⁹ Sung-Soo H (2011) 29

negotiated from scratch, rather they tend to be based on a myriad of model treaties, most often the OECD Model Treaty.²⁷⁰ These tax treaties have a severe shortcoming in that the text of the treaties is difficult to update.²⁷¹ Having briefly considered the nature and purpose of tax treaties, the next section gives a synopsis of the challenges of taxing the Internet.

2.6 INTERNET TAX PROBLEMS: A SYNOPSIS

Five problems of taxing the Internet are now considered. These are: defining the place of supply; loss of equity and fairness; characterisation of goods complexities; levelling the playing field; and multiple tax treaties and conventions. These five challenges were selected because of their centrality in the global Internet tax furore. The first challenge to be consider is defining the place of supply.

2.6.1 Defining place of supply: source vs. residency

The modern or post-Westphalian international system idealises that economic governance is based on territorial sovereignty.²⁷² Territorial jurisdiction is therefore of outmost importance when considering where to tax products.²⁷³ Kobrin and Wagner say that central to jurisdiction are the ‘where?’ questions.²⁷⁴ Accordingly, it is essential to assess where the transaction took place, where the income arose, and where the company is located. According to Forgione, international treaties largely provide for the taxation of business profits of multinational enterprises (MNCs) where the enterprise has a fixed or permanent establishment.²⁷⁵

Source rules are not the only consideration that countries use in taxing income achieved through transnational trade. Source and residence are however two conflicting principles. The use of residence is mutually exclusive of the use of source rules. Where permanent establishment rules are applied, the source country cannot levy a tax on the transaction.²⁷⁶

²⁷⁰ Kirsch MS (2009) 1065.

²⁷¹ Kirsch MS (2009) 1065.

²⁷² Kobrin SJ & Wagner E (2000) 6.

²⁷³ The place of supply is outmost importance to VAT application.

²⁷⁴ Kobrin SJ & Wagner E (2000) 6.

²⁷⁵ Forgione A (2003) 719. Permanent establishment is a subset of source rules.

²⁷⁶ Cockfield AJ ‘Transforming the Internet into a Taxable Forum: A Case Study in E-commerce Taxation’ (2001) 85 *Minnesota Law Review* 1174.

The developments in technology have added to the challenge of diminishing tax bases, in that digital technologies, contest existing international norms which are heavily dependent on physical presence as the basis for jurisdictional income taxation.²⁷⁷ Gormez-Arnau believes that many of these transactions cannot easily be pinned down to a particular jurisdiction.²⁷⁸ E-commerce has therefore intensified the use of technology in business, creating possibilities for a business to conduct transactions on a server or an Internet Service Provider (ISP) without any human intervention.²⁷⁹

Oguttu states that the high mobility of electronic transactions and global access to websites enables transactions conducted online to generate income without any infrastructure at a physical location.²⁸⁰ The question that arises is whether source requires some kind of physical activity or involvement by the taxpayer?²⁸¹ Oguttu avers that a server despite being automated machinery has a physical location, and if used regularly for business enterprise, can amount to a permanent establishment if the enterprise uses such a server for such purposes.²⁸² On the point of ISPs, Oguttu advances that such hosting is not tantamount to the server and its location being in the control of the enterprise.²⁸³ The implication of this would be that the ‘enterprise does not have a physical presence at the location of the server since the website through which it operates is not a tangible, fixed place of business’.²⁸⁴ Oguttu however concedes that if the enterprise owns or lease and operates the server on which the website is hosted, that server could be viewed as a permanent establishment, and thus the location at the enterprise’s disposal.²⁸⁵

Article 5 of the OECD Model treaty and the Commentary on the Model are invaluable interpretive tools in determining permanent establishment.²⁸⁶ Oguttu postulates that the meaning of the term agent also articulates to a dependant agent in a source country, wherein, according to the OECD Commentary, an Internet service provider will not constitute a dependent agent of the enterprise, thus ‘excluding them from the term “permanent establishment” in terms of art

²⁷⁷ Forgione A (2003) 719.

²⁷⁸ Gomez-Arnau ‘Taxation of Electronic Commerce in Spain’ (2000) 26 *International Tax Journal* 70.

²⁷⁹ Gutuza (2010) 332.

²⁸⁰ Oguttu AW (2005) 313 – 4.

²⁸¹ Gutuza (2010) 332.

²⁸² Oguttu AW (2005) 314.

²⁸³ Oguttu AW (2005) 314.

²⁸⁴ Oguttu AW (2005) 314.

²⁸⁵ See Oguttu AW (2005) 314; OECD Model Tax Commentary (2013) 9.

²⁸⁶ Oguttu AW (2005) 315.

5(4)(e) of the Model Convention'.²⁸⁷ Oguttu therefore identifies a critical challenge in the OECD Model. Gutuza concedes that when it is accepted that the 'business of an enterprise is carried on through a server, a server or an ISP could be viewed both as a "permanent" establishment and as the source of income.'²⁸⁸

Many authors seem to hold the view that existing tax principles are therefore then rendered archaic by e-commerce. Borkowski stated that the existing domestic and international regulations were written before the conception of e-commerce and fail to address the unique challenges created by electronic commerce.²⁸⁹ Basu advances that it may therefore be time to construct new norms and tenets of interpretation that can be used to determine the character of income from interstate online transactions.²⁹⁰ Source and residency rules have caused significant mayhem in attempting to tax the Internet. Loss of equity and fairness can also be cited as challenges to taxation of the Internet.

2.6.2 Loss of equity and fairness

According to Borkowski, 'the accelerated increase in online transactions, both business to business and business to consumer, has created concerns about fairness and equity relative to the taxation existing taxation systems that were until recently deemed adequate by business, consumers, and tax authorities worldwide'.²⁹¹ According to Downer, 'the objective of any tax system is to transfer resources from the private sector to the public sector. [The goal is to] maintain neutrality, fairness, and simplicity as this serves to advance desirable economic activity'.²⁹² Scudder concedes that the argument that differential treatment of Internet enterprises and traditional retailers affords the former an unfair advantage is permissible.²⁹³ Scudder cites the work of Goolsbee who asserts that 'there is clearly an economic distortion created from diverting commerce from of stores to on-line ventures simply for the purpose avoiding taxes'.²⁹⁴

²⁸⁷ Oguttu (2006) 153.

²⁸⁸ Gutuza (2010) 337.

²⁸⁹ Borkowski SC (2000) 2.

²⁹⁰ Basu S (2001) 9.

²⁹¹ Borkowski SC (2000) 2.

²⁹² Scudder JA 'E-commerce: Choosing the Appropriate Tax Model' (2003) *Major Themes in Economics* 7.

²⁹³ Scudder JA (2003) 7. This argument relates to indirect taxation, specifically VAT.

²⁹⁴ Cited Scudder JA (2003) 7.

Scudder intuitively supports his claim with empirical evidence depicting the steep growth of online retailers as compared to the marginal growth of traditional retailers.²⁹⁵

Scudder adds that in addition to the VAT implications discussed above, taxing the Internet also places a disproportionate tax burden on lower-income consumers than those richer consumers may be able to avert taxes substantially by making Internet purchases for most procurements, making the tax system less equitable.²⁹⁶ Basu believes that in attempting to construct the future blueprint of e-commerce taxation, the question of whether there is really a need for adherence to neutrality becomes of outmost importance.²⁹⁷ The next challenge is the characterisation of goods.

2.6.3 Characterisation of goods and services

Amidst the global Internet taxation furore, it remains uncertain how transactions conducted through global e-commerce mechanisms should be characterised.²⁹⁸ More and more, there has been a movement towards the supply of digital commodities, particularly entertainment products, software and advice.²⁹⁹ According to Benjamin and Nathanson, it may be difficult, impractical, or in certain instances impossible, to control and impose certain taxes on global e-commerce.³⁰⁰

The WTO Members at the 1998 Geneva Ministerial Conference, agreed on the imposition of a temporary moratorium on customs duties for all digitally delivered goods.³⁰¹ The main idea behind this moratorium was the difficulty of ‘distinguishing between the physical and electronic delivery of products delivered over the internet’.³⁰²

The current rules of the WTO on trade, namely, the GATT of 1994 and the General Agreement on Trade in Services (GATS) of 1995, are not able to effectively regulate some of the products deliverable on the Internet. As mentioned in the arguments above, one of the challenges of the

²⁹⁵ Scudder JA (2003) 7.

²⁹⁶ Scudder JA (2003) 7.

²⁹⁷ Basu S (2001) 9.

²⁹⁸ Cited Borkowski SC (2000) 2.

²⁹⁹ Dugan B and Dugan B ‘The Internet and the Law’ (2002) 33 *Wellington Law Review* 458.

³⁰⁰ Cited Dugan B and Dugan B (2002) 458.

³⁰¹ Basu S (2013) 203.

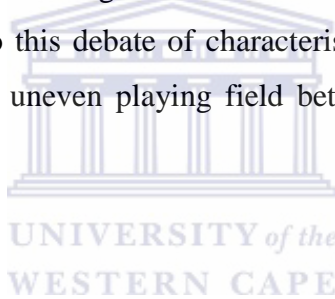
³⁰² Basu S (2013) 203.

Internet is the characterisation of certain goods and services.³⁰³ This is especially so in the case of digitally delivered products.³⁰⁴ Basu posed some critical questions on the issue, asking that:

‘On the one hand, products purchased electronically but delivered physically would appear to be subject to the existing WTO rules on trade in goods. On the other hand, a radiology scan delivered electronically would likely be a kind of service. Consider, though software downloaded from the internet (and which may or may not exist on a hard medium such as a CD). Is this a good or a service? Should the products fall under the purview of GATS, GATT or neither?’³⁰⁵

The issue of characterisation of goods and service is however largely a VAT issue (indirect tax issue). At most one of the biggest issues with regards to income tax is whether income is royalty income or other income.

The Internet is therefore driving a wedge between current tax principles and transactions conducted online.³⁰⁶ In addition to this debate of characterisation of goods, taxing the Internet has also stimulated debate on the uneven playing field between brick and mortar sellers and online retailers.



2.6.4 Levelling the playing field

Taxing the Internet has led to a predicament between online retailers and brick and mortar based retailers. This is because not taxing the Internet would lean towards online retailers, which could in turn lead to significant distortions that could put conventional retailers at a considerable disadvantage.³⁰⁷ Wiseman says that the tax differential could in effect cause a migration of conventional wholesalers to online platforms.³⁰⁸ However, taxing the industry would lead to severe shortcomings for online retailers, such as compliance costs. Once again the question of equity comes into play. The last challenge to taxing the Internet to be considered is the multiplicity of model laws and treaties.

³⁰³ See Chapter 2.7.1.(c) of this paper.

³⁰⁴ Basu S (2013) 203.

³⁰⁵ Basu S (2013) 203

³⁰⁶ Dugan B and Dugan B (2002) 458.

³⁰⁷ Wiseman AE (2010) 92.

³⁰⁸ Wiseman AE (2010) 92.

