

TAX AND E-COMMERCE: WHERE IS THE SOURCE

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I INTRODUCTION

In the world of e-commerce, access to the internet is virtually all an entrepreneur requires to operate an international business. This conjures up the idyllic imagery of an international business with the entrepreneur lazing in a beach chair in a low tax jurisdiction (one with white sandy beaches and a very good technical infrastructure), using his laptop (or some electronic device such as a blackberry or mobile telephone) to access his business websites. By accessing these websites, he would be able to 'watch' his customers purchasing his products and 'see' the profits going into a bank account set up in the same or some other low tax jurisdiction. Other than a website, a server or an Internet Service Provider (ISP),¹ the entrepreneur would have no other presence in the countries of his customers.

II THE INTERNET AND TRADITIONAL BUSINESS

The image described above illustrates the manner in which the internet can and has changed the traditional international business model: it has dispensed with the requirement that the entrepreneur, or his employees, agents, branches or intermediaries be in the country where the business is being conducted. Traditional business activities can now be conducted by a purely electronic presence,² through the use of websites, servers or ISPs, giving rise to the term 'e-commerce'.³ E-commerce has the further consequence that

¹ The online Oxford English Dictionary available at <http://dictionary.oed.com> s v 'internet service provider' states that an internet service provider is 'an organization that provides access to the internet, usually on a commercial basis, either via a modem or through a permanent line and usually also offers services relating to websites, the intranet, etc'.

² For a detailed discussion on e-commerce business, see Sven-Olof Lodin 'International tax issues in a rapidly changing world' (2001) 55 *Bulletin for International Fiscal Documentation* 2; Arthur J Cockfield 'The law and economics of digital taxation: Challenges to traditional tax laws and principles' (2002) 56 *Bulletin for International Fiscal Documentation* 606; Charles E McLure 'Taxation of electronic commerce: Economic objectives, technological constraints, and tax laws' (1996-1997) 52 *Tax LR* 269.

³ Annet Oguttu and Beatrix van der Merwe 'Electronic commerce: Challenging the income tax base' (2005) 17 *SA Merc LJ* 305.

business transactions, and in particular international business and finance transactions, which may otherwise have taken weeks to perform, can be carried out almost instantaneously — all that is required is a click on a website.

As the principles of tax law, which were developed prior to the advent of e-commerce, are based on the ‘traditional business’ model, it has been suggested that such traditional tax laws and principles need to be re-evaluated,⁴ so as to accommodate the phenomenon of e-commerce. This would include the re-evaluation of, inter alia:

- The concepts of source and residence.⁵ In this regard, there is a view that ‘[I]n the world of cyberspace, it is often difficult, if not impossible, to apply traditional concepts of source to connect an item of income with a specific geographic location. . . . The source-base system of taxation could lose its rationale and be rendered obsolete by e-commerce. . . .’⁶
- The allocation of the right to tax the income derived from e-commerce between the state of source and the state of residence in accordance with the Model Tax Convention of the Organisation of Economic Co-operation and Development (the OECD MTC).⁷
- The application of transfer pricing rules to e-commerce transactions.⁸
- The classification of the income derived from e-commerce.⁹
- The levying of indirect taxes such as value-added tax and sales tax.¹⁰
- The ability of governments to charge and collect taxes effectively on digital economic activity.¹¹

III THE APPLICATION OF SOURCE TO E-COMMERCE ENTERPRISES

The objective of this article is to explore one aspect of how traditional tax laws and principles apply to e-commerce, namely the application of the

⁴ Cockfield op cit note 2 at 608; Lodin op cit note 2 at 2; Charles E McLure ‘Tax competition in a digital world’ (2003) 57 *Bulletin for International Fiscal Documentation* 146; Richard L Doernberg et al *Electronic Commerce and Multi Jurisdictional Taxation* (2001).

⁵ Dennis Davis ‘Residence based taxation: is it up to the e-commerce challenge?’ 2002 *Acta Juridica* 161; McLure op cit note 2 at 361; Oguttu and van der Merwe op cit note 3 at 306–12.

⁶ Davis op cit note 5 at 168, referring to ‘Electronic Commerce in South Africa: Discussion Document published by the South African Revenue Service in 1999’. This conclusion and wording in the South African Revenue Service Discussion Document is virtually the same as in a US Treasury White Paper quoted in McLure op cit note 2 at 361.

⁷ William J Craig *Taxation of E-Commerce* (2001); McLure op cit note 2 at 352–4.

⁸ McLure op cit note 2 at 359; Lodin op cit note 2 at 4–5.