2.6.5 Multiple tax model laws and treaties

The fact that there is no uniform global legislation for regulating cross-border Internet taxation transactions is a big problem in itself. This means that different countries apply different standards when applying Internet tax law regulations. This therefore implies that treaties and models laws thus have a pervasive importance.³⁰⁹

As the arbiter of international trade, the WTO has played a less than satisfactory role in ensuring that there is a shift towards more uniform tax legislation for the e-commerce because of its multijurisdictional nature as well as other issues.³¹⁰ It, however, seems to be detached from e-commerce issues, only recommending areas of further study. The WTO was established with a broad mandate that sought, inter alia, to improve the standards of living, attain full employment, grow real income and effective demand, as well as expand the production of trade in goods and services.³¹¹ In the work of the WTO, one of its important functions is the provision of new trade rules. Since the WTO is seen to strongly advance the agenda of globalisation, the Internet has been a key driver in bringing people and economies together, and as such, is a critical component of the globalisation machinery. There should have therefore been an increasing need for the WTO to take a stand on Internet tax matters.

A google search of the role of the WTO in resolving of e-commerce taxation issues, as well as a thorough search of the leading scholarly electronic databases, such as, google scholar, science direct, SA epublications, JSTOR, and Heinonline, reveals very little work by the WTO on taxing e-commerce. The only tangible results studies such a search exposed were the special study done by members of the WTO secretariat in 1998 on electronic commerce and the role of the WTO, and the paper submitted by Walter Hellerstein to the WTO Committee on Trade and Development.³¹² One of the findings of the special study was that the WTO should design appropriate regulation and tax regimes for trade on the Internet.³¹³ The study conceded that ‘the

³⁰⁹ Vann RJ ‘International Aspects of Income Tax’ (1998) 2 *International Monetary Fund* 1.

³¹⁰ P Van der Bossche & W Zdouc *The Law and Policy of the World Trade Organisation Text, Cases, Materials* 3 ed (2013) 83.

³¹¹ Van der Bossche & Zdouc (2013) 83.

³¹² See Bacchetta M et al ‘Electronic Commerce and the role of the WTO’ available at https://www.wto.org/english/tratop_e/ecom_e/special_study_e.pdf (accessed 3 June 2015).

³¹³ Bacchetta M et al ‘Electronic Commerce and the role of the WTO’ available at https://www.wto.org/english/tratop_e/ecom_e/special_study_e.pdf (accessed 3 June 2015).

role of the WTO, within its areas of competence is to provide an environment conducive to international electronic commerce'.³¹⁴

Basu however found out that the WTO has done a substantial amount of work with regard to e-commerce.³¹⁵ Basu's study of the literature of the WTO and taxing the Internet also exposed the challenge in applying GATT and GATS to trade on the Internet. Basu was of the opinion that it makes more sense to define all electronic transmissions as services,³¹⁶ as such GATS would find application to these transactions. In passing, Basu commented that 'the main thrust should be on how to best utilise e-commerce to promote continued liberalization of global trade'.³¹⁷ Concluding on the role of the WTO in taxing the Internet, Basu had a few wise words to share:

'Nevertheless, keeping with its role as overseer and arbiter of international trade, the WTO is particularly concerned with E-commerce's impact on developing countries. With the other e-commerce issues, however, the WTO appears currently to be taking a detached posture, only suggesting areas of concern for further consideration and study, waiting for member countries to develop their own policy responses before taking any firm position of its own.'³¹⁸

Taxing the Internet has quite significant challenges which require administrators and legislators to apply their minds constructively to these problems. As Basu has noted, the WTO seems to be waiting for domestic governments to develop their own policies on taxing the Internet.

2.7 CONCLUSION

This chapter has established that there are both positives and negatives in taxing the Internet. Despite the desire by many nations to want to cash in on the opportunity for more revenue to enhance their tax bases, there seem to be severe complexities surrounding the implementation of Internet tax laws. With no global uniform legislation in place, taxing the Internet in the face of ever increasing cross-border transactions becomes more daunting. Therefore, a careful consideration of the revelations of this chapter could lead to conclusion that there is a need for a global tax governing body that not only regulates ordinary brick and mortar transactions but also

³¹⁴ Bacchetta M et al 'Electronic Commerce and the role of the WTO' available at https://www.wto.org/english/tratop_e/ecom_e/special_study_e.pdf (accessed 3 June 2015).

³¹⁵ Basu S (2013) 203.

³¹⁶ Basu S (2013) 203.

³¹⁷ Basu S (2013) 204.

³¹⁸ Basu S (2013) 204-5.

governs the online realm. The WTO seems to have been derelict in its duty when it comes to providing rules on taxing trade conducted over the Internet.

Furthermore, it could be argued that there is a need to harmonise existing tax treaties in order to ensure consistency and simplicity. Chapter 3 will discuss the implications of the South African digital tax framework and compare the South Africa digital tax system to the American and European digital tax models in an attempt to generate solutions for the local model.



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CHAPTER 3

THE SOUTH AFRICAN DIGITAL TAX FRAMEWORK COMPARED WITH THE EUROPEAN AND AMERICAN SYSTEMS

‘Thinking is one thing no one has been able to tax.’³¹⁹

Charles Kettering

3.1 INTRODUCTION

The proliferation of online transacting has not been nationalist, racist, xenophobic, or even Afrophobic. Online transacting has opened up nations to the rest of the world, and South Africa is no exception. As such, the South African taxman, just like many revenue authorities across the globe, has been keen to dip its fingers into the online tax pie. Jean Baptist Colbert once said that,

³¹⁹ General Motors ‘General Motors Engineering Journal’ (1953) *General Motors Corporation* 66.

‘the art of taxation consists in so plucking the goose as to get the most feathers with the least hissing’.³²⁰ This has become the nature of taxing systems. The first section below investigates the role played by investigative commissions in South Africa.

3.2 DEVELOPMENT OF INVESTIGATIVE REFORM IN SOUTH AFRICA: FROM THE STEYN COMMISSION TO THE DAVIS TAX COMMISSION

Even prior to the new constitutional dispensation,³²¹ the government of the Republic (or Union, in the case of the Steyn Committee)³²² always appointed commissions of enquiry for the purposes of assessing the tax structure and areas in need of reform.³²³ The first commission appointed was the Steyn Committee; commissioned to recommend the advisability of the source system which formed the basis of the taxing system since the first income tax laws were levied in the Union, and it recommended in 1951 that the source basis of taxation should be retained because of the complexities of migrating to the residence system and that there was no material impact on revenue.³²⁴ The Franzen Commission³²⁵ recommended in 1970 that the source system must be abandoned; its main argument centering on the fact that more income was beginning to flow into South Africa without being taxed.³²⁶ There is a sharp contrast in the arguments of these two commissions. The former argued the complexities of changing to the residence system, while the latter argued that income was starting to pour into the Republic without being taxed. During the period 1986 to 1987 the Margo Commission³²⁷ reviewed the source versus residence conflict comprehensively, concluding that the source basis should be maintained.³²⁸ Although the Margo Commission noted some advantages in migrating to the residence system, it also noted that the benefits of such a change would not justify the disruption that it would cause.

³²⁰ Baudopoulos AM *eCommerce and the Effects of Technology on Taxation: Could VAT be e-Tax Solution* (2015) 143.

³²¹ The Constitution of the Republic of South Africa, 1996.

³²² Beric et al (2013) 16.

³²³ Beric et al (2013) 16.

³²⁴ Cited Katz Commission 5th Report - Basing the South African Income Tax System on the Source or Residence Principle (1997) Katz Commission: Pretoria.

³²⁵ Commission of Enquiry into Fiscal and Monetary Policy in South Africa, chaired by Franzen DG.

³²⁶ Cited Katz Commission 5th Report, chapter 2.1.

³²⁷ Commission of Inquiry into the Tax Structure of South Africa, chaired by Margo CS.

³²⁸ Cited Katz Commission 5th Report, chapter 2.1.

In more recent times, the Katz Commission³²⁹ was the first commission to be appointed after independence, commencing its work in 1994.³³⁰ The Katz Commission issued nine interim reports from 1994 – 1999,³³¹ which dealt with various issues ranging from rule of law to constitutionalism.³³² On the point of rule of law and tax, the Commission stated as follows:

‘The Commission notes that the tax system is subject to the Constitution and must conform to society’s commitment to the Rule of Law. This means not only that the system should be effective in enforcing all tax laws, equally and irrespective of status, but also that citizens’ right to be taxed strictly in accordance with the terms of those laws should be scrupulously protected both in the design of those laws and their implementation.’³³³

The most relevant report for purposes of this paper is the Katz Commission 5th Report on basing the South African income tax system on the source or residence principle.³³⁴ The Commission on the point of source versus residency concluded that active income should continue to be taxed on a source basis while passive income should be taxed on a world-wide basis.³³⁵ However, South Africa became a residence system in 2001. According to the Income Tax Act, subject to certain exclusions, residents are taxed on their worldwide income, irrespective of where the income was earned; while non-residents are tax on income from a South African source.

The Katz Commission also considered the impact of e-commerce on the South African tax system and commented:

‘[It] received much evidence from a not too distant future where international trade investment will increasingly become a function of global electronic communication such as through the Internet. There is no doubt that these developments will greatly impact on some of the basic tenets of international taxation as they exist today.’³³⁶

The Commission was correct in its predictions that the landscape of international business would change, and, inter alia, that e-commerce would become an integral part of global commerce,

³²⁹ Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, chaired by Katz MM.

³³⁰ Beric J & Croome LJ *Tax Administration* (2010) 5.

³³¹ Beric et al (2013) 16.

³³² Beric J & Croome LJ (2010) 5.

³³³ Cited Beric J & Croome LJ (2010) 5.

³³⁴ Katz Commission 5th Report, chapter 2.1.

³³⁵ Cited Katz Commission 5th Report, chapter 9.1 & 9.3.

³³⁶ Katz Commission 5th Report, chapter 7.4.1.

necessitating the reform of tax rules.³³⁷ At the time of the release of the Report, there was no precedent to deal with the expected developments noted by the Katz Commission. However, the Commission expected South Africa to respond to the global challenge of e-commerce as soon as global economies began formalising policies with regard to the Internet, which was not done until much later.³³⁸

The Davis Commission³³⁹ appointed in February 2013, is the latest of these commissions to grace the South African tax commission enquiry landscape.³⁴⁰ The Davis Tax Commission has already released its interim report on base erosion and profit shifting.³⁴¹

At this point we can already note that these commissions had already exposed some of the challenges the current tax system is battling to resolve, such as, the contentious issue of source versus residence and the issue of base erosion and profit shifting. As such, the role played by these commissions of enquiry cannot be played down. The Katz Commission was correct in its averments that e-commerce would play an increased role in the future.



3.3 OVERVIEW OF E-COMMERCE IN SOUTH AFRICA

A review of the literature on electronic commerce in South Africa seems to show a split in views over its state. The main argument adopts the position that South Africa has enjoyed considerable growth in online sales.³⁴² This argument draws from empirical evidence and argues that there were an estimated 14 million users of the Internet by 2014.³⁴³ It acknowledges the work done by the global market research company, Ipsos, which exposed a growing interest by South African Internet users to fill their ‘electronic shopping baskets’.³⁴⁴ The study avers that 22% of South

³³⁷ South African Institute of Chartered Accountants ‘Tax implications of E-commerce’ available at https://www.saica.co.za/integritax/2000/800_Tax_implications_of_e_commerce_1.htm (accessed 4 June 2015).

³³⁸ South African Institute of Chartered Accountants ‘Tax implications of E-commerce’ available at https://www.saica.co.za/integritax/2000/800_Tax_implications_of_e_commerce_1.htm (accessed 4 June 2015).

³³⁹ Commission of enquiry on the South African tax system, chaired by Judge D Davis.

³⁴⁰ Beric et al (2013) 16.

³⁴¹ Davis Tax Committee Interim Report on Base Erosion and Profit Shifting (2014).

³⁴² See generally, ‘Study reveals E-commerce is on the rise in South Africa’ available at South <http://www.itnewsafrika.com/2015/03/study-reveals-that-E-commerce-is-on-the-rise-in-south-africa/> (accessed 15 June 2015).

³⁴³ ‘South Africa’s Digital Tax Starts on 1 April – How will you be affected?’ available at <http://www.nashua.co.za/south-africas-digital-tax-starts-on-1-april-how-will-you-be-affected/> (16 April 2015).

³⁴⁴ Cited ‘South Africa’s Digital Tax Starts on 1 April – How will you be affected?’ available at <http://www.nashua.co.za/south-africas-digital-tax-starts-on-1-april-how-will-you-be-affected/> (16 April 2015).

African Internet users indicated that they concluded purchases online, while 48% projected that they expected to do so in future.

The secondary argument draws its conclusions from a global perspective. It concedes that ‘... e-commerce penetration is still relatively low in South Africa’.³⁴⁵ Hagen, one of the authors in support of the secondary argument states that ‘e-commerce in South Africa, in 2014, is still in its infancy’.³⁴⁶ Guided by consumer research, Hagen notes that this retardation can be linked to certain perceptions. True or false, he is of the view that these perceptions have hindered online growth. Hagen lists these perceptions as:

- Delivery charges are prohibitive. Consumers would rather go into a store than spend on delivery.
- Consumers are under the impression that if they do not have a credit card, they cannot shop online (even though most stores offer at least EFT payment as an alternative).
- Consumers are (still) worried about security, specifically related to credit card fraud.
- Consumers are worried about size and fit (if clothing is sold) and are not sure about how they would go about returning items.
- Where site content is thin, consumers feel unsure about purchasing and would rather go in-store to get advice.

A closer inspection of the positions of these two opposing camps seems to expose that they still share some middle ground. Both camps concede that the electronic commerce is set to grow and has been set on a positive growth trajectory.

The South African E-commerce Report surveyed over 10 000 Internet users in South Africa.³⁴⁷ This study gave a very insightful exposition about the online shopping habits of South Africans. The Report found out that 26.74% of Internet users spend in the range of R201 to R500 per month on online shopping. Another 21.6% spend in the range of R501 to R1000, while a further 9.11% spend more than R2000.³⁴⁸ The study also found out that about 6.51% of the users would be willing to spend more than R10 000 in a single shopping event. Strangely enough, the study

³⁴⁵ ‘Study reveals E-commerce is on the rise in South Africa’ available at South <http://www.itnewsafrika.com/2015/03/study-reveals-that-E-commerce-is-on-the-rise-in-south-africa/> (accessed 15 June 2015).

³⁴⁶ Hagen ‘E-commerce in South Africa in 2014’ available at <http://limabean.agency/article/the-state-of-E-commerce-in-south-africa-in-2014#.VVuLrPmqko> (accessed 16 June 2015).

³⁴⁷ South African E-commerce Report.

³⁴⁸ South African E-commerce Report

showed that 45.62% of the shoppers have at least an undergraduate degree or above, with only 0.71% have no formal education.

An analysis of the above study reveals that there is still a lot of potential for electronic commerce growth in South Africa, especially if penetration reaches those who have no formal education. Realisation of the explosive use of online services has been hampered by the digital divide.³⁴⁹ The eruption in the use of smartphones and tablets is set to eliminate this digital divide in future.³⁵⁰ With 50% of smartphone users having used it to shop online, and another 21% expecting to do so, the future of South African electronic commerce is definitely one for sore eyes.³⁵¹

Now that an overview of electronic commerce in South Africa has been given, the remaining issue to be analysed related to the existing framework to tax the proceeds of electronic commerce.



3.4 SOUTH AFRICAN DIGITAL TAX FRAMEWORK

3.4.1 Introduction

‘Like many other countries, the South African government has come to recognise the need to establish a policy framework for electronic commerce and is determined to create an environment that is conducive to the development of electronic commerce.’³⁵² Lehlokoe is of the view that it is imperative that South Africa must develop a ‘policy that is in harmony with international best practice so that it is not excluded from trading electronically with its global partners’.³⁵³ Lehlokoe avers that the intention of South Africa is not to re-invent nor work in isolation, but rather to monitor and follow developments and discourses on the international

³⁴⁹ The gulf between those who have ready access to internet and those who have not. See generally, ‘Digital Divide’ available at <http://dictionary.reference.com/browse/digital+divide> (accessed 16 June 2015).

³⁵⁰ ‘Study reveals E-commerce is on the rise in South Africa’ available at South <http://www.itnewsafrika.com/2015/03/study-reveals-that-E-commerce-is-on-the-rise-in-south-africa/> (accessed 15 June 2015).

³⁵¹ ‘Study reveals E-commerce is on the rise in South Africa’ available at South <http://www.itnewsafrika.com/2015/03/study-reveals-that-E-commerce-is-on-the-rise-in-south-africa/> (accessed 15 June 2015).

³⁵² Lehlokoe D ‘Towards an Electronic Commerce Policy for South Africa’ (1999) ADF 1.

³⁵³ Lehlokoe D (1999) 1.

scene on electronic commerce and its implications.³⁵⁴ Lehlokoe concedes that the ultimate objective of developing electronic commerce in South African is to grow the economy (through creation of jobs and expansion of international trade), as well as better the lives of those who reside in South Africa.³⁵⁵ As such, the taxation of e-commerce must be done cautiously. Cognisance must be taken at all times that the framework must ensure the validity and certainty of transactions.³⁵⁶ South Africa, came out of its regulatory shell in 2014; when it announced the Electronic Services Regulation, as its first legislative framework response to the challenge cross-border electronic commerce poses to the tax system. The historical context of the legislation is an integral component thereof.

3.4.2 Historical Context

On 30 January 2014, the South African National Treasury issued a media statement, calling for public comment on the Electronic Services Regulation.³⁵⁷ The call for public comment; followed the announcement by the Minister of Finance in the 2013 budget that all foreign businesses supplying e-books, music and other digital services in South Africa would be required to register as VAT vendors.³⁵⁸ The draft regulation was open for comment until close of business on 20 February 2014. ‘The main concern raised by businesses and tax advisors was that the scope of Regulations was too wide as it included certain types of electronic services that are predominantly of a business to business nature.’³⁵⁹ A significant number of submissions also noted the amendments as imposing a new kind of tax.³⁶⁰ At the end of the consultative process, 50 written comments had been received from business groupings, companies, private individuals, representative organisations and tax advisors, with a stakeholder session having been hosted by the National Treasury and the SARS on 20 February 2014 and 19 March 2014 (information

³⁵⁴ Lehlokoe D (1999) 1.

³⁵⁵ Lehlokoe D (1999) 1.

³⁵⁶ SA Green Paper on Electronic Commerce (2000) 27.

³⁵⁷ National Treasury ‘Electronic Services Regulation: Request for Public Comments’ (2014) 1. This regulation focuses on administrative issues of VAT collection.

³⁵⁸ National Treasury ‘Electronic Services Regulation: Request for Public Comments’ (2014) 1.

³⁵⁹ National Treasury ‘Final Electronic Services’ (2014) 2.

³⁶⁰ National Treasury ‘Final Electronic Services’ (2014) 1.

session).³⁶¹ On 28 March 2014, the National Treasury published the final Electronic Services Regulation in the Government Gazette No. 37489.³⁶²

The Regulation took into account the submissions made during the consultative process and excluded certain electronic services from the list, in order to narrow the scope of application of the Regulation.³⁶³ However, imported services not specifically included in the Regulation are still subject to VAT in terms of s 14 of the VAT Act.³⁶⁴ The press release on the Regulation also noted that some of the submissions, as noted above, wrongly contended that the amendment imposed a new kind of tax. The National Treasury took the view that the Regulation merely changes tax liability from the importer of the foreign services, 'to the foreign supplier to address concerns about non-compliance in terms of the current rules and to level the playing field between local suppliers of e-services and foreign suppliers'.³⁶⁵

At this point one may probably object that the alteration of the definition of a 'service' in terms of the VAT Act to include certain electronic services does not qualify as a new kind of tax on electronic services not previously taxed, but rather a shift in onus to increase compliance. While the averments of the National Treasury are true, this study takes the view that alternate interpretations can be given. According to the grammatical method of interpretation, the meaning of a document can be found within its four corners.³⁶⁶ The media statement on the draft Regulation, where the National Treasury first introduced the Regulation in its draft form to the nation, can be interpreted to show that the National Treasury never intended to create a new tax but merely to fit e-commerce into the VAT regime. Thus, one could argue that the Regulation is merely an extension or amendment of the VAT regime.

It is however, plausible to argue that subjecting certain electronic services to tax, where previously these services did not form part of the definition of taxable services within the purview of the VAT Act, actually amounts to a new tax on electronic services. It creates a new framework for the taxation of imported services not subject to customs duties or VAT because they originate from a borderless sphere where no customs agents exist or postal agents act as

³⁶¹ National Treasury 'Final Electronic Services' (2014) 1.

³⁶² National Treasury 'Final Electronic Services' (2014) 1.

³⁶³ National Treasury 'Final Electronic Services' (2014) 1.

³⁶⁴ National Treasury 'Final Electronic Services' (2014) 2.

³⁶⁵ National Treasury 'Final Electronic Services' (2014) 1 – 2.

³⁶⁶ Mc Kendrick E *Contract Law: Text, Cases, and Materials* (2012) 372.

intermediaries in the collection of the taxes. Although both views on whether or not a new kind of tax has been created have been considered, the author is uncertain about the position. The debate on the view of the National Treasury on whether a new tax was created probably has you thinking by now: what is the purpose of the amendments to the VAT Act. The Electronic Services Regulation will now be examined.

3.4.3 Electronic Services Regulation

The Electronic Services Regulation gives effect to the amendments in 2013 to the VAT ACT, which alter the way in which certain electronic services are now dealt with.³⁶⁷ The Regulation seeks to ensure the implementation of the VAT ACT to e-commerce transactions. According to the Regulation, non-resident suppliers of certain electronic services are now required to register for VAT in respect of taxable supplies of electronic services that exceed R50 000.³⁶⁸ The Regulation took effect on 1 April 2014, from which point, a transaction will constitute an electronic service for VAT purposes where at least two of the following circumstances are present:

- ‘the recipient of those electronic service is a South African resident;
- payment to the non-resident supplier in respect of the supply of electronic services originates from a South African bank account;
- the recipient has an address in South Africa to which the tax invoice for the electronic services supplied by the non-resident will be delivered.’³⁶⁹

The Regulation divided electronic services into seven categories, namely; educational services, games and games of chance, information system services, Internet-based auction services, maintenance services, miscellaneous services, and subscription services.³⁷⁰

As noted in the press statement by the National Treasury on the publication of the Regulation, SARS provides ‘a streamlined VAT registration and administrative process that will significantly reduce the compliance burden for businesses’.³⁷¹ In addition, ‘foreign electronic suppliers will

³⁶⁷ National Treasury ‘Final Electronic Services’ (2014) 2.