⁹ McLure op cit note 2 at 355–8; Lodin op cit note 2 at 5; McLure op cit note 4 at 154; Oguttu and Van der Merwe op cit note 3 at 312

¹⁰ McLure op cit note 2 at 362–6; McLure op cit note 4 at 147.

¹¹ Cockfield op cit note 2; McLure op cit note 2 at 361; Oguttu and Van der Merwe op cit note 3 at 320.

current South African jurisprudence of ‘source’ to e-commerce enterprises operated through the use of a server or an ISP, and where physical presence is not required. The question which this article seeks to explore is whether the source of income can be found at the location of the server or ISP.

IV THE ROLE OF SOURCE IN SOUTH AFRICA

South Africa’s Income Tax Act¹² uses source as the jurisdictional link for the taxation of non-residents, as does the legislation of many other jurisdictions. Source is used to bring the income of non-residents into the South African income tax net where their income arises or has its originating cause located within the territorial boundaries of South Africa. In addition, source is also used in the South African context to limit and calculate the unilateral foreign tax credit found in s6quat of the Income Tax Act. The source rules are therefore relevant to non-residents and residents. A third potential use of the source rules emerged in the case of *ITC 1779*¹³ where, in the context of s 20(1) of the Income Tax Act, counsel for both the Commissioner and the taxpayer agreed to use the source principles as guidelines to determine the place at which the taxpayer carried on his trade. The use of ‘source’ as a guideline can also be extended to the interpretation of the term ‘permanent establishment’ as used in double taxation agreements and in various provisions of the Income Tax Act. As *ITC 1779* dealt with internet trading, it is apposite to use the facts and arguments of this case to analyse the application of the source rules to e-commerce.

The taxpayer in *ITC 1779*, a South African resident, was assessed on his worldwide income for the 2002 year of assessment. The dispute centred on whether he was carrying on a trade within South Africa in the context of s 20(1) of the Income Tax Act. The court, relying on *Millin v Commissioner for Inland Revenue*,¹⁴ decided in favour of the taxpayer on the basis that

‘it was the exercise of appellant’s wits and labour that played the essential role in his trading. There can be no doubt that these were exercised by him in the Republic when he made the crucial decisions as to the transactions to be entered into’.¹⁵

However, the outcome of the case is of limited importance to this discussion — it is the e-commerce aspects that are of interest.

The e-commerce aspect is found in the manner in which the taxpayer conducted his trade, namely through the use of the internet. The particular trading structure, set up by Global Forex Trading (GFT), a division of a corporation based in Michigan in the United States of America, required, inter alia, access to the internet and a suitable computer. Once these requirements were met, the taxpayer commenced trading by entering into

¹² Act 58 of 1962.

¹³ 66 SATC 353.

¹⁴ 1928 AD 207, 3 SATC 170.

¹⁵ *ITC 1779* supra note 13 at 356.

currency swap transactions, which did not involve the actual transfers of currencies. A foreign exchange trading account was set up with GFT in the USA and the profit or loss made by the taxpayer was credited to or debited from this account. Whether or not the taxpayer made a profit or loss depended both on the movement of the different currencies and the timing of the taxpayer's decisions to buy and sell the currencies. In order to carry on this trade profitably, the taxpayer needed to stay informed of worldwide political and economic events. GFT provided this information and other relevant information on its website, which the taxpayer was able to access by using software installed on his computer. Despite the information provided on the various websites, the taxpayer made a loss in his endeavours as a foreign exchange trader in the relevant year of assessment, and he sought to set off this loss against his other income in terms of s 20(1).¹⁶

However, the proviso to s 20(1) and its limitation of the set off proved to be a stumbling block. The proviso disallowed set off where the assessed loss arose from the carrying on of any trade outside South Africa.¹⁷ The set off was accordingly disallowed by the South African Revenue Service on the basis that the taxpayer's trade as a foreign exchange dealer was carried on outside the territorial boundaries of South Africa. The taxpayer, of course, in order to use the assessed loss, argued that his trade as a foreign exchange dealer was carried on in South Africa. Counsel for the taxpayer and the Commissioner agreed to use the concept of 'source' as a guideline in determining the location of the actual place of trading.

The application of the traditional source principles would locate the source of income at a place where there is some activity of the taxpayer. This implies a physical presence of the taxpayer. In the circumstances of *ITC 1799*, where the taxpayer is a trader, this gives rise to two possible locations for the source of the income. The first was the United States of America: the place where all his transactions were entered into and carried out.¹⁸ The

¹⁶ Section 20 (1) reads as follows:

'For the purpose of determining the taxable income derived by any person from carrying on trade, there shall be set off against the income so derived by such person,

- (a) . . .
- (b) any loss incurred by the taxpayer during the same year of assessment in carrying on any other trade either alone or in partnership with others, otherwise than as a member of a company the capital of whereof is divided into shares.'

¹⁷ The proviso to s 20(1) reads as follows:

'Provided that there shall not be set off against any amount,

- (a) . . .
- (b) derived by any person from the carrying on within the Republic of any trade, any
 - (i) assessed loss incurred by such person during such year or
 - (ii) any balance of assessed loss incurred in any previous year of assessment in carrying on any trade outside the Republic.'

¹⁸ *ITC 1799* supra note 13 at 359.

source would then be located at the place where the contract is concluded (depending on where and when offer and acceptance takes place). The second was South Africa: the place where the taxpayer applied his mind and made his decisions in respect of his trading activities.¹⁹

It seems e-commerce presents a third possible location for the source of the income, namely the location of the server or ISP. The distinction between this location of the source and the potential locations on an application of the traditional source principles is that the originating cause, namely the trade or business of the taxpayer (that is the buying and selling) is conducted purely by electronic means and not by the taxpayer's physical presence or activity.

E-commerce creates the possibility for a business to be conducted automatically on a server or an ISP without the intervention of any person. For example, a non-South African resident company wishing to distribute advertisements, information and entertainment programmes to a South African customer base can install a server at premises in South Africa. The server can then be used to transfer computer programmes to South African customers without the intervention of any person. In order to ensure that the server is maintained, a contract may be entered into with a person physically present in South Africa, who would feed information and computer programmes onto the server. The actual buying and selling of the computer programmes would take place automatically through the server, without the intervention of any personnel. Likewise, a South African resident company can install a server on premises in the United Kingdom, or 'rent space' on an ISP in the United Kingdom. The server or ISP, as the case may be, can be used to transfer computer programmes and information to clients in Europe by using a telecommunications system, without the use of any personnel. The question that arises is whether, in these circumstances, the server or the ISP can be the source of the income made from the automated sales.

Before looking specifically at whether source could be a server or an ISP, consideration must be given to whether source always requires physical activity or some involvement by the taxpayer. Two circumstances where physical activity or involvement may not be required involve the use of the taxpayer's capital and the leasing of an asset of the taxpayer. In these circumstances, the location of the source of income may be located where the capital or asset is actually used, as opposed to where the taxpayer is physically active or involved with the asset.

(a) *Source and the use of capital*

The use of the taxpayer's capital as the source of income was considered in *Commissioner for Inland Revenue v Black*.²⁰ The taxpayer had carried on business as a stockbroker in Johannesburg in partnership with others, and also as a private business. In respect of the latter enterprise, the taxpayer made

¹⁹ Ibid.

²⁰ 1957 (3) SA 536 (A), 21 SATC 226.

arrangements with a London firm for the purchase and sale of shares on his behalf on the London Stock Exchange. The shares were paid for, held and delivered in London and the proceeds of the shares were received in London. The London firm charged the taxpayer brokerage, stamp duties and transfer fees. As in *ITC 1779*, the location of the source of income could either be in South Africa (the place where the taxpayer authorised the transactions) or in London (the place where the capital was used and the transactions effected). In rejecting the argument that confirmation or authorisation by the taxpayer was the originating cause of the accrual of the income, Schreiner ACJ considered the role of the London firm as agents of the taxpayer. As agents they were entitled to buy and sell shares on the taxpayer's behalf without the taxpayer's confirmation and authorisation. Schreiner ACJ stated that although the element of control over the transactions may be of importance depending on the circumstances of the case, until the taxpayer terminated the authority of the London firm, they could deal without reference to him. He furthermore held that

'another reasonable conclusion which could not be said to be untrue was that the main, the real, the dominant, the substantial source of the income was the use of the taxpayer's capital in London and the making and executing of the contracts in London'.²¹

In applying *Black's* case, and in particular the above statement of Schreiner ACJ, the following factors could be used in support of locating the source of the taxpayer's income in *ITC 1779* outside of South Africa:

- the taxpayer was obliged to keep funds in a United States of America bank account to meet his obligations to GFT;
- money was transferred by the taxpayer to such bank account during the year of assessment;
- all the transactions for the buying and selling of the foreign exchange were effected with GFT, which operated in the United States of America; and
- the contracts were all concluded in the United States of America.