³⁶⁸ The Regulations was published in GGNo. 37489 of 28 March 2014 as Government Notice No. R221.

³⁶⁹ Paragraph (b) (vi) of the definition of ‘enterprise’ read with s 23(1)(a).

³⁷⁰ Electronic Service Regulation, s3 – 9.

³⁷¹ National Treasury ‘Final Electronic Services’ (2014) 2.

not be required to open a South African bank account'.³⁷² These foreign electronic service providers, who are obliged to register, are then referred to as vendors.³⁷³

3.4.4 Purpose of the Regulation

According to the National Treasury, the Regulation was formulated amidst local and international efforts, 'to bring cross border e-commerce (specifically the digital economy) into the VAT regime'.³⁷⁴ The National Treasury averred that 'the current application of VAT on imports does not lend itself to the effective enforcement on imported services or e-commerce where no border posts [or parcel delivery agents, for example the Post Office] can perform the function as collecting agents, as in the case with physical goods'.³⁷⁵ The National Treasury argued that the resultant effect would be that local consumers could purchase imported digital products without paying VAT. It conceded that the resultant outcome not only led to the competitive disadvantage of local suppliers of digital services, but also led to the loss of revenue to the fiscus.

While the above averments are generally conceded, it is submitted that the Electronic Service Regulation was not withstanding this aspect, rather a half-baked response. E-commerce cannot fall into the taxation net only by addressing indirect taxes.³⁷⁶ There are major issues around direct taxation that needed to be addressed, most of which revolve around the overarching international taxation principles, of note permanent establishment.³⁷⁷ Permanent establishment has already been discussed in chapter one and two of this paper, where it was identified that the principle has severe shortfalls, particularly where the OECD Model and its Commentary do not identify a permanent establishment in the country where a website is located. Thus it is critical that the issue of permanent establishment be addressed.

³⁷² National Treasury 'Final Electronic Services' (2014) 2.

³⁷³ SARS 'Legal & Policy, Value-Added Tax: VAT 404 Guide for Vendors' (2014) 6.

³⁷⁴ National Treasury 'Electronic Services Regulation: Request for Public Comments' (2014) 1.

³⁷⁵ National Treasury 'Electronic Services Regulation: Request for Public Comments' (2014) 1.

³⁷⁶ OECD Observer 'E-commerce and taxation: a virtual reality' available at

http://www.oecdobserver.org/news/archivestory.php/aid/416/E-commerce_and_taxation:_a_virtual_reality.html (accessed 30 June 2015).

³⁷⁷ OECD Observer 'E-commerce and taxation: a virtual reality' available at

http://www.oecdobserver.org/news/archivestory.php/aid/416/E-commerce_and_taxation:_a_virtual_reality.html (accessed 30 June 2015).

As long as SARS cannot identify whether a non-resident has permanent establishment in South Africa, such revenue continues to escape untaxed.³⁷⁸ According to the Davis Commission, ‘rules should be enacted that require non-resident companies with South African sourced income (excluding certain passive income) to submit income tax returns even if they do not have a [permanent establishment] in South Africa’.³⁷⁹ The Davis Commission believes that this would ensure non-residents are included in the tax system. The Davis Commission however recommends that South Africa wait for the outcome of the OECD’s work on permanent establishment to be concluded.

Having argued that the National Treasury did not perhaps adequately address the challenges of cross-border electronic commerce on taxation, it is important to note that the National Treasury itself believes that there is still room to develop regulations in this area. In its press statement on publishing the Electronic Services Regulation, the National Treasury noted, with insight:

‘More broadly, and beyond these regulations, the National Treasury notes that the growth and development of electronic services raises many complex issues, and hence that traditional tax (both indirect and direct) and regulatory measures may not be as effective in meeting their objectives as they for traditional goods and services. There is a need to modernise current governmental processes to better incorporate technological innovations in the electronic services sector and to ensure that South Africa keeps abreast with international developments in this area, and is competitive. Treasury will therefore be initiating a consultative process to develop a comprehensive paper on the treatment of electronic services, particularly in the area of financial sector regulation, payment systems and taxation, as well as to consider measures to better protect customers.’³⁸⁰

It is also important to note that the National Treasury and the SARS are at present in the process of reviewing the currently applicable threshold in order to ensure that small electronic service suppliers are not duly impacted.³⁸¹

Lao Tzu, a major figure in Chinese philosophy, once said that a journey of a thousand miles begins with a single step.³⁸² The National Treasury could have been wise in putting a part

³⁷⁸ Katz Commission 5th Report.

³⁷⁹ Katz Commission 5th Report.

³⁸⁰ Katz Commission 5th Report.

³⁸¹ National Treasury ‘Final Electronic Services’ (2014) 2.

measure while conducting research on a more comprehensive legislation. However, work done by the various commissions cited above shows that incremental revelations have been made on issues surrounding taxing the Internet. Further, that the interim report of the Davis Tax Commission which contained detailed challenges of the digital economy to the contemporary tax system was released just two months after the final Regulation was published, and a few days after the Regulation was just put into force. This validates the point made above, that the work of the investigative commissions of enquiry has been severely downplayed in South Africa. Collaborative efforts by the Davis Tax Commission, the SARS, and the National Treasury could have yielded a more comprehensive framework for cross-border electronic commerce taxation. The bizarre outcomes towards an e-commerce taxation framework can maybe be explained by the findings of the South African Green Paper on Electronic Commerce 2000 (Green Paper).

3.5 SOUTH AFRICAN GREEN PAPER ON ELECTRONIC COMMERCE AS AN INTERPRETIVE TOOL IN ANALYSING THE NATURE OF THE CURRENT ELECTRONIC TAX FRAMEWORK

After the recommendations of the Katz Commission anticipating the effects of technology and e-commerce on the country's tax base, a discussion paper was issued in 1999 to initiate dialogue leading to a consultative Green Paper released in 2000.³⁸³ According to Borkowski, 'ground rules were established for e-commerce taxation, highlighting the degree to which tax and tariff policies in South Africa, as elsewhere, have not been able to be updated to encompass the realities of electronic commerce'.³⁸⁴ In order to aid in the formulation of the Green Paper the government introduced an e-commerce debate website.³⁸⁵

Paragraph 1.4 of the Green Paper envisioned the following path to be taken toward the development of policy and eventual legislation:

- 'Phase 1 – Discussion document – July 1999.
- Phase 2 – Green paper to be completed in February 2000.

³⁸² BBC News 'Lao Tzu' available at

<http://www.bbc.co.uk/worldservice/learningenglish/movingwords/shortlist/laotzu.shtml> (accessed 8 June 2015).

³⁸³ Borkowski SC (2000) 19.

³⁸⁴ Borkowski SC (2000) 20.

³⁸⁵ Borkowski SC (2000) 20, www.ecomm-debate.co.za; no longer operational at the time of writing of this paper.

- Phase 3 – White paper to be completed in September 2000.
- Phase 4 – E-commerce legislation and/ or specific sets of legislation – End of year 2000.³⁸⁶

The wishes of the Green Paper remained castles in the air as a White Paper was never subsequently published. Consequently, the vision envisaged by the Green Paper especially the framework for taxing electronic commerce in South Africa considered in Chapter 4 thereof was never achieved.³⁸⁷

Chapter 4.1 of the Green Paper introduced the challenge of harmonising electronic commerce and the South African tax system. It notes that e-commerce has changed the traditional way of doing business, resulting in new electronic products and delivery systems.³⁸⁸ Certain products can be delivered electronically, instead of physically, generating the problem of characterisation of certain digitally delivered goods, resulting in confusion within the context of Double Tax Agreements. Further, that the development of the Internet could be shrinking tax bases, hence reducing fiscal revenues.³⁸⁹ Importantly, the Green Paper notes that the ‘reasons behind these are on the one hand the difficulties inherent in defining jurisdiction in cyberworld; and on the other hand the problem of administration and enforcement’.³⁹⁰ The Green Paper then supported the averments made by Lehlokoe that

‘In addressing these problems and in developing a taxation framework, it is important to ensure that the taxation systems are fair, predictable and do not distort the conduct of business. The challenge therefore for South Africa is to develop a taxation policy that is not isolated from its e-commerce partners.’³⁹¹

The Green Paper then looked at the issues from an international taxation perspective, considering the work of governments and organisations; inclusive of the OECD, the US government and the WTO. It looked at a myriad of challenges to e-commerce and taxation. For the purposes of this study it is important to note only that they considered the problem of characterisation of income

³⁸⁶ Paragraph 1.4, SA Green Paper on Electronic Commerce (2000).

³⁸⁷ Chapter 4, SA Green Paper on Electronic Commerce (2000) 36 – 46.

³⁸⁸ SA Green Paper on Electronic Commerce (2000) 36.

³⁸⁹ SA Green Paper on Electronic Commerce (2000) 36.

³⁹⁰ SA Green Paper on Electronic Commerce (2000) 36.

³⁹¹ SA Green Paper on Electronic Commerce (2000) 36.

(residence versus source) and the urgent need for the application of indirect taxes to e-commerce.³⁹²

‘Indirect taxes should apply where consumption takes place, and an international consensus should be sought on the identification of the place of consumption. Consensus is essential in order to avoid double taxation or unintentional non-taxation.’³⁹³ This system is not without challenges. This is as the supplier can potentially fail to identify the location of the customer who could potentially be outside the jurisdiction where consumption occurred.³⁹⁴ The Green Paper noted that the supply of electronic products should not be treated in the same manner as the supply of goods, supporting the position adopted by Basu in Chapter 2 above that the supply of electronic products should be treated as the supply of services. The Green Paper also urged consideration of the reverse charge mechanism, whereby, in relation to VAT systems, a customer has to account for output VAT on imported services, but gives the importing country the right to an input tax deduction.³⁹⁵ The Green Paper noted that the collection of indirect taxes from private consumers posed a great challenge to the application of indirect taxes to e-commerce.³⁹⁶ It noted three main options for consideration:

- ‘The supplier is required to account for taxation in the country of consumption.
- The customer is required to account for the tax. This is the position in South Africa where goods are not required to be entered through Customs and Exercise or a service is rendered.
- The payment intermediary (such as bank or credit card company dealing with the payment) is required to account for the tax.’³⁹⁷

The Green Paper analysed all three options and ascertained all three to be potentially unsatisfactory, suggesting that perhaps the best approach would be to require the supplier to account for the tax, under simplified existing registration procedures.³⁹⁸ On the point of customs and exercise duties, the Green Paper noted that ‘when establishing the treatment of imported supplies for custom duty purposes, a distinction should be drawn between goods ordered

³⁹² Taxes are often classified as direct or indirect. There is a general consensus that income tax is a direct tax and that consumption taxes (sales, VAT, or exercises) are indirect taxes. Thuronyi V *Comparative Tax Law* (2003) 54.

³⁹³ SA Green Paper on Electronic Commerce (2000) 36.