Taken as a whole, it could be argued that these factors indicate that the taxpayer's capital, in the form of money, was used outside of South Africa. For the purpose of this discussion, the use of the taxpayer's capital as a potential source is of importance. If the source of income can be located at the place where the taxpayer's capital in the form of money is used then, by analogy, the source of income can be located where other forms of capital (such as equipment) is being used. This potentially opens the door for capital in the form of a server or an ISP to be the 'originating cause' (source) of the taxpayer's income. This possibility is however, limited by Schreiner ACJ linking the capital to the activities of the taxpayer as undertaken by his London agent, indicating that in addition to the use of capital, and the making and executing of the contracts, the taxpayer has to have some activity

²¹ Ibid at 543B of the SALR report.

either personally or through an agent. This combination of the use of capital and authorisation distinguishes *Black's* case from *ITC 1799*, where the use of capital and the authorisation was separated by being located in separate countries.

The question that arises is whether the use of capital on its own can be the source of income where the use and authorisation is located in different countries. This capital could be in the form of money or, in the world of e-commerce, electronic equipment such as a server or an ISP. Capital in the form of a server or an ISP could potentially be such a source where it facilitates the actual buying, selling and delivery; ie the conclusion and execution of the contracts, on the server or through an ISP, without any human intervention.

The activity of buying, selling and delivery, which would be the business of the taxpayer located on the server or the ISP, would then give rise to the income. The judgments of Schreiner JA in *Commissioner for Inland Revenue v Lever Bros and Unilever Ltd*²² and *Commissioner for Inland Revenue v Epstein*,²³ despite being minority judgments, are persuasive authority for the possibility that some activity on the part of the taxpayer is not always required to determine the source of the income. In *Lever Bros*, Schreiner JA stated the following:

'[T]hat the source of receipts, received as income, is not the quarter from whence they come, but the originating cause of their being received as income, and that originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may *take the form of employment of capital either by using it to earn income* or by letting its use to someone else. Often the work is some combination of these.'²⁴

He followed this up with the following comment in *Epstein*:

'What is relevant and may be crucial is where he carries on the business from which the income in question is derived. Where the taxpayer's income originates is not where he personally exerts himself but where the business profits are realised.'²⁵

The above statements of Schreiner JA may open a path to move away from the physical presence requirement in respect of business income, particularly in respect of e-commerce transactions where the physical presence of the taxpayer, either directly or indirectly, is not required in order to undertake the business activities.

²² 1946 AD 441, 14 SATC 1.

²³ 1954 (3) SA 689 (A), 19 SATC 221.

²⁴ *Lever Bros* supra note 22 at 9–10 of the SATC report (emphasis supplied)

²⁵ *Epstein* op cit note 23 at 234 of the SATC report.

(b) *Source and leasing*

Support for the proposition that physical presence is not required can also be found in relation to income earned from the leasing of movable property. As the originating cause of this income is the use of the lessor's property by the lessee, the location of the originating cause could either be the place where the equipment is used or the place where the business of leasing is undertaken.²⁶

In *COT v British United Shoe Machinery (SA) (Pty) Ltd*,²⁷ a 1964 Southern Rhodesia Federal Supreme Court judgment, specifically in the opinion of Clayden CJ, the 'two conflicting guides to the location of that source'²⁸ in respect of leasing were considered. These two guides, it was noted, pointed first to the contract under which use is granted by the lessor, and secondly the place where the income producing asset produces the income. The contract under which use is granted may or may not indicate where the asset is to be used. If the contract does indicate where the asset is to be used, with the emphasis being placed on the use of the asset at a particular place, then source is located at the place where the asset is used.

However, given that the above judgment is only persuasive, there are no clear judicial principles in South African law regarding the 'originating cause' of income earned from leased property.

(c) *The ISP or server as the location of the originating cause*

The two circumstances described above — the use of capital and lease respectively — which appear to not require an element of physical presence, do require some activity on the part of the taxpayer. However, given that for both these activities the taxpayer's use of his capital is of importance, it may be possible to conclude that if the taxpayer's capital, either in the form of money or equipment, is used to generate the income and this use of capital is viewed as the activity, then neither physical presence nor an activity on the part of the taxpayer is required, and the use of a server or an ISP can be the originating cause.

It is apparent though that in order for the server or ISP to be the originating cause, the taxpayer's other activities would have to be fairly limited. The taxpayer should not, for example, be involved in decision making, as was the case in *ITC 1779* (where his decision to buy or sell was made in South Africa). The result might have differed if, in that case, the taxpayer was merely watching the sales and not applying his wits and labour at the time the profits were being earned. In my view, automated sales taking place through the use of the server or ISP would result in the taxpayer's activities being limited.

²⁶ *ITC 170* (1930) 5 SATC 164 (U), *COT v British United Shoe Machinery (SA) (Pty) Ltd* 26 SATC 163, 1964 (3) SA 193 (FC); *ITC 1087* (1966) 28 SATC 196 (R).