³⁹⁴ SA Green Paper on Electronic Commerce (2000) 40.

³⁹⁵ SA Green Paper on Electronic Commerce (2000) 41.

³⁹⁶ SA Green Paper on Electronic Commerce (2000) 41.

³⁹⁷ SA Green Paper on Electronic Commerce (2000) 41.

³⁹⁸ SA Green Paper on Electronic Commerce (2000) 41.

electronically but delivered by traditional means and direct on-line delivery of electronic products'.³⁹⁹ With the wide reception of online commerce, a need existed for a greater SARS presence at the major places of postal entry, in order to monitor larger volumes of smaller packages.⁴⁰⁰ An important observation was then made that even where an imported good is exempted from Customs Duty in terms of a *de minimis* rule, VAT was still payable.⁴⁰¹

For the purposes of this study, the last relevant issue considered by the Green Paper was that of tax administration and compliance. It was noted that accurate identification of the party responsible for paying a particular tax is a cornerstone requirement of any tax regime.⁴⁰² However, identifying the physical owner of a website inadequately identified can be a time consuming and rigorous task.⁴⁰³ From an information perspective, 'the ability to access reliable and verifiable taxpayer information is essential for any tax administration to be able to do its job properly'.⁴⁰⁴ With the increased possibilities of storing information overseas at a cheaper rate, this may complicate SARS's efforts to verify the reliability of digital records.⁴⁰⁵ Concluding on the issue of taxing the Internet, the Green Paper noted:

'Many commentators are of the opinion that there is no need, at this stage, for the implementation of any new taxes relating specifically to e-commerce and that with modifications, where necessary, existing legislation is capable of coping with the risks concerning e-commerce transactions. Most of the developments taking place internationally are going to require consensus from all stakeholders on order to ensure that e-commerce is harnessed and not effectively stifled.'⁴⁰⁶

Having looked at the relevant contents of the Green Paper for the purposes of this study, we will now look at the Regulation through the eyes of the Green Paper. The Regulation was simply an amendment to the existing VAT regime aimed at shifting tax liability from the importer of the service to the foreign supplier of certain electronic services in order to address challenges of non-compliance and levelling the playing field between local suppliers of e-services and foreign

³⁹⁹ SA Green Paper on Electronic Commerce (2000) 41.

⁴⁰⁰ SA Green Paper on Electronic Commerce (2000) 41-2.

⁴⁰¹ SA Green Paper on Electronic Commerce (2000) 42.

⁴⁰² SA Green Paper on Electronic Commerce (2000) 44.

⁴⁰³ SA Green Paper on Electronic Commerce (2000) 41.

⁴⁰⁴ SA Green Paper on Electronic Commerce (2000) 42.

⁴⁰⁵ SA Green Paper on Electronic Commerce (2000) 42.

⁴⁰⁶ SA Green Paper on Electronic Commerce (2000) 46.

suppliers. Technically, it would not amount to a new tax because non-listed e-services foreign suppliers are still subject to VAT in terms of s 14 of the VAT Act. Hence, it could be said that the National Treasury responded to the recommendation of the Green Paper that with modifications, existing legislation is capable of coping with the challenges e-commerce transactions pose. Further analysis offers support for this argument; this is, as the Green Paper noted, one of the more urgent tax issues, namely addressing the application of indirect taxes to e-commerce. Thus, the Regulation amended the relevant indirect tax regime in South Africa (VAT regime) in order to synchronise e-commerce with the VAT system.

Doubtlessly, there are similarities between the recommendations of the Green Paper and the Regulation. To settle the issue, the Green Paper suggested that perhaps the best approach in terms of the collection of the indirect taxes at issue would be to require the supplier to account for the tax, under simplified existing registration procedures. This is exactly the position that has been adopted by the National Treasury in its Regulation. Onus has been shifted from the importer of the electronic service to the supplier under a streamlined registration process. Both the Regulation and the Green Paper do not provide any provisions for transforming the collection of direct taxes in the digital era. Apparently, the Green Paper connects the dots as to what guided the implementation of the Regulation. The next section deliberates on the tax frameworks in selected countries, and analyses how these countries have gone about resolving this digital taxation problem.

3.6 AMERICAN DIGITAL TAX FRAMEWORK

3.6.1 Introduction

There is a global consensus that any taxation of global e-commerce must be fair, equitable and neutral in its application, but the dilemma that subsequently arises is the establishment of a taxation framework that actually is able to meet these criteria.⁴⁰⁷ ‘The accelerated increase in on-line trans-actions, both business to business and business to consumer, has created concerns about fairness and equity relative to the taxation of traditional commerce and has exposed the cumbersome and inappropriate aspects of many existing taxation systems that until recently were

⁴⁰⁷ Borkowski SC (2000) 1.

deemed adequate by business, consumers, and tax authorities worldwide.’⁴⁰⁸ This study now considers how the American government responded in the face of these inadequacies.

3.6.2 Overview and framework

The US prides itself as a capitalist free market economy.⁴⁰⁹ ‘As a free-market economy, the U.S. subscribes, in principle, to a hands-off, minimalist approach to the regulation of commerce.’⁴¹⁰ The Clinton administration was of the view that because of the decentralised nature of the Internet economy the preferred policy should be one of industry self-regulation.⁴¹¹ Many citizens in the US share views similar to those of the Clinton administration, seeing ‘internet taxation as a “Trojan horse”’: a back-door way for government to collect more taxes from other kinds of commerce’.⁴¹²

On 21 October 1998, Internet taxation was effectively banned in the United States, except for those states which already had existing law dealing on it,⁴¹³ through the enactment of the ITFA,⁴¹⁴ which imposed a moratorium on the levying of all Internet taxes.⁴¹⁵ Section 1101 of the ITFA stated that (a) no state or political subdivision thereof shall impose any of the following taxes during the period beginning October 1, 1998, and ending November 1, 2001: (1) taxes on Internet access, unless such tax was generally imposed and actually enforced prior to October 1, 1998, and (2) multiple or discriminatory taxes on electronic commerce.⁴¹⁶

Lambert is of the view that the main purpose of the moratorium was to buy time so that politicians and legislators could study the issue in more detail.⁴¹⁷ Lambert in support of this claim, noted that this was why the ACEC was created to develop recommendations by April 2000, some of whose members were drawn from state and local governments.⁴¹⁸

⁴⁰⁸ Borkowski SC (2000) 1.

⁴⁰⁹ Pappas CW ‘Comparative U.S. & EU Approaches to E-commerce Regulation: Jurisdiction, Electronic Contracts, Electronic Signatures and Taxation’ (2003) 325 *Denver Journal of International Law & Policy* 328.

⁴¹⁰ Pappas CW (2003) 328.

⁴¹¹ Cited Cockfield AJ (2001) 1201.

⁴¹² Poole et al *The Internet: A Historical Encyclopedia* 1st ed (2005) 245.

⁴¹³ See Chapter 1.1.

⁴¹⁴ Internet Tax Freedom Act 1998.

⁴¹⁵ Internet Tax Freedom Act, s 1101.

⁴¹⁶ Internet Tax Freedom Act, s 1101.

⁴¹⁷ Poole et al (2005) 247.

⁴¹⁸ Poole et al (2005) 247.

The INDA proposed to slightly amend the position in the ITFA, stating that (a) no state or political subdivision thereof may impose any of the following taxes; (1) taxes on Internet access (2) multiple or discriminatory taxes on electronic commerce.⁴¹⁹ Section 2 (a) of the INDA generally amends s 1101 of the ITFA. The subtle difference between the two provisions is that s 2 (a) of the INDA omits the position where such taxes were imposed before 1 October 1998. The conforming amendments to the ITFA inserted the phrase, ‘except to the extent such services are used to provide internet access before the period’.⁴²⁰ The INDA was subsequently passed by the House of Representatives on 17 September 2003.

The Internet Tax Freedom Act Amendments Act of 2007 (ITFAA), unlike the INDA did not make any significant amendments on the moratorium. The ITFAA only replaced the ‘2007’ in s 1101 (a) and 104 (a)(2)(A) with ‘2014’, thus instituting an extension of the moratorium. With regard to the grandfathering of states that tax Internet access, the ITFAA amended the sunset clauses of these grandfather provisions. Thus, s 1104(a) of the ITFA was amended as follows:

‘Paragraphs (1) and (2) shall not apply to any State that has, more than 24 months prior to the date of enactment of this paragraph, enacted legislation to repeal the State’s taxes on Internet access or issued a rule or other proclamation made by the appropriate agency of the State that such State agency has decided to no longer apply such tax to Internet access.’⁴²¹

The ITFAA took effect on 1 November 2007, ending in 2014. ‘At the end of the 113th Congress, the House and Senate agreed to a one year extension of the ban on internet access’,⁴²² in order to avoid the expiration of the moratorium at the end of 2014. In 2015, the moratorium extension, ends yet again. The question at issue is therefore whether a sixth temporary extension will be granted or a permanent extension will be given. On 15 July 2014, the House of Representatives passed the Permanent Internet Tax Freedom Act (PITFA), which was however never passed by the Senate.

⁴¹⁹ Internet Non-discrimination Act, s2(a).

⁴²⁰ Internet Non-discrimination Act.

⁴²¹ Internet Tax Freedom Act Amendments Act of 2007, s6.

⁴²² Judiciary Committee ‘Bipartisan Members of Congress Introduce Bill To Ban Internet Access Taxes’ available at http://judiciary.house.gov/index.cfm/press-releases?ContentRecord_id=19695DDF-3BF5-4F7B-A9D5-1A630CA8335A (accessed 10 June 2015).

As at June 2015, the House of Representatives had yet again passed the PITFA on 9 June 2015. The PITFA seeks to create a permanent moratorium on Internet access taxes.⁴²³ Section 2 of the PITFA proposes that s 1101(a) of the ITFA be amended by striking out ‘during the period beginning November 1, 2003, and ending November 1, 2014’.⁴²⁴ The PITFA is widely a bipartisan legislation aimed at keeping the Internet affordable and driving innovation by banning taxes permanently.⁴²⁵ The PITFA aims at relieving Americans from any more additional taxes, than already imposed.⁴²⁶

Supporting the making of the ban on Internet taxes permanent, Bob Goodlatte, Chairman of the House of Representatives Judiciary Committee, said:

‘Whether business owners or jobseekers, grandparents or students, all Americans benefit from tax-free access to the Internet. Internet access drives innovation and the success of our economy. It is a gateway to, opportunity, and the rest of the globe. And year after year, Congress has chosen to temporarily extend the bipartisan ban on Internet access taxes. The time has come to make it permanent.’⁴²⁷

Despite the enthusiasm of the members of the House of Representatives, the PITFA Bill must be subject to a vote by the US Senate. Fierce challenge can be expected when the Bill is debated on the Senate floor. These will come from the four states, Ohio, Tennessee, Texas, and Wisconsin, the only states allowed to continue with their current laws on Internet taxes as a result of the grandfather clause.⁴²⁸ Consequently, they received large sums of money from these Internet access taxes, and hence would prefer it if the current state of affairs persists. Further, ‘with US states getting poorer and poorer, it is expected for their governing bodies to be in a constant

⁴²³ Judiciary Committee ‘House Passes Permanent Internet Tax Freedom Act (PITFA) To Ban Internet Access Taxes’ available at <http://judiciary.house.gov/index.cfm/press-releases?id=2D7C5C09-0CB9-4E85-BD8B-409059E29C8E> (accessed 10 June 2015).

⁴²⁴ Permanent Internet Tax Freedom Act, s2.

⁴²⁵ Judiciary Committee ‘House Passes Permanent Internet Tax Freedom Act (PITFA) To Ban Internet Access Taxes’ available at <http://judiciary.house.gov/index.cfm/press-releases?id=2D7C5C09-0CB9-4E85-BD8B-409059E29C8E> (accessed 10 June 2015).

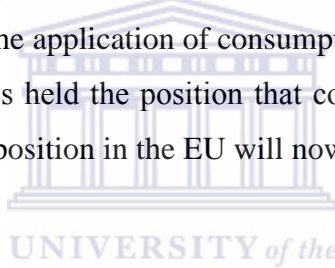
⁴²⁶ Judiciary Committee ‘House Passes Permanent Internet Tax Freedom Act (PITFA) To Ban Internet Access Taxes’ available at <http://judiciary.house.gov/index.cfm/press-releases?id=2D7C5C09-0CB9-4E85-BD8B-409059E29C8E> (accessed 10 June 2015).

⁴²⁷ Judiciary Committee ‘Bipartisan Members of Congress Introduce Bill To Ban Internet Access Taxes’ available at http://judiciary.house.gov/index.cfm/press-releases?ContentRecord_id=19695DDF-3BF5-4F7B-A9D5-1A630CA8335A (accessed 10 June 2015).

⁴²⁸ ‘US Prepares to Approve a Permanent Ban on All Internet Access Taxes’ available at <http://news.softpedia.com/news/US-Prepares-to-Approve-a-Permanent-Ban-on-All-Internet-Access-Taxes-483896.shtml> (accessed 10 June 2015).

search for new revenue streams'.⁴²⁹ A permanent ban on Internet taxes in the US, if voted for by Congress, would change the nature and landscape of the discourse on electronic commerce taxation not only in America, but across the globe. 2015 might be a defining year in the American Internet taxation setting, but may yet again yield a disappointing sixth extension of the moratorium.

In short, the Internet taxation framework of the US, until changed by Congress remains one of a temporary nature, in which Internet access taxes and multiple or discriminatory taxes are prohibited (except in the grandfathered states) by a moratorium that has been extended five times since its initial inception through the ITFA in 1998. The possibility of a permanent moratorium exists, but it still needs the rubber stamp of Congress and which is highly difficult because of the multiple interests of the various states. 'Historically, the EU and the US took different policy positions toward applying consumption taxation on E-commerce. The U.S., at the federal level, has been more reluctant to permit the application of consumption taxes electronic commerce than the EU.'⁴³⁰ 'The EU member states held the position that consumption taxes should be applied on electronic transactions.'⁴³¹ The position in the EU will now be investigated.



3.7 EUROPEAN UNION DIGITAL TAX FRAMEWORK

3.7.1 Introduction

Basu notes that some authors argue that e-commerce has not transformed the fundamentals of taxation, while others assert that there is need for dramatic change.⁴³² Krever submits that 'a more sober study will reveal that in many respects much of the hyperbole about e-commerce and tax is just that and in the overall scheme of things the impact of e-commerce on tax systems may be limited'.⁴³³ With EU having set itself up as an entity highly responsive to new legislative needs, we turn to the response made by the European Union.

⁴²⁹ 'US Prepares to Approve a Permanent Ban on All Internet Access Taxes' available at <http://news.softpedia.com/news/US-Prepares-to-Approve-a-Permanent-Ban-on-All-Internet-Access-Taxes-483896.shtml> (accessed 10 June 2015).

⁴³⁰ Basu S (2013) 205.

⁴³¹ Basu S (2013) 205.

⁴³² Basu S (2013) 4.

⁴³³ Cited Basu S (2013) 4.

3.7.2 Overview and framework

‘The EU countries derive a large proportion of government revenue from consumption taxes on domestic goods and services (mainly VAT).’⁴³⁴ ‘VAT extra charges contribute 45% to the EU Community budget (in addition to customs duties and GNP contributions).’⁴³⁵ In contrast, the US budget is mainly constituted of tax revenues from personal and corporate income tax and social security contributions,⁴³⁶ hence, the taxation or lack thereof of e-commerce has minimum impact. This argument establishes that the desire to tax e-commerce hinges upon different premises, as the fiscus contributions of nations vary.

With the borderless nature of electronic commerce, it therefore creates severe challenges to the EU tax system, which as shown above, is heavily reliant on indirect or consumption taxation.⁴³⁷ In its initial response, the EU began attempting to deal with the issue of VAT collection amongst its Members.⁴³⁸ This VAT on online purchases was therefore with regard to purchases within the EU, but not non-European firms.⁴³⁹ It was not until May 2002 that the EU decided to extend VAT on Internet sales to European purchases from companies outside Europe.⁴⁴⁰ These tax rules applied ‘to the supply over electronic networks (digital delivery) of software and computer services generally, plus a wide array of information services. U.S. and other non-EU firms are required to register in one country but pay the VAT rate of the country which they are located’.⁴⁴¹ In addition, the supply of services outside the European Union, which previously charged VAT under the pre-electronic commerce era, would now be VAT free.⁴⁴²

This policy raised severe policy challenges for States outside the EU. Hostetler sums up these issues as including ‘the taxation of digital commerce, unequal taxation of EU versus non-EU firms, high compliance costs, EU competition with the Organization for Economic Cooperation

⁴³⁴ Jones R & Basu S (2002) 39.

⁴³⁵ Jones R & Basu S (2002) 39.

⁴³⁶ Jones R & Basu S (2002) 39.

⁴³⁷ Dickie J *Internet and Electronic Commerce Law in the European Union* 1st ed (1999) 19.

⁴³⁸ Annie B *Electronic Commerce: Concepts, Methodologies, Tools, and Applications* (2002) IX.

⁴³⁹ Klotz RJ *The Politics of Internet Communication* (2004) 193

⁴⁴⁰ Klotz RJ (2004) 193.

⁴⁴¹ Hostetler BC *The European Union: Expand, Shrink or Status Quo* (2006) 150.

⁴⁴² Buys & Cronje (2004) 289.

and Development's (OECD's) multilateral discussion of the taxation of e-commerce, and the possibility of a complaint to the WTO'.⁴⁴³

From 1 January 2015, telecommunications, broadcasting, and electronic services in the EU are now taxed in the country where the customer belongs; regardless of whether the customer is a business or consumer or whether the supplier is based in the EU or outside.⁴⁴⁴ The European Union argues that the main reason behind these changes is to 'bring the VAT treatment of these services in line with one of the main principles of VAT that, as a consumption tax, revenues should accrue to the member state in which the goods were consumed'.⁴⁴⁵ The changes to the supply of electronic commerce are clearly depicted in table 2 below:

TABLE 2: EFFECT OF NEW EU ELECTRONIC SERVICE SUPPLY RULES

EU BUSINESSES supplying to:	
Business in another EU country	No VAT charged. Customer must account for the tax (reverse-charge mechanism).
Consumer in another EU country	Must charge VAT in the EU country where the customer belongs (not where the business is based). Example A Polish customer downloading an App on his mobile phone from a Finnish supplier. The Finnish company must charge the customer Polish VAT. MOSS available
Business or consumer outside the EU	No EU VAT charged. Example A Hungarian company sells an anti-virus program to be downloaded through its website to businesses or private individuals in Australia. NO VAT But if the service is effectively used & enjoyed in an EU country, that country can decide to levy VAT (option for Member States).
NON-EU BUSINESSES supplying to:	
Business in the EU	No VAT charged. Customer must account for the tax (reverse-charge mechanism).
Consumer in the EU (telecoms, broadcasting or electronic services)	Must charge VAT in the EU country where the customer belongs. Example A person living in Barcelona pays a US company for access to American TV channels. The US company must charge the customer Spanish VAT. MOSS available

Source: European Union Taxation and Customs Union

⁴⁴³ Hostetler BC (2006) 150.

⁴⁴⁴ Taxation and Customs Union 'Telecommunications, broadcasting & electronic services' available at http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm (accessed 1 June 2015).

⁴⁴⁵ Taxation and Customs Union (2014) 10.

These new rules affect EU and non-EU suppliers of digital services that sell to consumers inside the EU.⁴⁴⁶ The implications of the 2015 VAT changes is that VAT will no longer be payable in the country of the supplier, but it will now be tendered where the customer is resident, if a customer is resident in the EU.⁴⁴⁷ Non-EU businesses supplying electronic services to EU consumers are not affected as current rules already guarantee taxation in the country where consumer resides.⁴⁴⁸ To be compliant, an EU service provider must charge the correct VAT based on the customers location, ensure the correct location of the customer and ensure non conflicting evidence (for example a billing address and a matching IP address), and report their VAT to each EU state or use a Mini-One-Stop-Shop (MOSS) which would report on behalf of the enterprise. Essentially, the MOSS has two schemes of registration, namely: one for taxable persons with a place of business in the EU (Union Scheme) and one where non-EU taxable persons can register where it has no fixed business in the EU (non-Union scheme).⁴⁴⁹ ‘For the non-Union scheme, taxable persons already registered in the VoeS system [VAT on electronically supplied services] will retain their existing individual VAT identification numbers.’⁴⁵⁰

‘In order to register for the mini One Stop Shop, the taxable person is required to provide certain information to the Member State of identification. Member States are free to choose precisely how they collect this information from the taxable person, but it must be provided electronically. In practice, Member States will provide a web portal for the submission of this information.’⁴⁵¹

⁴⁴⁶ Taxation and Customs Union ‘Telecommunications, broadcasting & electronic services’ available at http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm (accessed 1 June 2015).

⁴⁴⁷ Ernst & Young ‘Overview of EU VAT Changes for Digital Products and Services in 2015’ (2013) *Ernst & Young 2*.

⁴⁴⁸ Taxation and Customs Union (2014) 10.

⁴⁴⁹ European Commission ‘Guide to the VAT mini One Stop Shop’ available at http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm (accessed 23 July 2015).

⁴⁵⁰ Taxation and Customs Union (2014) 8.

⁴⁵¹ European Commission ‘Guide to the VAT mini One Stop Shop’ available at http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm (accessed 23 July 2015).

Registration under normal circumstance takes place on the first day of every calendar quarter⁴⁵² after the taxable person informs the Member State of identification of their intention to use the scheme.⁴⁵³

‘If a taxable person using the Union scheme has any fixed establishments outside the Member State of identification, the mini One Stop Shop registration details have to include the VAT identification number or tax reference number, and name and address of each of these fixed establishments in other Member States.’⁴⁵⁴

E-services affected include any services automatically delivered over the Internet, or electronic network, where there is little or no human intervention, such as:

- ‘Images or text, such as photos, screensavers, e-books and other digitised documents
- Music, films and games, including games of chance and gambling games, and of programmes on demand
- On-line magazines
- Website supply or web hosting services
- Distance maintenance of programmes and equipment
- Supplies of software and software updates
- Advertising space on a website’⁴⁵⁵

Some authors have argued that the new VAT rules may adversely affect low-income earning businesses by not prescribing a minimum earning threshold on the VAT and further creates a compliance burden by requiring them to prove the place of supply.⁴⁵⁶ This may stifle innovation, as for example, a small business selling music to a customer in London will have to charge VAT on the downloads according to the rates in London. As there is no minimum threshold, the small

⁴⁵² For example, if, on the 15th February 2016, a taxable person informs the Member State of identification that it wishes to commence using the scheme, and it provides the required information, the taxable person will be able to use the mini One Stop Shop for supplies made on or after the 1st April 2016. See Taxation and Customs Union (2014) 8.