²⁷ *British United* supra note 26.

²⁸ *British United* ibid at 167 of the SATC report.

In terms of South African source jurisprudence, there is therefore authority, albeit limited, that the source does not always involve physical activity or involvement by the taxpayer. The answer to whether source could be located at the place where a server or an ISP is located must therefore be in the affirmative, provided that it is accepted that a business can operate automatically without human intervention. If the business of an enterprise can be, and is, conducted automatically, with no (or limited) intervention by the taxpayer, then surely the activities taking place on the server or ISP give rise to the income, and must be the source of the income?

The possibility of the taxpayer's business being conducted through the use of a server or an ISP is supported by the commentary on the OECD MTC.²⁹ The OECD MTC uses the concept of 'permanent establishment' to allocate the right to tax business income to the country of source.³⁰ If there is no permanent establishment in the source country, then only the country of residence of the business has the right to levy tax on the business profits. The OECD MTC is in effect allocating the right to levy tax between the source country (the country in which the permanent establishment is located) and the residence country (the country in which the business enterprise is a resident). It is useful to consider under what circumstances a server or an ISP can constitute a permanent establishment.

In the event that a server, website or ISP establishes a permanent establishment in a country, a double taxation agreement which has an article based on art 7 of the OECD MTC would allocate the right to levy tax on the business profits attributable to the country in which the permanent establishment is located.

The relevant paragraphs of the definition of a permanent establishment as set out in art 5 of the OECD Model Tax Convention are:

'5(1) For the purpose of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

5(2) The term "permanent establishment" includes specifically —

- (a) a place of management;
- (b) a branch;
- (c) an office;
- (d) a factory;
- (e) a workshop and
- (f) a mine, an oil gas well, a quarry or any other place of extraction of natural resources.'

In terms of the commentary on art 5 to the OECD Model Tax Convention³¹ (the commentary), a server or an ISP may constitute a fixed place of business through which the business of an enterprise is being carried

²⁹ Paragraphs 42.1 to 42.10 of the OECD commentary on art 5 of *The OECD's Model Tax Convention on Income and on Capital* (2005 version).

³⁰ See OECD commentary on art 7 of the *OECD's Model Tax Convention*.

³¹ See paras 42.1 to 42.10 of the OECD commentary on art 5 of the *OECD's Model Tax Convention* op cit note 29.

on, and may accordingly be a permanent establishment. With respect to a server,³² it would be a permanent establishment in so far as:

1. it is a computer (a tangible property) which has a physical location (with a physical presence);³³
2. this location is fixed in that it is established at a distinct place with a certain degree of permanence;³⁴
3. the enterprise has the server at its disposal in that it either owns or leases and operates the server (an ISP which merely acts as a host for the business of the enterprise would not fulfil this requirement);³⁵ and
4. the business of the enterprise is being carried on through the server (looking at the nature and level of activity).³⁶

It is particularly the last requirement which bears a synergy to the South African concept of source, where the location of the source of income is the place where the business of the enterprise is being carried on and which leads to the possibility of the source of income being located at the place where the server is located. If 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.

V CONCLUSION

It is clear that even though South Africa has moved to a residence basis of taxation, source still remains an important consideration. In order to determine the source of business income, the traditional source rules, as developed by the South African courts, emphasise the activities and physical presence of the taxpayer. This emphasis may preclude the possibility of the place of trading and source of income being located on a server. South African tax law will, however, have to consider the impact that e-commerce, through the internet, has made on the way that business is run. Given the increase in e-commerce and the use of the internet as a method to trade, it is likely that countries will seek to tax business activity taking place on servers or ISPS located within their jurisdictions. Our current notions of the place of trading and source may have to be expanded. This expanded notion of source, it is submitted, does not require a complete re-configuration of the traditional source guidelines. Schreiner JA's statement in *Epstein* that the 'taxpayer's income originates not where he personally exerts himself but where the business profits are realised'³⁷ is well suited to deal with this expanded notion of place of trading. Another possibility is merely to accept

³² Analogous reasoning would apply to an ISP being seen as a permanent establishment.

³³ See para 42.2 of the OECD commentary on art 5 of the *OECD's Model Tax Convention* op cit note 29.

³⁴ Ibid para 42.4.

³⁵ Ibid para 42.3.

³⁶ Ibid para 42.5.

³⁷ *Epstein* supra note 23 at 234 in the SATC report.

that a trade and a business can be carried out by electronic means through the use of a server or an ISP with taxpayer activity being minimal or non-existent.