⁴⁵³ Taxation and Customs Union (2014) 8.

⁴⁵⁴ Taxation and Customs Union (2014) 8.

⁴⁵⁵ HM Revenue & Customs ‘Revenue and Customs Brief 46 (2014): VAT rule change and the VAT Mini One Stop Shop – additional guidance’ available at <https://www.gov.uk/government/publications/revenue-and-customs-brief-46-2014-vat-rule-change-and-the-vat-mini-one-stop-shop-additional-guidance/revenue-and-customs-brief-46-2014-vat-rule-change-and-the-vat-mini-one-stop-shop-additional-guidance> (accessed 1 July 2015). For a more comprehensive list see Article 7 of Council Implementing Regulation (EU) No 1042/2013.

⁴⁵⁶ Ross E ‘Six-month grace period for business affected by new EU VAT laws’ available at <http://www.theguardian.com/small-business-network/2015/jan/06/grace-period-businesses-affected-new-eu-vat-laws> (accessed 1 June 2015).

business previously exempt through the £81 000 threshold in the United Kingdom will now have to pay tax for the sale of the music. The next section provides an in-depth analysis of the three frameworks referred to in this paper.

3.8 IN-DEPTH ANALYSIS OF THE THREE FRAMEWORKS

The three frameworks discussed above clearly depict how various domestic and international groups have battled with how to apply tax law to the Internet and e-commerce transactions.⁴⁵⁷ Siebert states that the ‘the most challenging areas are sales and value-added taxes, particularly when tax treatment of goods and services differs, when digitized transactions and activities cloud the determination of permanent establishment, and when the “character” of income earned (e.g., profits vs. royalty income) is unclear’.⁴⁵⁸ Siebert delves deeper into the issue and identifies that, the problem is further not restricted to the treatment of domestic transactions, but also extends to the international sphere when ‘transactions cross international borders and the tax treatment is different’.⁴⁵⁹

The EU and the US are similar in that they dealt with the same challenges of applying sales tax and VAT to e-commerce, at a local level, as well as across borders.⁴⁶⁰ Siebert analyses the frameworks of the US and the EU and notes:

‘Neither body fully recognizes that decisions taken in the domestic arena have implications for the cross-border application of these types of taxes. Inconsistent tax treatment of transactions between the United States and the European Union, and within each country as well, have already surfaced.’⁴⁶¹

For example, as noted in the discussions above, the US has states which were allowed to continue apply Internet taxes, which then creates challenges for foreign enterprises who then have to establish which states have these taxes, on what, and how much. However, in terms of the EU, Siebert’s argument would not hold water anymore as a critical examination of the new 2015 VAT changes would reveal that the changes have sowed seeds of consistency as non-EU

⁴⁵⁷ Siebert H *Economic Policy Issues of the New Economy* (2002) 88.

⁴⁵⁸ Siebert H (2002) 88.

⁴⁵⁹ Siebert H (2002) 88.

⁴⁶⁰ Siebert H (2002) 88.

⁴⁶¹ Siebert H (2002) 88.

suppliers of electronic services and EU suppliers of such services to other EU countries are now placed in the same position, having to account for VAT in the EU country where the customer is located.

A sharp distinction arises between the two with regard to consumption taxes. Despite significant opposition, the US still maintains the non-imposition of consumption taxes on electronic transactions while the EU and its Member States maintain the position that consumption taxes should be applied on electronic transactions.⁴⁶² Interestingly, Basu adds flavour to the discourse on consumption taxes by arguing that the reason for the US not levying consumption taxes on electronic commerce had more of a political reason than an economic one.⁴⁶³ Sadly, Basu did not expand on this point as he alluded to the fact that it fell beyond the scope of his research.⁴⁶⁴ The Congressional Research Service however disagreed with Basu, noting that the main reason behind the moratorium was rather to protect the Internet from the administrative and financial burdens that taxation brings, while further stifling the advance of Internet technology and associated economic activity.⁴⁶⁵

Siebert also brings to the fore a sharp difference between the US and the EU frameworks.⁴⁶⁶ Siebert sums it up as follows:

‘In contrast to the United States, the EU tax authorities are trying to draw a bright line between goods and services purchased over the internet, and to a greater extent than the United States already have captured these transactions in their tax orbit. All transmissions (those under the general term “soft goods,” such as software, books, or architectural drawings) have been classified as services which, therefore, should be taxed at the appropriate VAT rate. Whereas the EU ruling would seem to simplify and increase certainty in the tax environments, there are many different rules governing applicable location and rates for taxing services so the simplicity is part illusion. Moreover as the creation of production bundles becomes more complex, the bright line fades.’⁴⁶⁷

⁴⁶² Basu S (2013) 205.

⁴⁶³ Basu S (2013) 205.

⁴⁶⁴ Basu S (2013) 205.

⁴⁶⁵ Congressional Research Service Report for Congress RL33261 (2008) Congressional Research Service 3.

⁴⁶⁶ Siebert (2002) 90.

⁴⁶⁷ Siebert (2002) 90.

Siebert is correct in his assertions: the US has mostly been conceived with the debate on whether or not the moratorium must subsist or must have a sunset which may allow for wider discourse on the matter.⁴⁶⁸ This is mainly because of the revenue implications of not taxing the Internet, amidst growing online enterprise revenues and transactions as established in chapter 2.

The US has however gone a step further in preventing Internet access taxes, unlike the EU which has been more focused on indirect taxes, primarily VAT.⁴⁶⁹ ‘The taxation of Internet access most commonly refers to the application of state and local sales and use taxes to monthly charges that retail subscribers pay for access to the Internet.’⁴⁷⁰ ‘When applied, the tax on Internet access is most commonly a retail general sales tax, but may also take the form of other transactional taxes such as a telecommunications or gross receipts.’⁴⁷¹

It is interesting to investigate whether preferential tax treatment by not taxing the Internet promotes free trade. Former Governor of Utah, Michael Leavitt, opined that ‘free trade means levelling the playing field, not special advantages’.⁴⁷² Therefore, lucrative incentives to exempt, e-commerce sales tax or VAT do not promote free trade, but rather create special advantages.⁴⁷³ Governor Leavitt summed up the behaviour as being protectionist behaviour cloaked as free trade, aimed at giving an unfair advantage to a group of seller. This argument seems very basic, but holds water. Basu states in passing that ‘those who oppose the taxation of Internet increase the appeal of their political rhetoric by characterising the tax as a revenue protection measure when it is not’.⁴⁷⁴

The EU model and the South African model are similar and both differ from the US model. For purposes of this study therefore, a further examination will not be done of the differences and similarities between the South Africa framework and that of the US as the results would evidently be similar to those of an analysis of the US and the EU frameworks. Rather, the differences and similarities between the EU and the South African systems will now be considered.

⁴⁶⁸ CRS (2008) 3.

⁴⁶⁹ Segovia J, Szczepaniak PS & Niedzwiedzinski M *E-commerce and Intelligent Methods* (2013) 35.

⁴⁷⁰ CRS (2008) 6.

⁴⁷¹ Internet Nondiscrimination Act Report with Additional Views (2003) 6.

⁴⁷² Cited Basu S (2013) 205.

⁴⁷³ Basu S (2013) 205.

⁴⁷⁴ Basu S (2013) 205.

Both the EU and South Africa have so far looked at the challenges of consumption taxes, in particular VAT. They both imposed taxes on certain digital services, by attempting to rein in the digital economy into the VAT system ‘without placing domestic businesses at a disadvantage compared with foreign competitors’.⁴⁷⁵ On the same note, both South Africa and the EU are similar in that their responses to the e-tax furore is that they place focus on VAT and do not consider other kinds of taxes, such as the Internet access taxes considered by the United States. It seems that they have applied VAT as the e-tax solution. Furthermore, both systems mandate foreign suppliers of electronic services to register as VAT vendors.⁴⁷⁶ In addition, both use a streamlined registration system for these foreign suppliers of electronic services.⁴⁷⁷

At this point one can almost assume that the drawbacks of these two models are similar. Of course, it is submitted that it is not as simple as that. To begin with, both systems are riddled with compliance challenges, where they impose at times severe compliance costs on foreign electronic service providers, harming particularly the ones operating at a smaller scale. In addition, both systems face the challenge that in the current digital environment, it is difficult to always find the location of a customer,⁴⁷⁸ as ‘payment of VAT is determined based on what, where, and to whom goods and services are sold’.⁴⁷⁹

There are however some subtle differences between the South African digital tax model and that of the EU. Of note, is the fact that despite both systems having compliance challenges, the EU rules have practical impossibilities with regard to adherence. This is as there are 81 VAT rates in the 28 EU countries, which change dependent on product and region, while there exists no central up to date source for these rates.⁴⁸⁰ Furthermore, the new requirement of having to store two pieces of non-contradictory information present numerous challenges for both small and large businesses in terms of acquisition of the data and storage of the sensitive information. One could also argue that the lack of a clear defined definition for automated digital services exacerbates the compliance challenges, as each member of the EU could possibly interpret the term differently. Ernst and Young concedes that the new EU VAT rules have wider business

⁴⁷⁵ Schenk A, Thuronyi V & Cui W *Value Added Tax* 2 ed (2015) 222.

⁴⁷⁶ Hostetler BC (2006) 150.

⁴⁷⁷ Buys and Cronje (2004) 290.

⁴⁷⁸ Liflander R *The Everything Online Business Book: Use the Internet to Build Your Business* (2000) 231.

⁴⁷⁹ Segovia J, Szczepaniak PS & Niedzwiedzinski M (2013) 35.

⁴⁸⁰ ‘Key Facts About the New EU VAT Rules’ available at <http://euvataction.org/key-facts/> (accessed 2 July 2015).

implications as they create technical, financial and commercial impediments, which it believes will take time to be resolved in the independent units of the EU.⁴⁸¹ The introduction of the MOSS and VOES systems for local sellers and foreign sellers, respectively, also distinguishes the EU and the South African systems.⁴⁸² The practical implementation of the MOSS and VOES systems, their reduction of the compliance burden, and subsequent dispensability to other parts of the globe remain to be seen.

3.9 CONCLUSION

From the discussion above, it seems that all three frameworks have focussed on indirect taxation. Segovia *et al* argue that e-commerce will perhaps never have any effect on direct taxation.⁴⁸³

Their argument is based on the following:

[The] Internet allows performing transactions on distance, it gives an opportunity to a business to reduce or avoid tax footprint outside the country where it is resident. Websites and servers through which sales are made cannot constitute a taxable presence in another country. A website alone is not a fixed place of business and so goes not create a taxable jurisdiction.⁴⁸⁴

Chapter 2 and 3 of this paper in contrast note that the Internet has an effect on direct taxation. Perhaps over time, revelations can be made on how issues on direct taxation such as those identified in this paper can be resolved. It remains however that different countries have adopted different policies on taxing the Internet; America lying at one end of a continuum, while the EU and South Africa lie at the other sharing similar although different policies. The next chapter provides a conclusion and furnishes recommendations.

⁴⁸¹ Ernst & Young (2013) 2.

⁴⁸² MOSS is a mini-one-stop-shop that allows EU sellers to register in one country so they don't have to register, collect VAT and distribute it in every country.

⁴⁸³ Segovia J, Szczepaniak PS & Niedzwiedzinski M (2013) 35.

⁴⁸⁴ Segovia J, Szczepaniak PS & Niedzwiedzinski M (2013) 35.

CHAPTER 4

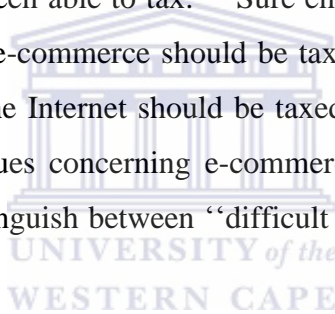
CONCLUSION AND RECOMMENDATIONS

‘There is no such thing as a good tax’⁴⁸⁵

Winston Churchill

4.1 INTRODUCTION

The last two decades have seen the explosion of electronic commerce across the globe. E-commerce burst onto the scene, quickly becoming a game changer that has irrefutably changed the nature and order of business transactions worldwide. Charles Kettering once said that thinking is one thing no one has been able to tax.⁴⁸⁶ Sure enough, the discourse on e-commerce quickly shifted to whether or not e-commerce should be taxed. This debate has created a great rift between those who feel that the Internet should be taxed and those who feel otherwise. ‘In attempting to resolve taxation issues concerning e-commerce, “out-of-the-box” thinking is a good first step. We must also distinguish between “difficult problems and the problems that are untruly unsolvable”’.⁴⁸⁷



4.2 CONCLUSION

The current *de-facto* international tax system was constructed with a view to regulating tangible goods, and is falling short in the face of emerging global trends, such as, trade goods and (especially) services and trade over the Internet.

As regards revenue, it has been established that taxes should inherently be fair and equitable. Not taxing the Internet goes against the international tax principle of neutrality; not taxing the Internet places sellers operating out of brick and mortar establishment at a disadvantage. As a

⁴⁸⁵ Financial Mail ‘Editorial: SARS Must Repair the Social Contract’ available at <http://www.financialmail.co.za/opinion/editorial/2015/03/12/editorial-sars-must-repair-the-social-contract> (accessed 15 June 2015).

⁴⁸⁶ General Motors (1953) 66.

⁴⁸⁷ Oduntan OA ‘Taxation of Electronic Commerce: Prospects and Challenges for Nigeria’ (unpublished LLB thesis, University of Lagos, 2010).

result, a failure to tax the Internet would then lead to inefficiency and market distortions, for which there is no justification to e-commerce preferential tax treatment. Furthermore, in Chapter 2 it was established that a failure to tax the Internet would result in the erosion of local tax bases and the shifting of these profits to other jurisdictions.

One of the most significant challenges has been the problem of applying source and residence rules to goods purchased over the Internet. It must be investigated how the power to tax can be established more effectively in the digital biosphere. This study notes the findings of the Davis Tax Commission Interim Report that at this stage, as regards direct tax, there is limited scope for South African residents to shift profits via electronic transactions. There is however a need to evolve the source rules for non-residents where their income has an originating cause in South Africa, in order to account for the vexatious nature of the Internet.

This study notes further that taxing the Internet also brings about the unique challenge of taxing a myriad of digitised products and electronically conveyed services. The volume of these transactions and the lack of central registration pose significant challenges to the efficient taxing of these digitised products and electronic services.

In addition, the sale of these digitised services not only escapes local VAT and sales taxes, but also cross-border duties which physical goods are subject to at international borders. This has important ramifications in that it becomes increasingly difficult to protect domestic markets from international products in a highly competitive market.

Chapter 2 provided statistical evidence as to the robust nature of the transactions concluded online and their value. As such, a hands-off 'wait and see' approach, such as, the one adopted by the WTO and several countries is no longer advisable. Electronic commerce is here to stay, and has become an indispensable component of the world trading system. In addition to that, the discussion in Chapter 2 also noted that despite the availability of arguments in favour of taxing the Internet, there were also alternative policy considerations that justified not taxing the Internet. One of these was the establishment of e-commerce as an infant industry that has the ability to mature into an important component of the economy, which is flexible and more productive. One can therefore argue that the resultant market distortions and inefficiencies arising out of not taxing the Internet in the short term could be justified by the resultant long-term benefits that leaving the Internet untaxed could create.

Multiple tax treaties and conventions, discussed in Chapter 2 have also not made taxing the Internet easier. With various policies in place in various States, it becomes a compliance nightmare for companies that operate on a global scale.

Electronic commerce is therefore changing business frontiers, not only in South Africa, but globally. There is now an increasing appetite to conduct business electronically rather than physically. Society as always evolves to represent the constructs of a particular time. A cornerstone of the evolution of society is the need to invent in order to keep moving forward. This time however, technology may have evolved far more than we can efficiently manage the process. After a thorough examination of the e-tax paradox, one might realise that taxing the Internet is not the problem, but it rather forms part of a larger challenge, which is managing technological evolution. There seems to be more innovation in moving processes forward, but less inclination toward innovation in managing such processes. There is therefore need for future studies that redefine the parameters of this e-tax paradox.

4.3 RECOMMENDATIONS

4.3.1 Basic proposal

It is my humble submission that a uniform framework for taxing the Internet is not only desirable but necessary. This study notes the fact that if countries can subscribe to the GATT and GATS rules for the treatment of goods and services, respectively, it begs the question as to what then makes the taxing of electronic commerce any different. This study acknowledges the fact that trade is more political than tax, making its coordination complex and politically difficult. However, the effectiveness of a harmonised global electronic tax policy makes such a prospect lucrative, as it can potentially address issues that can never be wholly addressed a local level. Naturally, one could not expect a global problem to be wholly resolved by local solutions. Therefore, this study submits that, just as the WTO allows for exceptions in certain instances if Members can justify it that exceptions be given to nations seeking to vary their tax rates or not tax e-commerce. It is further submitted that a framework to be developed to remedy the current challenges around digital taxation should have the following characteristics: (WTO uniform legislation; a central registration system, collection and payment mechanisms, an imbedded audit system, and a built-in privacy mechanism)

4.3.1.1 WTO uniform legislation

This study recommends that there is a need for harmonised global electronic commerce taxation legislation that is widely applicable and enforceable. In this regard, the WTO must be at the forefront of such a process; either amending its GATT and GATS rules on trade in goods and services, respectively, or acknowledging a third phenomenon of trade, one conducted on the Internet, which in certain instances straddles the line between goods and services, thus requiring specialised rules tailored for such a dispensation. The era of multiple model laws which lack international judicial enforceability must slowly come to an end. Instead, countries at the current Doha round of negotiations in the WTO must constructively engage with the prospects and challenges of taxing electronic commerce and evaluate the role e-commerce plays on the global scene at the current rounds of negotiations in the WTO.

4.3.1.2 Central registration system

This study noted the challenge of identifying the location of businesses for tax purposes because of the virtual and borderless nature of the Internet. There is therefore a need to create a centrally managed portal where ISPs can register, detail their country of origin, identify their place of effective management, and register as VAT vendors in the countries where they intend to sell their services and digitally delivered products. This would be a streamlined process that allows the use of technology to manage a technologically intensive process.

The opinion of this study differs from the proposals made by the EU and authors that there must be local registration systems where foreign suppliers can be allowed to register with one or more local establishments in order to create a physical presence. In this regard, this would defeat what the Internet stands for, which is, digitisation, streamlining, and virtualisation of processes in order to increase interconnectedness. Registering international Internet businesses in every local jurisdiction in which they operate in order to establish physical presence, implies de-virtualisation of a virtual system. In a world where businesses operate in more than 100 countries from one location, it may be rather ridiculous to require these businesses to create a physical presence in each of these 100 countries.

An effectively designed portal linked to local jurisdictions should be able to inform the foreign electronic service provider, which products are subject to tax and how much the tax due would

be. Foreign electronic service providers could therefore add a new jurisdiction to their registration record at the click of a button when they receive a new customer. It is important that we remain adaptable to change, and not respond to new challenges with old solutions, but rather see challenges as prospects for innovation and ingenuity.

4.3.1.3 Collection and payment mechanisms

Eased registration processes and uniform legislation alone cannot remedy the challenges nations face in the enforceability of digital tax laws. This study recommends that there is no need to create specialised systems to collect VAT from foreign electronic service providers. The Internet is like a self-sustaining virus that creates opportunities to further its existence. There are many third party payment services on the Internet, such as, PayPal and more recently digital money in the form of Bitcoin, that can be used to effect payment to the respective recipients. In addition banks also offer Internet banking which could also aid the collection process. This process would be linked through the portal to the administration system of the respective country. In accordance with the general terms of such agreements, each country would then be responsible for the payment of the fee to the third party or the system could be designed in a manner and form that it automatically transfers the transaction fee to the third party, which would be more desirable.

4.3.1.4 Imbedded audit system

The system should be designed with a built-in audit system so that it has checks and balances. This would allow a local country to generate an audit report of the system of the transactions that have been done via the portal and assist it in ensuring compliance. At an international level, if local countries can give accurate financial reports on e-commerce, this would also aid the monitoring of the growth and development of electronic commerce in order to aid informed decision making.

4.3.1.5 Built-in privacy mechanism

Privacy remains a key concern in transactions conducted over the Internet. As such, the digital taxation system must have built-in privacy safeguards. Third party collection agents must sign

sworn affidavits in which they agree not to divulge any information acquired. Further, the central system must be managed from a secured designated location.

4.3.2 South African proposal

This study suggests that the National Treasury set a timeline for the creation of a White Paper on the taxation of electronic commerce and the drafting of a more comprehensive Regulation. In drafting the White Paper and amending the Electronic Service Regulations, note must be taken of the Davis Tax Commission Interim BEPS Report and the Katz Commission Reports which contain significant insights into taxing electronic commerce in South Africa. The private sector (concerned organisations and individuals) must also be given adequate platforms to give their input into this process. It is submitted that until there is more harmonised global legislation, there is need for more tailored e-tax legislation for South Africa. This study uncovered that e-commerce makes different contributions to local fiscuses, thus the impact and extent of e-commerce taxation or lack thereof varies. Thus in conclusion, this study strongly encourages a shift from a cut and paste approach where various pros of various systems are compiled to make one local legislation and suggests in its stead a custom made e-tax solution for South Africa.

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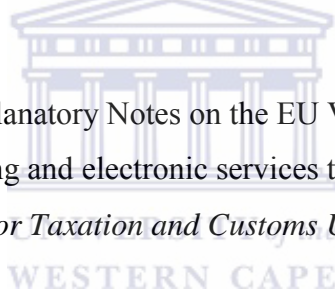
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